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Securities Law Alert

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Second Circuit: Securities Fraud Claims Predominantly Foreign Where the Transaction Implicated Only the Interests of Two Foreign Companies and a Foreign Country

On January 25, 2021, the Second Circuit affirmed the dismissal of a securities fraud lawsuit against a Bermudan holding company operating out of New York and its controller, alleging that defendants had misrepresented the holding company's fee arrangement before plaintiff, a Bermudan corporation, had purchased shares in the holding company in a private offering. *Cavello Bay Reinsurance v. Shubin Stein*, 986 F.3d 161 (2d Cir. 2021) (Jacobs, J.). The Second Circuit held that even assuming, without deciding, the transaction was "domestic" under *Absolute Activist Value Master Fund v. Ficeto*, 677 F.3d 60 (2d Cir. 2012), the claims were so predominantly foreign as to be impermissibly extraterritorial under *Parkcentral Global HUB v. Porsche*, 763 F.3d 198 (2d Cir. 2014).

Principles Determining the Extraterritorial Reach of Section 10(b)

Plaintiff asserted claims under the Securities Exchange Act, including for rescission under Section 29(b) and for securities fraud under Section 10(b) and Rule 10b-5. Beginning its extraterritorial analysis, the court stated "Section 10(b) of the Securities Exchange Act does not apply beyond U.S. borders. But, in a mostly border-less economy, a plaintiff is allowed some room for a foreign dimension to its claims." Citing to the Supreme Court's bright-line rule in *Morrison v. National Australia Bank*, 561 U.S. 247 (2010), the court stated that "[u]nless a security is listed on a domestic exchange, a domestic transaction is a necessary element of a § 10(b) claim." However, the court explained "the presence of a domestic transaction alone cannot satisfy the statute's geographic requirements," and under *Parkcentral,* "claims must not be so predominantly foreign as to be impermissibly extraterritorial."

The court explained that under *Morrison*, courts are "to use the 'focus' of the statute to determine whether a case involves a domestic application of § 10(b).” The court continued that “[t]he focus is upon purchases and sales of securities in the United States, not upon the place where the deception originated.” *Id.* The court noted that the Supreme Court later clarified in *RJR Nabisco v. European Community*, 136 S. Ct. 2090 (2016) that “if the conduct relevant to the focus occurred in a foreign country, then the case involves an impermissible extraterritorial application regardless of any other conduct that occurred in U.S. territory.” Citing to Second Circuit precedent, the court stated that, “[p]ut differently, courts must evaluate whether the domestic activity involved implicates the ‘focus’ of the statute.” The court cautioned that “even if a transaction occurs in the United States, the features and incidents of the transaction may nevertheless be so foreign that it is not regulated by § 10(b).” For example, “*Parkcentral* ruled that the complaint stated an impermissibly extraterritorial claim despite the presence of a domestic transaction.”

Plaintiff Failed to Plead a Domestic Application of Section 10(b)

Applying these principles, the court concluded that plaintiff “has failed to plead a domestic application of § 10(b).” The court explained that “[t]he claims here are based on a private agreement for a private offering between a Bermudan investor [] and a Bermudan issuer [,]” and that plaintiff “purchased restricted shares in [the holding company] in a private offering.” Further, the court continued that “[t]he shares reflect only an interest in [the holding company], and they are listed on no U.S. exchange and are not otherwise traded in the United States.”

The Agreement’s SEC Registration Requirement Not Enough to Trigger Interests That Section 10(b) Is Meant to Protect

The court described the main connection of the shares to the U.S. as “the subscription agreement’s restriction clause requiring [plaintiff] to register the shares with the SEC (or meet an exemption) should [plaintiff] wish to resell them.” The court reasoned that “[w]hile that clause may set up a future invocation of U.S. law, it operates as a mere contractual impediment to resale, conditioning resale on the invocation of U.S. law by a party that has made the purchase in a way that avoids regulation by the United States.” The court pointed out that plaintiff “provides no reason to think an SEC registration requirement—contingent and future—triggers some U.S. interest or other interest that the statute is meant to protect . . . .” The court observed that plaintiff “seeks access to a domestic forum and judicial resources; but the transaction is structured to avoid the bother and expense (and taxation) of U.S. law.” The court concluded that “[t]he transaction implicates only the interests of two foreign companies and Bermuda.”

Alleged Contacts With Territory of the U.S. Did Not Relate to the Purchase and Sale of Securities

The court further deemed that plaintiff’s allegations against the holding company (that it made the misstatement from New York; that the funds were to be invested in U.S. insurance services; that its principal place of business, CEO, and directors were in New York; and that it was managed by a U.S. company) were “not enough.” Instead, the court stated that the contacts with the territory of the U.S. “that matter are those that relate to the purchase and sale of securities.” Addressing the allegations that the parties’ communications executing the agreement were between New York and Bermuda, the court stated that “acts evincing contract formation do not resolve the question whether the claims are nevertheless so predominantly foreign.”

Ninth Circuit: Projected Timelines Concerning a New Product Are Forward-Looking Statements

On January 26, 2021, the Ninth Circuit affirmed the dismissal with prejudice of a putative securities fraud class action alleging that a car company and two of its officers misled investors about the company's progress in building production capacity for its first mass-market electric vehicle. *Wochos v. Tesla*, 2021 WL 246210 (9th Cir. 2021) (Collins, J.). The court held that none of the 15 statements at issue were actionable as they were protected as forward-looking statements under the Private Securities Litigation Reform Act ("PSLRA"), or to the limited extent that they were not so protected plaintiffs failed to adequately plead falsity.

Plaintiffs in this case alleged that the company announced production goals for its new vehicle for "the end of 2017 that it knew it would not be able to achieve, and it repeatedly reaffirmed that it was on track to reach those targets, even as the end-of-the-year deadline drew closer and as delays grew increasingly significant."

Unadorned "On Track" Statements Are Forward-Looking Statements

Discussing the relevant standard, the court noted that "the PSLRA carves out a safe harbor for forward-looking statements by adding § 21E to the Securities Exchange Act." After reviewing the company's statements, the court found that the company's "goal to produce 5,000 vehicles per week is unquestionably a forward-looking statement under § 21E, because it is a plan or objective of management for future operations, and this plan or objective relates to the products of [the company]." The court further found that "[the company's] various statements that it was on track to achieve this goal and that there are no issues that would prevent [the company] from achieving the goal are likewise forward-looking statements." The court reasoned that "[b]ecause any announced objective for future operations *necessarily* reflects an implicit assertion that the goal is achievable based on current circumstances, an unadorned statement that a company is on track to achieve an announced objective, or a simple statement that a company knows of no issues that would make a goal impossible to achieve, are merely alternative ways of declaring or reaffirming the objective itself." The court pointed out that "[t]he statutory safe harbor would cease to exist if it could be defeated simply by showing that a statement has the sort of features that are inherent in *any* forward-looking statement."

Assumptions Underlying or Relating to a Declared Goal Are Forward-Looking Statements

The court then explained that the issue "is whether [p]laintiffs have sufficiently pleaded that any of the challenged May statements went beyond the mere declaration of the year-end goal in a way that include[d] a non-forward-looking statement." The court then reiterated "that it is not enough to plead that a challenged statement rests on subsidiary premises about how various *future* events will play out over the timeframe defined by the forward-looking statement." Citing the safe harbor, the court explained that "such statements of the assumptions underlying or relating to a declared objective are also deemed to be forward-looking statements." The court determined that "[t]his reasoning precludes [p]laintiffs' theory that [the company's] year-end goal rested on scheduling assumptions that [the company] knew it was unlikely to meet." The court concluded that "[a]ny such schedule about how future production would play out on the way toward the announced goal is simply a set of the assumptions about future events on which that goal is based." The court continued, stating that "[l]ike the goal itself, such projected timelines are forward-looking statements."

Central District of California: Securities Fraud Claims Dismissed Where Plaintiff Failed to Allege That Defendants Would or Could Have Known the Extent of the Pandemic

On January 25, 2021, the Central District of California dismissed a putative class action lawsuit alleging that a real estate finance company, certain of its officers and directors, and its private equity sponsor made misrepresentations and/or omissions of material fact in the company's offering documents. *Berg v. Velocity Fin.*, 2021 WL 268250 (C.D. Cal. 2021) (Klausner, J.).[1] Notably, this is the first decision on a motion to dismiss in a securities class action involving allegations related to COVID-19, according to Stanford University's Securities Class Action Clearinghouse.

No Plausible Inference That Defendants Anticipated the Growth of Nonperforming Loans

Plaintiff alleged that defendants "failed to disclose that at the time of the IPO the [c]ompany's non-performing loans had dramatically increased in size from the figures provided in the [o]ffering [m]aterials, as measured by both the amount of unpaid principal balance and as a percentage of the [c]ompany's overall loan portfolio." The court held that "[t]aken together, there is no plausible inference that [d]efendants anticipated the rate of nonperforming loans to have increased to the extent that it did prior to the IPO." The court concluded that "[i]nstead, the [investor call] transcript supports the inference while some growth of nonperforming loans was expected, there was also an unexpected increase due to the coronavirus pandemic."

Plaintiff further alleged that "[d]efendants failed to disclose the potential impact of a brewing pandemic on [the company's] business and operations." Specifically, the company stated in its offering materials that "[w]e believe that there is a substantial and durable market opportunity for investor real estate loans . . . ." The court held that the company's "statement about the real estate market [is] no different from the nonactionable statements in *Police Retirement System*."[2] The court explained that the company's statement in this case "is like the company in *Police Retirement System* stating, 'that there is potential growth in the dVP market.'" The court continued that "[i]n both cases, the companies propound the favorable state of their respective markets, and the companies' ability to capitalize on them." The court concluded that "these statements cannot form the basis of a Section 11 securities claim."

Item 303 Disclosure Not Required if Plaintiff Failed to Allege That Defendants Would or Could Have Known the Pandemic's Extent

Plaintiff alleged that defendants also violated Item 303 of Regulation S-K because the offering materials failed to disclose that "a brewing pandemic presented uncertainty that was likely to adversely affect the economy and real estate market." The court explained that "Item 303 requires disclosure when there is knowledge of an adverse trend, material impact, and that the future material impacts are *reasonably likely to occur* from the present-day perspective." With respect to these allegations, the court found that "[p]laintiff does not allege that [d]efendants would or could have known the extent of the coronavirus pandemic, or even the presence of the disease in America, at the time of the [January 2020] IPO." The court then held that "[t]hus, there would have been no need for [d]efendants to include any disclosure about the pandemic in its offering materials."

No Need for Specific Item 105 Disclosure if Plaintiff Failed to Adequately Allege How Defendants Would Have Known About Coronavirus Risks

Plaintiff alleged that defendants also violated Item 105 of Regulation S-K by failing to "adequately warn purchasers of common stock in connection with the IPO of the issues [the company] was then facing as a result of the coronavirus." The court explained that "Item 105 requires a discussion of the material factors that makes an investment in

1. Simpson Thacher represents defendants in this action.

2. *Police Ret. Sys. of St. Louis v. Intuitive Surgical*, 759 F.3d 1051 (9th Cir. 2014).

the registrant or offering speculative or risky." The court pointed out that "[a]t minimum, [d]efendants disclosed that its business may be affected by changes in national, regional or local economic conditions or specific industry segments, which may be caused by 'acts of God.'" The court found that "[p]laintiff has not adequately alleged how [d]efendants would have known about the coronavirus risks at the time of the IPO to be able to include a more specific warning." The court then concluded that "[d]efendants did not need to include more specific disclosures about the coronavirus pandemic."

Southern District of New York: Disclosures in Wake of Cyberattack Defeated Securities Fraud Claims

On February 4, 2021, the Southern District of New York dismissed with prejudice a securities fraud class action against an international package delivery company and certain of its officers and directors alleging that the company misrepresented the status of its recovery from a significant cyberattack. *In re FedEx Sec. Litig.*, 2021 WL 396423 (S.D.N.Y. 2021) (Abrams, J.). The court held that "plaintiff fail[ed] to adequately plead the falsity of [the company's] statements about its recovery from [the cyberattack] because those same statements were accompanied by numerous disclosures about the difficulties faced and expenses incurred by [the company] in that process."

Background

In 2016, the company acquired a subsidiary to expand its presence in Europe. In 2017, the company announced that this subsidiary had been impacted by a cyberattack that took the form of a computer virus. Plaintiff pension fund alleged that the company misrepresented the status of its recovery from the cyberattack. Plaintiff claimed the company's statements concerning its recovery "were materially misleading because they failed to disclose 1) that [the subsidiary's] international service was largely disabled for six months due to the virus; 2) that [the subsidiary] was losing a significant proportion of its high-margin customers due to its failure to operate internationally; and 3) that [the cyberattack] had substantially delayed, rather than accelerated, the integration of [the subsidiary] into [the company]." Plaintiff claimed these facts demonstrated that "[d]efendants lacked a reasonable basis for their positive statements about the [c]ompany and its prospects, including its ability to meet the [subsidiary's] [i]ncome [i]mprovement [t]arget."

Numerous Disclosures Belied Claim That Cyberattack Damage Was Belatedly Disclosed

The court stated that "[e]ven accepting [p]laintiff's allegations as true, [it] conclude[d] that the challenged statements, when considered in their full context, would not mislead a reasonable investor as to [the cyberattack's] effect on the [c]ompany or as to the status of [its subsidiary's] integration." The court stated that "[the company's] numerous disclosures during the [c]lass [p]eriod belie [p]laintiff's contention that [it] *belatedly* disclosed to the market the damage [the cyberattack] had caused to the [c]ompany and . . . [its subsidiary] in December 2018." The court continued that "[u]nder those circumstances, [d]efendants' professed optimism about [the subsidiary] in the wake of the [] attack is an insufficient basis for securities fraud, even though hindsight suggests that such optimism may have been misguided."

Cautionary Statements, Often Bolded and Italicized, Warned Investors

The court explained that "an examination of [the company's] statements in their full context illustrates the inadequacy of [p]laintiff's fraud allegations." The court noted that "[e]ach of the quarterly reports[,] from which [p]laintiff has selected allegedly misleading statements[,] contained language, often bolded and italicized for emphasis, that warned investors about the potentially lingering effects of the June 2017 cyberattack." For example, the court pointed to the company's December 2017 10-Q report that was filed six months after the attack, which stated that the cyberattack's "***ongoing impact could negatively affect our results of operations and financial condition in the future, particularly if our continuing recovery efforts do not proceed as expected.***" The court stated that "[t]hese cautionary statements exemplify [d]efendants' repeated disclosure of the [c]ompany's difficulties in recovering from [the cyberattack]." In light of these disclosures, the court "conclude[d] that [p]laintiffs have failed to allege sufficient facts to establish that [the company's] more optimistic statements misled the investing public." The court further stated that "[e]ven accepting the allegedly omitted facts as true, none of the categories of statements challenged by [p]laintiff was actionably false or misleading under the securities laws."

Delaware Supreme Court: Post-Merger Standing Exists if Merger Fairness Is Challenged Due to Failure to Secure a Pending Derivative Claim's Value

On January 22, 2021, the Delaware Supreme Court reversed the Court of Chancery's dismissal, due to lack of standing, of post-merger claims challenging a merger's fairness for the controller's failure to recoup the value of derivative claims. *Morris v. Spectra Energy*, 2021 WL 221987 (Del. 2020) (Seitz, C.J.). The court explained that "[w]ith limited exceptions, a merger extinguishes an equity owner's standing to pursue a derivative claim against the target entity's directors or controller." However, the court held that "the same plaintiff has standing to pursue a post-closing suit if they challenge the validity of the merger itself as unfair because the controller failed to secure the value of a material asset—like derivative claims that pass to the acquirer in the merger."

Background

After a $3.3 billion "roll up" of minority-held units involving a merger between an acquiring corporation and a limited partnership, plaintiff (a former minority unitholder of the limited partnership) lost standing to litigate his alleged $661 million derivative suit on behalf of the limited partnership against its general partner. Subsequently, plaintiff filed a new class action complaint alleging that the merger exchange ratio was unfair because the general partner had agreed to a merger that did not reflect the material value of plaintiff's derivative claims. The Court of Chancery granted the general partner's motion to dismiss plaintiff's new class action complaint for lack of standing, applying the three-part test from *In re Primedia, Inc. S'holders Litig.*, 67 A.3d 455 (Del. Ch. 2013).

The Court Reiterates the Three-Part *Primedia* Test

The court stated that "[t]he main issue on appeal is whether the Court of Chancery stayed true to the standard of review on a motion to dismiss for lack of standing." The court then announced that the lower court "strayed from the proper standard of review, and [plaintiff] had standing to pursue his post-merger complaint." The court stated that in this case, "we think that the *Primedia* framework provides a reasonable basis to conduct a pleadings-based analysis to evaluate standing on a motion to dismiss." The court explained that "[f]irst, the court must decide whether the underlying derivative claims were viable, meaning they would survive a motion to dismiss." The court noted that "[m]eritless derivative claims would have no impact on the merger price." The court stated that "[s]econd, the derivative claim recovery as pled must be material in relation to the merger consideration." The court stated that "[a]n immaterial derivative claim would have little or no impact on the merger price." Third, the court stated that "the court should also assess whether the complaint alleges that the acquirer would not assert the underlying derivative claim and did not provide value for it."

The Chancery Court Did Not Draw All Reasonable Inferences in Plaintiff's Favor; Should Not Have Applied a Further Litigation Risk Discount

Applying this standard, the court stated that "the parties do not dispute the viability of the derivative claim." This was because plaintiff's derivative claim had survived a motion to dismiss before that lawsuit was ultimately dismissed by stipulation of the parties after the merger closed. The court also stated that the parties "did not dispute that [the general partner] secured no value for the derivative claim, and [the acquiring corporation] would not assert the claim post-merger."

Turning to materiality, the court stated that there were "two errors in the [lower] court's materiality analysis at the motion to dismiss stage of the proceedings." The court explained that "[f]irst . . . the court must accept [plaintiff's] factual allegations as true and draw all reasonable inferences in his favor." The court stated that "it was reasonably conceivable that the [g]eneral [p]artner acted in subjective bad faith." The court continued that "[i]t was also reasonably conceivable that, had [plaintiff] succeeded in the derivative suit challenging the reverse drop down transaction, the recovery could have been at least $660 million." The court concluded that "[a]pplying a further litigation risk discount at the pleading stage was inconsistent with the court's standard of review on a motion to dismiss for lack of standing."

The Chancery Court Did Not Use the Proper Calculation to Determine if the Derivative Claim Was Material; Should Not Have Applied a Percentage-Based Risk Reduction

The court stated that the second error was that "even if it was proper to discount the $660 million in damages alleged in the complaint to reflect the public unitholders' interest in the derivative recovery, to maintain equivalence, the court should have compared the $112 million *pro rata* interest in the derivative claim recovery to the public unitholders' proportional interest in the merger consideration." The court determined that "[u]nder this calculation, the derivative claim was material at the motion to dismiss stage." The court noted that "[i]n any event, on a motion to dismiss for lack of standing, we are not addressing the likelihood of success on a preliminary injunction record." Further, the court stated that "[a] percentage-based risk reduction should not be applied at this stage of the proceedings."

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