Simpson Thacher

Securities Law Alert

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– The Legal 500

Eleventh Circuit: Statements About Performance "Each Year" Held to Be Forward Looking; Actual Knowledge of Falsity Required

On August 1, 2022, the Eleventh Circuit affirmed a district court's dismissal of a putative securities class action alleging that a company that manufactures human nerve repair products had overstated the market for the company's products. *Einhorn v. Axogen*, 42 F.4th 1218 (11th Cir. 2022) (Brasher, J.). The court held that the company's statements about the number of nerve injuries and nerve repair procedures performed in the U.S. "each year" fell within the safe-harbor provision of the Securities Act for forward-looking statements.

Background and Procedural History

The company released various offering documents related to two public offerings of common stock. These offering documents addressed the company's purported growth potential and incorporated statements from the company's Form 10-Ks. For example, the company's 2017 10-K stated that: "We believe that each year in the U.S., more than 1.4 million people suffer damage or discontinuity to peripheral nerves resulting in over 700,000 extremity nerve repair procedures."

Subsequently, a short seller report concluded that there were only 28,000 peripheral nerve injury repair procedures each year in the U.S. The report was followed by a stock drop and plaintiff's class action alleging violations of the Securities Act and the Exchange Act. The U.S. district court for the Middle District of Florida dismissed the complaint with prejudice holding that the challenged statements were forward looking and protected by the safe-harbor provision.

The Securities Act Recognizes a Safe Harbor for Forward-Looking Statements

While the Securities Act creates a cause of action against persons or entities that make an "untrue statement of a material fact" or material omissions from a public filing related to an offering of securities, it also recognizes a safe harbor for "forward-looking" statements. The Eleventh Circuit has "held that the key

characteristic of a forward-looking statement is that its 'truth or falsity is discernible only after it is made.'" *Harris v. Ivax Corp.*, 182 F.3d 799 (11th Cir. 1999). Under *Harris*, a court is to look to the statement's context to evaluate whether it is forward looking or not.

The Phrase "Each Year" Is Forward Looking As It Is In Part a Prediction

The court concluded that the challenged statements were forward looking. The court explained that the "critical phrase" in the challenged statements is the company's assertion that a certain number of nerve injuries and procedures occur "each year." The court found that while "there is certainly an element of present or historical fact in the phrase 'each year,' the phrase is also forward looking" because the statement is in part a prediction about the number of injuries that will require repair. As found by the court, "[f]orward-looking statements 'often rest both on historical observations and assumptions about future events.'" (quoting *Harris*, 182 F.3d 799). Because the statements were used to support the company's market-size predictions, which were about "future economic performance," the court concluded that the predictions were forward-looking statements under the statute.

Plaintiff also argued that *Omnicare v. Laborers District Council Construction Industry Pension Fund*, 575 U.S. 175 (2015), relieved it of the burden to prove that the company made the statements with actual knowledge they were false or misleading. The court rejected this argument, holding that the safe-harbor provision "expressly requires a plaintiff to prove that a forward-looking statement was made with 'actual knowledge that the statement was false or misleading,'" while *Omnicare* ruled on whether an opinion can be actionable as a statement of fact and did not address the safe-harbor provision or remove the "actual knowledge" requirement. The Eleventh Circuit held that plaintiff's failure to plausibly allege the company's actual knowledge that the statements were false or misleading doomed its Securities Act claims.

Northern District of California: Plaintiffs Failed to Allege That Fintech Company Made False or Misleading Statements About Its Regulatory Compliance

On August 8, 2022, the Northern District of California dismissed with leave to amend a securities fraud class action alleging that a financial technology company and certain of its executives made false or misleading statements about the company's regulatory compliance. *Kang v. PayPal*, 2022 WL 3155241 (N.D. Cal. 2022) (Breyer, J.). Plaintiffs' core allegation concerned the company's statements that it had complied with a Consumer Financial Protection Bureau ("CFPB") consent order (the "Consent Order"). The court held that plaintiffs failed to plausibly allege a material false statement or omission because none of the company's alleged conduct violated the Consent Order.

The CFPB Complaint and the Consent Order

The company offers credit and debit products and allows consumers and merchants to send and receive digital payments. In 2015, the CFPB filed a complaint alleging that the company violated the Consumer Financial Protection Act by deceptively advertising promotional benefits, misleading customers about deferred interest, and enrolling customers in its credit product without their consent. The subsequent Consent Order enjoined the company from misrepresenting the terms and conditions of any promotion (such as deferred interest or money-back offers), required it to ensure that consumers receive the benefit of merchants' promotional offers, and prohibited the company from enrolling customers in its credit product without affirmative consent.

Purported Corrective Disclosures

In 2020, a nonprofit focused on alleviating student debt announced in a press release that for-profit colleges had misleadingly described the company's credit promotion. In 2021, Bloomberg News reported that the company faced a probe from the CFPB regarding the marketing of its credit product, and the company disclosed in a quarterly report that it had received a civil investigative demand from the CFPB "related to the marketing and use of [the company's] Credit [product] in connection with certain merchants that provide educational services."

Plaintiffs' Allegations

Plaintiffs commenced a lawsuit alleging that defendants made misleading statements in violation of Section 10(b) and Rule 10b-5(b) and for scheme liability in violation of Rule 10b-5(a). Among other things, plaintiffs alleged that the company was not complying with the Consent Order because it "knowingly enabled" educational institutions to deceptively market the terms of the company's credit product and continued to enroll customers in its credit product without their consent. Plaintiffs further alleged that defendants made false statements when describing the company's compliance efforts. For example, the company's Form 10-Q for Q1 of 2016 stated that the company monitors changes in laws and regulations "closely to ensure compliant solutions for our customers who depend on us," and the company's Form 10-Q for Q2 of 2016 stated, "We continue to cooperate and engage with the CFPB and work to ensure compliance with the Consent Order, which may result in us incurring additional costs associated with compliance or redress."

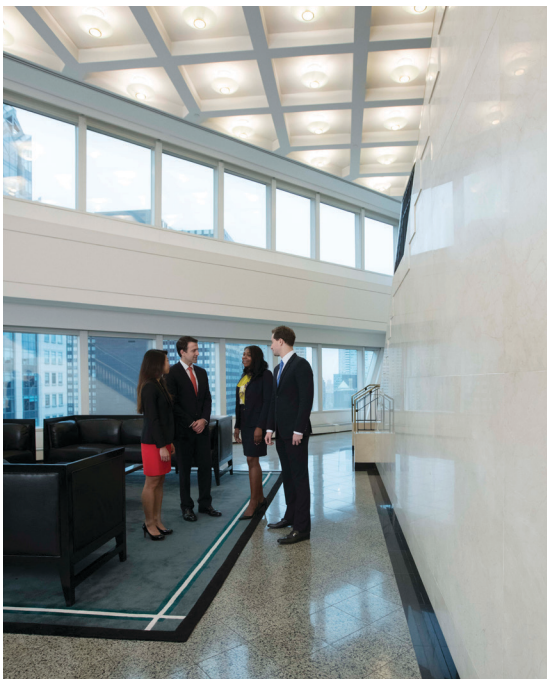
As No Alleged Conduct Violated the Consent Order, the Company's Compliance Statements Were Truthful

The court granted the company's motion to dismiss all claims because plaintiffs did not plausibly plead that the company made any misrepresentations. The court observed that a statement about compliance, such as with the Consent Order, is not made misleading just because a later regulatory inquiry occurs. The court pointed out that when the statements were made the company "had no obligation or requirement to elaborate on any alleged non-compliance because it had not yet been found to be non-compliant." (quoting *In re Facebook Sec. Litig.*, 477 F. Supp. 3d 980 (N.D. Cal. 2020)).

The court further determined that plaintiffs failed to plausibly allege that the company in fact violated any regulatory obligation. The Consent Order forbade the company from misrepresenting "any material aspect" of its credit product including "the terms and conditions of any promotional offer." However, the court noted that plaintiffs alleged that the merchants had misrepresented the credit product, not the company, and found that plaintiffs' alleged "mutual understanding" between the company and its merchants that both "were responsible for" adhering to the Consent Order did not impose additional

legal obligations on the company. The court concluded that because no alleged conduct violated the Consent Order, the company was truthful when it stated that it complied with the Consent Order. The court also pointed out that plaintiffs did not plausibly allege that the company violated its obligation not to enroll customers without their consent because plaintiffs only included a bare allegation that a confidential witness spoke to some customers who "did not recall" giving consent, and that general statements about compliance were quintessential corporate puffery not actionable under the securities laws.

Separately, the court also concluded that "[e]ven assuming the existence of one or more misleading statements, Plaintiffs fail to plead a strong inference of scienter." The court pointed out that plaintiffs failed to allege that any officer acted intentionally or with conscious recklessness because—even assuming that the company was in serious noncompliance that rendered its statements misleading—there was no plausible allegation that any of the officers knew this fact. Contrasting this case with *Oklahoma Police Pension & Retirement System v. LifeLock*, 780 F. App'x 480 (9th Cir. 2019), the court stated that even assuming that significant noncompliance occurred here, there were no allegations that any defendant was ever aware of it.



Middle District of Florida: Statements Including an Objective and Verifiable Fact Were Not Puffery

On August 4, 2022, the Middle District of Florida dismissed without prejudice a putative securities fraud class action alleging that a recycling company had made false and misleading statements about the company to investors. *Theodore v. PureCycle Techs.*, No. 6:21-cv-809 (M.D. Fla. 2022) (Byron, J.). The court held that the complaint failed to meet the standard of Federal Rule of Civil Procedure 9(b) as required for a securities fraud claim and must be dismissed because it failed to "precisely plead what statements or omissions were made in which documents or oral representations."

The company uses a patented process to recycle a particular type of plastic into a recycled resin suitable for food-grade consumer products. Plaintiffs alleged that defendants made various false and misleading statements, which were allegedly revealed by a May 6, 2021 short seller report. Plaintiffs initiated this action alleging a violation of Section 10(b) and Rule 10b-5.

Despite dismissing the complaint on the basis that it did not meet the standard of Federal Rule of Civil Procedure 9(b), the court went on to organize the alleged false and misleading statements into discrete categories. The court then addressed defendants' argument that certain of the alleged false statements were mere puffery and, therefore, not material. The court explained that "[t]he test for materiality in the securities fraud context is whether a reasonable man would attach importance to the fact misrepresented or omitted in determining his course of action." *SEC v. Merch. Cap.*, 483 F.3d 747 (11th Cir. 2007). Defendants argued that statements concerning the value of the patent—such as that the patented recycling method was "revolutionary," "transformative," and "unique"—were puffery. The court explained that the "mere use of words such as . . . 'transformative' does not change a statement from being objectively verifiable to one that is so vague and generalized that any reasonable investor would know it is mere puffery." The court stated that it must consider the

statements "holistically to determine whether there are tangible, verifiable facts included in the statements despite the use of any flowery language."

Applying this holistic approach, the court determined that statements describing the company's recycling process as "revolutionary" were puffery. However, the court determined that several other statements could not be considered puffery, such as the company's statement that its process uses "approximately 75% less energy" than "the traditional manufacturing process." The court concluded that "[b]y including a quantifiable comparison between the traditional manufacturing process and [the company's] process, it includes an objective and verifiable fact and cannot be considered puffery." While the court determined that certain of the statements were not puffery, nonetheless, the court dismissed the entire complaint because plaintiffs failed to identify the particular statements or omissions at issue with sufficient specificity and failed to properly plead scienter.

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