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Securities Law Alert

In This Edition:

- Sixth Circuit: Alleging That Index Funds Outperformed Managed Funds Fails to State a Breach of the Duty of Prudence Claim
- Ninth Circuit: Market Growth and Sales Performance Statements Determined to Be Non-Actionable Puffery
- Northern District of California: Dismissal Denied Where Defendants Touted That a Target Company Founder Would Play a Critical Post-Merger Role When the Founder Was In Fact Marginalized

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Simpson Thacher's "deep bench of trial and appellate lawyers" is "regularly retained to act on multibillion-dollar securities class actions and derivative suits."

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Sixth Circuit: Alleging That Index Funds Outperformed Managed Funds Fails to State a Breach of the Duty of Prudence Claim

On June 21, 2022, the Sixth Circuit affirmed a district court's dismissal of a putative class action alleging that a healthcare company and its 401(k) plan administrator breached the duty of prudence under ERISA by offering several actively managed investment funds when available index funds offered higher returns and lower fees. *Smith v. CommonSpirit Health*, 37 F.4th 1160 (6th Cir. 2022) (Sutton, J.). The court held that plaintiff failed to plead that defendants acted imprudently in offering the managed funds by alleging only that the managed funds' performance trailed the index funds' performance over a period of five years.

Background

Plaintiff, a former healthcare company employee, participated in the company's defined contribution 401(k) plan. The plan offered several actively managed funds and several index funds. Plaintiff commenced a class action against the company and the plan administrator claiming breach of fiduciary duty under ERISA,[1] arguing that it was a breach of the duty of prudence for defendants to offer actively managed investment funds when available index funds offered higher returns and lower fees. Plaintiff pointed to three-year and five-year periods in which three actively managed funds trailed the rates of return for related index funds. The district court dismissed the case, concluding that plaintiff failed to allege facts from which it could plausibly infer that the company and plan administrator acted imprudently.

The Duty of Prudence Is Context Specific

On appeal, the Sixth Circuit considered various Supreme Court precedents concerning the duty of prudence under ERISA. Under *Tibble v. Edison Int'l*, 575 U.S. 523 (2015), a fiduciary's duty of prudence creates "a continuing duty to monitor trust investments and remove imprudent ones." The Court also has stated that "[b]ecause the content of the duty of prudence turns on

1. 29 U.S.C. § 1132(a)(2).

the circumstances prevailing at the time the fiduciary acts, the appropriate inquiry will necessarily be context specific." *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409 (2014). In addition, the Court has recently held that, because ERISA fiduciaries face difficult tradeoffs, "courts must give due regard to the range of reasonable judgments a fiduciary may make based on her experience and expertise." *Hughes v. Nw. Univ.*, 142 S. Ct. 737 (2022).

The Sixth Circuit held that plaintiff failed to plausibly plead that the company acted imprudently merely by offering any actively managed funds in its mix of investment options as a general matter. With respect to the specific funds, the court also held that plaintiff failed to plausibly plead that the company violated ERISA by imprudently offering these specific actively managed funds. After noting index funds' positive features (mix of investment types and low management fees), the court stated that those features do not "make all other fund types imprudent." In other words, the fact that index funds have positive features does not mean that actively managed funds do not also have positive features or that some investors may not prefer managed funds. The court pointed out that while an actively managed fund may cost more than an index fund, it may generate greater returns in the long term.

Merely Alleging Another Investment Performed Better Does Not Plead an Imprudent Decision

The court stated that while a plaintiff generally must identify an alternative course of action (*e.g.*, another fund in which the plan might have invested) to show imprudence, alleging such an alternative course of action is not sufficient to plead a claim. Rather, the court explained that "these claims require evidence that an investment was imprudent from the moment the administrator selected it, that the investment became imprudent over time, or that the investment was otherwise clearly unsuitable for the goals of the fund based on ongoing performance." Accordingly, the court concluded that merely pointing to another investment that has performed better over a five-year period does not plausibly plead an imprudent decision. The court observed that to rule otherwise would mean that every actively managed fund with below-average results over the most recent five-year period would create a plausible ERISA violation; this in turn could cause plan administrators to avoid including any managed funds as plan options.

The court noted that its reasoning was similar to how the Eighth Circuit had evaluated a similar claim in *Davis v. Washington University in St. Louis*, 960 F.3d 478 (8th Cir. 2020). In *Davis*, the Eighth Circuit concluded that it was not imprudent for a fiduciary to offer both actively managed stock and real estate funds along with passively managed funds. The *Davis* court explained that the two general investment options "have different aims, different risks, and different potential rewards that cater to different investors. Comparing apples and oranges is not a way to show that one is better or worse than the other." Refusing plaintiff's invitation to compare the performance of actively managed funds and index funds within a five-year timeframe, the Sixth Circuit concluded that ERISA "does not give the federal courts a broad license to second-guess the investment decisions of retirement plans."

Ninth Circuit: Market Growth and Sales Performance Statements Determined to Be Non-Actionable Puffery

On July 7, 2022, the Ninth Circuit affirmed a district court's dismissal of a securities fraud class action against a medical product manufacturer and certain of its executives alleging that senior executives misrepresented the company's sales growth in China. *Macomb Cnty. Emps. Ret. Sys. v. Align Tech.*, 39 F.4th 1092 (9th Cir. 2022) (McKeown, J.).

The court agreed with the district court that six of the challenged statements were puffery.

Background

For a number of years, the company had double-digit revenue growth rates in China. For example, in every quarter in 2017 and 2018, the company's year-over-year revenue growth rate in China was between 70% and 100%. However, at the beginning of 2019, the company's revenue growth rate in China decreased, and in Q2 the rate fell to between 20% and 30%. These decreases were followed by a stock drop of approximately 27%. Subsequently, the plaintiff pension plan filed a class action under Section 10(b) and Rule 10b-5, alleging that company executives had misrepresented the company's growth in China throughout Q2 of 2019, "claiming strong numbers despite knowing (or recklessly disregarding) that the growth rate in China had slowed significantly."

The district court dismissed the action with prejudice, holding that the challenged statements, which described the market for the company's products in China and the company's performance there, were either non-actionable puffery or were not false or misleading. Plaintiff appealed.

Vague, Generically Positive Statements Were Puffery

On appeal, the court held that the district court correctly found that six of the challenged statements were non-actionable puffery. Under Ninth Circuit precedent, puffery involves "expressing an opinion that is not capable of objective verification." *Retail Wholesale & Dep't Store Union Local 338 Ret. Fund v. Hewlett-Packard*, 845 F.3d 1268 (9th Cir. 2017). Such statements are not actionable because professional investors, and most amateur investors, "know how to devalue the optimism of corporate executives." *Police Ret. Sys. of St. Louis v. Intuitive Surgical*, 759 F.3d 1051 (9th Cir. 2014). The Ninth Circuit explained that six of the challenged statements used vague, generically positive terms, such as describing China as "a great growth market," "a huge market opportunity," and "a market that's growing significantly for us," as well as describing the company's performance in China as "tremendous" and "great." The court determined that such characterizations were not "objectively verifiable" and did not present the kind of "precise information" on which investors rely.

The District Court Did Not Err As the Statements Were Not Made Against a Clearly Pessimistic Backdrop

Plaintiff argued that the district court erred by failing to "consider the context" in which these six statements were made. The Ninth Circuit disagreed. Citing *Intuitive Surgical*, the court explained that this was not a case where "general statements of optimism" were "made against a clearly pessimistic backdrop," which "may form a basis for a securities fraud claim[.]" Rather, on the facts at issue, the court emphasized that when the executives "made the six challenged statements, the company's sales were *still growing* in China, albeit at a diminished rate, so these feel-good descriptions . . . did not 'affirmatively create an impression of a state of affairs that differed in a material way from the one that actually existed.'" Quoting *In re Quality Sys. Sec. Litig*., 865 F.3d 1130 (9th Cir. 2017) (emphasis in original).

Northern District of California: Dismissal Denied Where Defendants Touted That a Target Company Founder Would Play a Critical Post-Merger Role When the Founder Was In Fact Marginalized

On July 1, 2022, the Northern District of California denied in part a motion to dismiss a securities fraud class action arising out of a reverse merger between a private technology company and a SPAC alleging that the company, certain of its executives and directors, and certain SPAC co-founders/executives made false or misleading statements or omissions that deceived investors into approving the merger and into purchasing company securities at an inflated price. *Moradpour v. Velodyne Lidar*, 2022 WL 2391004 (N.D. Cal. July 1, 2022) (Illston, J.). The court held that plaintiffs

adequately alleged that the technology company and two individual defendants misleadingly touted that the technology company's founder would play a key role post-merger when in fact steps were being taken to oust him.[2]

The reverse merger closed in September 2020. Plaintiffs claimed that defendants made a number of misleading statements about the founder's post-merger role. These included a July 2, 2020 joint press release announcing the merger that stated that the founder would "continue to play a critical role as executive chairman of [the resulting company]" after the merger; a July 2, 2020 conference call in which one defendant (a SPAC co-founder/ executive who later became chair of the company's board) discussed the management and engineering talent that the founder "has and will continue to assemble"; a statement in the same conference call by the technology company's President/CEO that the founder "will remain very involved in the engineering and technology vision of the Company"; and a July 2020 preliminary proxy stating that the founder "will serve as the post-combination company's executive chairman and will remain actively involved in the post-combination company's product and technology development strategy." In addition, in January 2021, the company published an FY2020 Release, in which the company's President/CEO stated that "there is no change in our fundamental outlook for the future" despite the impact of COVID-19.

Defendants moved to dismiss. On the issue of the founder's ongoing role, the court concluded that plaintiffs adequately alleged Section 10(b) and Rule 10b-5(c) claims against the technology company, the SPAC co-founder/executive who later became board chair of the resulting company, and the technology company's President/ CEO for intentionally touting the founder's continued involvement in the company while taking actions that contradicted the notion of such continued involvement. The court determined that plaintiffs adequately alleged that defendants' various statements were misleading because the board had disregarded the founder's input on corporate governance, strategy, and financial performance since the merger's consummation and the founder had already "stepped back from day-to-day management" seven months before the merger. As to the FY2020 Release, the court pointed out that earlier that same day the founder had already tendered his voluntary resignation as Executive Chairman. The court observed that his resignation would qualify as a change to the company's outlook given his status as founder and as "an industry icon" as described in the July 2020 preliminary proxy.

2. Plaintiffs also claimed that defendants: (i) misrepresented the company's revenue and growth trajectory in the run-up to the merger's approval and in the months that followed; (ii) misled shareholders about another company's continued involvement as a strategic investor and customer; and (iii) misled shareholders about the quality of the company's corporate governance and internal control over financial reporting. The court determined that plaintiffs failed to allege a violation of Section 10(b) based on these challenged statements.

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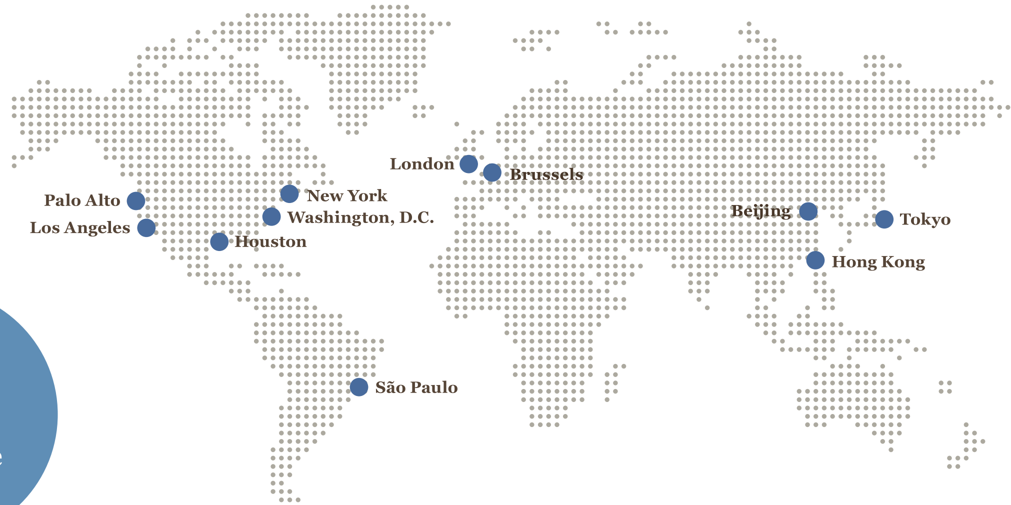

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