Simpson Thacher

Securities Law Alert

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Third Circuit: A District Court Must Impose "Some Form" of Rule 11 Sanctions When It Finds Rule 11 Violations in Proceedings Governed by the PSLRA

On April 5, 2023, the Third Circuit resolved whether a district court erred in failing to award attorneys' fees or impose any other sanctions in connection with determining that plaintiffs violated Rule 11 in bringing certain federal securities claims following their purchase of unregistered securities in a company's stock offering. *Scott v. Vantage Corp.*, 64 F.4th 462 (3d Cir. 2023) (Smith, J.). The Third Circuit affirmed the district court's determination that certain of plaintiffs' claims violated Rule 11 and that the company's founder (the only defendant party to the appeal) was not entitled to attorneys' fees. The court held, however, that the PSLRA "mandates the imposition of some form of sanctions when parties violate Rule 11 in bringing federal securities claims."

Background and Procedural History

Plaintiffs brought federal securities claims against the defendant company, its president, and the company's founder after they purchased stock in the company's 2016 stock offering under SEC Rule 506(b).[1] Plaintiffs became concerned about the company's financial condition shortly after they invested their funds but, having no right to rescind based on their stock agreements, plaintiffs sued, asserting ten counts against defendants, including three federal securities claims (an unregistered securities claim, a misrepresentation claim, and a Rule 10b-5 securities fraud claim). In 2019, the district court granted summary judgment for the company's founder and the company's president on the three federal securities law claims, which the Third Circuit affirmed. Before the district court's summary judgment ruling, the company entered bankruptcy proceedings.

1. Securities offerings under Rule 506(b) are exempt from registration. An issuer must still meet certain requirements, however, including that an issuer cannot engage in general solicitation or advertising, securities cannot be sold to more than 35 non-accredited investors, and that non-accredited investors must have sufficient knowledge and experience to evaluate potential risks.

After performing the PSLRA-mandated Rule 11 inquiry, the district court concluded that plaintiffs had violated Rule 11 with respect to their unregistered securities claim and their misrepresentation claim against the company's founder, but had not violated Rule 11 as to their 10b-5 securities fraud claim. Notably, the district court declined to award the company's founder attorneys' fees or impose any other sanction based on its conclusion that plaintiffs' Rule 11 violations against him "were not a substantial violation under the PSLRA" because plaintiffs had a reasonable basis to believe they had factual support for their securities fraud claim, which it considered to be "the heart of the complaint." By contrast, the district court awarded attorneys' fees to the company's president after determining that plaintiffs violated Rule 11 in their claims against him. The district court concluded that the claims against the company's president were "tenuous, and that his only connection to Plaintiffs' claims was his 'mere status' as a control person." As to the company, it entered bankruptcy proceedings before the district court conducted its Rule 11 analysis.

Certain of Plaintiffs' Federal Securities Claims Violated Rule 11

On appeal, the Third Circuit affirmed the district court's determination that plaintiffs' unregistered securities claim[2] and their misrepresentation claim[3] against the company's founder violated Rule 11. The Third Circuit also held that the district court did not abuse its discretion in determining that these claims lacked factual support in violation of Rule 11(b)(3). Noting that, under *Mary Ann Pensiero, Inc. v. Lingle*, 847 F.2d 90 (3d Cir. 1988), courts should assess Rule 11 compliance by assessing a party's or attorneys' conduct based on what was reasonable to believe at the time of the complaint, the Third Circuit stated that plaintiffs made only general unregistered securities allegations in the complaint and failed to identify any specific individuals as unaccredited investors. Similarly, as to the misrepresentation claim, the Third Circuit pointed to the district court's determination that plaintiffs' pre-filing investigation should have revealed the lack of factual support for their allegation that the offering was public.

The Third Circuit also affirmed the district court's determination that plaintiffs' 10b-5 securities fraud claim did not violate Rule 11. The Third Circuit concluded that there was no abuse of discretion in the district court's determination that plaintiffs had a reasonable basis to allege securities fraud. The Third Circuit also noted that while the district court did summarily dismiss the 10b-5 claim, "courts must ensure that Rule 11 'not be used as an automatic penalty against an attorney or a party advocating the losing side of a dispute.'" (quoting *Gaiardo v. Ethyl Corp.*, 835 F.2d 479 (3d Cir. 1987)).

2. In their unregistered securities claim, plaintiffs alleged that defendants failed to meet registration exemption requirements and that the offering violated federal securities law because the founder sold securities to allegedly unsophisticated and unaccredited investors without providing sufficient disclosures. The district court concluded that the founder reasonably believed that both investors in question were accredited at the time of their security purchases.

3. Plaintiffs alleged that the founder violated 15 U.S.C. § 771(a)(2) by making misrepresentations while selling company stock (for example, by misrepresenting the company's resources). The district court found that the documentation provided to prospective investors clearly identified the offering as private and for accredited investors only and concluded that such misrepresentation claims did not apply to the private sale of securities.

It Was an Abuse of Discretion Not to Impose Any Sanctions

Ultimately, the Third Circuit concluded that the district court abused its discretion in declining to impose any form of sanctions and vacated the portion of the order that declined to impose sanctions because the text of the PSLRA makes the imposition of sanctions mandatory after a court determines that a party has violated Rule 11. On remand, the Third Circuit instructed the district court to impose "some form of sanction" against plaintiffs in accordance with Rule 11, but took no position on what sanction to impose acknowledging that the district court was better situated to make that determination.

Ninth Circuit: Complaint Timely Where Plaintiff Could Not Have Discovered Necessary Facts Until an SEC Order Revealed That a Company's Statements Were Misleading

On April 11, 2023, the Ninth Circuit reversed and remanded a district court's dismissal of a securities fraud class action on the ground that it was untimely. *York Cnty. v. HP, Inc.*, 65 F.4th 459 (9th Cir. 2023) (Bybee, J.). The Ninth Circuit determined that the defendant printing supply company's "allegedly fraudulent statements, on their own, were insufficient to start the clock on the statute of limitations." The Ninth Circuit held that the complaint was timely, concluding that plaintiff could not have discovered the facts necessary to plead an adequate complaint until after the issuance of an SEC order that revealed the misleading nature of defendants' statements.

Background and Procedural History

During investor calls between November 2015 and June 2016, the defendant company made statements about whether it was meeting its inventory target ranges. The company allegedly failed, however, to disclose its complete inventory information or that it engaged in sales practices that led to short term gains but harmed overall profits.[4] Following an investigation, the SEC allegedly uncovered these practices and issued an order in 2020 ("SEC Order") instituting cease-and-desist proceedings. The company agreed to pay a fine but did not admit or deny the allegations. The SEC Order alleged that the company's disclosures omitted material information causing them to be incomplete and misleading.

Within weeks of the SEC Order, plaintiff filed a complaint alleging that the company violated Section 10(b) and Rule 10b-5. The company moved to dismiss on the basis that plaintiff's claims were time-barred by the two-year statute of limitations in 28 U.S.C. § 1658(b)(1), which provides "that private actions alleging securities fraud must be brought no more than '2 years after the discovery of the facts constituting the violation' of securities laws."[5] The district court dismissed the complaint as time-barred, finding that the public statements, loss in profits, and reductions in channel inventory had all taken place by 2016 and reasoning that a reasonably diligent plaintiff would have discovered the operative facts of its complaint in 2016, more than four years before the complaint was filed.

4. One of these practices was gray marketing, which involves selling supplies to a distributor who would then sell them at a discount outside of its assigned territory. These sales would force local distributors to lower their prices to compete with marked-down goods from other territories. The company also used pull-ins, which are discounts offered to encourage distributors to take additional shipments in a given quarter that would leave distributors with a full inventory at the beginning of the following quarter leading to lower sales.

5. The company also moved to dismiss on the basis that plaintiff's claims were time-barred by the five-year statute of repose in 28 U.S.C. § 1658(b)(2), which the district court did not address in view of its conclusion that the claims were barred by the statute of limitations. The Ninth Circuit expressed no opinion on the statute of repose issue.

Facts Not Deemed Discovered Until Plaintiff Has Sufficient Detail and Particularity to Survive a Motion to Dismiss

Relying on *Merck & Co. v. Reynolds*, 559 U.S. 633 (2010), the Ninth Circuit held that "a defendant establishes that a complaint is time-barred under § 1658(b)(1) if it conclusively shows that either (1) the plaintiff could have pleaded an adequate complaint based on facts discovered prior to the critical date and failed to do so, or (2) the complaint does not include any facts necessary to plead an adequate complaint that were discovered following the critical date." Under *Merck*, "the critical date" is defined as the date "two years before the complaint was filed." Adopting the reasoning of *City of Pontiac General Employees' Retirement System v. MBIA, Inc.*, 637 F.3d 169 (2d Cir. 2011), the Ninth Circuit further held that a "reasonably diligent plaintiff has not 'discovered' one of the facts constituting a securities fraud violation until he can plead that fact with sufficient detail and particularity to survive a 12(b)(6) motion to dismiss."

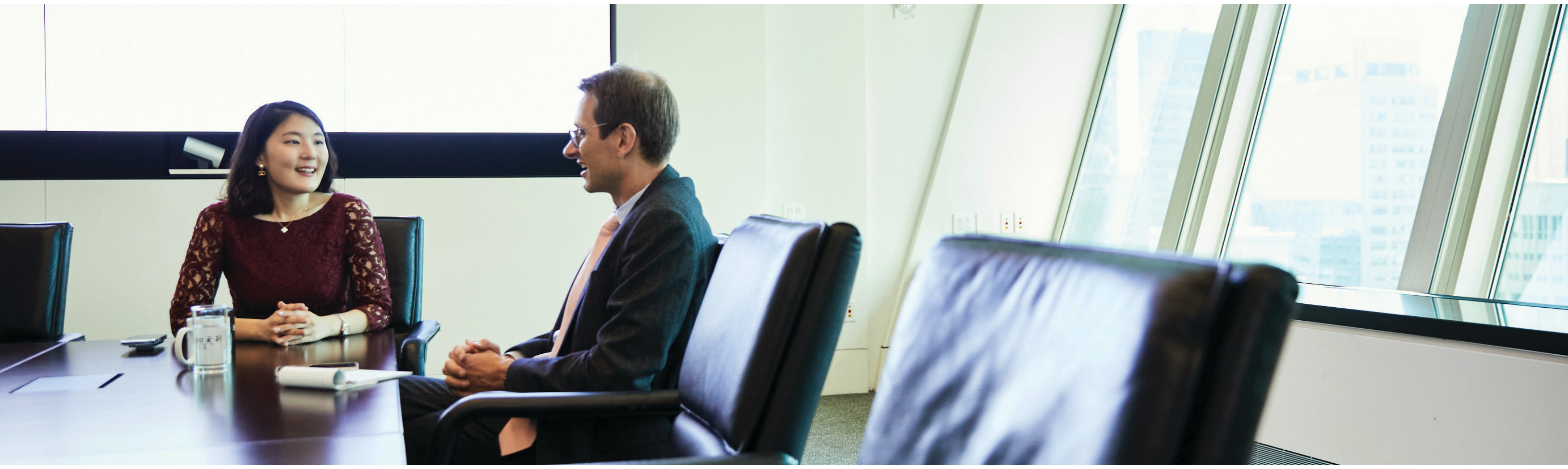
In this case, the critical date was April 21, 2019—two years before the complaint was filed on April 21, 2021. Separating the facts alleged to have occurred before the critical date from those alleged to have occurred after it, the Ninth Circuit noted the allegation that the false statements and misrepresentations were made approximately three years before the critical date. The court then pointed out plaintiff's assertion that it did not "discover the facts constituting the violation" until after the critical date because "the SEC Order put [the company's] prior statements in a new context, revealing that ostensibly innocuous statements were actually intentional misrepresentations." In other words, plaintiff argued that the issuance of the SEC Order provided sufficient evidence of scienter.

Because plaintiff pleaded facts that post-dated the critical date, the court explained that the company could show the claim was time-barred by either showing that: (i) plaintiff "could have pleaded its claim based solely on things that it knew or should have known prior to the critical date"; or (ii) "the SEC Order provided no information necessary" to plaintiff's claim. The court stated that the company did not explain how plaintiff could have known of the allegedly fraudulent practices prior to the critical date or have pleaded scienter without discovering these practices. For the same reasons, the court also concluded that the company failed to show that the SEC Order did not provide information necessary for plaintiff to plead an adequate complaint.

Southern District of New York: Interprets the Purchaser-Seller Rule in the Context of a De-SPAC Transaction

On March 31, 2023, the Southern District of New York dismissed[6] a securities fraud class action against a post de-SPAC company alleging that the pre-merger privately held

6. In its order, the court dismissed the class action without prejudice and granted plaintiffs one opportunity to amend the second amended complaint. However, plaintiffs failed to file an amended complaint within the 30-day timeframe.



company had made false and misleading statements before the merger in violation of Section 10(b). *In re CarLotz Sec. Litig.*, 2023 WL 2744064 (S.D.N.Y. 2023) (Abrams, J.).[7] The court held that plaintiffs—who purchased shares of the SPAC and the post-merger public company, not the privately held pre-merger company—lacked standing and that their challenge to any statements the pre-merger private company made about itself was foreclosed by *Menora Mivtachim Insurance v. Frutarom Industries*, 54 F.4th 82 (2d Cir. 2022).[8]

Background

The defendant company is an online used car marketplace that went public in January 2021 following a de-SPAC transaction. Plaintiffs brought this securities class action against the company, and various related entities and individuals. Plaintiffs alleged that officers of the pre-merger private company made materially false and misleading statements concerning their business model prior to the shareholder vote approving the de-SPAC transaction. Following the merger, the post-merger public company's stock dropped. All defendants moved to dismiss on the basis that plaintiffs lacked standing under Section 10(b) to challenge any statements made by the pre-merger private company or its officers about the pre-merger private company.

7. Simpson Thacher represents the following defendants in this action: Acamar Partners Sponsor I LLC, James E. Skinner, Domenico De Sole, Luis Ignacio Solorzano Aizpuru, Juan Carlos Torres Carretero and Teck H. Wong.

8. Please click here to read our discussion of *Frutarom*.

The Court Looks to the Purchaser-Seller Rule as Interpreted in *Frutarom*

In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the Supreme Court endorsed the "purchaser-seller rule" established in *Birnbaum v. Newport Steel*, 193 F.2d 461 (2d Cir. 1952), which limited plaintiffs under Section 10(b) to "actual purchasers or sellers of securities." In *Ontario Public Service Employees Union Pension Trust Fund v. Nortel Networks*, 369 F.3d 27 (2d Cir. 2004), the Second Circuit addressed the purchaser-seller rule, and held that plaintiff stockholders lacked standing for their Section 10(b) claim because while the stock of the company that they did purchase was negatively impacted by the material misstatement of another company (which had been involved in a number of business relationships with the company they owned stock in), they did not purchase the stock of the company that allegedly made the misstatement. Noting that a potential merger might require a different outcome, the court declined to decide how the purchaser-seller rule would apply to a potential merger. Subsequently, in *Frutarom*, the Second Circuit answered that question and held that "purchasers of a security of an acquiring company do not have standing under Section 10(b) to sue the target company for alleged misstatements the target company made about itself prior to the merger between the two companies."[9]

Determining that *Frutarom* foreclosed plaintiffs' challenge, the court pointed out that in this case neither of the named plaintiffs purchased shares of the pre-merger private company and that the only pre-merger shares purchased were those of the publicly

9. In *Frutarom*, plaintiff purchasers of a U.S. corporation's securities alleged that before a merger between the corporation and a non-U.S. firm—in which the firm became a wholly-owned subsidiary of the corporation—the firm made materially misleading statements. The Southern District of New York concluded that plaintiffs lacked standing to sue the non-U.S. firm defendants for statements relating to the firm because plaintiffs never purchased or sold its securities. A panel majority of the Second Circuit affirmed.

traded SPAC. The court further noted that the challenged statements were made by the pre-merger private company about itself, not the SPAC. The court rejected plaintiffs' attempt to equate the pre-merger private company with the post-merger public company, finding that "[p]laintiffs provide no explanation as to why, as a legal matter, the post-merger entity can be considered interchangeable with the pre-merger, privately held company."

In response to plaintiffs' concern that *Frutarom* allows parties to make misstatements before a de-SPAC transaction with impunity, the court pointed out that the *Frutarom* majority considered similar policy arguments and rejected them, reasoning that plaintiffs could still bring claims alleging material misstatements against target companies through SEC enforcement actions, shareholder derivative suits, or under state law.

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This will be the last edition of the Securities Law Alert distributed on a monthly basis. Beginning in June, we will distribute updates shortly after developments occur, in addition to periodic summaries.

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