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Securities Law Alert

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– Chambers USA

Southern District of New York: Extensive and Reasonably Specific Warnings in Offering Materials Constituted a Real Warning to Investors

On April 25, 2022, the Southern District of New York dismissed a putative securities fraud class action against a China-based, U.S.-listed technology company and certain of its employees and directors alleging that the company's offering materials contained false and misleading statements and omitted material facts in violation of Sections 11 and 15 of the Securities Act. *Yaroni v. Pintec Tech.*, 2022 WL 1215450 (S.D.N.Y. 2022) (Furman, J.). The court held that plaintiff failed to allege that the offering materials contained misrepresentations and omissions as to the company's internal controls because the controls-related warnings were extensive and reasonably specific, not generic or boilerplate, such that they constituted a real warning to investors. The court further determined that plaintiff failed to allege facts suggesting that the company knew or should have known about the internal control weaknesses at the time of the IPO.

Within months of the company's IPO, the price of its American Depositary Shares ("ADSs") declined sharply. Subsequently, the company's ADS price also fell following both the delayed filing of its 2018 Annual Report on Form 20-F and negative company disclosures. Plaintiff sued claiming that defendants made material misstatements or omissions in the company's offering materials on various subjects,[1] including the company's internal controls. Plaintiff alleged that the warnings in the offering materials on "the *potential* risk of ineffective internal controls over financial reporting and the *possible* restatement of prior financial statements were improper because these harms had already materialized as of the IPO."

1. Plaintiff claimed that defendants made material misstatements or omissions concerning: (1) the company's internal controls, its audit committee, and auditor; (2) cash loans made to its former parent company outside the ordinary course of business; (3) a loan made to another company; (4) the company's revenue recognition practices; and (5) certain line items in the company's financial statements.

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The court concluded that each claim failed as a matter of law. As to the internal controls allegations, the court explained that under *In re ProShares Trust Sec. Litig.*, 728 F.3d 96 (2d Cir. 2013), "when a registration statement warns of the exact risk that later materialized, a section 11 claim will not lie as a matter of law." The court determined that the warnings in the offering materials about the company's internal controls constituted a real warning. The court pointed out that, at the time of the IPO, the company did state that: (i) it had limited accounting personnel and warned that management had not completed an assessment of the effectiveness of its internal controls; (ii) its auditor had not audited its internal controls; (iii) a limited audit identified a material weakness (the company lacked sufficient financial reporting and accounting personnel with appropriate knowledge of GAAP and SEC reporting requirements); and (iv) it might identify additional material weaknesses in the future and that it might be required to restate its financial statements.

The court observed that "critically, to the extent the Complaint alleges that the warned-of risks had materialized, it does not allege that [the company] knew or should have known of that fact at the time of the IPO."

Southern District of New York: Disclosing Some Inexperience Does Not Create a Duty to Disclose All Inexperience

On May 3, 2022, the Southern District of New York denied dismissal of all claims in a putative securities fraud class action alleging that an investment company, its subsidiaries, and its president/co-founder failed to disclose material information about the company's investment opportunities in violation of Section 10(b), among other claims.[2] *Tecku v. Yieldstreet*, 2022 WL 1322231 (S.D.N.Y. 2022) (Marrero, J.). Notably, while the court determined that some allegations survived the motion to dismiss, the court was not persuaded that highlighting inexperience in some areas created a duty to disclose all inexperience.

The defendant investment company offered investment products mainly consisting of debt instruments, such as the company's "Marine Finance" line of investment products. This line of products involved the company loaning investor funds to a borrower who would purchase a marine vessel to deconstruct and sell for scrap. Plaintiffs commenced this action alleging that $90 million in five vessel deconstruction loans were in default. Plaintiffs alleged that the company's Form ADV disclosed its team's lack of experience in some areas but failed to disclose that its "Marine Finance" team had never been involved in a marine deconstruction deal.

The court determined that the company's alleged inexperience in marine deconstruction deals was merely information that plaintiffs would have liked to know and was not an actionable omission. The court stated that it was "not persuaded by an argument that if a company chooses to highlight its inexperience in some areas, the company has a duty to disclose all its inexperience, theoretically including inexperience that has no relevance to the parties' dispute." The court explained that the undisclosed inexperience did not render the included statements misleading, pointing out that plaintiffs did not allege that the company said these were the only areas of inexperience. The court reasoned that if it concluded otherwise then companies would choose not to disclose any inexperience to protect against needing to disclose all.

By contrast, the court denied dismissal of plaintiffs' allegations concerning actions by the company's president/co-founder that

2. In addition to alleging Section 10(b) violations, plaintiffs also alleged fraudulent inducement, aiding and abetting fraud, Section 20(a) violations, common law breach of fiduciary duty, aiding and abetting breach of fiduciary duty, and negligent misrepresentation.

deviated[3] from the diligence process promised in the offering documents for the five post-October 2018 vessel deconstruction deal offerings. Plaintiffs argued that defendants had a duty to update the offering documents to accurately represent the diligence process, or at least disclose the intervening events. The court determined that plaintiffs' allegations created "a strong inference of a duty" to disclose this information to potential investors because the president/co-founder's actions rendered the diligence process in the offering documents misleading or false. The court stated that even if the offering document "statements were accurate when published, the intervening events of October 2018 rendered the statements false, requiring Defendants to at least update investors that the diligence process differed from the process outlined in the document."

Eastern District of New York: Dismisses a Class Action Against an Airline Calling the Securities Fraud Allegations "Speculative"

On April 12, 2022, the Eastern District of New York dismissed a putative securities fraud class action against an airline and certain of its officers and directors alleging that they made misleading upbeat statements in a May 2020 earnings report, and violated Section 10(b) by failing to disclose certain auditor findings later disclosed in June. *In re GOL Linhas Aéreas Inteligentes Sec. Litig.*, 2022 WL 1093215 (E.D.N.Y. 2022) (Kovner, J.). The court held that plaintiffs "failed to adequately plead that the May 2020 earnings report contained material misstatements or omissions of fact . . . because they have not adequately pleaded that defendants knew of the auditor findings at the time of the May report."

In May 2020, the airline issued its earnings report for Q1 of 2020, which discussed falling customer demand, plans to cut capacity, and an expected revenue decline due to the pandemic. However, the report also noted the airline's experience navigating times of stress, the airline's "effective and structured liquidity management," and that while reporting a loss for Q1, the airline still reported a profit for its loyalty program. Subsequently, in June 2020 the airline disclosed that its auditor had substantial doubt about the airline's ability to continue as a going concern and identified material weaknesses in its internal control over financial reporting ("ICFR"). Plaintiffs alleged that defendants were liable under Section 10(b) on an omissions theory because the May 2020 earnings report, with its upbeat financial statements, did not disclose the auditor's negative findings that were later revealed. Plaintiffs contended that defendants must have known of the findings when the earnings report was issued.

Concluding that plaintiffs failed to adequately plead an actionable omission, the court explained that defendants could only be liable on plaintiffs' theory if they actually knew of the auditor's conclusions at the time that the earnings report was issued. While the complaint asserted that defendants learned of their auditor's concerns "at least as early as February 2020 and/or no later than May 3, 2020," the court determined, as in *San Leandro Emergency Med. Grp. Profit Sharing Plan v. Philip Morris*, 75 F.3d 801 (2d Cir. 1996), that "such an unsupported general claim is insufficient to survive a motion to dismiss." The court pointed out that plaintiffs did not point to specific internal reports from the auditor advising defendants of the auditor's anticipated findings before the May earnings report, and also failed to specify who prepared such reports, when they were prepared, and who reviewed them.

The court also concluded that plaintiffs fell short of adequately pleading an omissions-based claim based on circumstantial evidence. As to the ICFR deficiencies, plaintiffs argued that the auditors must have informed defendants about the deficiencies by May 2020 because of an auditing industry standard requiring auditors to disclose significant deficiencies and material weaknesses "in a timely manner" and "prior to the issuance of the auditor's

3. Plaintiffs alleged the president/co-founder deviated by identifying and vetting a deal on his own for future investments with one borrower using a short-term lending model. Plaintiffs alleged that under the company's promised diligence process, the company was supposed to rely on an industry expert to both identify potential vessel-deconstruction opportunities and vet whether these transactions fit into the expert's lending methodology. Second, the deals that survived the expert's vetting were supposed to receive an independent analysis by the company in which a multi-party credit committee with veto powers would review the transaction.

report." However, the court concluded that plaintiffs' inference rested on little more than speculation and that an auditing standard requiring "timely" disclosures did not support plaintiffs' inference. The court also found that plaintiffs failed to support their assertions that the auditor would have: (i) concentrated on ICFR at the outset; (ii) finished examining ICFR early in the audit; or (iii) reached tentative conclusions, and informed the airline's audit committee of such tentative conclusions, by the time of the May 2020 earnings report. Similarly, the court found that only speculation supported the allegation that the auditor reached its going-concern conclusion by May 2020, rather than reaching this conclusion in the following month when the airline disclosed it.

California State Appellate Court: Upholds and Enforces a Federal Forum Provision Requiring Securities Act Claims to Be Brought in Federal Court

On April 28, 2022, an intermediate California appellate court unanimously affirmed a lower court's dismissal—based on a federal forum provision ("FFP")—of a securities fraud class action against a Delaware corporation. *Wong v. Restoration Robotics*, 2022 WL 1261423 (Cal. App. Ct. 2022) (Miller, J.). Notably, this is the first appellate decision on the issue outside of Delaware since the Delaware Supreme Court's decision upholding the facial validity of FFPs under Section 102(b)(1) of the Delaware General Corporation Law ("DGCL") in *Salzberg v. Sciabacucchi*, 227 A.D.3d 102 (Del. 2020).

Soon after the defendant corporation's IPO, the corporation experienced a stock drop and plaintiff sued in California state court alleging that defendant's offering documents contained materially false and misleading statements in violation of Sections 11, 12(a)(2), and 15 of the Securities Act. Defendant moved to dismiss on the basis of its certificate of incorporation, which included an FFP stating that Securities Act claims must be brought in federal court unless the corporation consents in writing to an alternative forum. The trial court declined jurisdiction on the basis of the FFP and dismissed. On appeal, plaintiff primarily raised three arguments: (i) the FFP violated the Securities Act; (ii) the Delaware statutory scheme permitting the FFP violated the Commerce Clause and the Supremacy Clause; and (iii) the FFP was unenforceable as it was beyond investors' reasonable expectations.

As to whether the FFP violated the Securities Act, the court rejected plaintiff's argument that he had an unwaivable right to have his Securities Act claims heard in a state court under the anti-waiver provision of Section 77n.[4] The court reasoned that if the Exchange Act's exclusive federal jurisdiction provision could be overridden by a forum selection agreement without violating that Act's anti-waiver provision, then the Securities Act's concurrent jurisdiction provision could likewise be overridden by a forum selection agreement without violating its anti-waiver provision. In support of this the court cited *Rodriguez de Quijas v. Shearson/American Express*, 490 U.S. 477 (1989), for the principle that the two statutes should be construed harmoniously because they are interrelated components of the federal regulatory scheme for securities transactions.

As to constitutionality, plaintiff argued that the corporation's certificate of incorporation could not lawfully include an FFP as Delaware's statutory scheme violated the Commerce Clause and the Supremacy Clause. Noting that the presence of state action was required to bring a Commerce Clause claim, the court pointed out that generally a private entity, like the corporation, is not a state actor except in a few limited circumstances.

4. Stating that "any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."

The court observed that plaintiff's challenge arose from the corporation's decision as a Delaware corporation to include an FFP in its certificate of incorporation, which the court noted was permitted, but not required or even encouraged by Delaware law. The court held that it could not conclude that there was state action given plaintiff's "failure to demonstrate any precedent for his Commerce Clause claim and given the reluctance of courts to expand the state action doctrine[.]" The court also "conclude[d] that Delaware has a legitimate interest in allowing its corporations to include FFPs in their certificates of incorporation, and that any burden on interstate commerce from the inclusion of an FFP does not exceed the benefits provided by the statute."

Additionally, the court rejected plaintiff's argument that Delaware's statutory scheme permitting FFPs violated the Supremacy Clause, concluding that Section 115[5] of the DGCL "does not reflect any quarrel between Delaware and federal law over the content of the [Securities] Act or the extent of the remedies available under the [Securities] Act. Nor does it discriminate in favor of state law claims and against similar federal claims."

As to the FFP's enforceability, the court stated that under *Drulias v. 1st Century Bancshares*, 30 Cal.App.5th 696 (2018), a forum selection clause, like the FFP, "may be enforced unless there is a showing that it was outside the reasonable expectations of the weaker or adhering party or that enforcement would be unduly oppressive or unconscionable." The court rejected plaintiff's argument that an investor should not be expected to pore over a registration statement or otherwise investigate a company's certificate of incorporation or expect to be bound by a novel provision. The court observed that forum selection clauses have long been in existence, and just because one is innovative does not mean that it is unenforceable. The court further refused to excuse investors from familiarizing themselves with a company's disclosures, particularly in a corporation's governing documents.

5. Section 115 provides that the certificate of incorporation or bylaws of a Delaware corporation may require that "internal corporate claims" be brought exclusively in Delaware state courts, and may not prohibit the bringing of such claims in Delaware state courts. "Internal corporate claims" as defined in Section 115, includes claims for which the Delaware corporate law confers jurisdiction upon the Court of Chancery.

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