Simpson Thacher

Securities Law Alert

In This Edition:

November 2020

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–Chambers USA (quoting a client)

Ninth Circuit: FOIA Information Can Count as Corrective Disclosure

On November 3, 2020, the Ninth Circuit revived a securities fraud class action alleging that BofI Holding, Inc. and certain executives falsely denied that BofI was under investigation by the SEC. *Grigsby v. BofI Holding, Inc.*, 2020 WL 6438912 (9th Cir. 2020) (Christen, J.). The Ninth Circuit ruled that the publication of information obtained through a Freedom of Information Act ("FOIA") request can count as a corrective disclosure for loss causation pleading purposes. The court also reversed "the district court's loss causation ruling to the extent it deemed information obtained via a FOIA request to be publicly available prior to its disclosure."

Background

In May 2015, the SEC opened an informal inquiry into BofI and began a formal investigation in February 2016, for which it issued two subpoenas to BofI. Subsequently, "[i]n March 2017, the *New York Post* reported that the Department of Justice, with involvement from the SEC, was investigating BofI for possible money laundering." The same day, BofI issued a press release denying knowledge of "such purported money laundering investigation." Then "on October 25, 2017, the *Post* published an article titled Bank of Internet was under 16-month SEC investigation." Plaintiffs allege that this October 25, 2017 *New York Post* article "revealed that BofI's earlier denial of any knowledge of an SEC investigation was false." The October 25, 2017 *Post* article was based on information obtained through a FOIA request.

The district court dismissed plaintiffs' complaint, concluding that "plaintiffs failed to adequately allege loss causation." The district court determined that the October 25, 2017 *Post* article "did not reveal new information to the market, and thus could not be a corrective disclosure of any misrepresentation." Additionally, "the court decided as a matter of law that the information obtained pursuant to the FOIA request was publicly available prior to its disclosure." Plaintiffs appealed the district court's decision.

Ninth Circuit Addresses Whether Information Obtained Through a FOIA Request Can Be Corrective

The court started by stating that "[t]he disputed element in this appeal is loss causation." Refining the issue, the court stated that "[t]his appeal requires us to consider the discrete question whether information obtained through a FOIA request can be corrective of an allegedly false and misleading statement by revealing nonpublic information to the market."

With respect to defendants' argument in favor of treating information that might have been discoverable through a FOIA request as information that was already public, the court pointed out two flaws. "First, information must be requested before it can be received through the FOIA." The court continued, "[s]econd, information must be produced before it is publicly available, and not all FOIA requests yield disclosure of the sought-after information." The court cautioned that "[g]iven FOIA's general framework, the fact that a market actor lodges a FOIA request on a given date does not allow the conclusion that the information became publicly available on that date because FOIA requests do not always result in disclosures—and even when they do, the disclosures are not instantaneous."

The court explained that "[a]t a minimum, there must be some indication that the relevant information was requested and produced before the information contained in a FOIA response can be considered publicly available for purposes of loss causation." The court then held that "the district court erred by concluding as a matter of law that an article containing information obtained through the FOIA could not qualify as a corrective disclosure for purposes of establishing loss causation."

Ninth Circuit Considers Whether Plaintiffs Relying on FOIA Information Face a Heightened Pleading Burden

The court then considered "whether information contained in the FOIA response . . . had been publicly disclosed prior to the October 25, 2017 *Post* article." Citing *Loos v. Immersion Corp.*, 762 F.3d 880 (9th Cir. 2014),[1] the court set forth the standard stating that "[p]laintiffs' burden is to plausibly allege that the decline in the defendant's stock price was proximately caused by a revelation of fraudulent activity, rather than other factors." The court clarified that "[p]laintiffs' burden is to describe how the falsity of the defendant's misstatement was revealed to the market, not to describe all the ways in which it was *not* revealed." The court held that "plaintiffs relying on corrective disclosures that are in turn based on information obtained through the FOIA do not face a special pleading burden for purposes of alleging § 10(b) loss causation." The court pointed out that "by effectively requiring plaintiffs to show that no one else had obtained the same information through the FOIA before the October 25, 2017 *Post* article, the court elevated plaintiffs' pleading burden." The court stated that it was sufficient for the operative complaint to have "alleged that the *Post* article disclosed BofI had been the subject of a formal SEC investigation, that the article revealed the falsity of BofI's prior statement, and that the revelation caused BofI's stock price to drop."

Northern District of California: Lack of Allegations Regarding Motive Do Not Defeat an Inference of Scienter

On November 4, 2020, the Northern District of California denied in part a motion to dismiss securities fraud claims against Apple Inc. and certain of its executives determining that scienter was sufficiently alleged with respect to a statement by Apple CEO Tim Cook on Apple's business outlook in China. *In re Apple Inc. Sec. Litig.*, 2020 WL 6482014 (N.D. Cal. 2020) (Rogers, J.). The court found

1. Please click here to read our prior discussion of the Ninth Circuit's decision in *Loos*.

that plaintiff's lack of allegations regarding motive do not defeat an inference of scienter under a holistic analysis at the motion to dismiss stage.

Background

On November 1, 2018, Apple held a conference call with analysts and investors. In response to a question about emerging markets, Cook discussed "[t]he emerging markets that we're seeing pressure in are markets like Turkey, India, Brazil, Russia, these are markets where currencies have weakened over the recent period." Cook went on to state that "[i]n relation to China specifically, I would not put China in that category." On January 2, 2019, Cook sent a letter to investors announcing that "Apple will miss its earnings guidance by up to $9 billion." The letter noted that "China's economy began to slow in the second half of 2018" and "[t]his economic deceleration accounted for most of our revenue shortfall." Apple's stock price subsequently declined from $157.92 to $142.19 per share. Plaintiff alleged that Cook's statement (that he would not put China in the category of decelerating emerging markets) was false or misleading in light of his later admissions that Apple's China business was experiencing pressure at the time. Defendants argued that plaintiff's scienter allegations were insufficient as a matter of law.

The Court Must Examine Competing Inferences to Determine Scienter

Discussing the standard for pleading scienter under the Private Securities Litigation Reform Act, the court explained that "courts must engage in comparative evaluation by considering not only inferences urged by the plaintiff but also competing inferences rationally drawn from the facts alleged." The court continued that "[t]hus, an inference of scienter is only strong if it is cogent and at least as compelling as any opposing inference of non-fraudulent intent." The court stated that "[i]n making this evaluation, the court accepts all factual allegations in the complaint as true, considers the allegations holistically, and takes into account plausible opposing inferences." Further, the court stated that "[i]n the Ninth Circuit, scienter covers not only intent to deceive, manipulate, or defraud, but also deliberate recklessness."

A Lack of Allegations Regarding Motive Do Not Defeat an Inference of Scienter Under a Holistic Analysis

Examining the competing inferences, the court stated that "[d]efendants argue that plaintiff's theory of fraud does not make sense because defendants did not profit from the alleged fraud but, on the contrary, engaged in a $1 billion stock repurchase at supposedly inflated prices." Defendants compared the current case to *Nguyen v. Endologix, Inc.*, 962 F.3d 405 (9th Cir. 2020), "where the Ninth Circuit rejected a theory of fraud that it found does not make a whole lot of sense." In *Nguyen*, the court dismissed the allegations, "that defendant knew that the FDA would not approve the device based on the same intractable issues that prevented approval in Europe, but misrepresented the state of affairs[,]" as implausible. The *Nguyen* court found that "the scienter allegation does not resonate in common experience because it depends on the supposition that defendants would rather keep the stock price high for a time and then face the inevitable fallout once the unsolvable problem was revealed." In this case, the court noted "that *Nguyen* presents an unusual case because both the Supreme Court and the Ninth Circuit have found scienter on fairly similar allegations." Discussing the applicable precedent on the issue of scienter, the court stated that "[n]one of these cases involved an obvious motive for fraud. On the contrary, these courts expressly held that allegations of motive are *not* required." The court stated that it "does not interpret *Nguyen* to require a specific theory of defendants' motives at the pleading stage." Instead, the court considered *Nguyen* on its facts. The court explained that "[w]ithout stronger allegations of contemporaneous facts contradicting defendants' statements, the more plausible inference was that

defendants made promising statements about the timing of FDA approval based on the initial results of the U.S. clinical trial, but then modulated their optimism when the results began to raise questions." The court here pointed out that "[t]hus, while lack of obvious motive presented a challenge, the deeper concern stemmed from lack of data of contemporaneous falsity." The court thus found "that plaintiff's lack of allegations regarding motive do not defeat an inference of scienter under a holistic analysis." The court acknowledged that "while several courts in this District have found stock buy-backs to undermine scienter, the Court does not find that dispositive." The court explained that "cursory background knowledge suggests that [stock buy-backs] enrich shareholders, such as Cook and Maestri, in a way that is entirely consistent with scienter."

District of Delaware: No Obligation to Disclose Outside Counsel Legal Opinion When Public Filings Sufficiently Disclosed Risk

On November 4, 2020, the District of Delaware granted defendants' motion to dismiss all fraud-based claims arising out of Uniti's spinoff from Windstream Holdings, Inc. into a real estate investment trust ("REIT"). *SLF Holdings, LLC v. Uniti Fiber Holdings, Inc.*, 2020 WL 6484310 (D. Del. 2020) (Stark, J.). The court held that plaintiff failed to plead an actionable omission also because defendants sufficiently disclosed the risks regarding the spinoff and REIT in their public filings, and defendants were not obligated to disclose the specific risks identified in the assessments of its accounting firm and outside counsel.

Background

Uniti was created in 2015 when its former parent, Windstream, spun it off into a REIT. Windstream conveyed certain assets to the spinoff and Uniti entered into a master lease with Windstream (the "Master Lease") to lease those assets back to Windstream. An accounting firm provided Windstream "with an independent appraisal of the useful life of the assets being leased, which was a factor in concluding that the Master Lease was a true lease, and was not financing." Windstream also engaged outside counsel and received a legal opinion stating that "the IRS may argue that the proposed lease is merely a financing arrangement and that the purported lessor [Uniti] is, in substance, a secured creditor but holds no equity interest in the property." Before and after the spinoff, Uniti made public disclosures regarding Uniti's business, the Master Lease and spinoff. These disclosures included that "Uniti's success depended significantly on the viability of Windstream."

In July 2017, plaintiff in this case sold its membership interests in a fiber optic network provider to Uniti in exchange for cash and Uniti stock equivalents. Before the sale, "Uniti executives advertised the REIT structure, the Master Lease, Windstream's $650 million in annual rental payments, and the iron-clad dividend that Uniti would be able to pay." However, neither the accounting firm's analysis nor the outside counsel's legal opinion were disclosed to plaintiff during the negotiations. In 2019, Windstream filed for bankruptcy. Subsequently, plaintiff filed the instant action alleging "a complex and multifaceted financial fraud arising out of Uniti's spinoff[.]"

No Need to Disclose Legal Opinion Identifying Specific Risks if Public Filings Are Sufficient

Plaintiff claimed that "the general statements that Uniti would be dependent on [Windstream] to make payments under the Master Lease and events could materially and adversely affect Uniti's business were allegedly misleading because they failed to disclose the full spectrum of risk, including those identified by [the accounting firm and outside counsel]." However, the court stated that plaintiff "has failed to plead an actionable omission also because Defendants sufficiently

disclosed the risks regarding the spinoff and REIT in their public filings." The court pointed out that "[t]he spinoff documents, the Master Lease, the indentures, and Windstream's statements to regulators were all publicly available."

The court explained that "[t]he information disclosed in these materials identified the risks pertaining to the Master Lease, including that it could be recharacterized as something other than a true lease." Further, "[i]t also disclosed that Uniti's copper wiring had a useful life of 7-40 years." The court stated that "[t]hese disclosures put Uniti's shareholders and [plaintiff] on notice that the useful life of the copper assets could be shorter than the 15-year term of the Master Lease." The court held that "[h]aving made these public disclosures, which [plaintiff] admits it reviewed, Defendants were not obligated to disclose the specific risks identified in the assessments of [the accounting firm and outside counsel]."

Delaware Chancery Court: Applies *Rales* as General Demand Futility Test Largely Sidelining *Aronson*

On October 26, 2020, the Delaware Chancery Court dismissed a derivative action, related to an abandoned stock reclassification plan, against current and former directors of Facebook because plaintiff did not make a pre-suit demand and failed to establish demand futility. *United Food & Com. Workers Union & Participating Food Indus. Emps. Tri-State Pension Fund v. Zuckerberg*, 2020 WL 6266162 (Del. Ch. 2020) (Laster, V.C.). The court held that it would apply *Rales v. Blasband*, 634 A.2d 927 (Del. 1993) as the general demand futility test.

The Court Weighs the Two Demand Futility Tests Against Each Other

The court began its analysis by comparing the two demand futility tests the Delaware Supreme Court has established which are found in *Rales* and in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984). The court observed that "the *Aronson* test has proved to be comparatively narrow and inflexible in its application, and its formulation has not fared well in the face of subsequent judicial developments." Whereas, "[t]he *Rales* test, by contrast, has proved to be broad and flexible, and it encompasses the *Aronson* test as a special case."

The Court Points Out the Limitations of *Aronson*

Pointing out the weakness of *Aronson* as applied to the facts in this case, the court stated that "*Aronson* does not provide guidance about what to do with either the director who abstained [from the vote on the reclassification] or the two directors who joined the Board later." The court continued that "[t]he director who abstained from voting on the Reclassification suffers from other conflicts that renders her incapable of considering a demand, yet a strict reading of *Aronson* only focuses on the challenged decision and therefore would not account for those conflicts." Further, the court pointed out that "the plaintiff alleges that one of the directors who subsequently joined the Board has conflicts that render him incapable of considering a demand, but a strict reading of *Aronson* would not account for that either."

The Court Applies *Rales* as General Demand Futility Test

The court concluded that "[p]recedent thus calls for applying *Aronson*, but its analytical framework is not up to the task. The *Rales* test, by contrast, can accommodate all of these considerations." The court then announced that "[t]his decision therefore applies *Rales* as the general demand futility test." The court explained that it would draw "upon *Aronson*-like principles when evaluating whether particular directors face a substantial likelihood of liability as a result of having participated in the decision to approve the Reclassification."

The court stated that it would proceed "on a director-by-director basis, asking for each director (i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand, (ii) whether the director would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand, and (iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that is the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand."

Reviewing the facts concerning the directors who were on the board when the complaint was filed, the court considered whether they validly could consider a litigation demand. Finding a majority would be disinterested, independent, and capable of considering a litigation demand, the court held that demand was not excused and granted defendants' motion to dismiss.

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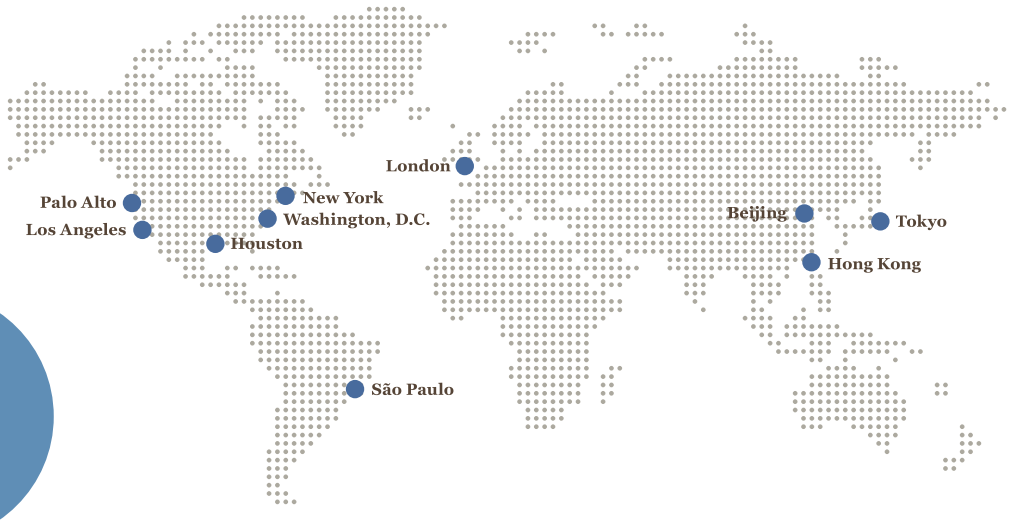

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