Simpson Thacher

Securities Law Alert

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– Chambers USA

Eighth Circuit: Affirms Dismissal of Derivative Action After Applying the Delaware Supreme Court's Recently Revised Demand Futility Test

On April 7, 2022, the Eighth Circuit affirmed a district court's dismissal, on the grounds of failure to plead demand futility, of a derivative action alleging that a pre-merger proxy statement contained false and misleading statements in violation of Section 14(a) of the Exchange Act. *Carpenters' Pension Fund of Illinois v. Neidorff*, 2022 WL 1039671 (8th Cir. 2022) (Shepherd, J.). The court held that plaintiffs failed to plead a material misrepresentation or omission and therefore failed to plead facts demonstrating that at least half of the board faced a substantial likelihood of liability on the Section 14(a) claim. The court thus affirmed the district court's dismissal based on plaintiffs' failure to allege that demand would have been futile.

A few months after merging with a target company, the corporation disclosed an increase in reserves for the target's increased liabilities. A stock drop followed. Plaintiffs alleged five derivative claims[1] against certain of the corporation's former and then-current directors and officers. As to the claim alleging a violation of Section 14(a), plaintiffs alleged that from the time the proxy statement was issued until the closing date, the corporation's directors and officers concealed their knowledge of the target's various financial and business problems.

Defendants moved to dismiss on the grounds that plaintiffs failed to plead demand futility. The district court granted defendants' motion and dismissed the case with prejudice.

1. The five claims were: (1) violation of Section 14(a) of the Exchange Act; (2) breach of fiduciary duties of good faith, fair dealing, loyalty, and due care; (3) breach of fiduciary duty of loyalty, good faith, and candor in connection with securities law violations; (4) insider trading; and (5) unjust enrichment. Below, we focus exclusively on the court's reasoning concerning plaintiffs' Section 14(a) claim.

Delaware's Demand Futility Test

Before reaching the merits, the court noted that it must first determine the proper framework for assessing demand futility. Because the nominal defendant was a Delaware corporation, the court applied Delaware law and the demand futility test articulated last year by the Delaware Supreme Court in *UFCW Union & Participating Food Indus. Emps. Tri-State Pension Fund v. Zuckerberg*, 262 A.3d 1034 (Del. 2021) (*Tri-State*).[2] After reviewing *Tri-State*'s three-part test, the court focused exclusively on the second *Tri-State* question, *i.e.*, whether at least half of the board (here, five of the nine directors) faced a substantial likelihood of liability as to any of plaintiffs' claims.[3]

Demand Not Excused Because Plaintiffs Failed to Plead a Material Misrepresentation or Omission

The court concluded that plaintiffs failed to plead particularized facts demonstrating that at least half of the directors faced a substantial likelihood of liability on the Section 14(a) claim because plaintiffs failed to plead facts showing that the proxy statement contained a material misrepresentation or omission. The court pointed out that the proxy statement used bold type to warn stockholders of "the uncertainties inherent in the unaudited financial projections" and cautioned them "not to place undue, if any, reliance on such unaudited financial projections." The court found that this cautionary language related directly to the allegedly misleading pro forma analyses and therefore rendered the alleged omissions immaterial as a matter of law.

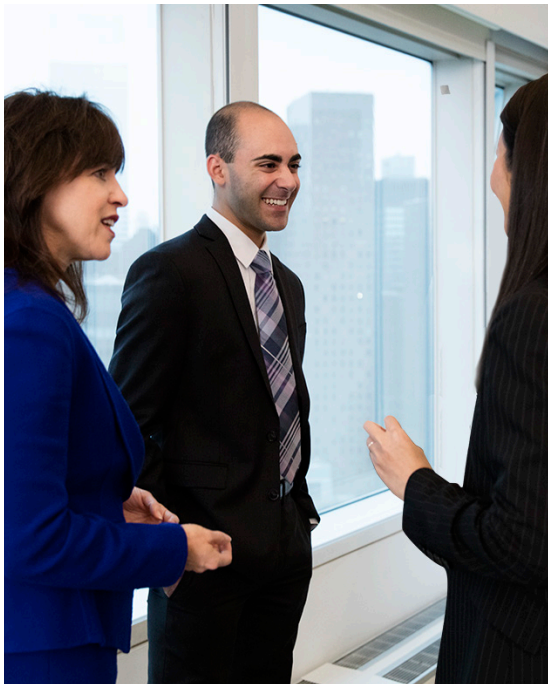
2. Please click here to read our discussion of the Delaware Supreme Court's decision in *Tri-State*.

3. The *Tri-State* demand futility test consists of three questions to be analyzed on a director-by-director basis: "(i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand; (ii) whether the director faces a substantial likelihood of liability on any of the claims that would be the subject of the litigation demand; and (iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that would be the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand." Demand is excused as futile if the answer to any of the three questions is "yes" for at least half of the members of the demand board. The court did not analyze the first or third question beyond noting that there was no appellate issue requiring resolution.

Fourth Circuit: Affirms Dismissal of Class Action Alleging That Data Protection and Privacy Statements Were False or Misleading

On April 21, 2022, the Fourth Circuit affirmed a district court's dismissal of a putative securities fraud class action against a hotel chain company and certain of its officers and directors alleging that the company's failure to disclose vulnerabilities in the IT systems of another hotel chain with which it merged rendered various of its public statements false or misleading in violation of Section 10(b). *In re Marriott Int'l*, 2022 WL 1178526 (4th Cir. 2022) (Heytens, J.). The court held that plaintiff failed to adequately allege that any of the company's statements were false or misleading when made.

In 2016, the company merged with another hotel chain and subsumed all of its operations, including its computer systems, reservation software and databases. In 2018, the company learned of a substantial data breach related to the subsumed guest reservation database. Subsequently, plaintiff commenced an action alleging that the company's failure to disclose severe vulnerabilities in the subsumed IT systems rendered 73 different public statements false



or misleading. The district court granted the company's motion to dismiss with prejudice, concluding that plaintiff did not adequately allege a false or misleading statement or omission, a strong inference of scienter or loss causation. Plaintiff appealed, narrowing its challenge to 18 statements.

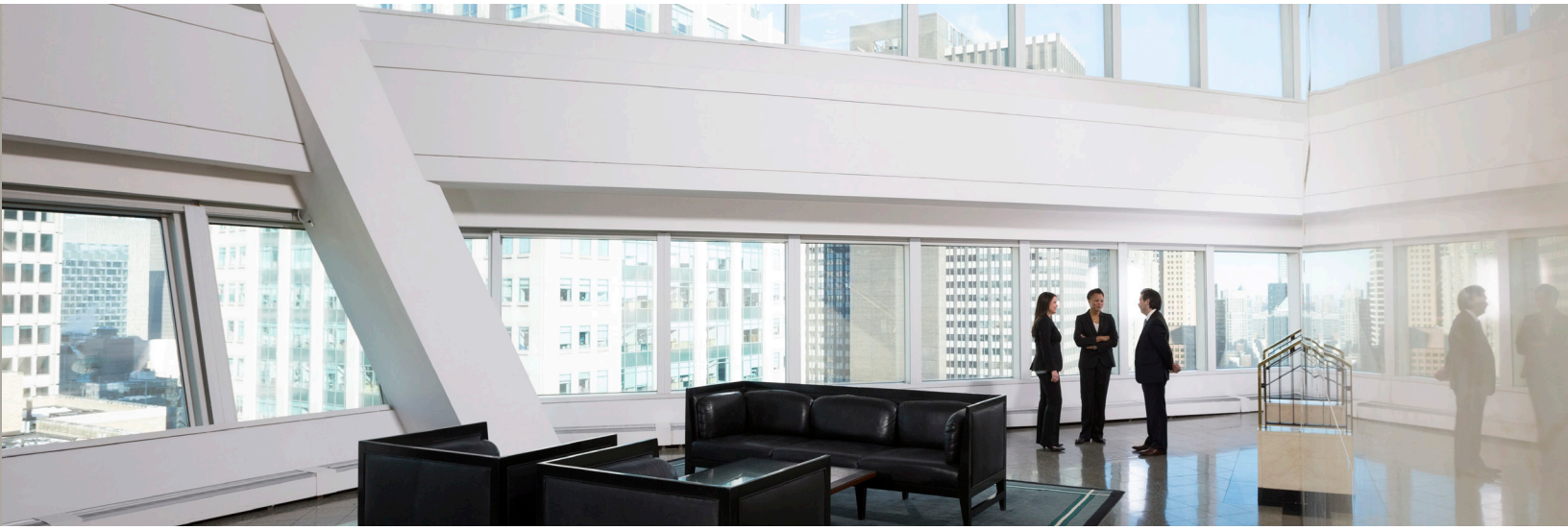
On appeal, the Fourth Circuit pointed out that "[n]ot all material omissions are actionable." Citing *Phillips v. LCI Int'l*, 190 F.3d 609 (4th Cir. 1999), the court explained that "an omission is actionable only if—absent the fact omitted—a reasonable investor, exercising due care, would gather a false impression from a statement, which would influence an investment decision."

Plaintiff's first set of challenged statements concerned the importance of data protection to the company's business. Plaintiff challenged the company's public statements that "the integrity and protection of customer, employee, and company data is critical to us as we use such data for business decisions and to maintain operational efficiency." Plaintiff claimed that by failing to disclose the "vulnerable state" of the subsumed IT systems, the company's statements created a misleading impression that the company was securing and protecting the acquired customer data.

The Fourth Circuit disagreed, noting that plaintiff's "whole theory of the case turns on those statements being true—*i.e.*, that data integrity is critically important to [the company] and its investors." The court explained that "[r]eiterating this basic truth is neither misleading nor creates the false impression [plaintiff] suggests." The court agreed with the district court that the company's statements on the importance of data protection "made no characterization at all with respect to the quality of its cybersecurity, only that [the company] considered it important." The Fourth Circuit also stated that a reasonable reader could not have understood the company to be overrepresenting its data protection because the same SEC submission that contained the challenged statements also disclosed key risks. For example, the company repeatedly warned that its systems may not satisfy the "information, security, and privacy requirements" imposed by laws and regulations and warned of information system breaches.

The court also determined that plaintiff's arguments concerning privacy statements[4] on company websites failed for similar reasons. The court held that plaintiff's allegations, even if true, did not demonstrate that the challenged privacy statements were false or misleading. The court pointed out that plaintiff conceded that the company devoted resources and sought to strengthen the security of the subsumed systems. The court also stated that no reasonable investor could have been misled by the privacy statements as they were accompanied by sweeping caveats.

4. For example, one company website stated that the company "seeks to use reasonable organizational, technical and administrative measures to protect" personal data, but noted that "no data transmission or storage system can be guaranteed to be 100% secure."



Southern District of New York: Denies Dismissal of Claims Concerning the Length of a Company's Sales Cycle

On February 25, 2022, the Southern District of New York denied a motion to dismiss a claim under Section 11 of the Securities Act against a company and certain of its officers and directors alleging that the company's IPO registration statement included materially misleading misstatements concerning the length of the company's sales cycle. *In re Tufin Software Techs. Sec. Litig.*, 2022 WL 596861 (S.D.N.Y. 2022) (Woods, J.).[5] The court held that plaintiff sufficiently alleged that defendants' statements were false and materially misleading.

Following its IPO, the company reported lower revenue and profit than prior guidance, citing an inability to close a number of transactions as one reason for the results. The company's share price fell 24% following these disclosures. After various lawsuits were consolidated, plaintiff alleged one cause of action against the company and the individual defendants for violating Section 11 of the Securities Act.[6] Plaintiff alleged that defendants' statements that the company's "sales cycle usually lasts several months from proof of concept to purchase order, and is often longer for larger transactions" were false and materially misleading. The company and the individual defendants moved to dismiss.

Plaintiff Sufficiently Alleged That Defendants' Statements as to the Length of the Company's Sales Cycle Were False and Materially Misleading

The court concluded that plaintiff sufficiently pleaded that defendants' sales cycle statements were false and materially misleading. As to falsity, the court noted that three confidential witnesses stated that the sales cycle was not usually several months, but could take at least two years to close and "was typically at least a year," and that a six-month deal was only achievable with luck. The court reasoned that if a six-month deal was only achievable with luck, then the statement that the sales cycle "usually" took only several months may have been false.

Defendants argued that there was no falsity because the registration statement adequately disclosed the length of the sales cycle by stating: "our sales cycle usually lasts several months from proof of concept to purchase order, and is often longer for larger transactions"; that the company's transactions were "often even longer than several months, less predictable, and more resource-intensive for larger transactions"; and that "our sales cycle is long and unpredictable."

The court stated that the term "usually" suggests that, more often than not, the sales cycle lasted only several months. The court explained that stating that a sales cycle was "often" longer would not, as a matter of law, preclude a reasonable investor from interpreting the statement to mean that the sales cycle usually lasted only several months instead of one to two years. Similarly, the court stated that the disclosure that the sales process is long and unpredictable "fails to sufficiently counteract [the] statement that the sales cycle 'usually' lasts several months." The court pointed out that the terms "long" and "unpredictable" did not denote a specific amount of time and defendants did not provide "any compelling reason to suggest that a reasonable investor would interpret that statement to mean that the sales cycle in fact took one or two years."

5. The court granted the motion to dismiss as to the other bases for the Section 11 claim concerning the company's salesforce training practices and customer education.
6. Section 11 of the Securities Act provides for potential liability where "any part of the registration statement, when such part became effective, contains an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

Southern District of New York: Dismisses Putative Class Action Against Drug Company After Applying *Matrixx* Materiality Standard

On March 21, 2022, the Southern District of New York dismissed a putative securities fraud class action alleging that a drug company and certain of its executives failed to disclose information concerning the safety of its only drug. *Rice v. Intercept Pharms.*, 2022 WL 837114 (S.D.N.Y. 2022) (Liman, J.). The court stated that under *Matrixx Initiatives v. Siracusano*, 563 U.S. 27 (2011), the mere existence of reports of serious adverse events does not significantly alter the "total mix" of information available to investors. The court then determined that, unlike in *Matrixx*, the complaint did not contain any allegations constituting the "something more" that would significantly alter the total mix of information.

After the FDA approved the company's drug to treat a liver disease, there were reports of two serious adverse events ("SAEs")[7] in patients using it. The company thereafter sought to have the drug approved to treat a second liver disease. The company experienced stock drops following company disclosures revealing issues the company faced seeking FDA approval and a published article indicating that the FDA was investigating whether the drug may cause liver injury. Plaintiffs alleged that defendants violated Section 10(b) of the Exchange Act by making a variety of statements about the drug without disclosing the SAEs. Plaintiffs claimed that this constituted securities fraud because the undisclosed information was material to: (i) the safety and continued use of the drug to treat the first liver disease; and (ii) the regulatory approval of the drug to treat the second liver disease. Defendants argued that the omitted SAEs were immaterial as a matter of law.

The Court Analyzes Materiality Under *Matrixx*

The court looked to *Matrixx* for the framework needed to analyze whether plaintiffs adequately pled that the allegedly undisclosed SAEs were material. In *Matrixx*, plaintiffs alleged that a drug company failed to disclose reports of a possible link between its leading product and patients' loss of their sense of smell (anosmia). The Supreme Court stated that the relevant question is "whether a *reasonable* investor would have viewed the nondisclosed information as having *significantly* altered the total mix of information made available." *Matrixx*, 563 U.S. at 44 (quoting *Basic v. Levinson*, 485 U.S. 224 (1988)). The Court held that "the mere existence of reports of adverse events—which says nothing in and of itself about whether the drug is causing the adverse events—will not satisfy this standard. Something more is needed, but that something more is not limited to statistical significance and can come from the source, content, and context of the reports." The Court concluded that this "something more" was alleged in *Matrixx* because the complaint alleged that the drug company received a variety of information that plausibly indicated a reliable causal link between the drug and patients' anosmia. The Court found that this "sufficed to raise a reasonable expectation that discovery will reveal evidence satisfying the materiality requirement."

Plaintiffs Fall Short of Alleging the "Something More" Needed to Satisfy *Matrixx*

Applying *Matrixx*, the court determined that plaintiffs failed to adequately allege that the nondisclosure of the two SAEs was material because, in contrast to *Matrixx*,

7. Information on SAEs is publicly available through an FDA database. This can prove challenging to plaintiffs alleging securities fraud claims based on omissions as generally an efficient market incorporates all publicly available information.

plaintiffs' allegations did not constitute the "something more" needed to meet the materiality standard. The court rejected plaintiffs' argument based on the risk odds ratio ("ROR") scores for each SAE. The ROR is the metric that gauges the frequency of adverse events. Plaintiffs alleged that an ROR score above 1 indicates a higher than expected reporting rate, and that many in the industry assume that an ROR score above 2 warrants attention. Plaintiffs further alleged that an unbiased third party determined that the ROR for the SAEs was "staggering and warranted attention." As to the first SAE (concerning reported cases of autoimmune hepatitis) the court found that the complaint itself undermined the significance of the ROR score because the ROR score was 1.83, below the ROR score of 2 that the complaint alleged "warrants attention" and "far below" the scores of 9 and 18 that the complaint called "staggering." The second SAE (concerning reported cases of hepatorenal syndrome) had an ROR score of 5.08. The court noted, however, that the FDA was aware of half of those cases when it revised the drug's label but chose not to include them on the warning label.

The court further pointed out that plaintiffs alleged no facts indicating that the two SAEs were in any way causally linked to the drug or otherwise material. The court determined that plaintiffs' conclusory assertion—that the long-term safety of the drug was material to the drug's approval for the second disease—could not fill this gap. The court noted that plaintiffs failed to allege anything linking the SAEs in patients with the first disease to the FDA's drug approval considerations or to plausibly allege that the SAEs had any significance concerning the drug's long-term safety.

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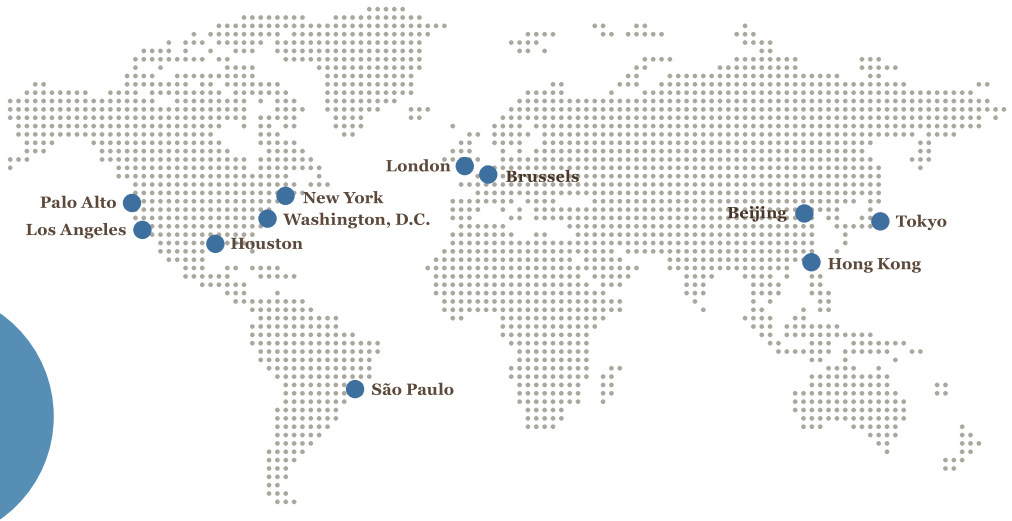

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