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Securities Law Alert

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– *Chambers USA* (quoting a client)

Ninth Circuit: Applies *Omnicare* Standard to Pleading Falsity of Opinion in Section 14(a) Claims

On April 20, 2021, the Ninth Circuit affirmed the dismissal of a putative securities class action alleging misrepresentations and omissions in a proxy statement used to secure shareholder approval for the sale of the defendant company in violation of Section 14(a), Section 20(a) and Rule 14a-9. *Golub v. Gigamon*, 2021 WL 1539954 (9th Cir. 2021) (Wardlaw, J.).[1] The court held that it would apply the standards for actionability for falsity under Section 11 explained in *Omnicare v. Laborers District Council Construction Industry Pension Fund*, 575 U.S. 175 (2015), to falsity of a statement of opinion under SEC Rule 14a-9 through either a misrepresentation-of-material-fact theory or an omission-of-material-fact theory.

Background

Plaintiff claimed that the company, its CEO, and its board violated Section 14(a) and SEC Rule 14a-9 when they released a materially false and misleading proxy statement to obtain stockholder support for a proposed sale of the company, allegedly at an undervalued price. Plaintiff alleged that the proxy statement contained misrepresentations of fact and omissions that made certain statements of opinion in the proxy statement false or misleading. Defendants moved to dismiss both plaintiff's initial and amended complaints. The district court granted both motions to dismiss, in part, because plaintiff failed to plead an actionably false misrepresentation or omission. Plaintiff appealed the dismissal.

Omnicare Standards for Pleading Falsity of Opinion Via Either a Misleading Representation or Omission Apply to Section 14(a) Claims

Beginning its discussion of the applicable standard, the court explained that Rule 14a-9 prohibits any statement which, under

1. The Ninth Circuit's discussion of the applicable standard appeared in this published opinion, while its application of the standard to the instant facts appeared in an unpublished memorandum. *See Golub v. Gigamon*, No. 19-16975, 2021 WL 1554439 (9th Cir. 2021).

the circumstances, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements not false or misleading. The court further explained that despite Rule 14a-9's use of the word "fact" it also permits "a plaintiff to plead and prove false the 'statements of reasons, opinions, or beliefs' of a company's directors[.]" Quoting *Va. Bankshares v. Sandberg*, 501 U.S. 1083 (1991). The court then pointed out that the Ninth Circuit has not addressed how *Omnicare* affects claims alleging falsity of an opinion under Rule 14a-9. The court explained that in *Omnicare*, "the Supreme Court examined the standards for alleging falsity of an opinion under [S]ection 11[.]" The Ninth Circuit then referenced its recent decision in *Wochos v. Tesla*, 985 F.3d 1180 (9th Cir. 2021), discussing *Omnicare* and summarizing the three ways that "a statement of opinion may nonetheless involve a representation of material fact that, if that representation is false or misleading, could be actionable." Specifically: (1) "every statement of opinion explicitly affirms one fact: that the speaker actually holds the stated belief"; (2) "some sentences that begin with opinion words like 'I believe' contain *embedded* statements of fact"; and (3) "a reasonable investor may, depending on the circumstances, understand an opinion statement to convey facts about how the speaker has formed the opinion—or, otherwise put, about the speaker's basis for holding that view." Citing *Wochos*, the court explained that "[s]uch a statement could potentially give rise to liability under an omission theory if the facts conveyed in that fashion are untrue, as would be apparent based on a more fulsome disclosure."

The court observed that "the district court hesitated to extend *Omnicare*'s discussion of how *omissions* can render a statement of opinion false or misleading to the Rule 14a-9 context without our explicit approval." Providing such approval, the court stated that "we hold that *Omnicare*'s standards for pleading falsity of opinion—via either a misleading representation or omission—apply to claims arising under [S]ection 14(a), as implemented by Rule 14a-9." The court concluded "that *Omnicare*'s elucidation of what 'facts' a statement of opinion may convey and the possibility and manner of proving those 'facts' false or misleading through an omission theory applies to the Rule 14a-9 context."

The Ninth Circuit summarily dealt with plaintiff's allegations in a separate unpublished memorandum concluding that, with respect to the alleged misrepresentations and omissions in connection with statements of opinion, plaintiff failed to allege falsity or to overcome the PSLRA's safe harbor. *Golub v. Gigamon*, No. 19-16975, 2021 WL 1554439 (9th Cir. 2021).

Ninth Circuit: Joins Other Circuits in Holding That Reliance on General Economic Principles Without More Is Not Enough to Plead a Duty-of-Prudence Violation Under *Fifth Third*

On April 19, 2021, the Ninth Circuit affirmed the dismissal of a putative class action alleging that an employee stock ownership plan ("ESOP") fiduciary breached his duty of prudence because he knew that the company's stock price was artificially inflated by undisclosed information concerning the company's *ex parte* communications with regulators, yet he failed to disclose the information promptly, which would have allowed the company's stock price to correct and mitigate the harm to the plan participants. [*Wilson v. Craver*, 2021 WL 1523253 (9th Cir. 2021) (Murguia, J.)](). The court held that plaintiff failed to state a claim for breach of the duty of prudence consistent with the standard announced in *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409

(2014), because plaintiff offered no context-specific allegations explaining why an earlier disclosure would be so clearly beneficial that a prudent fiduciary could not conclude that it would be more likely to harm the fund than to help it. The court further held that relying on general economic principles (that the longer a fraud is concealed, the greater the harm to the company's reputation and stock price), without more, was not enough to plead a duty-of-prudence violation, agreeing with the Second, Fifth, Sixth and Eighth Circuits.

The Court Sets Forth the *Fifth Third* Pleading Standard

The court stated that the "sole issue on appeal is whether [p]laintiff plausibly alleged a duty-of-prudence claim under the pleading standard announced in *Fifth Third*[.]" To allege a duty-of-prudence claim against an ESOP fiduciary under the *Fifth Third* pleading standard, "a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it." Referring to *Fifth Third*, the court explained that this is a context-specific inquiry, focused on the circumstances prevailing at the time that the fiduciary acts.

Plaintiff Claimed the District Court Applied an Impossible Standard

On appeal, plaintiff asserted that the district court applied an "impossible standard" and held that plaintiff "failed to state a duty-of-prudence claim solely because the proposed alternative—a corrective disclosure—would have caused a drop in [the company's] stock price." However, the Ninth Circuit stated that plaintiff "mischaracterizes the district court's order[]" and clarified that the district court "concluded that [p]laintiff's [second amended complaint] failed to include context-specific allegations plausibly explaining why a prudent fiduciary in [d]efendants' position 'could not have concluded' that a corrective disclosure would do more harm than good to the Stock Fund." The court summarized plaintiff's theory to be that no reasonable fiduciary could conclude that disclosing the truth would do more harm than good because "'the longer that corrective disclosure was delayed, the greater the negative price impact would be once disclosure finally occurred[]'" and that "'the longer [the] fraud went on, the more damage would be done to [the company's] reputation when the truth emerged.'"

Generic Economic Principles Not Enough to Plead Duty-of-Prudence Violations

Citing decisions from the Second, Fifth, Sixth and Eighth Circuits, the court observed that "nearly every court to consider duty-of-prudence claims post *Fifth-Third* has rejected the notion that general economic principles, such as those [p]laintiff relied on, are enough on their own to plead duty-of-prudence violations." The court pointed out that this "consensus is consistent with *Fifth Third*'s call for context-specific allegations and the Supreme Court's stated intent to provide some protection from meritless claims." The court held that "we join our sister circuits in concluding that the recitation of generic economic principles, without more, is not enough to plead a duty-of-prudence violation." The court further held that "where general economic principles are alleged, the complaint must also include context-specific allegations explaining why an earlier disclosure was so clearly beneficial that a prudent fiduciary could not conclude that it would be more likely to harm the fund than help it." The court concluded that the "district court did not err in requiring the same."

Northern District of Illinois: Items 105 and 303 Impose a Duty to Disclose an Alleged Years-Long Bribery Scheme as Regulatory Noncompliance

On April 21, 2021, the Northern District of Illinois denied dismissal of a putative securities fraud class action that alleged that an electric company, its subsidiary and certain executives made false and misleading statements and omissions that concealed an eight-year scheme to bribe state lawmakers to pass favorable legislation. *Flynn v. Exelon*, 2021 WL 1561712 (N.D. Ill. 2021) (Kendall, J.). While recognizing that the Seventh Circuit has not held that Items 105 and 303 of Regulation S-K impose a duty to disclose any regulatory noncompliance, the court held that plaintiff sufficiently alleged that defendants had a duty to disclose their alleged bribery scheme under Items 105 and 303 and failed to do so.

Disclosure Requirements Under Items 105 and 303

Defendants argued that they were not under a general duty to disclose, whereas plaintiff argued that Items 105 and 303 of SEC Regulation S-K impose a duty to disclose any regulatory noncompliance. The court stated that "Item 303, which sets forth disclosure requirements for Forms 8-K and 10-Q, requires disclosure of 'any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.'" Citing the regulation, the court also explained that "'Item 105 requires disclosure of the most significant factors that make an investment in the registrant or offering speculative or risky.'"

Defendants Had a Duty to Disclose Their Alleged Bribery Scheme Under Items 105 and 303

The court observed that although the Seventh Circuit has yet to rule on the issue, a line of recent Northern District of Illinois cases have held that Items 105 and 303 of SEC Regulation S-K impose a duty to disclose any regulatory noncompliance in its SEC forms. The court then held that plaintiff "sufficiently alleged that [d]efendants had a duty to disclose their alleged bribery scheme under Items 105 and 303 and that they failed to do so."

The court pointed out that plaintiff specifically alleged how defendants plausibly had a duty to disclose under Items 105 and 305. With respect to Item 105, plaintiff alleged that the company's 2018 Form 10-K and Forms 10-Q for the first two quarters of 2019 "failed to discuss the following significant factors that made investment in [the company] risky: that [the company] and [the subsidiary] faced substantial risk of criminal penalties, and substantial risk that proposed and future favorable legislation would be compromised, due to the [c]ompany's changed strategy from legal lobbying to an eight-year illegal and undisclosed bribery scheme[.]"

With respect to Item 303, plaintiff alleged that the same SEC forms "failed to disclose material trends, events, and uncertainties known to management that were reasonably expected to have a material adverse effect on the [c]ompany's resources and results of operations, namely that: the [c]ompany faced substantial risk of criminal penalties due to the [c]ompany's changed strategy from legal lobbying to an eight-year illegal and undisclosed bribery scheme[.]" As to this topic, the court concluded that plaintiff "sufficiently alleged that [d]efendants had a duty to disclose their alleged bribery scheme under Items 105 and 303 and that they failed to do so."

Southern District of Texas: Denies Dismissal of Class Action Alleging Defendants Made Misrepresentations to Obtain Shareholder Approval for a De-SPAC Transaction

On April 14, 2021, the Southern District of Texas denied the dismissal of a securities fraud class action alleging that defendants made a series of misrepresentations to induce plaintiff investors to vote for a de-SPAC transaction. [*Camelot Event Driven Fund v. Alta Mesa Res.*, 2021 WL 1416025 (S.D. Tex. 2021) (Hanks, J.)]. The court held that plaintiffs pled sufficient facts to establish claims under Sections 10(b), 14(a) and 20(a) where the company formed by the SPAC disclosed a $3.1 billion write-down less than one year after its first 10-K was filed. Notably, the court denied the dismissal as to all defendants, including executives and directors of the post-merger company, two executives at the SPAC that became the post-merger company, and four business entities, including the SPAC sponsor, which were alleged to be control entities.

Background

After its IPO in March 2017, the SPAC in this case identified two oil-and-gas companies, an upstream company and a midstream company, for acquisition. The target companies, though nominally separate, were "deeply intertwined" with overlapping owners and interconnected operations. The SPAC's stockholders voted to approve the merger in February 2018 and the merger closed.

Plaintiffs' Allegations

Plaintiffs alleged that, prior to the merger, defendants intentionally overstated the value of the assets that were acquired in the merger. Plaintiffs alleged that defendants used misleading reserve and financial projections to overstate the value of the target companies to secure the SPAC shareholders' approval of the merger.

The Court's Findings

After a lengthy recitation of the events following the merger, the court found that the company's SEC filings and other disclosures "indisputably show that [the company] experienced a massive drop in value during its brief time on the NASDAQ, to the point where the company wrote down over 80% of its market value after its first year in existence and where assets valued at $3.8 billion at the time of the special purpose acquisition company merger sold for, at most, $320 million in a bankruptcy proceeding two years afterward." The court found that it was "also indisputable that, toward the end of its short lifespan, [the company] acknowledged serious, systemic deficiencies in its financial reporting that created a reasonable possibility that a material misstatement of the company's annual or interim financial statements would not have been prevented or detected on a timely basis." Additionally, these reporting deficiencies triggered an ongoing SEC investigation.

Sufficient Facts Pled to Establish Claims Under Sections 10(b), 14(a) and 20(a)

The court stated that plaintiffs have "detailed numerous statements by various defendants from SEC filings, press releases, conferences, and earnings calls[,]" and determined that the "circumstances surrounding the company's financial reporting . . . are alone enough to entitle [p]laintiffs to discovery." In support of holding that plaintiffs pled sufficient facts to establish a Section 10(b) claim, the court noted that the 12 executive and director defendants all signed its first 10-K, which was filed less than two months after the SPAC merger closed. The court observed that less than a year after that 10-K was filed, the company disclosed a $3.1 billion dollar write-down and that it was unable to file its annual report on time because it expected to report material weakness in its internal control over financial reporting in the 2018 Form 10-K. The company also "confirmed that it expected to report a net loss of $3.1 billion for the year ended December 31, 2018 because of the write-down." The court held that "[u]nder the circumstances, the enormity of the write-down over such a short period of time is enough for the case against these defendants to proceed." The court further determined that plaintiffs "have pled facts sufficient to show that the defendants who signed the March 29, 2018 10-K acted with the requisite severe recklessness under Section 10(b). The same circumstances also satisfy the pleading standard for claims related to the [p]roxy under Section 14(a)[.]"

Further, the court concluded that plaintiffs pled sufficient facts to establish a claim under Section 20(a), where plaintiffs alleged "a complex web of securities ownership, contracts, business relationships, interlocking directors, and other factors that satisfies the 'relaxed and lenient pleading standard for evaluating whether a plaintiff has sufficiently alleged a claim for control person liability.'" Quoting *One Longhorn Land I, L.P. v. Defendant FF Arabian, LLC*, 2015 WL 7432360 (E.D. Tex. 2015).

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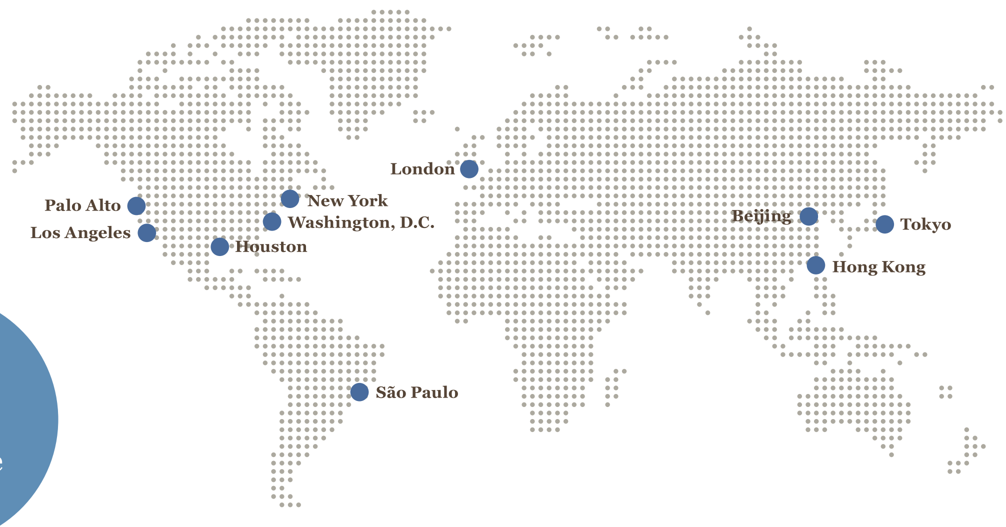

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