Simpson Thacher

Securities Law Alert

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– The Legal 500

Ninth Circuit: Whistleblower Complaint Filed by a Company Insider May Constitute a Corrective Disclosure

On October 8, 2020, the Ninth Circuit revived a securities fraud action that the district court had dismissed on loss causation grounds. *In re BofI Holding Sec. Litig.*, 2020 WL 5951150 (9th Cir. 2020) (Watford, J.). The Ninth Circuit held plaintiffs adequately alleged that a whistleblower complaint filed by a former employee constituted a corrective disclosure for loss causation purposes.

Ninth Circuit Addresses the Requirements for Pleading a Corrective Disclosure

The Ninth Circuit began by offering "a few basic ground rules" for determining what constitutes a corrective disclosure. First, the court emphasized that "a corrective disclosure need not consist of an admission of fraud by the defendant or a formal finding of fraud by a government agency." Rather, "[a] corrective disclosure can instead come from any source, including knowledgeable third parties such as whistleblowers, analysts, or investigative reporters." Second, the court noted that "a corrective disclosure need not reveal the full scope of the defendant's fraud in one fell swoop; the true facts concealed by the defendant's misstatements may be revealed over time through a series of partial disclosures." Third, the court clarified that "a disclosure need not precisely mirror the earlier misrepresentation. It is enough if the disclosure reveals new facts that, taken as true, render some aspect of the defendant's prior statements false or misleading."

The Ninth Circuit also addressed Rule 9(b)'s particularity requirement as applied to allegations of loss causation. The court recognized that "the plaintiff will always need to provide enough factual content to give the defendant some indication of the loss and the causal connection that the plaintiff has in mind." However, the court noted that this "effort should not prove burdensome, for even under Rule 9(b) the plaintiff's allegations will suffice so long as they give the defendant notice of plaintiff's loss causation theory and provide some assurance that the theory has a basis in fact."

Unproven Whistleblower Allegations by Insiders May Constitute a Corrective Disclosure Even If Not Corroborated

The Ninth Circuit found the district court erred in determining that the whistleblower complaint could not qualify as a corrective disclosure because it "contained only unconfirmed accusations of fraud" and had not been "followed by a subsequent confirmation of the fraud." The Ninth Circuit stated that in order to plead loss causation, plaintiffs "did not have to establish that the allegations in [the whistleblower's] lawsuit are in fact true." The court explained that "[f]alsity and loss causation are separate elements of a Rule 10b-5 claim," and noted that plaintiffs "adequately alleged that [the company's] misstatements were false through allegations attributed to confidential witnesses." The court joined the Sixth Circuit in rejecting a "categorical rule" that unproven allegations cannot constitute a corrective disclosure unless plaintiffs "identify an additional disclosure that confirmed the truth of [those] allegations."[1]

The Ninth Circuit held that "the relevant question for loss causation purposes is whether the market reasonably *perceived* [the whistleblower's] allegations as true and acted upon them accordingly." In the case before it, the court noted that the whistleblower's "descriptions of wrongdoing [were] highly detailed and specific, and they [were] based on firsthand knowledge that he could reasonably be expected to possess by virtue of his [former] position as a mid-level auditor" at the company. The court also found it significant that the stock price dropped more than 30% following the filing of the complaint. The court reasoned that "[a] price drop of that magnitude would not be expected in response to whistleblower allegations perceived as unworthy of belief." The court concluded that plaintiffs adequately alleged that the whistleblower complaint was a corrective disclosure.

The Ninth Circuit distinguished its prior decisions in *Loos v. Immersion Corp.*, 762 F.3d 880 (9th Cir. 2014), and *Curry v. Yelp*, 875 F.3d 1219 (9th Cir. 2017). In *Loos*, the court held that the announcement of a government investigation, standing alone, could not constitute a corrective disclosure.[2] The Ninth Circuit explained that unlike a whistleblower complaint, the announcement of an investigation "does not reveal to the market any *facts* that could call into question the veracity of the company's prior statements; all the market could react to was speculation about what the investigation will ultimately reveal." *BofI Holding Sec. Litig.*, 2020 WL 5951150. In *Curry*, the court held that customer complaints raising questions about the company's business practices could not qualify as corrective disclosures.[3] The Ninth Circuit pointed out that while the customers in *Curry* had no first-hand knowledge of the company's business practices, the whistleblower here was "a former insider of the company who had personal knowledge of the facts he alleged."

Analyses of Publicly Available Information May Constitute Corrective Disclosures

The Ninth Circuit affirmed the district court's determination that blog posts by anonymous short-sellers analyzing publicly available information did not constitute corrective disclosures. However, the Ninth Circuit made it clear that "[a] disclosure based on publicly available information can, in certain circumstances, constitute a corrective disclosure."[4] The court stated that in order

1. In *Norfolk County Retirement System v. Community Health Systems*, 877 F.3d 687 (6th Cir. 2017), the Sixth Circuit held that unproven allegations could constitute a corrective disclosure. The court reasoned that "every representation of fact is in a sense an allegation, whether made in a complaint, newspaper report, press release, or under oath in a courtroom."

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

3. Please click here to read our discussion of the Ninth Circuit's decision in *Curry*.

4. The Eleventh Circuit has adopted a bright-line rule that analyses of publicly available information cannot constitute corrective disclosures. *See Meyer v. Greene*, 710 F.3d 1189 (11th Cir. 2013) (holding that "the fact that the sources used" in the disclosure at issue "were already public is fatal to the [i]nvestors claim of loss causation"). The Ninth Circuit declined to follow the Eleventh Circuit's approach.

"[t]o rely on a corrective disclosure that is based on publicly available information, a plaintiff must plead with particularity facts plausibly explaining why the information was not yet reflected in the company's stock price." The court noted that factors that are relevant to the analysis "include the complexity of the data . . . and the great effort needed to locate and analyze it."

The Ninth Circuit found the district court erred in holding that plaintiffs must "allege facts explaining why other market participants *could not* have done" the same analysis of publicly available information. "For pleading purposes," the Ninth Circuit stated that plaintiffs simply "needed to allege particular facts plausibly suggesting that other market participants *had not* done the same analysis, rather than 'could not.'"

The Ninth Circuit acknowledged that the anonymous short-seller blog posts were the product of "extensive and tedious research" that arguably "provided new information to the market." However, the court noted that the authors "had a financial incentive to convince others to sell, and the posts included disclaimers from the authors stating that they made no representation as to the accuracy or completeness of the information set forth." The court found that "[a] reasonable investor reading these posts would likely have taken their contents with a healthy grain of salt."

Judge Lee, Dissenting, Expressed His View That It Is Unfair to Permit Plaintiffs to Demonstrate Loss Causation Through Unproven Allegations

Judge Lee dissented from the majority opinion with respect to the question of whether a whistleblower complaint brought by a company insider may suffice as a corrective disclosure. He cautioned that the decision could "have the unintended effect of giving the greenlight for securities fraud lawsuits based on unsubstantiated assertions that may turn out to be nothing more than wisps of innuendo and speculation." He expressed his view that he would "require additional external confirmation of fraud allegations in a whistleblower lawsuit for them to count as a corrective disclosure."

Second Circuit: Principal Investigator in a Clinical Trial Had a Duty Not to Trade in the Company's Stock

On September 22, 2020, the Second Circuit affirmed the insider trading conviction of a principal investigator in a clinical trial. [*United States v. Kosinski*, 2020 WL 5637600 (2d Cir. 2020) (Korman, J.)]. The Second Circuit found the defendant had a duty to refrain from trading on the basis of material nonpublic information both because he was a "temporary insider" and because he had a "fiduciary-like relationship" with the company.

Principal Investigators in Clinical Trials Are "Temporary Insiders"

The Second Circuit emphasized that "a qualifying relationship" for insider trading purposes "does not require one to be a traditional corporate insider." Rather, in *Dirks v. SEC*, 463 U.S. 646 (1983), the Court made it clear that a duty to refrain from trading in company stock arises when third parties "have entered into a special confidential relationship in the conduct of

the business of the enterprise and are given access to information solely for corporate purposes." *Kosinski*, 2020 WL 5637600 (quoting *Dirks*, 463 U.S. 646). The Second Circuit noted that it has "described such individuals as 'temporary insiders.'" *Kosinski*, 2020 WL 5637600 (quoting *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc)).

The Second Circuit determined that the defendant's "role as a principal investigator . . . fit[s] squarely within *Dirk*'s recognition of 'temporary insiders' who play fiduciary-like roles." The court reasoned that the defendant "was entrusted with [the company's] information solely because of his duty to ensure the integrity and accuracy of the phase three clinical trial, as well as the health of his patients." The court also found it significant that the defendant explicitly agreed to maintain the confidentiality of the information the company provided and to disclose holdings of company stock in excess of $50,000.

Principal Investigators Have a Fiduciary-Like Relationship With the Company

The Second Circuit further held that the defendant's "relationship with [the company] was fiduciary in nature because it was a relationship based on trust and confidence," memorialized in a confidentiality and stock disclosure agreement. The court found that the defendant's "trading vitiate[d] the principal investigator's critical function, by fixing his attention on his own monetary gain and depriving the company of the independent assessment required for FDA approval." The court explained that when "a principal investigator's financial interest becomes aligned with the outcome of the study—he has an incentive to lie about or conceal patients' results in order to influence the study's outcome, and ultimately his wallet." The court concluded that "[a]llowing principal investigators to trade on the nonpublic inside information entrusted to them in the course of a study would . . . undermine that study's integrity."

Chestman Factors Are Not the Exclusive Standard for a Fiduciary Relationship

In *Chestman*, 947 F.2d 551, the Second Circuit stated that "[a]t the heart of the fiduciary relationship lies reliance, and de facto control and dominance." The *Kosinski* court clarified that *Chestman*'s "three-factor standard . . . does not state the exclusive test of fiduciary status, nor the proof necessary to sustain a conviction under the misappropriation theory" of insider trading. The *Kosinski* court explained that "*Chestman* itself set out two other tests . . . one of which is the traditional test that one acts as a fiduciary when the business which he transacts . . . is not his own or for his own benefit, but for the benefit of another person, as to whom he stands in a relation implying and necessitating great confidence and trust on the one part and a high degree of good faith on the other part." The *Kosinski* court found that "while the evidence here was indeed sufficient to find that [the defendant] owed [the company] a fiduciary duty based on reliance, control, and dominance, that conclusion does not signal that only such factors can establish a fiduciary duty for purposes of determining insider-trading liability."

Southern District of New York: Cryptocurrency Is a "Security"

On September 30, 2020, the Southern District of New York held that digital tokens (a form of cryptocurrency) constitute "securities" for purposes of the Securities Act of 1933. [*SEC v. Kik Interactive*, 2020 WL 5819770 (S.D.N.Y. Sept. 30, 2020) (Hellerstein, J.)].

The court noted that "the definition of security includes an investment contract." *Id.* (citing 15 U.S.C. § 77b(a)(1)). In *SEC v. W.J. Howey Co.*, 328 U.S. 239 (1946), the Supreme Court held that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person" (i) "invests his money" (ii) "in a common enterprise" and (iii) "is led to expect profits solely from the efforts of the promoter or a third party."

The court observed that "[f]ew courts in this Circuit have had the opportunity to apply *Howey* in the context of cryptocurrency," and stated that it had "to decide this case without the benefit of direct precedent in relation to cryptocurrencies." The court explained that "the definition of investment contract is a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."

Because there was no dispute as to the first element of the *Howey* test (an investment of money), the court began by considering whether the investors participated in a "common enterprise." The court found the "economic reality" was that the company "pooled proceeds from its sales of [the digital tokens] in an effort to create an infrastructure for [those tokens], and thus boost the value of the investment." The court held that "[t]his is the nature of a common enterprise," because "[t]he stronger the ecosystem that [the company] built, the greater the demand for [the digital tokens], and thus the greater the value of each purchaser's investment."

The court rejected defendant's contention that no common enterprise existed because the company "expressly disclaimed any ongoing obligation to [investors] after the distribution of their [digital tokens]." The court explained that "an ongoing contractual obligation is not a necessary requirement for a finding of a common enterprise." The court also found "not dispositive" "the fact that [investors] could sell their [digital tokens] whenever they pleased." The court noted that "the key feature is not that investors must reap their profits at the same time; it is that investors' profits at any given time are tied to the success of the enterprise." The court underscored that "[t]his is not a scenario where the funds of each investor were segregated and separately managed, allowing for profits to remain independent."

The court next considered whether the investment came "with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." Under Second Circuit precedent, the court explained that it was required to "consider whether, under all the circumstances, the scheme was being promoted primarily as an investment." *Id.* (quoting *United States v. Leonard*, 529 F.3d 83 (2d Cir. 2008)).

The court noted that "[i]n public statements and at public events promoting [the cryptocurrency], [the company] extolled [the digital tokens'] profit-making potential." The company's CEO emphasized that "as demand increased, the value of [the digital tokens] would increase, and early purchasers would have the opportunity to earn a profit." The court found that "[t]he demand for [the digital tokens], and thus the value of the investment, would not grow on its own." Rather, "[g]rowth would rely heavily on [the company's] entrepreneurial and managerial efforts." The court concluded that the cryptocurrency therefore "satisfies this element of the *Howey* test."

Finally, the court found meritless defendant's argument that the term "investment contract" was unconstitutionally vague as applied to the digital tokens. The court explained that "*Howey* is an objective test that provides the flexibility necessary for the assessment of a wide range of investment vehicles." Although the SEC had not "issue[d] guidance on securities enforcement related specifically to cryptocurrencies" or brought "enforcement actions against other issuers of digital tokens," the court found "the law does not require the Government to reach out and warn all potential violators on an individual or industry level."

Eastern District of New York: Company Adequately Disclosed Risks of a New Software Rollout

On September 17, 2020, the Eastern District of New York dismissed a securities fraud action alleging that a cosmetics company and certain of its executives made material misstatements concerning the company's software rollout. *Lachman v. Revlon*, 2020 WL 5577406 (E.D.N.Y. 2020) (Kovner, J.). The court emphasized that "Rule 10b-5 does not impose a blanket obligation to disclose all information that would be material to investors."

The court held that the company was not "required to advise investors of every . . . risk [of the software rollout] in order to make the statements in its 10-K not misleading." The court further found that the company's "enumeration of a number of the risks could not reasonably be read to imply that other risks did not exist, because the 2016 10-K made clear that enumeration of risks was non-exclusive."

The court also held that statements regarding the company's expectations regarding the benefits of the software rollout were both "mere puffery" and "nonactionable opinion statements." The court explained that "[s]tatements about what a company 'expects' are not actionable unless" plaintiffs allege that "the expectations [did] not pan out and the speaker did not really believe them."

Finally, the court found that defendants' actions "before and after the launch undermine[d] any inference of scienter" because the company "disclosed before the [software] rollout that the transition carried substantial risks," and "made abundant disclosures [after the rollout] regarding the disruptions that the transition had caused." The court found this "steady stream of warnings render[ed] implausible" plaintiffs' fraud claims. The court determined that "[a]t worst, plaintiffs have established that defendants should have been more alert and more skeptical about the viability of [the software rollout] when it was launched," but "nothing alleged indicates that management was promoting a fraud."

Delaware Supreme Court: Chancery Court Did Not Err in Finding the Deal Price Was the Best Evidence of Fair Value Despite an Imperfect Sales Process

On October 12, 2020, the Delaware Supreme Court affirmed a Chancery Court decision holding that the deal price was the most reliable indicator of a metal mining company's fair value in an appraisal action, even though "[t]he sale process was not perfect." *Brigade Leveraged Capital Structures Fund v. Stillwater Mining Co.*, 2020 WL 6038341 (Del. 2020) (Montgomery-Reeves, J.). The Delaware Supreme Court further determined that the Chancery Court did not err in declining to adjust the deal price to account for an increase in palladium prices. The Delaware Supreme Court explained that "fair value is just that, fair. It does not mean the highest possible price that a company might have sold for."

The Delaware Supreme Court observed that the Chancery Court "walked through each step of the sale process" and "found that there were objective indicia of reliability." While the Delaware Supreme Court acknowledged that there were "fewer indicia of fairness than [it] identified when reviewing the sales processes in *DFC, Dell* or *Aruba*, the [Chancery Court] did not abuse its discretion by determining that the objective indicia that were present provide a cogent foundation for relying on the deal price as a persuasive indicator of fair value."[5]

5. Please click here to read our discussion of the Delaware Supreme Court's discussion in *Aruba*. (This discussion also addresses the Delaware Supreme Court's decisions in *DFC* and *Dell*.)

The Delaware Supreme Court noted that the Chancery Court recognized the "flaws" in the pre-signing process, such as "the lack of Board involvement until later in the sales discussions," but concluded that these "flaws" did "not undermine the reliability of the sale price." The Delaware Supreme Court found the Chancery Court "did not abuse its discretion when it held that the pre-signing process was sufficient to support reliance on the deal price as evidence of fair value," despite the imperfections in the process.

The Delaware Supreme Court also noted that the Chancery Court "considered and rejected" plaintiffs' contention that the deal price failed to account for the increase in palladium prices between signing and closing. The Chancery Court found, *inter alia*, that "the Merger Agreement was not designed to give the stockholders the benefit of a transaction that included the potential upside or downside that would result from changes in the price of palladium after signing." Moreover, the Chancery Court pointed out that if the company's "stockholders had wanted to capture the increased value of palladium, then they could have voted down the Merger and kept their shares."

Because the Chancery Court "thoroughly analyzed the facts surrounding [the company's] sale in accordance with [Delaware Supreme Court] precedent," the Delaware Supreme Court declined to "second-guess" the Chancery Court's determination that "the deal price was a reliable indicator of [the company's] fair value."

California State Court: Federal Forum Selection Provisions for Securities Act Claims Do Not Violate Federal or State Law

On September 1, 2020, a California Superior Court held that a federal forum provision ("FFP") requiring Securities Act claims to be brought in federal court is legal and enforceable under federal law and California law. [*Wong v. Restoration Robotics*, No. 18-civ-02609 (Cal. Super. Ct. 2020) (Weiner, J.)].

The court considered the Delaware Supreme Court's decision in *Salzberg v. Sciabacucchi*, 227 A.D.3d 102 (Del. 2020), which holds that an FFP is facially valid under Section 102(b)(1) of the Delaware General Corporation Law.[6] The Delaware Supreme Court compared FFPs to arbitration clauses. But the California Superior Court found that "unlike an arbitration clause, the FFP does not take away the rights of the parties to litigate in court, or to have a jury trial, or to appeal" but merely "remove[s] the opportunity to use the different *procedural* advantages of a state court forum." The court determined that an FFP "is most akin to a contractual forum selection clause."

The court found that defendants had demonstrated that the FFP was a mandatory forum selection clause, which was "subject to shareholder vote and approval, and was not applied retroactively." The court determined that the burden of proof therefore shifted to plaintiffs to demonstrate that the clause is "unenforceable, unconscionable, unjust or unreasonable"—and found plaintiffs failed to meet that burden.

The court rejected plaintiffs' contention that state court jurisdiction of Securities Act claims is non-waivable under Section 14 of the Securities Act. The court explained that such a clause "would not be legal or enforceable if [it] . . . attempted to create jurisdiction or select jurisdiction where none

6. Section 102(b)(1) provides that a company's certificate of incorporation may include "[a]ny provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders . . . if such provisions are not contrary to the laws of this State." 8 Del. C. § 102(b)(1). Please click here to read our discussion of the Delaware Supreme Court's decision in *Salzberg*.

would otherwise exist. But Section 22 of the Securities Act *does* allow federal jurisdiction over these claims, and the FFP does not attempt to limit the venue of any federal district action."

The court emphasized that the FFP causes "no disruption of the substantive rights of the shareholders to all protections provided by the Securities Act of 1933" and impacts "only the procedural aspect of state versus federal forum." The court stated that "[t]here is no procedural loss of Due Process, as they can present their federal claims to a federal court" and "have the opportunity for discovery, and trial by jury." The court observed that "[t]here is even greater authority in federal court to obtain personal jurisdiction over defendants, and to subpoena witnesses to trial."

While the court dismissed claims against the issuer and its directors and officers, the court denied motions without prejudice brought by the underwriter and venture capital defendants, noting that further substantiation was needed to determine if they are entitled to the benefit of the FFP.

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