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Second Circuit: Bank's Failure to Disclose Money Laundering Suspicions Not Actionable As There Was No Obligation to Self-Report

On August 25, 2021, the Second Circuit affirmed the dismissal of a putative securities fraud class action alleging that a bank's financial statements were misleading because they incorporated revenue from money laundering but failed to simultaneously disclose what the bank knew about possible money laundering at one branch. *Plumber & Steamfitters Local 773 Pension Fund v. Danske Bank*, 2021 WL 3744894 (2d Cir. 2021) (Jacobs, J.). The court pointed out that plaintiffs did not allege that the financial numbers were manipulated in any way, only that defendants failed to simultaneously disclose the anti-money laundering issues. The court held that "because [the bank] was under no obligation to self-report its growing suspicions regarding those issues, its disclosure of accurate historical data, standing alone, is not actionable."

Background and Plaintiffs' Allegations

Between 2007 and 2015, the bank allegedly failed to follow anti-money laundering (AML) protocols at one of its European branches, which allowed suspicious transactions of approximately $230 billion to flow through that branch. In 2018, after news of the bank's AML issues had become public but before the full breadth was revealed, plaintiffs purchased the bank's American Depositary Receipts. Plaintiffs alleged that the bank's 2013-2015 financial statements included the allegedly ill-gotten profits from the AML violations. Plaintiffs claimed that it was misleading under Section 10(b) of the Exchange Act and Rule 10b-5(b) for the bank to release these numbers without simultaneously disclosing what it knew about possible money laundering.

Accurate Financial Statements Do Not Become Misleading Due to Nondisclosure of Suspected Misconduct That May Have Contributed to the Results

The court held that plaintiffs did not have an actionable securities fraud claim for any of the bank's alleged misstatements or omissions. The court rejected plaintiffs' theory that it was misleading for the bank to release its financial statements without also disclosing what it knew about possible money laundering. The court began its analysis by stating that "companies do not have a duty to disclose uncharged, unadjudicated wrongdoing." The court further explained that "[a]s a corollary of that rule, accurately reported financial statements do not automatically become misleading by virtue of the company's nondisclosure of suspected misconduct that may have contributed to the financial results." The court noted that in a related context, the Sixth Circuit had concluded that a securities law violation could not be premised on a company's disclosure of accurate historical data. *In re Sofamor Danek Grp.*, 123 F.3d 394 (6th Cir. 1997).

The court stated that it was critical that plaintiffs did not allege that the financial numbers disclosed were manipulated in any way, just that the bank failed to simultaneously disclose the AML issues. The court consequently determined that "because [the bank] was under no obligation to self-report its growing suspicions regarding those issues, its disclosure of accurate historical data, standing alone, is not actionable." The court reasoned that otherwise every company whose quarterly financial reports include revenue from transactions that violated AML regulations could be sued for securities fraud.

The court thus affirmed the district court, concluding that the plaintiffs' "allegations do not move the claims outside the realm of corporate mismanagement and into the realm of securities fraud."

Third Circuit: FRCP 15(c) Applies to Statutes of Repose, Allowing Amendment of a Pleading After the Expiration of a Repose Period

On September 2, 2021, the Third Circuit affirmed the Middle District of Pennsylvania's decision to allow amendment of a pleading after the expiration of a repose period in a securities fraud class action alleging claims under the Securities Act and the Exchange Act. *Se. Pa. Transp. Auth. v. Orrstown Fin. Servs.*, 2021 WL 3923389 (3d Cir. 2021) (Ambro, J.). The court held that Federal Rule of Civil Procedure 15(c) allows amendment of a pleading after the expiration of a repose period because Rule 15(c)'s "relation-back" doctrine leaves the legislatively mandated deadline intact and does not disturb any of defendants' vested rights to repose.

Background and Procedural History

In 2012, plaintiff filed suit in federal court bringing claims under the Securities Act and the Exchange Act alleging that a bank, its officers, and its parent company (the "Bank Defendants") had made material misrepresentations in the bank's financial disclosures. Subsequently, plaintiff moved for leave to file a Third Amended Complaint in 2019, which reasserted previously dismissed

claims from the Second Amended Complaint, including claims against some parties[1] who had previously received a dismissal of all claims against them.

Plaintiff argued that it should be permitted to reinstitute the claims "because it found further evidence to support them through discovery after the partial dismissal of the Second Amended Complaint." Defendants argued that the reasserted claims were time barred because plaintiff sought to file the Third Amended Complaint outside the repose periods for Securities Act and Exchange Act claims. The district court granted plaintiff's motion and then granted defendants' motion to file an interlocutory appeal. Subsequently, the Third Circuit granted defendants' request to appeal.

The Relation-Back Doctrine Applies Because the Amended Complaint Restates the Original Claim with Greater Particularity and Amplifies the Factual Circumstances

The court began its analysis by explaining that, consistent with Rule 15's liberal approach to pleading, "the relation-back doctrine under Rule 15(c) allows a court to treat a later-filed amended pleading as if it had been filed at the time of the initial pleading." The court stated that Rule 15(c) "applies here as long as the Third Amended Complaint restates the original claim with greater particularity or amplifies the factual circumstances surrounding the pertinent conduct." The Third Circuit determined that the Third Amended Complaint "both restates claims with greater particularity and amplifies the factual circumstances surrounding the relevant conduct by adding significantly more factual detail to [plaintiff's] existing claims."

In response to defendants' argument that plaintiff's previously dismissed claims were extinguished by the expiration of the repose period even though the action continued, the Third Circuit pointed out that plaintiff brought both Securities Act and Exchange Act claims against all defendants before the applicable repose periods expired. The court then explained that "under Rule 54(b), any order that decides fewer than all the claims or the rights and liabilities of fewer than all the parties does not end the action as to any of the claims or parties." The Third Circuit stated that because the district court had not decided all claims as to all parties at the time of the repose period's expiration, none of plaintiff's claims in the action ended (except, as the court noted, for the dismissal of all claims against certain individual bank officers).

Relation Back Is Consistent with the Purpose of Statutes of Repose

As to whether the relation-back doctrine is consistent with the purpose of statutes of repose, the court explained that even if "a repose statute's purpose is to give defendants protection after a certain amount of time, it does not defeat that purpose for a plaintiff to bring an action within the time allotted—even if the plaintiff later amends the precise form of its pleadings." The court found that plaintiff brought its action initially within the applicable repose periods, and reiterated that "under Rule 54(b), reinstatement of dismissed claims cannot constitute the filing of a new action until a court has decided all claims against all parties to the initial action." The court also pointed out that while plaintiff did wish to expand its complaint with additional facts, it was "not bringing any new legal claims or adding new parties that were not included in the First Amended Complaint."

1. These parties were the underwriters of the bank's 2010 offering, the bank's independent auditor, and certain individual bank officers.

Northern District of California: Plaintiff's Inability to Reconcile a Company's Financial Reporting to Its Market Interpretation, Without More, Does Not Plausibly Allege a Misstatement

On August 17, 2021, the Northern District of California dismissed with leave to amend a putative securities fraud class action alleging that a solar energy company and certain executives misrepresented and/or failed to disclose that the company's revenues were artificially inflated. *Hurst v. Enphase Energy*, 2021 WL 3633837 (N.D. Cal. 2021) (Freeman, J.). The court held that the complaint failed to plead a material misrepresentation or omission under the heightened pleading standards of the Private Securities Litigation Reform Act (PSLRA). The court noted that the complaint was "entirely predicated on [a short seller's] Report's insistence that [the company's] financial reporting does not add up." However, the court determined the fact that plaintiff and the short seller could not "reconcile the financials reported by [the company] to their interpretation of the solar market, without more, does not plausibly allege a misstatement."

Background

Plaintiff claimed that defendants misrepresented and/or failed to disclose to investors that its revenues were inflated and that the company engaged in improper deferred revenue accounting practices. Plaintiff's allegations were largely derived from a 2020 short seller report. The report stated, among other things, that financial statements filed with the SEC by the company were "fiction" and that, based on their research, the short seller estimated that at least $205.3 million of reported US revenue in FY 2019 was fabricated. Plaintiff alleged that the company's FY 2019 revenue was artificially inflated "by a whopping 47.7%." The court stated that the report purported to be based on an analysis of the company's reported financials along with a private investigation based on interviews with former employees.

The PSLRA Demands More Than Allegations That "Cherry Pick" Financial Data from a Short Seller Report

The court granted defendants' dismissal motion on the basis that plaintiff failed to plead a material misrepresentation or omission. The court found that plaintiff failed to plausibly allege a misstatement by merely alleging that plaintiff and the short seller could not reconcile the company's financials to their interpretation of the solar market.

The court also noted that plaintiff did not identify any restatement of the company's accounting or any missed earnings revealing the impact of alleged accounting fraud. Considering the severity of the revenue inflation alleged—47.7% in FY 2019—the court found "it wildly implausible that neither such event would have occurred in the aftermath of the publication of the [short seller] Report." Again reiterating that the allegations were directly derived from a short seller report, the court concluded that the PSLRA demands more than allegations that "do little more than cherry pick financial data and present such data in a manner favorable to Plaintiff's theory."

Plaintiff Failed to Allege How the Company Violated Its Accounting Standard

Separately, the court found that plaintiff failed to point to any accounting standard that the company misapplied. Specifically, plaintiff alleged that the company adopted the ASC 606 accounting standard in January 2018, but the court found that plaintiff failed to allege how the company ran afoul of this standard. The court stated that the complaint

alleged in a "conclusory" fashion that the company began deferring both portions of its revenue after adopting the standard, but did not plead "facts that set out the why this deference was improper under GAAP." The court concluded that while it is indisputable that "premature revenue recognition is a GAAP violation," plaintiff must still plead facts supporting the existence of a GAAP violation. Explaining that GAAP provisions are subject to interpretation and "tolerate a range of reasonable treatments, leaving the choice among alternatives to management[,]" the court stated that plaintiff failed to plead any facts showing that the company exercised its judgment in a way that violated GAAP.

Southern District of New York: Exchange Act Does Not Apply Because the OTCQX Is Not an Exchange Under *Morrison v. National Australia Bank*

On August 30, 2021, the Southern District of New York dismissed with leave to amend an individual action and consolidated purported securities fraud class actions alleging that a Canadian company doing business in the U.S., its senior secured lender, and certain executives at both companies violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by failing to disclose information regarding the company's relationship with its senior secured lender/largest financer and certain terms of the two entities' financing. *In re iAnthus Cap. Holdings Sec. Litig.*, 2021 WL 3863372 (S.D.N.Y. 2021) (Kaplan, J.). The court held that the Exchange Act does not apply because its use would be extraterritorial and therefore improper. The court determined that the OTCQX, where the company's common shares trade in the U.S. over-the-counter market, is not an "exchange" as is required under the first prong of *Morrison v. Nat'l Australia Bank*, 561 U.S. 247 (2010).

Section 10(b) Does Not Apply Beyond U.S. Borders

The court began its discussion by quoting a recent Second Circuit decision stating that "Section 10(b) of the Securities Exchange Act does not apply beyond U.S. borders." Quoting *Cavello Bay Reinsurance v. Shubin Stein*, 986 F.3d 161 (2d Cir. 2021).[2] The court then explained that under *Morrison* courts must limit the application of Section 10(b) to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities."

First Prong of *Morrison* Applies Section 10(b) to Transactions in Securities Listed on a Domestic Exchange

The court stated that "[u]nder the first prong of *Morrison*, Section 10(b) is properly applied to transactions in securities listed on domestic exchanges." Plaintiffs alleged that the company's common shares trade in the U.S. over-the-counter market on the OTCQX. Therefore, the court framed the issue as whether the OTCQX qualifies as a domestic exchange. The court explained that, according to the SEC's implementing regulations under the Exchange Act, an exchange "is limited to an organization, association, or group of persons who (1) bring together the orders for securities of multiple buyers and sellers and (2) use established, non-discretionary methods under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade." The court, citing Black's Law Dictionary, then explained that by contrast "securities traded over-the-counter trade between brokers and dealers who negotiate directly and not on an organized securities exchange or other order-matchmaking service."

Citing the Third Circuit, the court also stated that "[o]ver-the-counter markets are not national securities exchanges within the scope

2. Please click here to read our discussion of the Second Circuit's decision in *Cavello Bay*.

of *Morrison* because the stated purpose of the Exchange Act refers to securities exchanges and over-the-counter markets separately, which suggests that one is not inclusive of the other and a national securities exchange is explicitly listed in Section 10(b)—to the exclusion of the OTC markets." *United States v. Georgiou*, 777 F.3d 125 (3d Cir. 2015). The court concluded that "over-the-counter transactions in [the company's] common stock are, by definition, those that do not occur on an exchange within the meaning of *Morrison*."

Plaintiffs Failed to Allege Facts Showing the Transactions Qualified as Domestic Transactions Under *Morrison*'s Second Prong

Separately, the court determined that plaintiffs also failed to allege specific facts showing that any of the three transactions at issue qualified as a "domestic transaction[ ] in other securities" under *Morrison*'s second prong. Transactions are considered domestic under *Morrison* only "when the parties incur irrevocable liability to carry out the transaction within the United States or when title is passed within the United States." The court explained that "plaintiffs must allege specific facts including, but not limited to, facts concerning the formation of the contracts, the placement of purchase order, the passing of title, or the exchange of money." With respect to the transactions at issue, plaintiffs failed to include specific allegations concerning their location and structure. The court noted that "the mere fact that a trade was made through the United States over-the-counter market does not indicate where the parties to that transaction incurred irrevocable liability or where title passed."

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