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Securities Law Alert

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First Circuit: Promises of Steak Dinners and Golf Outings Are Sufficient to Allege the Personal Benefit Requirement for Insider Trading Liability in Tipping Cases Brought Under the Misappropriation Theory

In *Dirks v. S.E.C.*, 463 U.S. 646 (1983), the Supreme Court held an insider can only face liability under Section 10(b) and Rule 10b-5 for disclosing material inside information to a third party—or tipping—if the insider "receive[d] a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings." The *Dirks* Court found that if a tipper receives no personal benefit for disclosing the information to a third party (the tippee), then the tippee has no duty to abstain from trading on that information.

On May 26, 2016, the First Circuit considered whether the personal benefit requirement applies in criminal tipping cases brought under the misappropriation theory of insider trading liability recognized in *United States v. O'Hagan*, 521 U.S. 642 (1997), rather than the classical theory of insider trading at issue in *Dirks*.[1] *United States v. Parigian*, 2016

1. In *Dirks*, the Court considered a case in which a corporate insider tipped material inside information to a third party. In *O'Hagan*, on the other hand, the Court addressed a case in which a law firm entrusted with its client's material nonpublic information misappropriated that information for trading purposes. In the case before the First Circuit in *Parigian*, the alleged misappropriator did not himself trade on the basis of inside information, but instead tipped that information to a third party who then traded on the information.

WL 3027702 (1st Cir. 2016) (Kayatta, J.). The First Circuit held that to the extent the personal benefit requirement applies in cases involving the tipping of misappropriated inside information, the promise of "various tangible luxury items," such as steak dinners and golf items, is sufficient to meet that requirement.

The First Circuit's decision deepened a circuit split on the scope of the personal benefit requirement, an issue the Supreme Court will address in the next term in the case of *Salman v. U.S.* (No. 15-628). The Supreme Court will consider whether the government must prove "an exchange that is objective, consequential, and represents at least a potential gain [to the tipper] of a pecuniary or similarly valuable nature," as the Second Circuit held in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014)[2]; or whether the government may establish the existence of a personal benefit by presenting "evidence of a friendship or familial relationship between tipper and tippee," as the Ninth Circuit found sufficient in *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015).[3]

Background

The case before the First Circuit involved an alleged insider trading scheme in which an executive at American Superconductor Corporation ("AMSC") disclosed "highly material inside information" concerning AMSC's "yet-to-be-announced earnings reports and major commercial transactions" to Eric McPhail, a close friend. Although McPhail and the insider allegedly had "an understanding that information conveyed between them was to remain confidential," McPhail allegedly began sharing AMSC-related information with a circle of his regular golfing companions, including Douglas Parigian. McPhail did not himself trade in AMSC stock. Rather, he allegedly "solicited 'getting paid back' by Parigian and [his other golfing companions] with wine, steak, and visits to a massage parlor." Parigian allegedly promised McPhail "a nice dinner" at a steakhouse to thank him for the tips, which allegedly netted Parigian more than $200,000 in trading profits.

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

3. Please click here to read our prior discussion of the Ninth Circuit's decision in *Salman*.

The government indicted Parigian for insider trading under the misappropriation theory of liability. The government contended that "Parigian knew or should have known that, by providing the inside information to Parigian, [McPhail] both breached a duty of trust and confidence [to the AMSC insider] and personally benefited by doing so." Parigian unsuccessfully moved to dismiss the indictment, then "entered into a plea agreement that preserved his right to appeal the denial of the motion." On appeal, Parigian contended that the indictment failed to allege several elements of criminal securities fraud, including a personal benefit to McPhail for tipping the information to Parigian.

First Circuit Finds the Alleged Promise of a Steak Dinner Sufficient to Allege a Personal Benefit in a Misappropriation Case

The First Circuit considered whether a personal benefit to the tipper is an element of an insider trading action brought under the misappropriation theory. The court noted that it has previously addressed this issue twice in the context of SEC civil enforcement actions.

The First Circuit explained that in *SEC v. Sargent*, 229 F.3d 68 (1st Cir. 2000), it found that "if a benefit need be proven" in a misappropriation-based tipping case, then the requirement was satisfied by "the government's evidence that the misappropriator and the tipper were business and social friends with reciprocal interests." Several years later, in *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006), the court similarly held that if a personal benefit requirement applies in misappropriation-based tipping cases, then "'the mere giving of a gift to a relative or friend is a sufficient personal benefit' to the giver." *Parigian*, 2016 WL 3027702 (quoting *Rocklage*, 470 F.3d 1).

While the First Circuit recognized that *Sargent* and *Rocklage* were both civil cases, the court found the question of whether a "benefit to the misappropriating tipper [is] an element of a Rule 10b-5 violation . . . would seem to call for the same answer in both a civil and criminal proceeding." The First Circuit held that if a personal benefit to the misappropriator is in fact required under its precedent, then "the indictment's allegations of a friendship between McPhail and Parigian plus an expectation that the tippees would

treat McPhail to a golf outing and assorted luxury entertainment [were] enough to allege [such] a benefit."

The First Circuit noted that in *Newman*, the Second Circuit "adopted a more discriminating definition of the [necessary] benefit to a tipper in a classical insider trading case," while in *Salman*, "the Ninth Circuit seemed to align itself more closely with [the First Circuit's] holding in *Rocklage*." The First Circuit stated that it did not know "[h]ow this will all play out" when the Supreme Court considers the personal benefit question next term. However, the First Circuit concluded that it was "bound to follow [its] circuit's currently controlling precedent," under which the promise of "various tangible luxury items in return for the tips" is sufficient to meet the personal benefit requirement.

First Circuit Finds the Indictment Sufficiently Alleged McPhail's Breach of a "Duty of Trust and Confidence" Owed to the AMSC Insider

The First Circuit also considered whether the government sufficiently alleged that "McPhail's tips to Parigian breached a duty of trust and confidence owed to" the AMSC insider within the meaning of the Supreme Court's decision in *O'Hagan*. The court observed that in *O'Hagan*, "that duty and its breach were obvious" because the misappropriator was the company's law firm and "it is clear that a company's legal counsel regularly receives information in trust and confidence."

Here, however, there was no allegation of any "formal type of fiduciary or confidential relationship" between McPhail and the AMC insider. The First Circuit explained that the indictment only "describe[d] a relationship in which one friend share[d] obviously confidential information concerning his business with another friend." To determine whether such a friendship could give rise to "the type of breach of trust necessary to support conviction under the misappropriation theory," the court turned to the text of the *O'Hagan* decision. The Supreme Court enumerated examples of "the kinds of relationships that might give rise to such a duty," including "'a relationship of trust and confidence.'" *Id.* (quoting *O'Hagan*, 521 U.S. 642).

The First Circuit also considered the SEC regulation clarifying the types of relationships that give rise to a "duty of confidence" under *O'Hagan*. Pursuant to the SEC's rule, "a 'duty of trust and confidence' exists . . . whenever [the parties] . . . have a history, pattern or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality." *Id.* (quoting 17 C.F.R.§ 240.10b5-2).[4]

4. The First Circuit recognized that there is a question as to whether this SEC rule "could serve as fully applicable in a criminal proceeding."

The First Circuit found "the indictment expressly allege[d] that [the AMSC insider] and McPhail actually had an understanding, based on their 'history, pattern and practice,' that the information [the AMSC insider] shared with McPhail 'was to remain confidential.'" The court concluded the government's allegations were "enough to plausibly describe the existence of the requisite duty and its breach."

First Circuit Finds Mens Rea Requirement of Scienter Applies in Criminal Tipping Cases

Parigian contended that the indictment was defective insofar as it alleged that he "knew or should have known" certain key facts. According to Parigian, the appropriate mens rea standard in criminal insider trading cases is scienter.

The First Circuit found Parigian had both forfeited and waived this argument, but determined that he otherwise "would have had a point." The court explained that "[t]he state of mind required to establish liability for fraudulently trading securities depends, in relevant part, on whether the government seeks to establish civil or criminal liability." The court noted that "[i]n a civil case, the government need only show that 'the tippee knows or should know that there has been a breach [of the tipper's fiduciary duty].'" *Id.* (quoting *Dirks*, 463 U.S. 646). But "[i]n a criminal case such as this one, . . . the 'knew or should have known' formulation runs up against a decades-long presumption that the government must prove that the defendant knew the facts that made his conduct illegal."

The First Circuit noted that both the Sixth and Seventh Circuits have "appl[ied] the *Dirks* [mens rea] formulation in criminal securities fraud cases." However, the First Circuit found "[t]he better view is that there is simply no reason why the mens rea requirement of scienter that routinely and presumptively applies in criminal cases would not apply in this criminal case where Congress has given no indication that it should not."

Second and Eleventh Circuits: Constitutional Challenges to Pending SEC ALJ Proceedings Are Premature

On June 1, 2016, the Second Circuit rejected as premature claims brought by respondents in a pending SEC enforcement proceeding alleging that the SEC's appointment of the administrative law judge ("ALJ") in the matter violated the Appointments Clause of Article II of the United States Constitution. *Tilton v. SEC*, 2016 WL 3084795 (2d Cir. 2016) (Sack, J.). Consistent with the provisions of the SEC's administrative review scheme, the Second Circuit determined that "the appellants must await a final [SEC] order before raising their Appointments Clause claim in federal court."

In so holding, the Second Circuit agreed with similar decisions issued last year by the D.C. Circuit and the Seventh Circuit. *See Jarkesy v. SEC*, 803 F.3d 9 (D.C. Cir. 2015);[5] *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015).[6]

On June 17, 2016, the Eleventh Circuit relied in part on the Second Circuit's decision in *Tilton* to reverse a district court ruling exercising jurisdiction over constitutional challenges to pending SEC administrative enforcement proceedings. *Hill v. SEC*, 2016 WL 3361478 (11th Cir. 2016) (Pryor, J.).

Background

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC generally has a choice of fora when bringing enforcement proceedings. The SEC may either file an action in federal district court, or conduct an administrative enforcement proceeding before the SEC or an ALJ. The SEC's administrative scheme provides for "two layers of review: A party that loses before the ALJ may petition for *de novo* review by the [SEC], and a party that loses before the [SEC] may petition for review by a federal court of appeals." *Tilton*, 2016 WL 3084795.

In the case before the Second Circuit, respondents in pending SEC administrative

5. Please click here to read our prior discussion of the D.C. Circuit's decision in *Jarkesy*.

6. Please click here to read our prior discussion of the Seventh Circuit's decision in *Bebo*.

enforcement proceedings brought suit in the Southern District of New York contending that the SEC proceeding was "unconstitutional because the presiding ALJ's appointment violated Article II's Appointments Clause." The district court dismissed the action for lack of subject matter jurisdiction. The court held "appellants' Appointments Clause challenge fell within the exclusive scope of the SEC's administrative review scheme and could reach a federal court only on petition for review of a final decision by the [SEC]." The instant appeal followed.

Applying the *Thunder Basin* Factors, Second Circuit Holds Congress Intended Appellants' Appointments Clause Claim to Be Reviewed Within the SEC's Administrative Scheme

Appellants contended that their Appointments Clause claim was beyond "the exclusive purview of the SEC's administrative review scheme" under the Supreme Court's decision in *Thunder Basin Coal Co. v. Reich*, 510 U.S. 200 (1994). The *Thunder Basin* Court stated that in evaluating whether plaintiffs' "claims are of the type Congress intended to be reviewed within [the applicable] statutory structure," courts must assess whether: (1) "a finding of preclusion could foreclose all meaningful judicial review," (2) the claims are "wholly collateral to a statute's review provisions," and (3) the claims are "outside the agency's expertise."

As discussed in further detail below, the Second Circuit held that the *Thunder Basin* factors "do not persuasively demonstrate that the Appointments Clause claim falls outside the scope of the SEC's overarching scheme." *Tilton*, 2016 WL 3084795.

SEC's Administrative Scheme Provides for Meaningful Judicial Review of Appellants' Appointment Clause Claim

While appellants recognized that the SEC's administrative scheme "offers *some* judicial review," they contended that "their exposure to the ongoing [SEC] proceeding—as distinct from any adverse ruling that might result—would itself constitute a grave constitutional injury that could not be redressed after the fact."

The Second Circuit explained that "litigants who unsuccessfully challenge the authority of a presiding judge or jury to decide a case must often wait to appeal the issue until after the court renders a final judgment." The Second Circuit reasoned that "[t]he litigant's financial and emotional costs in litigating the initial proceeding are simply the price of participating in the American legal system."

Appellants' Appointment Clause Claim Is Not "Wholly Collateral" to the SEC's Administrative Review Scheme

The district court held appellants' Appointments Clause claim "did not qualify as 'wholly collateral'" to the SEC's administrative review scheme "because it was procedurally intertwined with the SEC's ongoing proceeding, where it functioned as an affirmative defense."

The Second Circuit stated that it was "inclined to agree with the district court's assessment" pending "further guidance from the Supreme Court." The court reasoned that appellants' Appointments Clause claim was analogous to their defenses to the underlying Investment Advisers Act charges at issue because it was "a 'vehicle by which' the appellants [sought] to prevail in the proceeding." *Id.* (quoting *Elgin v. Dep't of Treasury*, 132 S. Ct. 2126 (2012)).

Appellants' Appointment Clause Claim Falls Within the Scope of the SEC's Expertise

The Second Circuit found that it was "a close question" as to whether "appellants'

Appointments Clause claim [fell] outside the SEC's expertise."

However, the Second Circuit observed that in *Elgin*, 132 S. Ct. 2126, the Supreme Court "emphasize[d] that an agency may bring its expertise to bear on a constitutional claim indirectly, by resolving accompanying, potentially dispositive issues in the same proceeding."

"Applying *Elgin*'s approach" to the case before it, the Second Circuit found the SEC might rule in favor of appellants on the Investment Adviser Act claims at issue, "in which case the constitutional question would become moot."

Appellants Must Await a Final SEC Order Before Raising Their Appointments Clause Claim in Federal Court

Concurring with "the decisions of the Seventh and D.C. Circuits in *Bebo* and *Jarkesy*," the Second Circuit concluded that "appellants must await a final [SEC] order before raising their Appointments Clause claim in federal court."

Sixth Circuit: A Corporate Executive's State of Mind May Only Be Imputed to the Corporation for Scienter Purposes If the Executive Made a Public Misstatement

On May 24, 2016, the Sixth Circuit affirmed dismissal of a securities fraud action against General Cable Corporation for failure to allege scienter. *Doshi v. General Cable*, 2016 WL 2991006 (6th Cir. 2016) (Cook, J.). The Sixth Circuit found that a senior corporate executive's alleged knowledge of certain theft and accounting errors could be imputed to the corporation. However, the Sixth Circuit held the executive's state of mind could *not* be imputed to the corporation for scienter purposes because the defendant did not make any public misstatements.

Background

Plaintiffs brought suit in the Eastern District of Kentucky alleging that General Cable Corporation and two of its executives had "acted at least recklessly in issuing or approving General Cable's . . . public financial statements," which were allegedly "materially false" because of accounting errors and an alleged theft scheme in the company's Brazilian operations. The district court dismissed plaintiffs' claims for failure to allege scienter. Plaintiffs appealed.

Sixth Circuit Declines to Impute to the Corporation the State of Mind of a Senior Executive Who Made No Public Misstatements

Plaintiffs alleged that Mathias Sandoval, the General Cable executive responsible for the company's Brazilian operations, submitted allegedly misleading financial data to General Cable, which the company then incorporated into its financial disclosures. Plaintiffs contended that Sandoval's state of mind could be imputed to General Cable for scienter purposes.

The Sixth Circuit found plaintiffs "sufficiently allege[d]" that Sandoval "knew of theft and inventory accounting errors in Brazil in January but failed to report those problems to General Cable until September 2012." However, the court held that even if Sandoval had "acted recklessly in transmitting [his division's] financial data to General Cable, only his knowledge of theft and accounting errors—not his state of mind—impute[d] to General Cable." The court reasoned that under its prior decision in *In re Omnicare Securities Litigation*, 769 F.3d 455 (6th Cir. 2014), "a corporate executive's or employee's state of mind" may only be imputed "to a corporate defendant when such a person *makes a public misstatement*." But here, plaintiffs did not allege any "public misstatement by Sandoval from which to impute his recklessness directly to General Cable." Rather, plaintiffs alleged only that "Sandoval submitted [his division's] financial data to General Cable, not that he drafted, reviewed, or approved General Cable's erroneous public financial statements."

Based on these allegations, the Sixth Circuit imputed to General Cable "Sandoval's knowledge of theft and accounting errors in Brazil," but not his scienter. The court explained that under Sixth Circuit precedent, it was then required to apply the factors set forth in *Helwig v. Vencor*, 251 F.3d 540 (6th Cir. 2001)[7] "to analyze whether all the facts alleged [gave] rise to a strong inference that General Cable [had] acted with the necessary scienter."

Applying the *Helwig* Factors, Sixth Circuit Finds Plaintiffs' Allegations Insufficient to Plead Corporate Scienter

The Sixth Circuit applied the *Helwig* factors and considered the allegations of the complaint holistically to determine whether plaintiffs adequately pled General Cable's scienter. The court found "[t]wo *Helwig* factors support[ed] inferring scienter: (1) divergence between internal reports and external statements on financial data; and (2) disregard for the most current factual information before making public financial statements."

However, the Sixth Circuit determined that "[t]he disparity between Sandoval's knowledge and what General Cable publicly misstated . . . reduce[d] the force behind these factors." The court explained that "Sandoval knew about theft and inventory accounting errors in [his division's] Brazilian operations" but "General Cable misstated its *firm-wide* financial data of which [Sandoval's] data composed only a part."

In light of "Sandoval's knowledge and the magnitude of [General Cable's] financial misstatements," the Sixth Circuit found it possible to "infer that General Cable [had] acted recklessly by issuing its public financial statements from January 2012 to September 2012." But the court stated that "a countervailing inference remain[ed] stronger: a theft scheme racked General Cable's operations in Brazil where local managers overrode accounting procedures, which, when coupled with the legitimate freedom afforded [Sandoval's division] to report its financial data, led General cable to issue materially false public financial statements." The Sixth Circuit held plaintiffs' "allegations therefore fail[ed] to create a strong inference that General Cable acted with scienter."

7. In *Helwig*, the Sixth Circuit enumerated a non-exhaustive list of nine factors courts must consider when evaluating a complaint's scienter allegations.

Eleventh Circuit: Section 2462's Five-Year Limitations Period Applies to SEC Claims for Disgorgement and Declaratory Relief, But Not to SEC Claims for Injunctive Relief

Pursuant to 28 U.S.C. § 2462, the Government may not bring any "action, suit, or proceeding for the enforcement of any civil fine, penalty, or forfeiture" more than five years after the claim accrues.

On May 26, 2016, the Eleventh Circuit held Section 2462's limitations period applies to SEC claims for disgorgement and declaratory relief, but not to claims for injunctive relief. *SEC v. Graham*, 2016 WL 3033605 (11th Cir. 2016) (Pryor, J.). The court determined that, for Section 2462 purposes, disgorgement is a type of "forfeiture" and declaratory relief "operate[s] as a penalty." However, the court found injunctions are "equitable, forward-looking remedies" outside the reach of Section 2462.

Background

At issue were claims that several individual defendants had "violated federal securities laws by selling condominiums that were functioning, in reality, as unregistered securities." The SEC brought suit against defendants in the Southern District of Florida, seeking declaratory and injunctive relief, as well as disgorgement and civil penalties.

Defendants moved to dismiss the SEC's claims under Section 2462 on the grounds that the alleged violations occurred more than five years before the SEC filed suit.

The district court held Section 2462 applied to bar all of the SEC's claims. The court found "the injunctive and declaratory relief the SEC sought were penalties" within the meaning of Section 2462, while "the disgorgement the SEC requested constituted forfeiture" under that provision. Defendants appealed.

Eleventh Circuit Finds Section 2462 Applicable to Disgorgement Claims Because Disgorgement Is a "Forfeiture" Under Section 2462

The Eleventh Circuit agreed with the district court's conclusion that disgorgement "can truly be regarded as nothing other than a forfeiture" within the meaning of Section 2462.

Because Section 2462 does not define the term "forfeiture," the Eleventh Circuit considered the term's ordinary meaning. The court found "forfeiture occurs when a person is forced to turn over money or property because of a crime or wrongdoing." The Eleventh Circuit discerned "no meaningful difference in the definitions of disgorgement and forfeiture," and observed that the Supreme Court "has used the terms interchangeably."

The court rejected the SEC's attempt to distinguish disgorgement from forfeiture by arguing that "disgorgement only includes direct proceeds from wrongdoing, whereas forfeiture can include both ill-gotten gains and any additional profit earned on those ill-gotten gains (i.e., secondary profits)." The Eleventh Circuit found that "even under" the SEC's proposed definitions, "disgorgement is imposed as redress for wrongdoing and can be considered a subset of forfeiture" subject to Section 2462's limitations period.

Eleventh Circuit Holds Section 2462 Applies to Claims for Declaratory Relief Because Such Relief Operates as a "Penalty"

The Eleventh Circuit held Section 2462's limitations period also applies to claims for declaratory relief. The court reasoned that declaratory relief "operate[s] as a penalty

under § 2462" because it "is backward-looking" and "intended to punish." The court explained that declaratory relief "serves neither a remedial nor a preventative purpose" but is instead "designed to redress previous infractions." The Eleventh Circuit stated that "[a] public declaration that the defendants violated the law does little other than label the defendants as wrongdoers."

Eleventh Circuit Holds Injunctive Relief Is Not a "Penalty" for Purposes of Section 2462

As to the SEC's claims for injunctive relief, the Eleventh Circuit concluded that its "precedent forecloses the argument that § 2462 applies to injunctions, which are equitable remedies." The court explained that in *United States v. Banks*, 115 F.3d 916 (11th Cir. 1997), it held Section 2462 inapplicable to a claim for injunctive relief brought to enforce the Clean Water Act. The *Banks* court found the government's injunction was "an equitable remedy and thus beyond the reach" of Section 2462. Following its holding in *Banks*, the Eleventh Circuit determined that "[a]n injunction requiring (or forbidding) future conduct is not subject to § 2462's statute of limitations."

The Eleventh Circuit stated that "[e]ven if [it] were not bound by *Banks*," it would still "conclude that § 2462 does not apply to injunctions like the one in this case" because injunctions are not "penalties" for Section 2462 purposes. Since the statute does not define the term "penalty," the court considered "the term's ordinary meaning." The court found that each of the variously formulated definitions of "penalty" "has the common element of looking backward in time." While "a penalty addresses a wrong done in the past," the Eleventh Circuit observed that injunctions "typically look forward in time." The court concluded that an injunction "is not a penalty within the meaning of § 2462," and held "the five-year statute of limitations [ ] inapplicable to injunctions such as the one the SEC sought in this case."

Southern District of New York: Companies Have No Obligation to Disclose Non-Binding Guidance from Government Agencies

On June 21, 2016, the Southern District of New York dismissed in its entirety a securities fraud action against Alibaba Group Holding Limited. *Christine Asia Co. v. Alibaba Group Holding Ltd.*, 2016 WL _____ (S.D.N.Y. 2016) (McMahon, C.J.).[8] The court held Alibaba had no obligation to disclose in its IPO Registration Statement either the existence or the substance of "informal and non-binding guidance" provided by a Chinese government agency concerning the company's e-commerce practices.

Background

Alibaba is a Chinese e-commerce company that operates a number of popular e-commerce marketplaces in which "independent third party merchants sell products to wholesale and retail buyers around the world." Alibaba, like many third-party platform operators, has long faced scrutiny regarding the alleged sale of counterfeit goods by third parties on its marketplaces.

On July 16, 2014, representatives of China's State Administration for Industry and Commerce ("SAIC") met with Alibaba to provide the company with administrative guidance concerning compliance with Chinese law, including newly enacted regulations by the SAIC ("the July 16 Meeting"). Among the topics discussed was the sale of counterfeit goods on Alibaba's marketplaces. Under the Chinese regulatory scheme, administrative guidance is a "non-compulsory" and "informal regulatory tool used by the SAIC to encourage businesses and industries to self-regulate." Earlier that year, the SAIC had announced the launch of the "Red Shield and Web Sword" program (the "Red Shield Program"), an initiative aimed at reducing counterfeit sales, among other practices.

On September 19, 2014, Alibaba conducted an initial public offering on the New York

8. Simpson Thacher represents Alibaba and the individual defendants in this matter.

Stock Exchange.[9] The company's Registration Statement "contained a litany of disclosures about the pitfalls of e-commerce, the Chinese regulatory environment, and the attendant risks to Alibaba's business." The company "disclosed that it had been criticized in the past due to the sale of pirated, counterfeit and illegal products on its sites" and explained that Chinese law "required it to police its marketplaces for unlicensed merchants and counterfeit goods." The company cautioned that it was subject to new more "stringent" ecommerce laws, it "expect[ed] to face increased scrutiny" from regulators, and that as a result of its business risks, it could be subject to a variety of adverse effects, including increased compliance costs and civil and criminal liabilities. However, the company did not "disclose the existence of the Red Shield Program" or "reveal that it had received administrative guidance from the SAIC."

On January 28, 2015, a self-described "white paper" appeared on the SAIC's website purportedly describing the July 16 Meeting. Although the white paper was removed from the SAIC's website within hours, numerous media outlets reported on the white paper. On January 29, 2015, Alibaba acknowledged in a press release and earnings call that the July 16 Meeting had taken place. Alibaba's share price fell substantially on January 28 and January 29. Seven class actions followed in various district courts; these actions were centralized in a multi-district litigation in the Southern District of New York.

Plaintiffs alleged Alibaba and several of its officers and directors had "knowingly or recklessly concealed" the July 16 Meeting and the SAIC's administrative guidance in order to "artificially inflate" the company's IPO price. Defendants moved to dismiss for failure to state a claim.

Court Holds Alibaba Had No Duty to Disclose the SAIC's Administrative Guidance Under Section 10(b) and Rule 10b-5

At the outset of its analysis, the court observed that Alibaba's Registration Statement was "unusually comprehensive." The court found Alibaba's disclosures "more than sufficient to warn investors that Alibaba faced continuing risks related to the sale of counterfeit goods in its marketplaces, and that it could face enforcement actions and substantial fines should it fail to properly police its marketplaces for defective and illegal goods." Moreover, the court determined that Alibaba's disclosures made it "clear that China's legal and regulatory environment [rendered] investing in a Chinese company, like Alibaba, risky."

The court found the key issue was whether: "an offering document that fully discloses all substantive investment risks [is] materially misleading if it fails to disclose that a government agency . . . met with the issuer to underscore the issuer's obligation to ameliorate those risks?" The court concluded that the answer is "no." As a general matter, the court explained that "a company is not compelled to disclose every communication it has with a regulator—even where, as here, a regulator has informed a company of deficiencies in its operations." The court noted that in *Acito v. IMCERA Group*, 47 F.3d 47 (2d Cir. 1995), for example, the Second Circuit held a health products manufacturer had no duty to disclose Food and Drug Administration ("FDA") inspections that uncovered deficiencies in the company's manufacturing operations. The Second Circuit in that case held that no disclosure was required because "the two inspections had not resulted in any adverse action that affected earnings—even though a third inspection ultimately resulted in the company shutting down the facility." Similarly, the *Alibaba* court noted that in *In re Sanofi Securities Litigation*, 87 F. Supp. 3d 510 (S.D.N.Y. 2015), the court held a pharmaceutical company had no duty to disclose FDA concerns regarding the testing methodology for a new pharmaceutical because it determined that such feedback "'does not express a binding agency decision.'" *Id.* (quoting *Sanofi*, 87 F. Supp. 3d 510).

Turning to Alibaba's disclosures, the court held Alibaba's failure to disclose the July 16 Meeting and its receipt of "informal and non-binding guidance" from the SAIC did not "render inaccurate any statement about the likelihood of an actual inquiry or investigation taking place." The court also found it immaterial that "[t]he Registration Statement did not specifically mention the 'Red Shield' Program'" because plaintiffs "allege[d] that the program was widely publicized" and "the

9. Simpson Thacher represented Alibaba in the IPO.

securities laws do not require disclosure of information that is publicly known."

The court rejected plaintiffs' contention that Alibaba's Registration Statement was materially misleading insofar as the company represented that no inquiry or investigation "has resulted in significant restrictions on [the company's] business operations." The court reasoned that plaintiffs had "not alleged facts tending to show that Alibaba *actually* face[d] a government inquiry or investigation that was *likely* to result in significant restrictions on Alibaba's business operations." Rather, plaintiffs alleged only "that Alibaba attended a meeting with Chinese regulators, at which it received *nonbinding* administrative guidance aimed at encouraging Alibaba" to self-regulate. The court underscored that "[m]aking Alibaba aware of concerns and prompting it to pay attention to problems it had plainly disclosed is not tantamount to the institution of a formal regulatory proceeding."

The court also determined that plaintiffs' reliance on the Second Circuit's decision in *Meyer v. Jinkosolar Holdings Co.*, 761 F.3d 245 (2d Cir. 2014), was misplaced. In *Jinksolar*, the defendant allegedly "disclosed that environmental violations generally posed a financial risk to the company, while not cautioning investors that it knew its efforts to comply with Chinese law were failing and could expose it to penalties." Here, however, the court explained that "Alibaba did not represent that its efforts to comply with the law were particularly effective, let alone foolproof." The court concluded that Alibaba's "disclosures were not likely to cause a reasonable investor to make an overly optimistic assessment of that risk."

Court Further Determines Alibaba Had No Duty to Disclose the SAIC's Administrative Guidance Under Items 303 or 503

With respect to plaintiffs' contention that defendants had a duty to disclose the SAIC's administrative guidance under Items 303 and 503 of Regulation S-K,[10] the court held "[n]either regulation compel[s] disclosure."

The court found meritless plaintiffs' argument that under the Second Circuit's decision in *Indiana Public Retirement System v. SAIC*, 818 F.3d 85 (2d Cir. 2016), "Item 303 requires disclosures of even *potential* harm to a company's business." The court underscored that "the Second Circuit has never imposed such a sweeping disclosure obligation."

In *Indiana Public Retirement System*, the Second Circuit held "a government contractor [had] violated Item 303 by failing to disclose that it had overbilled various New York City agencies by millions of dollars and that the overbilling practices subjected it to monetary and reputational risks." The *Alibaba* court explained that "the likelihood of harm in *Indiana Public Retirement System* was not merely potential—it was probable and, indeed, imminent." Here, however, the court determined there was "far less reason to believe that the July 16 Meeting 'might reasonably be expected' to have a material effect on Alibaba's business."

The court similarly found Section 503 did not "compel[ ] disclosure" of the July 16 meeting and the SAIC's guidance. While the court noted that there is "scant caselaw"

10. Pursuant to Item 303 of Regulation S-K, Registration Statements must include a description of "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." Item 303 does not apply to foreign corporations, but the SEC has stated that its interpretations of Item 303 apply to the Management Discussion & Analysis disclosures required under Item 5 of Form 20-F, which does apply to foreign corporations.

Item 503 of Regulation S-K mandates that Registration Statements "provide under the caption 'Risk Factors' a discussion of the most significant factors that make the offering speculative or risky."

on this provision, the court explained that the relevant inquiry for Item 503 purposes is "whether the Offering Documents were accurate and sufficiently candid." The court found the Registration Statement was "accurate and sufficiently candid" with regard to the SAIC's crackdown on violations of [Chinese law] on e-commerce sites like Alibaba." As to plaintiffs' claim that "Alibaba was obligated to admit that it was engaged in conduct that violated Chinese and American laws and regulations," the court emphasized that there were no allegations that Alibaba had "ever been charged with such misconduct." The court held that "in light of Second Circuit case law declining to impose a duty to disclose uncharged conduct under Item 503," plaintiffs had "failed to state a duty to disclose" pursuant to Item 503. *Id.* (citing *In City of Pontiac Policemen's and Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173 (2d Cir. 2014)).

Court Finds Plaintiffs Failed to Allege Scienter

The court held plaintiffs' Section 10(b) claims "fail[ed] for the additional reason that they [had] not pleaded facts giving rise to a strong inference that either the [i]ndividual [d]efendants or the [c]ompany acted with the requisite scienter." With respect to plaintiffs' scienter allegations as to Alibaba, the court found it "well established that a corporation's desire to raise funds through an IPO and to obtain favorable pricing for a bond offering do not give rise to a strong inference of scienter." As to the individual defendants, the court acknowledged that their profits from the IPO were "massive sums"; however, the court found plaintiffs' failure to allege facts showing that the individual defendants' "insider trading sales were unusual . . . temper[ed] any strong inference of scienter that [could] be raised based on [their] insider sales alone."

The court dismissed plaintiffs' claims in their entirety and denied plaintiffs leave to amend their complaint, concluding that the deficiencies in the allegations were "substantive," rather than inartful pleading. The court reasoned that the "linchpin" of the case was the July 16 Meeting, which could not "be construed as anything more than an informal meeting with regulators."

New York Court of Appeals: New York's Common Interest Doctrine Only Protects Attorney-Client Communications Disclosed to a Third Party in Connection with a Common Legal Interest in Pending or Anticipated Litigation

Pursuant to the common interest doctrine, "an attorney-client communication that is disclosed to a third party remains privileged if the third party shares a common legal interest with the client who made the communication and the communication is made in furtherance of that common legal interest." *Ambac Assurance Corp. v. Countrywide Home Loans*, 2016 WL 3188989 (N.Y. 2016) (Pigott, J.) (*Countrywide III*).

On June 9, 2016, the New York Court of Appeals held that New York's common interest doctrine only applies if the attorney-client communications were shared with a third party "in furtherance of a common legal interest *in pending or reasonably anticipated litigation*." *Id.* (emphasis added). Significantly, the court found New York's common interest doctrine inapplicable to attorney-client communications shared by entities with "a common legal interest in a commercial transaction or other common problem" where those entities "do not reasonably anticipate litigation."

Background

Ambac Assurance Corporation guaranteed payments on certain residential mortgage-backed securities ("RMBS") issued by a subsidiary of Countrywide Financial Corporation. "When the mortgage-backed securities that Ambac insured failed during the recent financial crisis," Ambac brought suit against Countrywide asserting breach of contract and fraudulent misrepresentation claims, among other claims. Ambac named Bank of America as a defendant in the suit based on its merger with Countrywide, pursuant to which "Countrywide sold substantially all of its assets to Bank of America." Ambac claimed "Bank of America became Countrywide's successor-in-interest and alter ego and was responsible for

Countrywide's liabilities to Ambac in the underlying action for fraud."

During the course of discovery, Bank of America contended that the common interest doctrine protected several hundred attorney-client communications shared with it by Countrywide "because they pertained to a number of legal issues the two companies needed to resolve jointly in anticipation of the merger closing." Ambac moved to compel these communications on the grounds that Bank of America and Countrywide "were not affiliated entities at the time of disclosure and did not share a common legal interest in litigation or anticipated litigation."

The trial court held the common interest doctrine inapplicable based on its determination that "New York law 'requires that there be a reasonable anticipation of litigation' in order for the common interest doctrine to apply." *Id.* (quoting *Ambac Assurance Corp. v. Countrywide Home Loans*, 41 Misc. 3d 1213(A) (N.Y. Sup. Ct. 2013)). On appeal, the First Department "concluded that pending or reasonably anticipated litigation was no longer a necessary element of the [common interest] exception." *Id.* (discussing *Ambac Assurance Corp. v. Countrywide Home Loans*, 124 A.D.3d 129 (App. Div. 2014) (*Countrywide II*)). In so holding, the First Department observed that federal courts have "'overwhelmingly rejected [a litigation] requirement'" for the common interest doctrine. *Id.* (quoting *Countrywide II*, 124 A.D.3d 129). Ambac appealed.

New York Court of Appeals Holds the Common Interest Doctrine Does Not Extend to Attorney-Client Communications Disclosed Outside the Context of Pending or Threatened Litigation

The Court of Appeals observed that "until the First Department's decision in this case, New York courts [have] uniformly rejected efforts to expand the common interest doctrine to communications that do not concern pending or reasonably anticipated litigation." Reversing the First Department's decision, the Court of Appeals declined to "expand[ ] the common interest doctrine to protect shared communications in furtherance of any common legal interest" other than "pending or reasonably anticipated litigation."

The Court of Appeals reasoned that this formulation ensures that the common interest doctrine remains "limited to situations where the benefit and the necessity of shared communications are at their highest, and the potential for misuse is minimal." The court explained that "[w]hen two or more parties are engaged in or reasonably anticipate litigation in which they share a common legal interest, the threat of mandatory disclosure may chill the parties' exchange of privileged information and therefore thwart any desire to coordinate legal strategy." The court found that in these types of situations, "the common interest promotes candor that may otherwise have been inhibited."

The Court of Appeals found this same rationale does not extend to "clients

who share a common legal interest in a commercial transaction or other commercial problem but do not reasonably anticipate litigation." The court observed that there was "no evidence . . . that mergers, licensing agreements and other complex commercial transactions have not occurred in New York because of [the] [s]tate's litigation limitation on the common interest doctrine." The court reasoned that "when businesses share a common interest in closing a complex transaction, their shared interest in the transaction's completion is already an adequate incentive for exchanging information necessary to achieve that end."

Moreover, the Court of Appeals determined that broadening the common interest doctrine "to communications made in the absence of pending or anticipated litigation" could result in a "substantial loss of evidence," and would entail "potential for abuse." The court observed that the common interest doctrine could be asserted with respect to "a wide range of communications between parties who assert common legal interests but who really have only non-legal or exclusively business interests to protect."

The court "conclude[d] that the policy reasons for keeping a litigation limitation on the common interest doctrine outweigh any purported justification for doing away with it."

Judge Rivera, Dissenting, States the Common Interest Doctrine Should Extend to the Transactional Context

In a lengthy dissent, Judge Rivera expressed her view that the common interest doctrine "should apply to private client-attorney communications exchanged during the course of a transformative business enterprise, in which the parties commit to collaboration and exchange of client information to obtain legal advice aimed at compliance with transaction-related statutory and regulatory mandates." Judge Rivera stated that applying the common interest doctrine in the transactional context "encourages parties committed to a merger to disclose confidential information to avoid submission of incomplete or noncompliant documents."

Justice Rivera opined that there was no "distinction between coparties or persons who reasonably anticipate litigation, and parties committed to the completion of a merger" because "[b]oth are incentivized to cooperate in order to secure a mutually beneficial outcome—one a successful litigation outcome, the other a successful commercial outcome." She stated that "[n]o rational basis exists to recognize the expectations for maintaining confidences in the former but not the latter."

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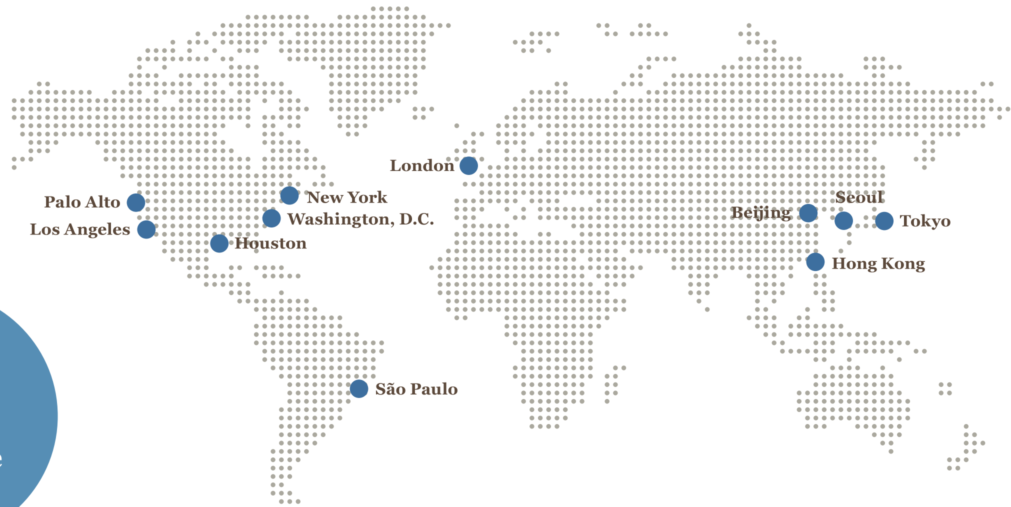

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