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Securities Law Alert

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– Chambers USA

Eleventh Circuit: Solicitation of Unregistered Securities Under Section 12 Can Occur Through Online Videos, Including on Social Media

On February 18, 2022, the Eleventh Circuit reversed the district court's dismissal of a class action alleging that the promoters of a new cryptocurrency violated Section 12 of the Securities Act by soliciting the purchase of unregistered securities through online videos. *Wildes v. BitConnect*, 25 F.4th 1341 (11th Cir. 2022) (Grant, J.). The court held that neither the Securities Act nor Eleventh Circuit precedent restrict liability to sales pitches to individual people, while excluding liability for communications directed to the public at large. Noting that solicitation has long occurred through other mass communications, the court determined that solicitation under Section 12 can occur through online videos.

Background

This case arose from an online lending platform where users could trade their digital currency for the platform's native token—a new cryptocurrency—and earn interest based on their token holdings. Promoters of the cryptocurrency posted thousands of videos online, on independent websites as well as social media, urging people to buy the new cryptocurrency. The videos were viewed millions of times.

Following scrutiny by state regulators, the trading platform closed, and the value of the cryptocurrency fell by almost 90%. Subsequently, buyers of the cryptocurrency sued alleging that the promoters of the cryptocurrency were liable under Section 12 of the Securities Act for soliciting the purchase of unregistered securities through their videos. The promoters moved to dismiss, arguing that their videos did not "directly communicate" with plaintiffs and that "the Securities Act covers sales pitches to particular people, not communications directed to the public at large." The district court dismissed, concluding that plaintiffs failed to state a Section 12 claim because they based their case on interactions with the promoters' "publicly available content" and that they needed to allege that the promoters had "individually" urged plaintiffs to purchase the cryptocurrency.

Promoting a Security in a Mass Communication Is Solicitation

The Eleventh Circuit framed the issue as "whether a person can solicit a purchase, within the meaning of the Securities Act, by promoting a security in a mass communication." The court began its analysis by noting that "nothing in the Securities Act makes a distinction between individually targeted sales efforts and broadly disseminated pitches." The court continued that Section 12 authorizes buyers of an unregistered security to sue a person who "offers or sells" it. Under the Securities Act, "a person offers a security every time he makes an offer to dispose of—or a solicitation of an offer to buy—a security for value." The court noted that Congress did not limit solicitations to "personal" or individualized ones as the district court did. Pointing out that the Securities Act suggests the opposite, the court explained that the Securities Act "makes a person who solicits the purchase of an unregistered security liable for using 'any means' of communication[,]" which the Securities Act defines to include radio and television advertisements. The court further stated that "Securities Act precedents do not restrict solicitations under the Act to targeted ones." The court noted that the Eleventh Circuit has "never added that those efforts at persuasion must be personal or individualized."

Solicitation Under the Securities Act Encompasses "New Means of Solicitation"

The Eleventh Circuit took issue with the district court's "cramped" reading of the Securities Act, which under its interpretation would hold a seller liable for recommending a security in a personal letter but not "for making the exact same pitch in an internet video—or through other forms of communication listed as exemplars in the Act, like circulars, radio advertisements, and television commercials." The court declined to adopt an approach that would allow a seller to dodge liability by selecting one means of communication over another, particularly where the Act expressly covers "any means" of communication. Determining that a "new means of solicitation is not any less of a solicitation[,]" the court concluded that when the promoters urged people to buy the cryptocurrency in online videos, they solicited the purchases that followed.

Northern District of California: Denies Dismissal Concerning Tech Company's Claim That It Offered End-to-End Encryption

On February 16, 2022, the Northern District of California dismissed claims in a securities fraud class action against a tech company and its CEO based on 14 alleged false and misleading statements and omissions regarding the company's operations and its collection and use of users' personal data. *In re Zoom Sec. Litig.*, 2022 WL 484974 (N.D. Cal. 2022) (Donato, J.). However, the court denied dismissal regarding defendants' statement that the company offered end-to-end encryption. As to this statement, the court determined that plaintiff satisfied the falsity element by alleging that defendants represented that the company offered "end-to-end encryption" when it did not.

The statement at issue appeared in the company's April 2019 Registration Statement and Prospectus, which stated, "We offer robust security capabilities, including end-to-end encryption[.]" Plaintiff claimed this statement violated Section 10(b) by making false and misleading statements and omissions concerning the ability to use end-to-end encryption in the company's main product offering.

Determining that plaintiff satisfied the falsity element for this statement, the court pointed to plaintiff's allegation that "end-to-end encryption means that not even the company that runs the messaging service can access the cryptographic keys necessary to decrypt the end users' communication," while the company "secretly maintained access to the cryptographic keys that could allow [it] to decrypt and decipher the communications between the end users."

Defendants argued that plaintiff's falsity allegations were insufficient because the term "end-to-end encryption" can have different meanings. The court, however, rejected this argument, explaining that defendants' own statements, as alleged in the complaint, demonstrated otherwise. In a company blog post, the CEO stated that, "we recognize that we have fallen short of the community's—and our own—privacy and security expectations." The CEO's post also referred and linked to a post by the company's Chief Product Officer stating "we want to start by apologizing for the confusion we have caused by incorrectly suggesting that [our] meetings were capable of using end-to-end encryption. While we never intended to deceive any of our customers, we recognize that there is a discrepancy between the commonly accepted definition of end-to-end encryption and how we were using it."

The court observed that plaintiff's allegations distinguish this case from *Wochos v. Tesla,* 985 F.3d 1180 (9th Cir. 2021).[1] In *Wochos*, the Ninth Circuit found that plaintiffs pleaded no facts to support their premise that the term "production car" had the distinctive and false meaning that plaintiffs claimed it did. By contrast, the court stated that here plaintiff identified defendants' "express acknowledgement" that they had "incorrectly suggested" their product was capable of using end-to-end encryption, and they had used the term end-to-end encryption "differently from the commonly accepted definition."

1. Please click here to read our discussion of the Ninth Circuit's decision in *Wochos v. Tesla*.

Court of Chancery of Delaware: Creditor Deemed a Controller by Dint of Its Voting Power and Consequently Owed Stockholders a Duty of Loyalty

On February 28, 2022, the Court of Chancery of Delaware denied dismissal of a breach of fiduciary duty claim in a putative class action brought by a target company's former stockholders against the target's largest creditor, which had threatened to block the target's pending SPAC merger unless the target's board agreed to a series of amendments to debt and warrant agreements. [*Blue v. Fireman*, 2022 WL 593899 (Del. Ch. 2022) (Zurn, V.C.)]. The court concluded that plaintiffs sufficiently pled that the creditor was the target's controller by virtue of its voting power and, therefore, owed the target's stockholders a duty of loyalty. The court further determined that plaintiffs pled that the creditor breached that duty by refusing to

vote its proxy in favor of the merger unless it received the amendments it sought.

Background

In 2020, around the time the target was negotiating the key terms of its pending merger with a SPAC, its largest creditor demanded favorable amendments to debt and warrant agreements. The creditor controlled 83% of the target's voting power through an irrevocable proxy. After the target board unanimously approved the merger documents, the creditor declared that it would not vote its proxy in favor of the merger unless its demands were met. The target board went on to approve the amendments and announced the merger, which was valued at approximately $120 million. Plaintiffs, former target stockholders, commenced this action alleging breach of fiduciary duty, among other claims, against the creditor and its affiliates as controllers, and certain directors the creditor had appointed to the target's board. Plaintiffs alleged that as a result of the amendments, $40 million in merger consideration was diverted from the target's stockholders to the creditor. Defendants moved to dismiss.

Plaintiffs' Breach of Fiduciary Duty Claim Was Direct

As a threshold matter, the court determined that plaintiffs' claims were direct, not derivative, such that plaintiffs' standing was not extinguished by the merger. Referencing longstanding Delaware precedent, the court specifically determined that plaintiffs' breach of fiduciary duty claim was direct because

it alleged that the merger was unfair due to the improper, material diversion of merger proceeds from the stockholders to the creditor.[2]

The court explained that plaintiffs alleged that the board's decision to approve the amendments diverted merger proceeds to a controller—the creditor—in a way that "tainted the merger's fairness and materially reduced the merger consideration for [the target's] other stockholders." The court also found that the timing of the amendments with respect to the merger negotiations indicated the diverted consideration would have otherwise gone to the stockholders, which called the merger's fairness into question. As to whether the diversion was improper, the court noted that the creditor "was able to wield its influence to extract a benefit for itself at the expense of [the target's] stockholders." The court pointed out that even though the creditor did not actually use its proxy to block the merger, it "does not mean its threats to do so are not improper."

Plaintiffs Pled the Creditor Is a Controller

The court determined that plaintiffs pled that the creditor, standing alone, was a controller that owed fiduciary duties to the target stockholders. The court explained that "[o]ne method of pleading control sufficient to impose fiduciary duties is to allege that a defendant has the ability to exercise a majority of the corporation's voting power." Quoting *Voigt v. Metcalf,* 2020 WL 614999 (Del. Ch. Feb. 10, 2020). The court continued that "Delaware law is well-settled that a stockholder who can exercise more than 50% of a company's voting power is a controller." The court emphasized that in this case the creditor held both debt and its irrevocable proxy; that it was inconsequential that the creditor secured its voting power via the creditor-debtor relationship; and that the creditor had control because it could vote most of the target's stock, not because it held most of the target's debt.

2. "*Golaine* [*v. Edwards*, 1999 WL 1271882 (Del. Ch. 1999)], as applied in *Houseman, Straight Path,* and *Komen*, instructs that to be direct, the side transaction must divert merger consideration from stockholders, rather than from the acquirer; the diversion must be 'improper,' that is, the product of misconduct by the defendants; and the diversion must materially affect the merger's process or price, calling the merger's fairness or validity into question."

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The court then determined that defendants did not meaningfully dispute that plaintiffs pled that the target's fiduciaries breached their duties. Specifically, the court determined that plaintiffs pled breaches in the director defendants' decision to approve the amendments and in the creditor's role in causing the amendments to be approved. The court further stated that the creditor's procurement of the amendments triggered entire fairness review. The court stated that "[h]ere, as in *Straight Path*, [the creditor] competed with [the target's] common stockholders by extracting a different benefit (the Amendments) out of the Merger consideration."[3]

Notably, the court stated that whether entire fairness should apply to the merger or only the amendments was not entirely clear from the existing case law and requested supplemental briefing on the scope of the creditor's burden under entire fairness.

3. *In re Straight Path Commc'ns Consol. S'holder Litig.*, 2018 WL 3120804 (Del. Ch. June 25, 2018).

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