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Securities Law Alert

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October 2022

Second Circuit: Acquirer Shareholders Lacked Standing to Sue a Merger Target Under Section 10(b) Because They Never Bought or Sold the Target's Shares

On September 30, 2022, the Second Circuit affirmed a district court's dismissal of a putative securities fraud class action brought by shareholders of a U.S. company that acquired a non-U.S. target company, alleging that the target made misstatements about itself in advance of the merger in violation of Section 10(b). *Menora Mivtachim Ins. v. Frutarom Indus.*, 2022 WL 4587488 (2d Cir. 2022) (Park, J.). Creating a bright-line rule, the Second Circuit held that plaintiffs lacked standing under Section 10(b) to sue the target because plaintiffs had bought shares of the acquirer, not shares of the target.

Background and Procedural History

Plaintiffs alleged that for several years before the merger, executives at the target bribed key employees of important clients to generate business and bribed foreign import officials. Plaintiffs alleged that in the lead up to the merger, the target made materially misleading statements about the sources of its business growth and its compliance with anti-bribery laws. After the acquisition closed the target became a wholly-owned subsidiary of the acquirer. Several months later, the acquirer acknowledged that the target had "made improper payments to representatives of a number of customers" and the acknowledgment was followed by a stock drop.

Plaintiffs sued the acquirer, two of its officers, the target, and five of its officers, alleging that they made materially misleading misstatements in violation of Section 10(b). The Southern District of New York granted defendants' motion to dismiss, finding that the complaint failed to allege with the requisite particularity that the target's misconduct continued into the class period.[1] The district court concluded that, "in any case, the allegedly false statements and omissions of material fact were not actionable or material" and that "plaintiffs lack statutory standing under Section 10(b) to bring claims against the [target] defendants for statements made about [the target]." Plaintiffs appealed the decision only against the target and certain of its officers.

Acquirer Shareholders Lack Standing to Sue a Target Company Under Section 10(b)

The Second Circuit began its analysis by discussing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), where the Supreme Court adopted the "purchaser-seller rule" from *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952). The rule "requires plaintiffs to have bought or sold a security of the issuer about which a misstatement was made in order to have standing to sue under Section 10(b)." In *Blue Chip Stamps*, the Court expressed concern that to hold otherwise would lead to vexatious litigation and warned against permitting "endless case-by-case erosion" of the rule in the future.

Plaintiffs argued that as acquirer shareholders, they had standing because there was a "sufficiently direct relationship" between the target's misstatements about itself and the price of the acquirer's shares. However, the Second Circuit rejected this argument as meritless, explaining that judicially created private rights of action should be narrowly construed. The Second Circuit refused to adopt plaintiffs' "direct relationship" test stating that doing so would begin the erosion of the purchaser-seller rule. Further, the Second Circuit observed that such a test would cause courts to engage in a "shifting and highly fact-oriented" inquiry requiring them to determine whether there was a sufficiently direct link between one company's misstatements and another company's stock price. The Second Circuit concluded that, in this case, plaintiffs lacked statutory standing to sue the target because they bought shares of the acquirer not the target.

1. The class period ran from the time of the merger announcement to approximately one week after the acquirer's stock price drop.

Second Circuit: Vacates Class Action Dismissal Concluding That the District Court Misinterpreted the Scope of a Forum Selection Clause and Attributed Undue Weight to a Foreign Country's Interest

On August 26, 2022, the Second Circuit vacated and remanded a district court's dismissal of a lawsuit, on the ground of forum non conveniens, challenging a going-private merger involving the defendant e-commerce company and the purchase of its outstanding publicly-traded American Depositary Shares ("ADSs") by the company's controlling shareholders. [*Fasano v. Guoqing Li*, 47 F.4th 91 (2d Cir. 2022) (Kearse, J.)]. The Second Circuit held that the district court gave the forum selection clause[2] at issue an unwarrantedly narrow interpretation causing it to undercount the defendants who should be covered by it and that the district court erred in weighing the public interest factors.

2. The forum selection clause provides, in relevant part, "Any controversy, claim or cause of action brought by any party hereto against the Company arising out of or relating to the Shares or other Deposited Securities, the American Depositary Shares, the Receipts or the Deposit Agreement, or the breach thereof shall be settled by arbitration . . . however, that any such controversy, claim or cause of action relating to or based upon the provisions of the Federal securities laws of the United States . . . shall be submitted to arbitration if, but only if, so elected by the claimant."

Background and Procedural History

The company, incorporated in the Cayman Islands, became publicly traded in 2010 with its shares trading as ADSs on the NYSE, covered by a deposit agreement containing a forum selection clause requiring arbitration of certain disputes. In 2015, the company's CEO/founder led a group of allegedly controlling shareholders[3] that proposed a going-private merger by offering to buy out the company's minority shareholders. The going-private merger closed in 2016. Subsequently, plaintiff former owners or holders of the company's ADSs commenced a putative class action against the company and its controlling shareholders challenging the merger and alleging negligent misrepresentation, breach of fiduciary duty, and federal securities claims under Sections 10(b), 13(e), and 20(a) of the Exchange Act. The Southern District of New York determined that the forum selection clause only applied to the claims "relating to or based upon" federal securities law—not the negligent misrepresentation and breach of fiduciary duty claims—and that only the company was a signatory to the deposit agreement, therefore, many of the codefendants were not subject to the forum selection clause. The district court further held that the public interest factors favored dismissal on the ground of forum non conveniens because the forum selection clause was applicable to only half of plaintiffs' claims and to only five of the 13 named defendants.

It Was Reasonably Foreseeable That the "Buyer Group" Would Be Bound by the Forum Selection Clause

On appeal, the Second Circuit concluded that the district court erred: (i) by giving the forum selection clause an unwarrantedly narrow interpretation, thereby undercounting the non-signatory defendants who should be covered by the forum selection clause; and (ii) in weighing the public interest factors.

As to the district court's conclusion that certain defendants could not have foreseen being bound by the forum selection clause, the court stated that the lower court's "unduly narrow" focus on the issuance of the company's ADSs (rather than the ADSs themselves or their alleged confiscation) "infected its conclusion as to what parties the Forum Selection Clause covers." Weighing defendants' connection to the subject matter of the action, and the propriety of finding the forum selection clause was applicable to them, the Second Circuit found it persuasive that these defendants were in the buyer group that caused plaintiffs' ADSs to be eliminated and that the proxy statement repeatedly stated that they would be subject to the deposit agreement's terms and conditions. The court concluded that "it was reasonably foreseeable to any member of the 'Buyer Group' that they would be subject to the underlying deposit agreement, and therefore its Forum Selection Clause."

The Public Interest Factors Did Not Justify a Forum-Non-Conveniens Dismissal

The Second Circuit also concluded that the public interest factors could not justify a forum-non-conveniens dismissal. As to the district court's conclusion that dismissal was warranted because only half of plaintiffs' claims were covered by the forum selection clause, the Second Circuit indicated that it appeared that the district court was seeking to avoid bifurcation of the case. However, the Second Circuit stated that it was not possible to avoidance bifurcation if plaintiffs insisted on their rights under the deposit agreement to have their federal securities claims litigated in court because the deposit agreement required all of their other claims to be submitted to arbitration.

Cayman Islands Has No Genuine Interest In Adjudicating U.S. Federal Securities Claims

The Second Circuit also concluded that while plaintiffs' common-law claims were likely governed by Cayman Islands law because the company was incorporated there, a forum-non-conveniens dismissal could not serve the Cayman Islands' interest in having those claims "decided at home" because the deposit agreement required those claims to be submitted to arbitration in New York. The court reasoned that because plaintiffs' common-law claims could only be pursued in a New York arbitration, if

3. Aside from the company's CEO/founder, this group included certain officers or directors of the company, its parent company, and three British Virgin Island entities that were controlled by the CEO/founder.

the forum-non-conveniens dismissal stood then the only claims to be determined in the Cayman Islands would be the federal securities claims. The Second Circuit stated that it could not see any genuine interest of the Cayman Islands in adjudicating such claims, in contrast to the U.S., which the court stated has a vital interest in having its own courts decide an unsettled securities law question (namely, whether Section 13(e) implies a private right of action).

Southern District of New York: Defendant Company Did Not Act as an ERISA Fiduciary When It Recommended Defined Contribution Plan Participants Roll Over Assets Into Its Managed Account Service

On September 27, 2022, the Southern District of New York dismissed with prejudice a putative class action alleging that a financial services company and its subsidiary (together, "the company") violated the Employee Retirement Income Security Act ("ERISA"), by inducing plaintiff participants in employer-sponsored defined contribution retirement plans to transfer assets from these plans to the company's managed account service. *Carfora v. Tchrs. Ins. Annuity Ass'n of Am.*, 2022 WL 4538213 (S.D.N.Y. 2022) (Failla, J.). The court held that plaintiffs failed to allege that the company acted as a fiduciary when recommending rollovers, finding that, among other things, plaintiffs failed to plead facts demonstrating that the company rendered investment advice on a regular basis to the plans.

Background

The company provided plaintiffs' employer-sponsored plans with various administrative and investment related services while also running an individual advisory business in its capacity as a broker-dealer and investment advisor. Plaintiffs alleged that the company encouraged them to roll the money from their defined contribution plans over into the company's "Portfolio Advisor," a managed account service, allowing the company to earn higher fees. However, plaintiffs alleged that Portfolio Advisor had higher fees but did not consistently perform better than employer-sponsored plans. Plaintiffs commenced this putative class action asserting that the company acted as an ERISA fiduciary by soliciting them into the Portfolio Advisor program. The company sought dismissal, arguing that it was not an ERISA fiduciary and as such could not have breached any fiduciary duties.

The Court Weighs Whether the Company Was a Functional Fiduciary Under ERISA

The court explained that ERISA and its regulations lay out two avenues through which one can become a plan fiduciary subject to its statutory duties: either as a named fiduciary in the plan's written instrument or as a *de facto*, functional fiduciary. Because plaintiffs acknowledged that the company was not a named fiduciary, the court considered whether the company could be considered a functional fiduciary. ERISA provides that, "a person is a fiduciary with respect to a plan to the extent he renders investment advice for a fee . . . with respect to any moneys or other property of such plan, or has any authority or responsibility to do so." 29 U.S.C. § 1002(21)(A)(ii). The court stated that it would consider, among other things, the relevant statutory and regulatory provisions of ERISA, including the five-part investment advice test[4] promulgated by the Department of Labor in 1975, to determine whether the company was a functional fiduciary during the relevant time period.

Two to Three Interactions Was Insufficient to Constitute Providing Advice on a Regular Basis

As to whether the company provided "investment advice" on a "regular basis" under the five-part investment advice test, the court concluded that it did not. The court

4. The test is used to determine who qualifies as an "investment advice" fiduciary under the functional fiduciary statutory provision, stating that, "To plead that a defendant is a fiduciary because it provided investment advice for a fee in satisfaction of 29 U.S.C. § 1002(21)(A)(ii), a plaintiff must plead that (i) the defendant provided individualized investment advice; (ii) on a regular basis; (iii) pursuant to a mutual agreement, arrangement, or understanding that (iv) the advice would serve as a primary basis for the plan's investment decisions; and (v) the advice was rendered for a fee."

explained that to provide advice on a "regular basis," there must have been some number of instances in which advice was provided. However, the court found that plaintiffs' allegations of two to three interactions was "clearly insufficient." The court determined that the company's consultative sales process[5] did not constitute advice on a "regular basis" in a strictly numerical sense given the limited number of actual interactions with plan participants prior to the rollover decision. The court also pointed out that this limited number of actual interactions was related only to one investment decision, which was the roll over. According to the court, the term "regular basis" should not be considered as a mere quantitative inquiry, but could also be "understood in the context of routinely providing plans with investment advice on a variety of decisions." The court reasoned that "[t]he plain meaning of 'regular' runs counter to advisement related to a one-time decision, even if this decision is a consequential one."

Aggregate Roll-Over Recommendations Did Not Constitute Advice on a Regular Basis

As to plaintiffs' contention that all of the company's interactions with various plan participants in the aggregate could constitute regular investment advising, the court determined that this was "not supported in the caselaw, and indeed is contradicted by the statutory text and prevailing regulations."

Southern District of New York: Dismisses Class Action Alleging That a Drug Company Failed to Disclose Drug Trial Information

On September 12, 2022, the Southern District of New York dismissed with prejudice a putative securities fraud class action alleging that a drug company that was developing a COVID-19 vaccine failed to disclose information about its Phase II/III clinical trials in violation of Section 10(b) of the Exchange Act. *In re AstraZeneca plc Sec. Litig.*, 2022 WL 4133258 (S.D.N.Y. 2022) (Oetken, J.). The court held that plaintiffs failed to identify any misleading statement, determining that the challenged statements were not actionable because they "merely recite historical fact." The court disagreed that the challenged statements were misleading—on the ground that they created the impression that the trials were producing positive results and experienced no significant setbacks—stating that there is no generalized duty to disclose negative facts.

In 2020, the company began to develop a COVID-19 vaccine and conducted Phase II/III clinical trials. Plaintiffs alleged that the company failed to disclose, among other things, that some trial participants received half doses, that the clinical trials suffered from widespread flaws in design, errors in execution, that the clinical trials did not follow applicable protocols and guidelines, and that as a result the drug was unlikely to be approved for commercial use in the U.S. Plaintiffs commenced this action after a series of stock drops that were allegedly caused by various corrective disclosures. Defendants moved to dismiss under Federal Rules of Civil Procedure 8, 9(b), and 12(b)(6), as well as the PSLRA.

After concluding that the complaint failed to identify any misleading statement under Section 10(b), the court further determined that the complaint should be dismissed "under the PSLRA because it falls short of the PSLRA's 'particularity threshold.'" Explaining that the PSLRA obligates a

5. During the consultative sales process, the company's advisors would cold-call participants in company-administered employer sponsored plans to offer free financial planning services, the advisor would then meet with the participant, the advisor would create an individual financial plan based on the meeting and have a follow-up meeting where the advisor would pitch Portfolio Advisor.

plaintiff to "demonstrate with specificity why and how" each statement is materially false or misleading, the court held that the complaint did not adequately do so. The court pointed out that the complaint merely identified various defendant statements and repeated a "copy-and-pasted list of omissions." Citing *In re Alcatel Sec. Litig.*, 382 F. Supp. 2d 513 (S.D.N.Y. 2019), the court stated that such allegations did not specify why and how each statement was misleading because they do not specify what understanding each statement left investors, and how that understanding was inconsistent with alleged omissions.

The court further concluded that the complaint failed to state a claim "because it does not identify any statement made misleading by any alleged omission." As to plaintiffs' claim that defendants failed to disclose that some Phase II/III trial participants received half doses; that some received late second doses; and that the trial reflected "a patchwork of disparate patient subgroups, each with subtly different treatments" the court stated that "an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts." *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015). The court stated that plaintiffs "have not identified any inaccurate, misleading, or incomplete statement relating to" the Phase II/III dosing. As to company statements, such as the one highlighting "the start of a Phase II/III UK trial of AZD1222 in about 10,000 adult volunteers" the court stated that plaintiffs "identified only accurate statements describing the launch and historical progression of the Phase II/III clinical trials." Plaintiffs argued that these statements, even if literally truthful, were still misleading. However, the court stated that plaintiffs failed to allege "any relevant context to create a misleading impression." According to the court, plaintiffs' argument—that the statements alone created a misleading impression that the trials were proceeding as expected, producing positive results, and experiencing no significant setbacks or unusual issues—was the same as stating that the absence of a negative disclosure gave the impression that there were no negative facts. The court cautioned that if this were the standard then every omission would be actionable. Instead, the court explained, "there is no generalized duty to disclose negative facts." *In re Philip Morris Int'l Inc. Sec. Litig.*, 2021 WL 4135059 (S.D.N.Y. Sept. 10, 2021).

Plaintiffs also alleged that defendants put the "conduct of the trials at issue" when they mentioned the Phase II/III trials because under *In re Vivendi Securities Litigation*, 838 F.3d 223 (2d Cir. 2016) "once a company speaks on an issue or topic, there is a duty to tell the whole truth." However, the court disagreed finding that defendants' statements were "at such a high level of generality, and the alleged omitted facts so granular, that there is no violation of that principle here."

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