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Securities Law Alert

In This Edition:

March 2021

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– Chambers USA

Fourth Circuit: Inference of Scienter "Exceptionally Weak" Where BDC's Investment Strategy Appeared Bad Only in Hindsight and BDC Disclosed That Investments Would Be Classified as Junk

On February 22, 2021, the Fourth Circuit affirmed the dismissal with prejudice of a securities fraud class action against a business development company ("BDC") as well as director liability claims against three directors/executives alleging that defendants failed to disclose the risks of the BDC's investment strategy, which involved offering mezzanine financing to lower middle market companies. *In re Triangle Capital Corp. Sec. Litig.*, 988 F.3d 743 (4th Cir. 2021) (Agee, J.). The court held that the heightened burden for pleading scienter under the Private Securities Litigation Reform Act ("PSLRA") was not satisfied. The court found that the inference of scienter rested on "statements and omissions of facts arising from the execution of legitimate, subjective business judgments that, only when viewed in hindsight, allegedly become misleading."

Background

Plaintiff argued that defendants "knew in 2014 and 2015 that the mezzanine lending market was contracting, and that the mezzanine deals that remained were of inferior quality than what was available before the rise of unitranche lending." Plaintiffs asserted that "this knowledge, coupled with the 'false' representations about the quality of those deals and the state of the mezzanine market, give rise to a strong inference of scienter."

Specifically, plaintiff argued that certain statements to investors equated to admissions that defendants knew in 2014 and 2015 that they were investing in low-quality deals. In a May 2017 investor call, one of the defendant executives said, in reference to the BDC's 2014 and 2015 business activity, that "there was a period where [the BDC] was chasing yield more than it should have." In a November 2017 investor call, another defendant executive explained how the investment decisions from 2013 to 2015

contributed to some investments later going on full non-accrual status. This executive stated that the adherence to a mezzanine investment strategy during a period of massive change in the market "was the wrong strategic call" when "other investment strategies were available which provided a better risk-reward equation."

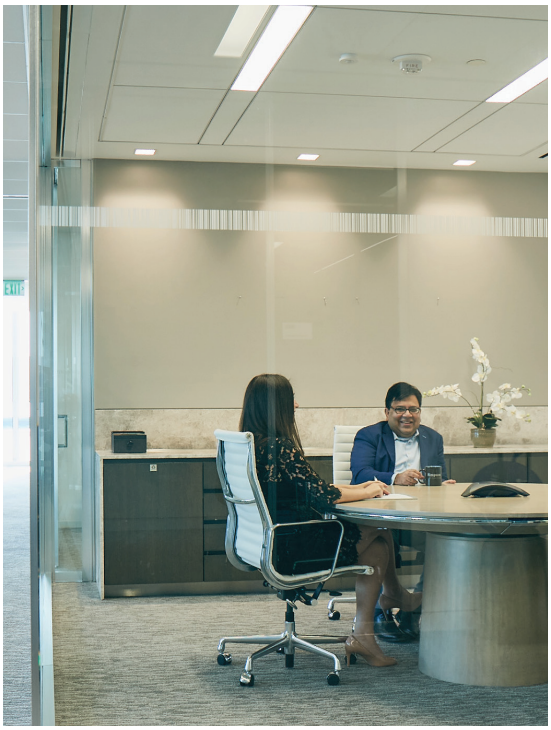
Inference of Scienter Is Weak in Part Due to Ambiguities and Lack of Motive

Focusing only on the element of scienter, the court determined that "to the extent that we can make any inference of scienter from [plaintiff's] allegations, it is exceptionally weak." With respect to plaintiff's allegation that the defendant executives (who largely controlled the investment committee's decisions) were advised that the mezzanine lending market was contracting and that it should focus on unitranche lending, the court stated that "two factors diminish the strength of any scienter inference that could be drawn." First, plaintiff "never specifies when this advice was given, how firm in their conviction these investment advisors were in recommending that [the BDC] should avoid mezzanine deals moving forward, or what a mix of mezzanine and unitranche investments should look like." Second, plaintiff failed to allege that defendants had some particular motive to defraud investors. The court concluded that these "ambiguities, and the lack of a motive to defraud, thus diminish the strength of any scienter inference that can be drawn from the allegation."

Retrospective Statements Do Not Support a Strong Inference of Scienter

Plaintiff also alleged that an investment bank's report that compiled survey results and commentary about lending market trends concluded that the mezzanine market was "rapidly shrinking." However, the court found that "the Report contains just as many optimistic statements about the state of the mezzanine lending market as it does those expressing concern with the potential changes in that market." The court concluded that "[w]ithout more, we cannot reasonably infer from [the executive's] retrospective statement in [the] May 2017 [investor call] that in 2014 and 2015, [] [d]efendants knew that the quantity of investments was incompatible with quality."

The court continued that "[f]or similar reasons, we cannot reasonably draw that same inference from [the] November 2017 conversation with investors." The court noted that "[o]f course, many bad investments will, in retrospect, look like the wrong strategic call." However, the court cautioned that nothing said in the November 2017 investor call "plausibly suggests that [the BDC] or its C-level executives *knew* or recklessly disregarded the fact that each of their portfolio companies bore inherently more risk than the typical 'high yield' or '*junk*' securities that constituted [the BDC's] investment portfolio." The court stated that "[i]n fact, [the BDC] regularly disclosed to its investors that 'junk' was how their investments would be classified." The court observed that pleading fraud by hindsight is precisely what Congress intended the PSLRA to eliminate. The court concluded that "[c]onsidering these allegations holistically and in their proper context, we hold that [plaintiff] has failed to allege a strong inference of scienter." The court then stated that "the much stronger inference is that [d]efendants had an honest debate about the merits of a subjective business judgment, and in hindsight, simply made the wrong choice with some investments."



Eastern District of Pennsylvania: CEO's Background and Industry Experience Supported an Inference of Scienter at the Pleading Stage

On February 16, 2021, the Eastern District of Pennsylvania largely denied a motion to dismiss a securities fraud class action against a drug company and certain of its executives alleging that they made false or misleading statements about the company's COVID-19 vaccine development and its ability to manufacture it. *McDermid v. Inovio Pharms.*, 2021 WL 601159 (E.D. Pa. 2021) (Pappert, J.). The court held that scienter was pled with the requisite particularity concerning the CEO's various statements that the company had constructed, not merely designed, a vaccine within hours based on the CEO's background and experience in the pharmaceutical industry and his consistent use of the term "construct."

Defendants' Motion to Dismiss Arguments

Defendants sought to dismiss plaintiffs' claims based on the CEO's "vaccine construction statements because they failed to state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." Plaintiffs alleged that there was a significant difference between "constructing" and "designing" a vaccine "because a vaccine construct is an actual vaccine, not a mere design of one." Defendants argued that plaintiffs failed to allege that the CEO "intended to deceive when he said construct instead of design, and even if they had, such a claim would be implausible because the terms are synonymous."

The Court Weighs the CEO's Specialized Background and Experience

The court held that plaintiffs "have pled scienter with the requisite particularity." The court noted that plaintiffs "detail [the CEO's] background and experience in the pharmaceutical industry, which strongly suggest he would understand the difference between constructing and designing a vaccine (taking as true [p]laintiffs' allegation that these terms have distinct meanings in this context)." The CEO's "extensive" experience included having worked in vaccine development at a different well-known pharmaceutical company, publishing more than 100 scientific papers, holding numerous patents, and sitting on editorial boards and scientific review panels. The court pointed out that that plaintiffs also allege that "not only did [the CEO] claim [the company] 'constructed' its vaccine in three hours several times during a televised interview, he took the claim a step further when speaking with then-President Trump on television, claiming [the company] had 'fully constructed' its vaccine in three hours." The court stated that "[c]onsistent usage of 'construct' and the heightened claim that the company had 'fully constructed' the vaccine support a strong inference of scienter." The court reasoned that "[e]ven if [d]efendants' claim that [the CEO] consistently used 'construct' because he thought it was synonymous with 'design' raises a plausible inference that he did not act with scienter, that inference is no more plausible than the inference raised by [p]laintiffs' allegations."

Southern District of New York: No Duty to Disclose Risk of a "#MeToo Reckoning" Where Plaintiff Failed to Allege Risk Was Concrete and Substantial

On February 3, 2021, the Southern District of New York dismissed a securities fraud class action against a restaurant company and two of its former executives, which alleged that they made misrepresentations and omissions regarding the company's culture where the defendant executives and other non-party executives allegedly sexually harassed the company's employees and "cultivated a toxic

workplace culture." *Okla. Law Enf't Ret. Sys. v. Papa John's Int'l*, 2021 WL 371401 (S.D.N.Y. 2021) (Wood, J.). The court held that plaintiff failed to plausibly allege that the "positive assurances about the [c]ompany's culture exceeded the protected bounds of generic puffery" or to plausibly allege that "the risk that [the company] would face a #MeToo reckoning was so concrete and substantial that there arose an affirmative duty to disclose it."

Background

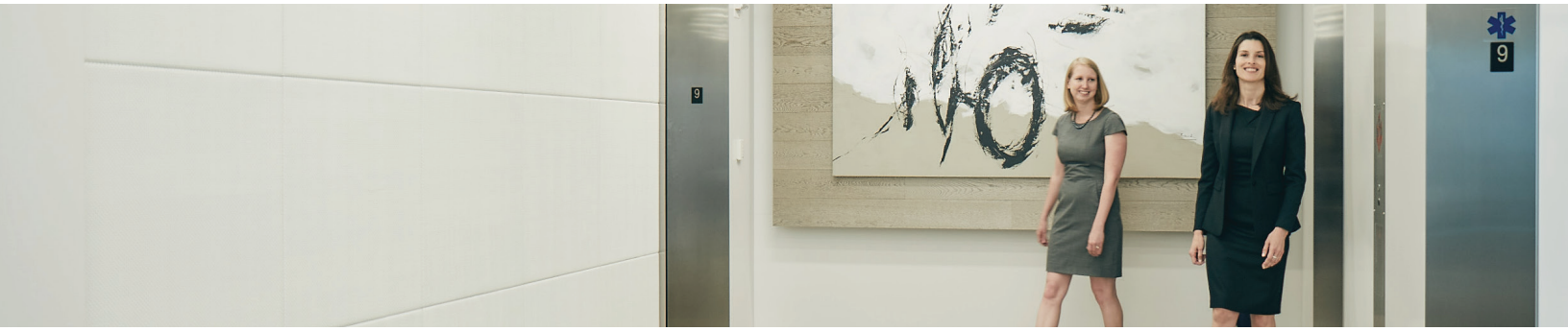
One of the two executive defendants in this case was the company's founder who held various high-level positions in the company over his tenure, including CEO. The founder's name and likeness were central to the company's brand, and he frequently appeared in its advertisements. Beginning in 2017, defendants "faced a range of negative publicity." For example, in 2018 *Forbes* published an article in which numerous unnamed, former employees described "disturbing instances of workplace sexual harassment and misconduct" by senior executives.

Risks Had Not Already Materialized Where Allegations Were "General and Conclusory"

The court held that the risk disclosures in the company's SEC filings were not misleading. Plaintiff alleged that when the company filed its 2016 and 2017 annual reports on form 10-K, its "risk disclosures were misleading (*i.e.*, the risks identified had already materialized) because the #MeToo movement was well underway and because [d]efendants had knowledge of their own misconduct and the hostile and unlawful work environment at [the company] at the time." The court held that, "even drawing all inferences in favor of [p]laintiff, its allegations still fail to show that the risks described above had already materialized at the time the [c]ompany filed its 2016 and 2017 10-K statements." The court explained that plaintiff "fail[ed]—again—to specify *when* the [c]ompany failed to comply with labor laws (and what these labor laws were), *when* the [c]ompany's executives engaged in misconduct, and *when* their harassing behavior became widely known (including to those individuals who had the power to fire them)." The court described plaintiff's claims about the influence of the #MeToo movement and plaintiff's claims that the defendant executives "were aware of and were fueling an unlawful workplace culture" as "general and conclusory."

No Duty to Disclose Uncharged, Unadjudicated Wrongdoing

Plaintiff also alleged that the founder engaged in "illegal and unethical sexual behavior, resulting in at least two confidential settlements." Citing *City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS,* 752 F.3d 173 (2d Cir. 2014), which stated that "companies do not have a duty to disclose uncharged, unadjudicated wrongdoing," the court determined that "[t]his allegation suffers from the same flaw as [p]laintiff's other general and conclusory allegations: it does not amount to anything more than uncharged, unadjudicated wrongdoing." Additionally, quoting from a recent case where a prominent media company executive also faced #MeToo allegations, the court stated that "[e]ven if the risk that [the company's] executives would be disgraced or fired increased with the expanding influence of the #MeToo movement, 'an increase in a risk does not mean the risk has already come to pass, such that a disclosure that simply identifies the risk would be misleading.'" Quoting *Constr. Laborers Pension Tr. v. CBS*, 433 F. Supp. 3d 515 (S.D.N.Y. 2020).



Southern District of New York: Accounting Firm Did Not Ignore "Red Flags" Where It Disclosed That Its Audit Report Could No Longer Be Relied Upon

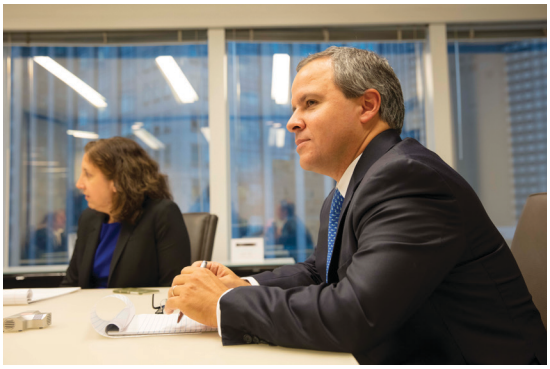
On February 23, 2021, the Southern District of New York granted certain defendants' motions to dismiss the third amended complaint in a putative securities fraud class action alleging that they made misstatements arising out of a company's initial public offering materials and subsequent financial statements. *Xu v. Gridsum Holding*, 2021 WL 773002 (S.D.N.Y. 2021) (Ramos, J.). With respect to the company's former accounting firm, the court held that scienter was not adequately alleged because plaintiffs failed to plead facts suggesting that the firm's audit was so deficient as to effectively be no audit at all, or that it ignored "red flags" that were so obvious that it must have been aware of fraudulent behavior.

Plaintiffs' Fraud Allegations

The defendant auditor in this case prepared audit opinions in connection with the company's 2015 and 2016 financial statements. With respect to the 2016 opinion, plaintiffs alleged that the auditor was "liable for fraud based on its statement that the accompanying financial documents present fairly, in all material respects, the financial position of [the company]," and its statement that it "conducted its audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board." Plaintiffs further argued that certain audit procedures were not performed.

Applicable Standard for Holding an Auditor Liable for Fraud

The court held that plaintiffs did not adequately allege scienter. The court explained that "Section 10(b) and Rule 10b–5 require plaintiffs to allege a state of mind demonstrating an intent to deceive, manipulate or defraud, also known as scienter." Further, "[u]nder Rule 9(b) and the PSLRA, a plaintiff must allege facts leading to a 'strong inference' of scienter." The court explained that a plaintiff can "either alleg[e] facts showing that the defendants had both motive and opportunity to commit the fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness." Citing Second Circuit precedent, the court explained that "to hold an auditor liable for fraud, such circumstantial allegations [of conscious misbehavior or recklessness] must, in fact, approximate an actual intent to aid in the fraud, such as conducting an audit so deficient as to amount to no audit at all, or disregarding signs of fraud so obvious that the defendant must have been aware of them." The court held that plaintiffs failed to meet this standard and further, alleged no facts showing that the auditor had any motive to perpetuate fraud.



Auditor Did Not Ignore Red Flags Where It Identified and Raised Internal Control Issues

On the issue of whether the auditor ignored red flags, the court stated that plaintiffs "allege facts suggesting that [the auditor] eventually did identify and raise several internal control issues relevant to this case." The court ruled "[i]n light of this, [p]laintiffs do not plead facts supporting a strong inference that [the auditor] must have been aware of, and ignored, red flags." The court noted that plaintiffs "allege that [the auditor] informed [the company] that its 2016 Audit Report could no longer be relied upon because, over the course of the following year's audit, [the auditor] identified issues relating to certain revenue recognition, cash flow, cost, expense items, and their underlying documentation that [it] had previously raised with the Company." The court continued that the company "later revealed that [the auditor] had stated that these issues raised questions related to its ability to rely on the representations of management."

Countervailing Facts Offset Auditor's Alleged Failure to Perform an Auditing Procedure

Noting plaintiffs' argument that "in the course of the 2016 audit [the auditor] still failed to perform a basic audit cutoff procedure to reconcile vendor statements with [c]ompany-recorded invoices, despite knowing of [the company's] internal control weaknesses", the court determined that "[w]hile this allegation, in a vacuum, might constitute evidence that [the auditor] ignored a 'red flag,' it is not enough to offset the countervailing facts in the record that undermine a strong inference of scienter." The court determined that these countervailing facts distinguished this case from the "red flag" cases cited by plaintiffs. For example, the court described the red flags in *Varghese v. China Shenghuo Pharm.*, 672 F. Supp. 2d 596 (S.D.N.Y. 2009), as "more severe and voluminous, and not undermined by other alleged conduct by the auditor." The court concluded by stating "[o]n the whole, [p]laintiffs' allegations support the inferences that [the] 2016 audit opinion was deficient, even negligent, and that [the auditor] likely did not perform procedures that it should have. But they do not support the inference that these errors were done fraudulently."

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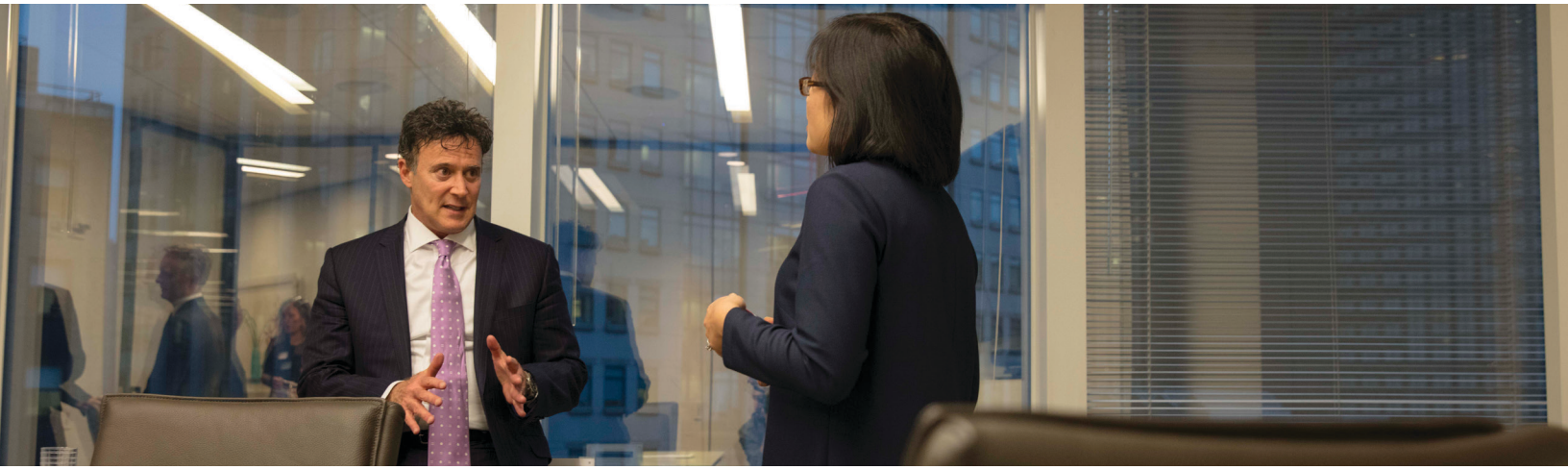

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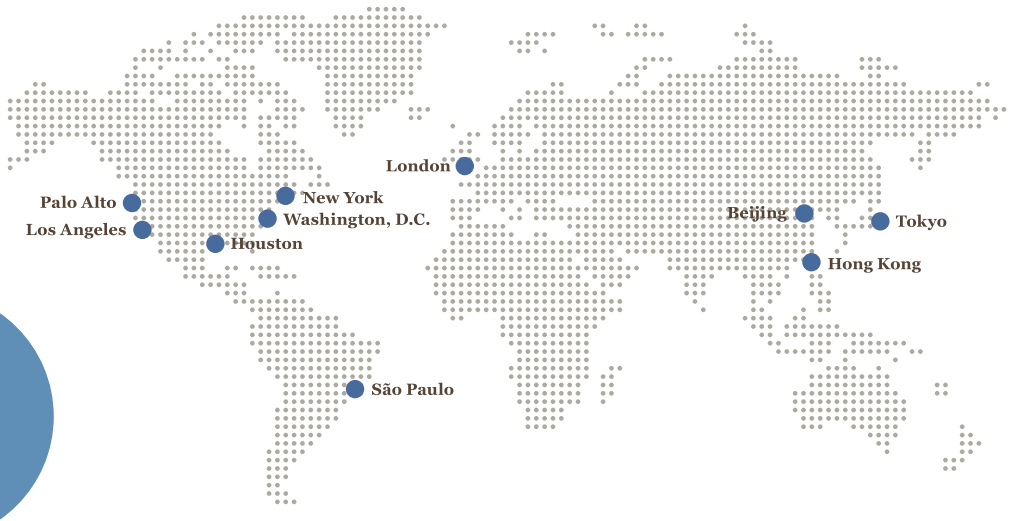

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