Simpson Thacher

Securities Law Alert

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Simpson Thacher "has a very experienced and knowledgeable team for securities class action defense."

– *The Legal 500*

Southern District of New York: Dismisses Securities Fraud Class Action Due to Conclusory Factual Allegations and Unidentified Sources

On January 10, 2023, the Southern District of New York dismissed with prejudice a putative securities fraud class action alleging that an online sports betting company and certain affiliated executives made false and misleading statements concerning a target company in advance of a three-way business combination between the company, the target, and a SPAC, with the resulting company becoming public. *In re Draftkings Sec. Litig.*, 2023 WL 145591 (S.D.N.Y. 2023) (Engelmayer, J.). Noting that plaintiffs' allegations were based almost entirely on a short seller report, which itself was based largely on unsourced or anonymously sourced allegations, the court held that the complaint's "threadbare sourcing and the conclusory quality of these factual allegations and attributions are ultimately fatal" to all of its claims.

The target developed software for online and retail sportsbook and casino gaming products. Following the business combination, a published short seller report claimed that the target operated in certain foreign jurisdictions where gambling was illegal (so-called "black-market" jurisdictions). Within weeks, plaintiffs commenced this action and asserted claims under Section 10(b) and Rule 10b-5, alleging that the company had made materially false and misleading statements about the target's violations of foreign law and their potential consequences. Specifically, plaintiffs alleged that while the company had stated in the merger agreement, the proxy statement, other public filings and press releases that the target was in compliance with the gaming laws of six black-market foreign countries, that the target had, in fact, secretly and illegally operated in these jurisdictions. Defendants moved to dismiss.

Noting that the complaint relied almost entirely on the short seller report, the court found that two features of the report were problematic, in compounding ways. First, the court explained that it must consider the complaint's allegations with caution because the short seller has an economic motivation to drive down the company's stock price. *See Long Miao v. Fanhua, Inc.*, 442 F. Supp. 3d 774 (S.D.N.Y. 2020). Second, the short seller report was based on "confidential sources," rather than identifiable and/or verifiable sources. The court explained that while "a confidential source need not be identified for his or her statements to be credited on a motion to dismiss, such a source must be 'described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.'" *Emps.' Ret. Sys. of Gov't of the V.I. v. Blanford*, 794 F.3d 297 (2d Cir. 2015). Putting these factors together, the court noted that "[a]s the case law further reflects, where these two problematic features coincide—when a complaint's factual attributions to unidentified sources derive not from interviews by plaintiffs' counsel, but from a short-seller report's attributions to such sources—there is still greater need for care." *In re Draftkings Sec. Litig.*, 2023 WL 145591, at *56.

The court further explained that if plaintiffs' counsel has not interacted with the unidentified source and was ignorant of the source's name, position, and other attributes tending to bear on the source's credibility, "and instead extracted and pled as true statements from a report by a short seller attributing adverse facts to unidentified persons, these aspects of the complaint, if not corroborated, are fairly discounted or put aside altogether as ill-pled." *Long Miao*, 442 F. Supp. 3d. The court found that such was the case here, noting that the complaint relied on statements from the short seller report attributed to unidentified former employees to support plaintiffs' claim that the target engaged in black-market operations. The court noted that the statements of attribution were general in nature and "devoid of details lending themselves to corroboration" such as where, when, and how the target operated in each jurisdiction at issue.

Explaining its denial of plaintiffs' request to amend, the court noted that plaintiffs had already amended the complaint twice (once before and once after a motion to dismiss). The court had warned plaintiffs then that if they chose to amend rather than oppose a motion to dismiss, then no further opportunities to amend would ordinarily be granted. Further, the court stated that plaintiffs failed to: (i) identify additional factual allegations that would cure the deficiencies noted in the motion to dismiss; (ii) explain how further investigation or diligence would rectify the deficiencies; or (iii) offer any reason for the court to disregard its earlier warning.

Southern District of New York: Plaintiff Failed to Plead That Crypto Exchange Platform Was a Statutory Seller or Actively Solicited Sales Under *Pinter*

On February 1, 2023, the Southern District of New York dismissed a putative class action brought by customers alleging that a company sold cryptocurrencies as unregistered securities through its two online digital trading platforms. [*Underwood v. Coinbase Global*, 2023 WL 1431965 (S.D.N.Y. 2023) (Engelmayer, J.)](). Discounting the amended complaint's allegations, which contradicted the original complaint, the court held that plaintiffs failed to plead that the company was

a "statutory seller" under *Pinter*'s first prong[1] as plaintiffs did not plead that the company passed title to the buyer. The court also held that plaintiffs failed to allege that the company actively solicited the sales under the second prong.[2]

"Section 12(a)(1) of the Securities Act creates a private right of action for the purchaser against the seller in any transaction that violates Sections 5(a) or (c)," which "prohibit any person from selling unregistered securities using any means of interstate commerce unless the securities are exempt from registration." 15 U.S.C. § 77e(a), (c). To state a claim under Section 12(a)(1), plaintiff must allege defendant meets the "statutory seller" requirements articulated in *Pinter*. Under *Pinter* an individual is a "statutory seller" if defendant either: (i) "passed title, or other interest in the security, to the buyer for value" (in other words, was the "direct seller"); or (ii) "successfully solicited the purchase of a security, motivated at least in part by a desire to serve its own financial interests or those of the securities' owner."

In their amended complaint, plaintiffs alleged that the company was the statutory seller under the first prong of *Pinter* because the company held title to the cryptocurrencies at the time of the transactions among the users because the digital assets were placed in a centralized wallet. Therefore, plaintiffs alleged that for every transaction involving these digital assets, the only blockchain address that a user ever interacted with was provided and owned by the company such that users interacted with the company, not with each other. Noting that while such "allegations would ordinarily assist plaintiffs in pleading this theory" the court determined that because these allegations were contrary to those in the original complaint, it should disregard the amended pleading.

The court observed that the original complaint's factual allegations related to counterparties undermined plaintiffs' thesis in the amended complaint that the company was a statutory seller under the first prong. Specifically, the original complaint had alleged that once digital assets were credited to a user's wallet, the user could enter into trade agreements with other users for purchases and sales of digital assets; however, the amended complaint alleged that buyers and other users as sellers were not in privity with one another. The court further observed that the original complaint's factual allegations about who held title to the digital assets undermined plaintiffs' thesis in the amended complaint. Specifically, the original complaint incorporated a user agreement that was in effect during the class period and indicated that the users were the title holders, thereby contradicting the amended complaint's allegations that the company held title to the digital assets. In language directed to the user, the user agreement stated, "You control the Digital Currencies held in your Digital Currency Wallet" and that "Title to Digital Currency shall at all times remain with you and shall not transfer to [the company]." Therefore, the court held that amended complaint's allegations fell short of meeting the first prong of *Pinter*.

Regarding the second prong of *Pinter*—examining whether the company solicited the transactions—the court explained that to hold a defendant liable under Section 12 as a seller, plaintiffs must demonstrate defendant's "direct and active participation in the solicitation of the immediate sale." The court determined that the amended complaint's allegations failed because they did not "describe conduct beyond the

1. *Pinter v. Dahl*, 486 U.S. 622 (1988).

2. Plaintiffs also asserted certain state-law claims that are not discussed in this summary, which were based on the company's alleged sale of unregistered securities and failure to register as a broker-dealer. These state-law claims were dismissed without prejudice based on the court's decision not to exercise supplemental jurisdiction. Additionally, plaintiffs brought a claim under Section 29(b) of the Exchange Act, alleging that the company utilized illegal contracts with users in violation of the Exchange Act's registration requirements. As with plaintiffs' Securities Act claim under Section 12(a)(1), the Exchange Act claim was also dismissed with prejudice.

'collateral' participation that *Pinter* and its progeny exclude from Section 12 liability." The amended complaint alleged, among other things, that the company promoted the tokens with descriptions of the tokens, participated in direct promotions, and wrote news updates on token price movements. The court described these efforts as akin to marketing efforts, materials, and services that courts have held to be insufficient to establish active solicitation under *Pinter*'s second prong. Generally, it appears that active solicitation involves defendant directly contacting investors. For example, in *Holsworth v. BProtocol Foundation*, 2021 WL 706549 (S.D.N.Y. Feb. 22, 2021), the court dismissed a Section 12 claim, stating that plaintiff failed to show that he was directly contacted by defendants or that he purchased securities as a result of any active solicitations by defendants.

Court of Chancery of Delaware: Clarifies for the First Time That Corporate Officers, Not Just Directors, Have a Duty of Oversight

On January 25, 2023, the Court of Chancery of Delaware denied dismissal of a derivative action alleging that the defendant former head of human resources for a global fast food company breached his fiduciary duties by: (i) consciously ignoring red flags regarding sexual harassment and misconduct at the company (duty of oversight); and (ii) personally engaging in sexual harassment (duty of loyalty). *In re McDonald's S'holder Derivative Litig.*, 2023 WL 387292 (Del. Ch. 2023) (Laster, V.C.). Rejecting defendant's argument that Delaware law does not impose any obligation on officers that are comparable to the duty of oversight for directors established by *In re Caremark International Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), the court announced that "[t]his decision clarifies that corporate officers owe a duty of oversight." While acknowledging that no previous Delaware decision has explicitly stated this proposition, the court stated that "diverse authorities indicate that officers owe a fiduciary duty of oversight as to matters within their areas of responsibility."[3]

The Scope of an Officer's Duty of Oversight

Concluding "that oversight liability for officers requires a showing of bad faith[,]" the court explained that "[t]he officer must consciously fail to make a good faith effort to establish information systems, or the officer must consciously ignore red flags." The court stated that the duty of oversight is context-driven and its application will differ depending on the officer's role. For example, some officers, like the CEO, will have a company-wide remit, while others are generally limited to particular areas, reporting red flags only within their areas of responsibility. The court cautioned, however, "a particularly egregious red flag might require an officer to say something even if it fell outside the officer's domain."

Plaintiffs' Allegations Support an Oversight Claim Against Officer Defendant

As to the applicable standard, the court stated: "To plead a Red-Flags Claim that will survive a Rule 12(b)(6) motion, a plaintiff must plead facts supporting an inference that the fiduciary knew of evidence of corporate misconduct. The plaintiff also must plead facts supporting an inference that the fiduciary consciously failed to take action in response. The pled facts must support an inference that the failure to take action was sufficiently sustained, systematic, or striking to constitute action in bad faith. A claim that a fiduciary had notice of serious misconduct and simply brushed it off or otherwise failed to investigate states a claim for breach of duty."

3. Among these authorities, the court cited *Caremark*, *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009) (holding that officers' fiduciary duties are the same as directors' fiduciary duties), principles of agency, decisions from other jurisdictions, and academic commentary.

The court found that plaintiffs asserted a "Red-Flags Claim" because plaintiffs described that defendant: (i) knew about evidence of sexual misconduct; and (ii) acted in bad faith by consciously disregarding his duty to address the misconduct.

The court found that plaintiffs alleged a number of red flags, including coordinated EEOC complaints, employee strikes and Congressional inquiries, indicating for pleading purposes that sexual harassment occurred at the company and supporting a reasonable inference that defendant knew about the red flags. The court observed that defendant was the executive officer with day-to-day responsibility for overseeing the human resources function and promoting a safe and respectful environment, and was thus "supposed to have his ear to the ground and be knowledgeable about the Company's employees." As to bad faith, the court explained that Delaware law presumes that directors and officers act in good faith, and a complaint must plead facts sufficient to support an inference of bad faith intent. The court stated that several factors support an inference of scienter. In this regard, the court pointed to plaintiffs' allegations that defendant engaged in multiple acts of sexual harassment and concluded that "[w]hen a corporate officer himself engages in acts of sexual harassment, it is reasonable to infer that the officer consciously ignored red flags about similar behavior by others."

Plaintiffs Also Stated a Claim for Breach of the Duty of Loyalty Based on Officer Defendant's Own Acts of Sexual Harassment

The court also denied dismissal of plaintiffs' claim that defendant's own acts of sexual harassment constituted a breach of the duty of loyalty. The court explained that an alleged harasser acts in bad faith and breaches the duty of loyalty because a harasser engages in sexual harassment for selfish reasons, which conflicts with an officer's duty of loyalty.

The court concluded by noting: "Sexual harassment is bad faith conduct. Bad faith conduct is disloyal conduct. Disloyal conduct is actionable."

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