

Securities Law Alert

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Second Circuit: Affirms Dismissal of a Securities Fraud Class Action Against a Leading Hotel Chain

On August 20, 2018, the Second Circuit summarily affirmed dismissal of a securities fraud action against a leading hotel chain “for substantially the same reasons” set forth in the district court’s order. [*Police & Fire Ret. Sys. of the City of Detroit v. La Quinta Holdings*, 735 F. App’x 11 \(Mem\) \(2d Cir. 2018\)](#).¹

The district court dismissed the suit with prejudice on the grounds that the company had adequately disclosed each of the risks at issue, including the impact of falling oil prices, the need for renovations at certain properties, the transition of the company’s call center, and the sale of certain hotels. [*Police & Fire Ret. Sys. of the City of Detroit v. La Quinta Holdings*, 2017 WL 4082482 \(S.D.N.Y. 2017\)](#). The district court reasoned that “[w]hen evaluating whether a company provided sufficient disclosures,” a court “should consider not only the disclosures the company makes, but also information already in the public domain and facts known or reasonably available to the shareholders.” The district court found meritless plaintiffs’

1. Simpson Thacher represents La Quinta Holdings Inc., The Blackstone Group L.P., and certain La Quinta officers and directors in this matter.

Simpson Thacher’s securities litigation team is “at the top of the list—its lawyers are hard-nosed, smart, efficient and highly professional.”

—*The Legal 500* 2018

allegations that certain “disclosures should have been made earlier.” The court explained that “[m]ere allegations that statements in one report should have been made in earlier reports do not make out a claim of securities fraud.” Finally, the district court dismissed claims in connection with what the court found to be a statement of opinion made by the hotel chain’s then-CEO, based on its determination that the opinion was not misleading when considered with other “representations together and in context.”

Third Circuit: Affirms Dismissal of a Securities Fraud Class Action Where the Allegations Suggested Mismanagement Rather Than Fraud

On September 20, 2018, the Third Circuit affirmed dismissal of a securities fraud class action against a car rental company brought on the heels of an acknowledgement in an SEC filing that a “sometimes inappropriate tone at the top . . . may have led to inappropriate accounting decisions.” *In re Hertz Global Holdings, 2018 WL 4496352 (3d Cir. 2018) (Jordan, J.)*. The Third Circuit found the district court did not err in interpreting this statement as “an admission of ‘mismanagement,’ as opposed to an admission of ‘misconduct.’” The Third Circuit found the allegations did not “necessarily suggest” that defendants were “engaged in a systematic fraud.” The court determined that it was “[m]ore plausible . . . that the [i]ndividual [d]efendants were just bad leaders.”

The Third Circuit found plaintiffs’ other allegations equally insufficient to plead scienter. First, the court held that the “size and scope” of the company’s financial restatement did not support a strong inference of scienter because plaintiffs failed to “plead particularized allegations of fraudulent intent.” The court observed that “any inference of scienter was circumscribed by the fact that the accounting errors were spread across myriad accounting categories.” The court also noted that for each income category, the amount of the overstatement ranged from 9.97% to 32.12%. The Third

Circuit explained that “[c]ourts that have looked to the magnitude of a financial restatement to strengthen the inference of scienter have been faced with restatements significantly more drastic” than those at issue here.

Second, the court found the allegation that the individual defendants certified the accuracy of the company’s SEC filings did not “add to the scienter puzzle in the absence of any allegation that [any] defendant knew he was signing a false SEC filing or recklessly disregarded inaccuracies contained” in that filing. Third, the court placed no weight on allegations that the individual defendants “each resigned in close proximity to the public release of bad news.” The court explained that “[c]hanges in leadership are only to be expected when leadership fails.” The court stated that in order “for corporate departures to strengthen an inference of scienter, there must be particularized allegations connecting the departures to the alleged fraud.”



Finally, the Third Circuit determined that the alleged insider trading activity did not support a strong inference of scienter because the individual defendants did not sell their holdings when the stock was trading at its peak. Moreover, plaintiffs alleged that only two of the five individual defendants engaged in insider trading. Although these two individual defendants allegedly sold a sizable percentage of their holdings, the court explained that “even large percentages of holdings sold at first blush appearing suspicious are not sufficient to infer scienter when other factors, such as the timing of the relevant sales, weigh against that inference.” The court found that the lengthy class period also mitigated any inference of scienter based on alleged insider trading because “it is not unusual for insiders to trade at some point during their tenure with a company.”

Fifth Circuit: Statements Concerning Transparency, Quality and Corporate Responsibility Are Inactionable Puffery

On October 3, 2018, the Fifth Circuit affirmed dismissal of a securities fraud action alleging that a grocery retailer made misstatements concerning the company's "commitment to transparency, quality and corporate responsibility," among other alleged misstatements. [*Emps. Ret. Sys. v. Whole Foods Mkt.*, 2018 WL 4770729 \(5th Cir. 2018\) \(King, J.\)](#). The court held these "generalized statements" constituted inactionable puffery even though the retailer had "built a brand around holding itself to higher ethical standards than its competitors." The court found that a "reasonable investor" would not assess the company's value based on such "self-serving statements." Rather, reasonable investors would "rely on facts to determine whether" the company is in fact "transparent and otherwise holds itself to high standards."

The Fifth Circuit also held that plaintiffs failed to allege loss causation. According to plaintiffs, the retailer's financial statements were inflated as a result of companywide weights-and-measures-related overcharging violations. Plaintiffs contended that a July 29, 2015 stock price drop reflected a corrective disclosure of these alleged accounting misstatements, even though the market had been aware of the overcharging violations for several weeks. Plaintiffs alleged that "revenues failed to meet expectations because [the retailer's] customers took exception to the possibility of being defrauded and voted with their feet." But plaintiffs did not allege that "the disappointing sales numbers somehow represented customer dissatisfaction with [the retailer's] accounting practices." The court found plaintiffs' theory of loss causation "conflate[d] the nonactionable weights-and measures fraud with the allegedly actionable securities fraud." The court explained that even if the retailer had "not record[ed] the ill-gotten receipts as revenue," the retailer's customers "would have reacted just as negatively" to news of the overcharging violations and plaintiffs "would have suffered the exact same harm regardless of whether [the retailer] had overstated its revenue." The Fifth Circuit

concluded plaintiffs "fail[ed] to identify a decline in stock price that shortly followed a corrective disclosure."

Southern District of New York: Denies Class Certification in a Breach of Contract Action Concerning the Alleged Failure to Perform Suitability Analyses

On September 17, 2018, the Southern District of New York denied class certification in a breach of contract action alleging that a broker-dealer failed to conduct suitability analyses before recommending that customers invest in certain closed-end mutual funds. [*Fernandez v. UBS AG*, 2018 WL 4440498 \(S.D.N.Y. 2018\) \(Stein, J.\)](#).² The court held that Rule 23(a)(3)'s typicality requirement was not met because "the manner in which [the broker-dealer] allegedly failed to perform a suitability analysis before recommending a [f]und to a proposed class member is different for each class member." The court further held that Rule 23(b)(3)'s predominance requirement was not satisfied because the single common question concerning the scope of the broker-dealer's contractual obligation to conduct suitability analyses was "substantially outweighed by numerous individual questions."

The suitability provision in the client agreements at issue stated as follows: "We must have a reasonable basis for believing that any securities recommendations we make to you are suitable and appropriate for you, given your individual financial circumstances." The court observed that "[w]hether an investment is suitable for a particular client is an inherently individualized inquiry" that "depends on the unique characteristics of both the investor and the investment at a particular point in time." Plaintiffs nevertheless claimed that they would be able to present "common proof" of the broker-dealer's alleged across-the-board failure to conduct suitability analyses by "focusing on the conduct of the [broker-dealer], together with a representative sample of client accounts."

2. Simpson Thacher represents UBS AG and its affiliates in this matter.

The court found plaintiffs failed to show that the facts in dispute were “susceptible to generalized proof,” and held that “individual questions overwhelm the classwide questions” for several reasons.

First, the court rejected plaintiffs’ contention that the investments were “inherently unsuitable” for any investor because they were not structured to preserve capital, one of the stated investment objectives. The court disagreed that “a security with multiple enumerated objectives is unsuitable per se if it is inconsistent with *any one* of its objectives,” and noted that plaintiffs “cite[d] no evidence that this standard has ever actually been applied in the real world.” With respect to plaintiffs’ related argument concerning the alleged “riskiness” of the investments, the court determined that a security’s excessive riskiness for one client “is not itself proof that the security is excessively risky (or unsuitable) for all investors.”

Second, the court found plaintiffs’ expert did not provide the requisite “generalized proof” that the broker-dealer “fail[ed] to undertake any client-focused suitability analyses before recommending the [f]unds to the proposed class members.” Plaintiffs’ expert assumed that an appropriate suitability analysis had been conducted only if an advisor provided written documentation of the analysis, “together with all of the reasons underlying that determination” with respect to each relevant suitability factor. The court found this approach “not credible,” and determined that there was no basis for the requirement that a suitability analysis must include “express consideration and documentation of every single” suitability factor.³ The court found plaintiffs’ expert in fact demonstrated that the broker-dealer’s “alleged suitability failures were far from uniform” because each individual financial advisor may have considered certain factors, but not others, when conducting a suitability analysis for each individual client.

Third, the court held plaintiffs could not rely on “communications directed to the public at large,” such as advertisements and client fliers, to establish that the broker-dealer had “recommended” the investments at issue to each of the individual plaintiffs. The

court found that “whether a transaction was recommended such that [the broker-dealer’s] suitability obligations arose . . . is an individualized question.” Fourth, the court found plaintiffs could not show that the alleged failure to conduct suitability analyses caused their losses without demonstrating that the investments were “*actually* unsuitable” for each individual plaintiff. Fifth, the court determined that “class members would be individually subject to affirmative defenses such as failure to mitigate and duty to object.”

Finally, the court found that there would be individual questions concerning damages, because “the proper measure of market-adjusted damages is (1) what clients would have received if [the broker-dealer] had performed a suitability analysis and recommended a suitable investment, less (2) what they actually received from their investments in the [f]unds.”

The court concluded that while plaintiffs may not pursue their claims as a class, “they may arguably pursue their individual claims in FINRA arbitrations if they so choose.”

Southern District of New York: Dismisses Securities Fraud Class Action Against an Argentinian Real Estate Company

On September 10, 2018, the Southern District of New York dismissed a securities fraud class action against an Argentinian real estate company and related defendants. [*Sachsenberg v. IRSA Inversiones y Representaciones Sociedad Anónima*, 2018 WL 4308546 \(S.D.N.Y. 2018\) \(Broderick, J.\)](#).⁴ Plaintiffs alleged that the company failed to disclose its control over a recently-acquired Israeli holding company and failed to consolidate the financial statements of the Israeli holding company into its own financial statements. The court held that plaintiffs failed to allege any material misstatement or omission because the Argentinian company did not have control over the Israeli entity during

3. The parties disputed whether the factors set forth in FINRA Rule 2111 governed the suitability analysis set forth in the client agreements.

4. Simpson Thacher represents IRSA Inversiones y Representaciones Sociedad Anónima, Cresud Sociedad Anónima Comercial and executives Eduardo Sergio Elsztain, Saúl Zang and Matías Iván Gaivironsky.

the time period at issue due to an ongoing arbitration concerning the acquisition.

Pursuant to International Financial Reporting Standard 10, which the parties agreed was the governing rule, “the test for consolidation . . . is actual practical control over the subsidiary free of any barriers (economic or otherwise) that prevent an investor from exercising control.” The court found that because of the ongoing arbitration, the Argentinian company “lacked the practical ability to exercise control” over the Israeli entity and thus had no obligation to consolidate that entity into its financial statements.

The court further held that plaintiffs failed to allege scienter. With respect to plaintiffs’ suggestion that defendants sought to avoid consolidating the Israeli entity to avoid breaching the Argentinian company’s debt covenants, the court explained that “the desire to comply with financial covenants in loan agreements is insufficient to support a strong inference of scienter through motive and opportunity.” The court also noted that the Argentinian company subsequently consolidated the Israeli entity into its financial statements, yet no noteholder had claimed a breach of any debt covenant since then. The court deemed “circular” plaintiffs’ argument that defendants were reckless in failing to consolidate.



The court held that plaintiffs could not allege scienter based solely on the theory that the alleged fraud involved the company’s “core operations.” The court explained that “since the enactment of the [Private Securities Litigation Reform Act of 1995], the Second Circuit has expressed doubt as to the continued independent viability of the core operations doctrine.” The court

stated that it could consider plaintiffs’ “core operations allegations to constitute a supplementary, but not an independent, means to plead scienter.” The court held plaintiffs “fail[ed] to provide any basis for a conclusion that [d]efendants had a motive to defraud,” and further found plaintiffs’ “allegations of conscious misbehavior or recklessness . . . virtually nonexistent.”

Northern District of Indiana: Dismisses Securities Fraud Class Action Claims Against Former Private Equity Investors in a Medical Device Company

On September 26, 2018, the Northern District of Indiana held that plaintiffs adequately alleged securities fraud claims against a medical device company, but dismissed plaintiffs’ Section 12(a)(2) and insider trading claims against the company’s former private equity investors (the “Private Equity Defendants”).⁵ [*Shah v. Zimmer Biomet Holdings*, 2018 WL 4637247 \(N.D. Ind. 2018\) \(Simon, J.\)](#). The court held plaintiffs did not allege that the Private Equity Defendants were “statutory sellers of any of the securities in question,” as required for liability under Section 12(a)(2) of the Securities Act of 1933. The court also found plaintiffs did not allege that the Private Equity Defendants “actually possessed material non-public information” at the time they made the alleged insider trades.

The court explained that “Section 12 liability attaches only to a person who ‘offers or sells’ a security, and that person is liable only to those persons ‘purchasing such security from him.’” *Shah*, 2018 WL 4637247 (quoting 15 U.S.C. § 77l(a)(2)). The court further noted that in *Pinter v. Dahl*, 486 U.S. 622 (1988), the Supreme Court “made the categorically narrow nature of Section 12 liability clear and limited it only to ‘the buyer’s immediate seller.’” *Shah*, 2018 WL 4637247 (quoting *Pinter*, 486 U.S. 622).

In *Shah*, plaintiffs alleged that the Private Equity Defendants sold their shares in the medical device company, but failed to plead that plaintiffs purchased those shares from

5. Simpson Thacher represents one of the private equity defendants, KKR Biomet LLC, in this matter.

the Private Equity Defendants. The court found that the offering documents made clear that the Private Equity Defendants “agreed to sell **to the underwriters**.” The court held that as a result, “plaintiffs did not purchase their stock directly from the Private Equity Defendants but instead from the underwriters and thus the Private Equity Defendants cannot be held liable under Section 12.” The court also found plaintiffs could not ground their Section 12 claims on the solicitation of sales, because plaintiffs did not allege that any of the Private Equity Defendants “directly communicated with any plaintiff, encouraging them to purchase any [company] stock.”

The court found plaintiffs’ insider trading claims against the private equity defendants equally insufficient because plaintiffs did not allege that the private equity investors “actually possessed material non-public information.” Although plaintiffs alleged that two of the issuer’s directors were “controlled by” certain of the private equity defendants, plaintiffs did not allege that “any information relating to [the] problems” at issue was “in fact shared with the Private Equity Defendants.” The court determined that plaintiffs “alleged nothing more than that the Private Equity Defendants had *potential* access to insider information.” The court explained that “access to information is not the same as actually possessing the specific information and knowing it.”

Delaware Supreme Court: *MFW’s Ab Initio* Requirement Is Satisfied if the Controller Conditions the Transaction on *MFW’s* Procedural Protections Before the Commencement of Substantive Economic Negotiations

On October 9, 2018, the Delaware Supreme Court held that *MFW* does not impose a bright-line rule requiring a controlling stockholder to condition a proposed transaction on the satisfaction of *MFW’s* two “key procedural protections” in the controller’s initial offer. [*Flood v. Synutra Int’l*, 2018 WL 4869248 \(Del. 2018\) \(Strine, C.J.\)](#). The court found *MFW’s ab initio* requirement is satisfied if the controller

“conditions its bid on [these] protections at the beginning stages of the process . . . before any economic negotiations commence.” The Delaware Supreme Court further held that if the transaction satisfies the *MFW* standard, then plaintiffs can state a duty of care claim only by alleging that the independent special committee acted with gross negligence. Plaintiffs cannot plead a duty of care violation based solely on an allegedly inadequate deal price.

MFW’s Ab Initio Requirement Does Not Impose a Bright-Line, First Offer Rule

The *MFW* court held that the business judgment standard of review applies to a controlling stockholder transaction if the transaction “is conditioned *ab initio* upon the approval of both an independent, adequately-empowered Special Committee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders.” *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (*MFW*).⁶ In *Synutra*, plaintiffs argued that *MFW’s ab initio* requirement is satisfied only if these two conditions are in place from the controller’s first offer. Plaintiffs contended that “if a controller’s first approach does not contain the required conditions, then it is stuck with entire fairness review, even if the controller still commits itself to *MFW’s* requirements early on before any economic negotiations.” The Delaware Supreme Court rejected this “cramped reading” of the *ab initio* requirement, and explained that the purpose of this rule is simply to ensure that the controller cannot use *MFW’s* conditions as “bargaining chips” once “negotiations to obtain a better price from the controller have commenced.” The court held that the *ab initio* requirement is satisfied “so long as the controller conditions its offer on the key protections at the germination stage of the Special Committee process” before the start of “substantive economic negotiations.” The Delaware Supreme Court stated that its decision was consistent with its summary affirmance of the bench ruling in *Swomley v. Schecht*, 2014 WL 4470947 (Del. Ch. 2014), *aff’d*, 128 A.3d 992 (Del. 2015) (TABLE). There, the Delaware Chancery Court found the *ab initio* requirement was satisfied even though the controller’s first proposal did

6. Please [click here](#) to read our discussion of *MFW*.

not condition the transaction on *MFW*'s protections. The *Swomley* court found it sufficient that the controller announced *MFW*'s conditions "before any negotiations took place." *Swomley*, 2014 WL 4470947.



Plaintiffs Cannot Plead a Duty of Care Violation Based on an Inadequate Price

In *MFW*, the Delaware Supreme Court stated in a footnote (footnote 14) that the complaint at issue may not have survived a motion to dismiss because "allegations about the sufficiency of the price call[ed] into question the adequacy of the Special Committee's negotiations." *MFW*, 88 A.3d 635. Plaintiffs in *Synutra* relied on *MFW*'s footnote 14 to argue that a duty of care violation may be "based on an insufficient price." *Synutra*, 2018 WL 4869248. In *Synutra*, the Delaware Supreme Court expressly overruled *MFW*'s footnote 14 to the extent it suggests that "a due care violation can be premised . . . on a court's after the fact sense that the committee should have extracted more price concessions." The court held that if the transaction complied with *MFW*'s requirements, then a plaintiff may not "avoid the business judgment rule by raising questions about whether the Special Committee . . . was adroit in bargaining."

The *Synutra* court explained that "the entire point of the *MFW* standard is to recognize the utility to stockholders of replicating the two key protections that exist in a third-party merger: an independent negotiating agent whose work is subject to stockholder approval." The court reasoned that "if [the *MFW*] standard injects the reviewing court into an examination of whether the Special Committee's good faith efforts" were effective, then controllers would have "no incentive to use the approach most

favorable to minority stockholders." The court reaffirmed the holding in *Swomley* that if a controlling stockholder transaction was conditioned *ab initio* on *MFW*'s two procedural protections, then "a plaintiff can plead a duty of care violation only by showing that the Special Committee acted with gross negligence, not by questioning the sufficiency of the price."

Delaware Chancery Court: Finds a "Material Adverse Effect" for the First Time

One of the key terms in an acquisition agreement is "Material Adverse Effect," which essentially defines when a buyer does not have to complete an agreed-upon acquisition as a result of an adverse change to a target's business during the period between signing and closing. Despite all of the attention given to this term by M&A practitioners, until the recent decision in *Akorn, v. Fresenius Kabi*, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018) (Laster, V.C.), the Delaware Court of Chancery had never found that a buyer was justified in terminating a public company merger agreement on the basis that a Material Adverse Effect occurred.

Delaware courts to consider this issue have found that a Material Adverse Effect requires that "unknown events" threaten earnings potential in a "durationally-significant manner." *IBP v. Tyson Foods*, 789 A.2d 14 (Del. Ch. 2001). In *IBP*, for example, the Delaware Chancery Court held that a 64% quarterly decline in year-over-year sales did not constitute a Material Adverse Effect because the decline was only in a single quarter and the target's business was cyclical by nature.

In *Akorn*, the buyer terminated the merger agreement on the grounds that (1) significant declines in the target's performance amounted to a Material Adverse Effect (and therefore, a failure of the standalone MAE condition), and (2) serious FDA compliance failures breached the target's regulatory compliance representations in a manner that constituted a Material Adverse Effect (and therefore, a failure of the target's ability to "bring-down" its representations and warranties at closing). During the four quarters following execution of the merger

agreement, the target's year-over-year EBITDA declined by 86% due to competitors entering the market, loss of a material contract and other issues. In the same period, the target experienced year-over-year quarterly revenue declines of more than 25%, operating income declines of more than 80%, and net income declines of more than 90%. Moreover, a whistle-blower came forward raising allegations concerning the target's FDA compliance practices, and further investigation uncovered significant FDA compliance issues which the court determined reduced the target's equity value by 21% and would take up to four years to remedy.

The court held that the buyer had satisfied its "heavy burden" to demonstrate that a Material Adverse Effect had occurred based on both the severe decline in the target's performance and its myriad FDA compliance issues. With respect to the target's business performance, for example, the court found that the year-over-year decline was material and durationally significant as "[t]here is every reason to think that the additional competition will persist and no reason to believe that [the target] will recapture its lost contract." Additionally, while cautioning that a 20% decline in a target's equity value is not necessarily sufficient to show a Material Adverse Effect, the court found that the 21% decline coupled with the need for up to four years to remedy the compliance issues

meaningfully contributed to satisfying the Material Adverse Effect standard. The target argued that its decline in performance and FDA compliance issues could not result in a Material Adverse Effect because the buyer knew of the potential for competition and was aware of some FDA compliance issues from its due diligence. The court rejected this argument, and explained that risks that a buyer discovers in its diligence will not preclude the buyer from showing that a Material Adverse Effect has occurred based on problems that arose as a result of those risks. Rather, the court looks to the terms of a contract and its allocation of risks between the parties to determine whether the parties specifically agreed to exclude items uncovered in due diligence or unforeseen events from the definition of Material Adverse Effect.

It does not appear that *Akorn* represents a sea change in Delaware law on what constitutes a Material Adverse Effect. The court reaffirmed its prior decisions requiring an adverse change to threaten earnings potential in a "durationally-significant manner." The *Akorn* ruling is also specific to the facts and circumstances of the transaction. Nonetheless, the decision will likely be heavily scrutinized by practitioners as the only concrete example to date of a Delaware court finding a Material Adverse Effect. The target has appealed the *Akorn* ruling.

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