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Skadden

Inside the Courts

A Quarterly Update From Skadden Securities Litigators

Trends and Filings That Matter

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Additionally, we were named to the **Fearsome Foursome**, the top four firms that clients "don't want to litigate against," and ranked as a **Top 1% Securities & Finance: Litigation Powerhouse** by The BTI Consulting Group.

Skadden has **defended more federal securities class actions** than any other firm for the period January 1, 2019, through September 30, 2024, according to Lex Machina.

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Spotlight

A Recurring Trend: Securities Fraud Complaints Targeting Key Metrics

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Key Points

- The plaintiffs' bar has taken notice of key performance indicators (KPIs) and non-GAAP metrics, and has found some success in asserting claims predicated on allegedly misleading disclosures relating to these metrics.
- Plaintiffs often claim that a company's disclosure of one metric is materially misleading because it omits disclosure about other, more relevant metrics.
- Plaintiffs also have accused companies of misleading investors in the way that they define or calculate their key metrics.
- With appropriate attention routinely given to how key metrics are utilized internally and disclosed externally, companies can help minimize the risk of securities litigation centered on this subject of recurring interest to the plaintiffs' bar.

In securities litigation, plaintiffs focus on certain types of disclosures on a routine basis. One frequent target area are key performance indicators (KPIs). These key metrics provide meaningful insight into public companies' financial and operating performance. They are not metrics that have uniform definitions or methodologies for calculation subject to industry standards, unlike accounting metrics that are subject to GAAP — generally accepted accounting principles. The SEC has provided guidance on how companies should disclose KPIs as well as non-GAAP metrics, and it routinely issues comment letters to public companies on these issues. The plaintiffs' bar has taken notice and has found some success in asserting claims predicated on allegedly misleading disclosures relating to these metrics. Cases provide useful insights for companies that report such key metrics to investors.

Making Statements About One Performance Metric But Not Another

Plaintiffs often claim that a company's disclosure of one metric is materially misleading because it omits disclosure about other, more relevant metrics. A case in point: *Shenwick v. Twitter*, 282 F. Supp. 3d. 1115 (N.D. Cal. 2017). There, plaintiffs challenged disclosures by Twitter about its MAU — Monthly Average Users — a performance indicator used by social networking and other companies to count the number of unique users of a product within a month.

Plaintiffs claimed that Twitter touted the "acceleration" and "turnaround" of its MAU. At the same time, however, it allegedly did not disclose that it was experiencing flat or declining DAU — Daily Active User — trends. Plaintiffs asserted that "MAU was unhelpful at best and misleading at worst in the absence of companion DAU" data that had more bearing on user engagement, which was critical to assessing the advertising opportunity to generate revenue. Plaintiffs claimed that without disclosure of flat or declining DAU trends, investors were led to believe that Twitter's MAU projections were "viable" and that its MAU growth was "high quality."

The court held that Twitter had no independent duty to disclose DAU. The court, however, found that plaintiffs stated a viable claim that the undisclosed DAU trends rendered implausible the MAU growth trends that Twitter chose to "tout" in its public statements. The court recognized that both DAU and MAU were critical to Twitter's business and that Twitter's executives would have known about the adverse DAU trends when they spoke positively about MAU trends. Accordingly, the court held that plaintiffs sufficiently alleged a claim. Twitter subsequently settled the case for approximately $800 million.

Plaintiffs are not always successful in asserting claims based on similar theories, as illustrated in *Jedrzejczyk v. Skillz Inc.*, 2023 WL 2333891 (N.D. Cal. Mar. 1, 2023). There, plaintiffs asserted that Skillz's metrics on user engagement and revenue generation for its mobile gaming platform were false and misleading. Skillz allegedly disclosed its average revenue per user (ARPU) without disclosing what plaintiffs contended was more relevant — average revenue per paying user (ARPPU). Plaintiffs claimed that defendants obfuscated a downturn in ARPPU by "focusing primarily on reporting the platform's MAU," which allegedly "gave them the impression that adding users to the Skillz platform was the primary factor driving revenues when it was really just a vanity metric."

The court rejected the claim. The court explained that Skillz was "not obligated to disclose any and all metrics relevant to its business — just those that if omitted, would create an impression of a state of affairs that differs in a material way from the one that actually exists." The court reasoned that the case was different from *Twitter*: while ARPPU and MAU were related, they were "not contingent: a negative trend in one does not *ipso facto* negate a positive trend in the other."

Alleged Manipulation of Metrics

Plaintiffs have also accused companies of misleading investors in the way that they define or calculate their key metrics. Consider *Orbis Glob. Equity Fund Ltd. v. NortonLifelock Inc.*, 2023 WL 1800963, at *11 (D. Ariz. Feb. 7, 2023). Plaintiffs alleged that Symantec manipulated its non-GAAP operating margin metric to give a misleading picture of the company's profitability by excluding recurring operating expenses as "transition and transformation" ("T&T") costs — which Symantec's peers did not do and which allegedly contradicted Defendants' statements that their T&T expenses were not incurred in the ordinary course. Plaintiffs relied on statements from high-level executives at the company who provided examples of the types of costs "pushed in the T&T bucket" to "inflate" Symantec's profitability. Eventually, Ernst & Young ("EY") was retained to study Symantec's practices related to non-GAAP measures and found "significant problems." Symantec subsequently disclosed that it had "relatively weak and informal processes with respect to some aspects of the review, approval and tracking of transition and transformation expenses."

The court ruled that plaintiffs adequately alleged securities fraud The court explained: "While Defendants were not obligated to report non-GAAP measures, once they chose to do so they were bound to do so in a manner that wouldn't mislead investors." The court credited statements from company employees who corroborated the plaintiffs' claim that over $365 million of T&T costs during the relevant period were improperly excluded — a significant percentage of the non-GAAP measures that Symantec reported. The court also found that E&Y's determinations precluded dismissal of the case, particularly in light of its analysis showing that only two out of Symantec's 38 peers adjusted their non-GAAP measures for 'transition costs' and one stopped doing so during the relevant period. This undercut Symantec's assertion that its non-GAAP metrics "facilitated comparisons to its peers." The company settled related class claims for over $70 million.

Other companies have defeated claims that they manipulated their metrics by pointing to clear disclosures defining the metric and its calculation. In *Shen v. Exela Technologies, Inc.*, 2021 WL 2589584 (N.D. Tex. June 24, 2021), plaintiffs accused Exela, a global business process automation provider, of deceiving investors about its financial condition. Plaintiffs claimed that Exela touted its "adjusted EBITDA." EBITDA is a metric that stands for earnings before interest, taxes, depreciation, and amortization. Adjusted EBITDA, on the other hand, is a metric that approximates the normal earnings power of a business excluding non-cash expenses and excluding, or adding back, non-recurring cash expenses. Plaintiffs alleged that Exela engaged in "accounting shenanigans" by adding back supposedly non-routine expenses when, in fact, the expenses were routine, recurring expenses.

The court ruled that Exela told "the whole truth and nothing but about how it was calculating adjusted EBITDA." The court pointed out that for non-GAAP metrics there is no "'right' formula because, unlike GAAP metrics, they have no uniform definition." After reviewing Exela's disclosures on the subject, the court was convinced that "Exela expressly disclosed" that certain of its non-cash "optimization and restructuring expenses" were added back into Adjusted EBITDA.

A court reached a similar conclusion in *In re Netflix, Inc. Securities Litigation*, 2005 WL 3096209 (N.D. Cal. Nov. 18, 2005). Plaintiffs alleged that Netflix misled investors about its "churn rate," and other key metrics derived from it, including average subscriber lifetime and the subscriber lifetime value. Plaintiffs claimed that the reported churn rate was artificially deflated to make Netflix's customer base look stronger than it was. Plaintiffs challenged Netflix's measurement of churn as "inaccurate, illogical, and unconventional."

The court rejected plaintiffs' securities fraud allegations. Importantly, the court observed that Netflix repeatedly disclosed its definition of churn and disclosed the raw data that would enable investors and analysts to calculate churn using the definition and methods preferred by the plaintiffs. Even if there were "other, more common methods that would have been more predictive, descriptive, or consistent," that did not make Netflix's disclosures fraudulent. The court explained it was "not a case in which defendants used one calculation method when another is mandated by industry practice, generally accepted accounting principles, or federal securities regulations." In the absence of any mandated way of disclosing "churn," the court found that the "critical key to understanding Netflix's methodology was adequately and repeatedly disclosed."

Key Takeaways

Key performance metrics provide useful insights about business performance and prospects. Because these metrics are frequently the focus of securities litigation, public companies and those charged with preparing disclosures should consider taking steps to minimize the risk of facing securities litigation claims predicated on allegations that the presentation or disclosure of the metrics is misleading.

As a starting place, it is important that company leaders carefully review the SEC's rules, regulations, and guidance on KPIs and non-GAAP metrics. Companies should consider providing a clear definition of their key metrics and information about how the metric is calculated, including information about the assumptions and inputs and how they are calculated. If the company changes its definition or methodology, disclosures about those changes and the reasons for the changes would be prudent.

With appropriate attention routinely given to how key metrics are utilized internally and disclosed externally, companies can help minimize the risk of securities litigation centered on this subject of recurring interest to the plaintiffs' bar.

Aerospace

Ninth Circuit Affirms Dismissal of Insider Trading Claims Against Satellite Operator Investors Based on Stock Sales After FCC Chairman Vote

In re Silver Lake Grp., LLC Sec. Litig. (9th Cir. July 24, 2024)

What to know: The Ninth Circuit affirmed the dismissal of insider trading claims against several large investors in a satellite operator, holding that the plaintiffs failed to sufficiently allege that any defendant investor sold stock with knowledge of the company's meeting with the FCC that preceded the commission's decision to publicly auction the company's spectrum broadcasting license.

The Ninth Circuit affirmed the dismissal of insider trading claims against several large investors in satellite operator Intelsat, which provides broadcasting services — including the "C-Band" — used for television broadcasts. After discussions began to revoke Intelsat's license to the C-Band, Intelsat and other satellite broadcasters proposed a private auction of the C-Band despite the Federal Communications Commission's (FCC's) typical practice of utilizing public auctions to allocate spectrum bands like the C-Band.

There was significant public discussion and market speculation about whether the FCC would permit the private auction or give way to political pressure calling for a public auction. Intelsat met with the FCC on November 5, 2019, to discuss the C-Band auction. Intelsat representatives and other satellite operators attended. The plaintiffs did not allege that any of the investor defendants attended the meeting.

After the market closed on November 5, Intelsat investors BC Partners and Silver Lake, and Intelsat chairman David McGlade, sold Intelsat shares in a private sale. On November 18, 2019, the FCC chairman announced he would cast the deciding vote in favor of a public auction, and Intelsat's stock price declined. Intelsat later filed for bankruptcy.

The plaintiff, a hedge fund, brought a securities class action against the investors, alleging insider trading violations of Sections 10(b), 20(a) and 20A of the Securities Exchange Act of 1934 (Exchange Act). The district court granted the defendants' motion to dismiss.

The Ninth Circuit affirmed, first determining that the plaintiff had standing to sue under Section 20A, which requires plaintiff-buyers to trade "contemporaneously" with defendant-sellers. The court disagreed with the defendants that the plaintiff did not trade contemporaneously because it purchased on the public market while the defendants sold their shares in a private transaction. The court explained that trading may be contemporaneous even where it occurs on different markets. Because all of the trading took place between November 5-6, the court held that it was contemporaneous.

After holding that the plaintiff had standing, the court next held that the plaintiff did not sufficiently allege that any defendant possessed material nonpublic information when they sold their shares. Specifically, the plaintiff did not plead that any defendant knew about the November 5 meeting, or that the fact of the meeting or any information learned at the meeting constituted material nonpublic information. The court further reasoned that, even if the defendants knew of the meeting, this knowledge would not be material because they could only speculate about what course of action the FCC would take after the meeting.

Cannabis

SDNY Dismisses Claims of False and Misleading Statements Against Cannabis Company and Officers, Finding Plaintiffs Failed To Plead Scienter

In re Canopy Growth Sec. Litig. (S.D.N.Y. July 17, 2024)

What to know: The Southern District of New York dismissed claims against a cannabis company and three of its officers alleging they made false and misleading statements about the financial prospects of the company's newly acquired sports drink subsidiary. The court dismissed the claims, holding that the plaintiffs failed to plead "even a weak inference" of scienter.

The U.S. District Court for the Southern District of New York dismissed putative class action claims brought under Section 10(b) of the Securities Act of 1933 (Securities Act) and Section 20(a) of the Exchange Act against a cannabis company and three of its officers for allegedly making false and misleading statements about the financial prospects of the company's newly acquired sports drink subsidiary.

The plaintiffs alleged — based on information from confidential witnesses who supposedly were former employees of the company and the subsidiary — that the defendants misled investors as to the subsidiary's revenue, distribution and inventory, and concealed internally known problems such as the subsidiary's (i) failure to enter into enforceable contracts with distributors, (ii) its excess and aging inventory and (iii) the extreme pressure it faced to meet revenue targets. Specifically, the plaintiffs alleged that the defendants' statements about the subsidiary's performance were misleading because the subsidiary's revenue was allegedly artificially inflated. The plaintiffs also claimed the statements did not disclose the subsidiary's failure to enter into enforceable distribution contracts and that it had significant unsold inventory with limited shelf life.

The court dismissed the claims, holding that the plaintiffs failed to plead "even a weak inference" of scienter. In so holding, the court held that statements from the confidential witnesses could not establish the "strong inference of scienter" required by the Private Securities Litigation Reform Act (PSLRA), reasoning that the confidential witnesses — who were lower-level sales and marketing employees — did not have a basis for the requisite knowledge of the subsidiary's financials. The court further noted that the witnesses' statements were too vague, not probative of the defendants' state of mind and failed to identify specific instances in which the defendants "received information ... contrary to their public declarations."

The court also rejected the plaintiffs' alternative theories of scienter based on the individual defendants' alleged public statements, the company's "sudden reversal of fortune," the "size and scale" of the inventory and internal control problems, and the departures of certain company executives. The court reasoned that "express[ing] general optimism and highlight[ing] the successes of an acquired subsidiary does not, without more, support the inference" of scienter. Nor was there a "sudden reversal of fortune" that could support an inference of scienter because the "revenue adjustment ... was relatively modest — a decrease of 4%." The court also held that the departures of the company's CEO and CFO were not "unusual and suspicious" enough to support an inference of scienter.

Food and Beverage

SDNY Finds Disclosures by Drive-Through Coffee Company Were Not Actionable, Are Protected by PSLRA Safe Harbor Provision

Rein v. Dutch Bros, Inc. (S.D.N.Y. June 24, 2024)

What to know: The Southern District of New York dismissed securities fraud claims against a drive-through coffee company, holding that the defendants' public disclosures were not actionable and protected by the PSLRA's safe harbor provision.

The U.S. District Court for the Southern District of New York dismissed a putative class action against a drive-through coffee company and certain of its officers, alleging that the defendants made misrepresentations and omissions in the company's public documents. The plaintiffs claimed the documents understated the threat to the company's sales and profitability presented by rising inflation affecting the cost of commodities that were key to the company's success. The plaintiffs specifically alleged that the defendants' public statements were false and misleading because the defendants were making "positive statements" regarding its business even though the company was experiencing "increased margin pressure and decreased earning and profitability."

The court disagreed, holding that none of the statements raised by the plaintiffs were actionable under the PSLRA. The court noted that the plaintiffs needed to plead that the defendants actually did not hold the opinion or that the facts in support of the defendants' statements were untrue, which the plaintiffs did not do. The court further found that because the company's "basket of inflation" was in the single digits, its public statements matched that qualitative disclosure and gave reasonable investors necessary context by stating that the "basket of inflation" was "mild" and that prices were "not really up."

The court further disagreed with the plaintiffs' allegations that the defendants' public statements were false and misleading because they projected a positive picture of the company's business model without disclosing the difficulties presented by inflation. It noted that the plaintiffs did not plead when the statements were made, nor the date when the CEO who made the statement became aware "of the extent to which inflation had cut into" the company's earnings. The court further noted that the statements were "forward-looking" because they were projections, and the plaintiffs failed to plead that the projections were not believed by the CEO when the statements were made.

Finally, with respect to scienter, the court held that the officers only sold "relatively modest figures" of their shares. It noted that since the officers' sales of their shares occurred later in the class period, "an inference of scienter derived from the timing of trades does not follow" in this case.

Life Sciences and Health Care

First Circuit Affirms Dismissal of Securities Claims Against Biotechnology Startup, Holding Plaintiffs Failed To Plead Scienter

Quinones v. Frequency Therapeutics, Inc. (1st Cir. July 2, 2024)

What to know: The First Circuit affirmed the dismissal of securities claims against a biotechnology startup, alleging that the company misled the market by making positive statements concerning a clinical trial while knowing there were underlying problems with the study. The court found the plaintiffs failed to plead scienter.

The First Circuit affirmed the district court's dismissal in a case brought against a biotechnology startup focused on hearing loss treatments, agreeing that the totality of the allegations did not show scienter. The plaintiffs brought their claim under Sections 10(b) and 20(a) of the Exchange Act, alleging that the company misled the market by making positive statements concerning a phase 2 clinical trial while knowing that there were underlying problems with the study.

Specifically, the plaintiffs alleged that the defendants should have known that the clinical trial had been compromised by a biased enrollment. During the enrollment period, confidential entry criteria had been shared on a web forum, allowing participants to fake their way into the study by overstating their symptoms. Based on this bias, the plaintiffs alleged that certain of the defendants' statements concerning the trial were false and misleading, and that the defendants were reckless in ignoring signs that the trial was biased.

On appeal, the plaintiff argued that the district court erred by failing to consider scienter based on all of the allegations. In affirming the dismissal, the First Circuit noted that "[c]ertainly while '[e]ach individual fact about scienter may provide a brushstroke,' our obligation [is] to consider 'the resulting portrait,'" and the "plaintiffs cannot amalgamate a series of sketchy brushstrokes and call it a van Gogh." Here, the First Circuit found that the plaintiffs had failed to plead scienter because (i) the confidential witnesses were not close enough to the executives to allege the defendants' knowledge, (ii) a purported 15% sale of stock during the relevant period was insufficient to show scienter and (iii) an executive appearing for an interview with the same web forum that had exposed the entry criteria did not demonstrate the defendants' knowledge of that breach.

Third Circuit Denies Request To Appeal Securities Class Certification Under FRCP 23(f)

Forsythe v. Teva Pharm. Indus. Ltd. (3d Cir. May 16, 2024)

What to know: The Third Circuit denied a defendant's petition to appeal a class certification order in a securities class action under FRCP 23(f), holding that whether the Exchange Act reaches dual-listed securities is not a question of class action law suitable for resolution on an interlocutory appeal.

The Third Circuit denied Israel-based pharmaceutical company Teva Pharmaceuticals' petition to appeal a class certification order in a securities class action under Federal Rule of Civil Procedure 23(f) (Rule 23(f)). The case was brought by a group of purported Teva shareholders alleging Teva and certain individuals made false statements about a multiple sclerosis drug in violation of Section 10(b) and 20(a) of the Exchange Act. The district court granted the plaintiffs' motion for class certification.

Teva subsequently petitioned the Third Circuit for permission to appeal the order of class certification under Rule 23(f), arguing that the appeal was proper because (i) Teva's petition presented a novel legal issue, the resolution of which would advance class certification jurisprudence within securities law; and (ii) the district court erred in its predominance analysis relating to the plaintiffs' proposed classwide damages methodology. Specifically, Teva argued that purchasers of Teva shares on the Tel Aviv Stock Exchange (TASE) should not be included in the class definition because there is not an analogous cause of action for securities fraud under Israeli law. In addition, Teva argued that the predominance analysis applied by the district court to the plaintiffs' classwide damage analysis was not consistent with the plaintiffs' theory of liability.

The Third Circuit rejected Teva's appeal. First, the court held that Teva's argument that purchasers on the TASE should not be included in the class — while novel and important — was not a question relating to whether the requirements for class certification were met, and was thus not a proper subject for a Rule 23(f) appeal.

The court also held that the district court's acceptance of the plaintiffs' proposed damages model was not erroneous at the class certification stage. The plaintiffs proposed an event study, which reached the conclusion that the defendants made material misrepresentations and omissions that artificially inflated Teva's stock price. When the truth was revealed, the plaintiffs claimed, the stock price declined and caused financial loss to the plaintiffs. The court noted that the plaintiffs' model was a common one, and in any event, held that an inability to calculate damages across a class does not bar class certification.

Delaware Supreme Court Clarifies Test for Advance Notice Bylaws, Finding Valid Bylaws Unenforceable

Kellner v. AIM ImmunoTech Inc. (Del. July 11, 2024)

What to know: The Delaware Supreme Court clarified the test for challenges to advance notice bylaws. It found a company's challenged bylaws valid, except one deemed unintelligible. However, it determined the board acted inequitably by amending bylaws to interfere with a stockholder's director nominations, finding certain valid bylaws were unenforceable.

The Delaware Supreme Court clarified the test for challenges to advance notice bylaws in a case brought against biopharmaceutical company AIM ImmunoTech, Inc. In response to activist activity, including a previously failed proxy contest, AIM's board amended the company's bylaws, focusing on the advance notice procedures. A different stockholder supported by largely the same group behind the failed prior proxy contest nominated proposed directors for election. The board met to consider the proposal and ultimately rejected it. The nominating stockholder sued. The Delaware Court of Chancery invalidated four of the challenged bylaws, but nevertheless held that the plaintiff's nomination notice contravened AIM's valid bylaws and upheld the board's rejection of the notice because it "obscure[d] obvious arrangements or understandings pertaining to the nomination."

On appeal, the Delaware Supreme Court began its analysis by recognizing that advance notice bylaws assist a board's "information-gathering and disclosure functions, allowing boards of directors to knowledgeably make recommendations about nominees." It then articulated the standard to determine the validity and enforceability of advance notice bylaws: (i) bylaws are valid if they are consistent with the charter, not prohibited by law and address a proper subject matter; and (ii) bylaws are enforceable if their adoption, amendment and/or application — as applicable under the circumstances — was equitable under the Delaware Supreme Court's decision in *Coster v. UIP Companies, Inc.* Under *Coster*, the board adopting advance notice bylaws must (i) be faced with a threat to an important corporate interest and not act for a selfish disloyal purpose, and (ii) respond reasonably to the threat in a manner not coercive or preclusive to the stockholder franchise.

Even though the advance notice bylaws were not adopted on a "clear day," the Delaware Supreme Court had "no trouble" concluding the amended bylaws were valid. The board had the power to amend bylaws under AIM's certificate of incorporation and Delaware code. One exception was an "indecipherable" 1,099-word, single-sentence provision regarding disclosure of ownership in AIM and its competitors. The court determined this bylaw was "excessively long, contains vague terms, and impose[d] virtually endless requirements on a stockholder seeking to nominate directors."

The Delaware Supreme Court agreed with the lower court that given the "insurgents' troubling history," the board's information-gathering function was threatened and "transparency in board elections" was an important corporate objective in amending the bylaws. However, relying on the lower court's assessment about the unreasonableness of a majority of the challenged bylaws, the Delaware Supreme Court concluded that the AIM board amended its bylaws for the improper primary purpose of thwarting stockholders' proxy contests and maintaining control. Thus, while valid, the board's conduct failed the first prong of the *Coster* test, making all the challenged bylaws unenforceable. But the Delaware Supreme Court declined to provide the plaintiff with any relief, crediting the Court of Chancery's findings that the plaintiff had "submitted false and misleading responses to some of the requests" in the advance notice bylaws. The Delaware Supreme Court declared that "[t]he case is closed."

Northern District of Illinois Partially Grants Motion To Dismiss Infant Formula Derivative Action, but Holds Demand Was Futile for Remaining Counts

In re Abbott Labs. Infant Formula S'holder Derivative Litig.
(N.D. Ill. Aug. 7, 2024)

What to know: The Northern District of Illinois partially granted a motion to dismiss a shareholder derivative action relating to the shutdown of an infant formula manufacturing facility and formula recall. The court dismissed in part the plaintiffs' securities claims, but held that demand was futile as to the remaining counts.

The U.S. District Court for the Northern District of Illinois granted, in part, a motion to dismiss a shareholder derivative action brought on behalf of Abbott Laboratories by shareholders against certain of Abbott's executive officers and board of directors. The plaintiffs alleged that the defendants violated Section 14(a) and Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, as well as committed breach of fiduciary duties, insider training, corporate waste and unjust enrichment.

The plaintiffs alleged that the Food and Drug Administration (FDA) inspected Abbott's infant formula manufacturing facility in 2019 and 2021, and found violations of federal food and safety laws. In 2022, Abbott closed its infant formula manufacturing facility, allegedly due to contamination of infant formula, and recalled the formula. The facility remained closed until midway through 2022.

In October 2022, Abbott filed a form 8-K that showed an approximately 30% decline in its net earnings in the company's third quarter 2022 financial results. Abbott attributed this decline in part to the facility shutdown, a related consent decree from the U.S. Department of Justice (DOJ), and related wrongful death lawsuits and the resulting damages alleged to be caused by the contaminated formula.

As the plaintiffs did not make a pre-suit demand on the board, the court evaluated whether the plaintiffs adequately showed that demand would be futile under the plaintiffs' assertion that a majority of the director defendants faced a substantial likelihood of liability for each count. After a claim-by-claim analysis, the court dismissed in part the plaintiffs' securities claims, but held that demand was futile as to the remaining counts.

First, the plaintiffs alleged that certain defendants violated Section 14(a) of the Exchange Act by issuing, or causing to be issued, materially false and misleading statements in 2021, 2022 and 2023 proxy statements. The plaintiffs alleged that the defendants misleadingly portrayed Abbott's safety, compliance and oversight functions to investors through material omissions in the proxies. The defendants argued that the plaintiffs failed to adequately allege demand futility because they did not plead facts establishing that a majority of the board faced a substantial likelihood of liability under Section 14(a), and instead merely quoted large sections of the proxy statements and made broad assertions that the information was false or misleading. The court agreed with the defendants and found that the plaintiffs relied on unactionable generic claims that did not specifically reference manufacturing safety, and failed to allege that specific statements in Abbott's proxies were rendered misleading because of the omitted information. Therefore, the defendants did not have a substantial likelihood of liability on the proxy claim.

Second, the plaintiffs alleged that the defendants violated Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder,

by disseminating or causing to be issued false or misleading statements to inflate the price of Abbott's stock. The plaintiffs alleged that the defendants caused Abbott to repurchase millions of shares of stock in 2019 and 2021 at inflated prices. The defendants argued that the plaintiffs failed to sufficiently allege reliance under Rule 10b-5 because the board members who authorized the stock repurchase were the same people who knowingly made the false statements and could not reasonably rely on their own false statements. The court rejected the argument that Abbott's directors could not reasonably rely on their own false statements — and therefore could avoid liability based on those statements — as circular. The court found that the defendants face a substantial likelihood of liability on the securities fraud claim.

Third, the court denied the defendants' motion to dismiss the plaintiffs' claim for breach of fiduciary duties. The plaintiffs argued that (i) the defendants failed to oversee Abbott's compliance with federal food safety regulations; (ii) Abbott's board committees had no direct responsibility for manufacturing or product safety, did not monitor or discuss product safety on a regular basis, paid little-to-no attention to safety issues at the manufacturing facility and only received *ad hoc* reports; and (iii) management saw worsening violations that did not reach the board. The court determined that these allegations were sufficient to expose the defendants to a substantial risk of liability under a *Caremark* theory. The court dismissed the plaintiffs' remaining state law claims.

District of Massachusetts Dismisses Securities Fraud Claims Against Drug Development Company for Failure To Plead Actionable Misstatements, Scienter

State Tchrs. Ret. Sys. v. Charles River Lab. Int'l, Inc.
(D. Mass. July 1, 2024)

What to know: The District of Massachusetts dismissed securities fraud claims brought against a drug development company and certain of its officers for failure to plead any actionable misstatements about the company's compliance with animal testing laws or scienter.

The U.S. District Court for the District of Massachusetts dismissed securities fraud claims brought against a drug development company and certain of its officers based on allegedly misleading statements about the company's compliance with animal testing laws. The company imports animals, including nonhuman primates (NHPs), either to sell to pharmaceutical companies for use in drug safety assessment studies or to use, itself, in conducting such assessments for clients.

The commercial trade of macaques, one such NHP, is protected by federal and international law. As COVID-19 spread, demand for macaques surged for the purpose of testing vaccine safety and efficacy. The plaintiff alleged that the company obtained more than 10,000 macaques in 2020-22 from Cambodian suppliers. However, in 2021, the DOJ announced that it was investigating the unlawful trafficking of wild macaques into the U.S. from Cambodia, which revealed that several of the company's suppliers allegedly obtained macaques from a farming network that was indicted by the DOJ for allegedly conspiring to introduce wild macaques into the U.S. market. When the news of the investigation broke, the company's stock fell.

The plaintiff sued, alleging that the company made numerous statements in its public filings that were false and misleading at the times made. These purported misrepresentations primarily concern the company's contacts with the Cambodian supplier whose executives were indicted, as well as compliance with applicable import laws and regulations regarding NHPs.

The court found that the company's statements asserting their belief that they were in compliance with the law were not materially false or misleading because the plaintiff did not allege the company had violated any applicable law or actually obtained macaques from the indicted supplier. The court also found it to be significant that the company disclosed it received a DOJ subpoena in connection with the investigation no less than five days after it had been issued. To the extent that the plaintiff sought to premise falsity on statements in the company's codes of business conduct and ethics, the court found that such statements lacked enough specificity to amount to anything more than nonactionable corporate puffery.

The court also found that the allegations failed to raise a strong inference of scienter because the trading data disclosed that the individual defendants frequently sold or gifted stock, and the individual defendants' holdings *increased* in the period leading up to the company's publicization of the DOJ investigation.

SDNY Dismisses, in Part, Claims Against Dental Manufacturer for Failure To Plead Actionable Misstatements, Preserves Scienter Claims

San Antonio Fire & Police Pension Fund v. Dentsply Sirona Inc. (S.D.N.Y. May 1, 2024)

What to know: The Southern District of New York dismissed, in part, claims brought against a manufacturer of dental products and technologies for failure to plead actionable misstatements, but preserved other claims because the plaintiff had sufficiently pled scienter.

The U.S. District Court for the Southern District of New York dismissed, in part, claims brought under Sections 10(b) and 20(a) of the Exchange Act against a manufacturer of dental products and technologies, and certain of its executives, while preserving claims against the company, its former CEO and former CFO. The plaintiff alleged that the company had made false and misleading statements concerning earnings and supply chain challenges, and that the company artificially inflated revenue through channel stuffing.

While the court dismissed allegations as to certain statements that were nonactionable opinion and/or puffery, it preserved statements discussing the strength and sustainability of the company's earnings. In finding that the plaintiff had pled scienter, the court first found that the plaintiff had pled motive by alleging a sufficiently direct link between the alleged fraud and the defendants' performance-based pay.

In finding that the plaintiff had sufficiently pled the defendants' fraudulent state of mind, the court further held that (i) the defendants knew statements about inventory levels were false, and that statements disclosing that the supply chain was fine were false where the defendant CEO confronted suppliers about problems; (ii) the defendants "maintained an inappropriate tone at the top" of the company by pressuring the sales team, suppressing dissent and generally allowing wrongdoing; and (iii) the departure of certain defendants suggested wrongdoing.

Media and Entertainment

Fifth Circuit Holds Investors Have Article III Standing Under Exchange Act Despite Corrective Disclosure by Corporation

Okla. Firefighters Pension & Ret. Sys. v. Six Flags Entm't Corp. (5th Cir. Apr. 18, 2024)

What to know: The Fifth Circuit reversed the lower court's grant of an entertainment corporation's motion for judgment on the pleadings and denial of investors' respective motions for leave to file an amended complaint and to intervene. The appeals court held that even though corrective disclosures had addressed certain alleged misstatements, investors had purchased stock prior to the disclosure of other alleged misstatements, and therefore had Article III standing.

The Fifth Circuit reversed a lower court's grant of Six Flags Entertainment Corporation's motion for judgment on the plaintiffs' various pleadings, finding the district court erred on each motion. In 2014, Six Flags agreed to develop several theme parks with Riverside Investment Group. In February 2020, Electrical Workers Pension Fund, Local 103, International Brotherhood of Electrical Workers (Local 103) alleged on behalf of all who bought Six Flags' common stock between April 25, 2018, and January 9, 2020, that Six Flags violated Sections 10(b) and 20(a) of the Exchange Act, and Rule 10b-5 thereunder, by making material misstatements and omissions regarding the development of the theme parks and Riverside. In its prior decision in the case, the Fifth Circuit held that the several alleged misstatements and/or omissions were not actionable because the defendants corrected their disclosures.

On remand, Oklahoma Firefighters filed a motion for leave to file an amended complaint, seeking to substitute Local 103 with Key West Police & Fire Pension Fund (Key West). Six Flags moved for judgment on the pleadings, arguing that Oklahoma Firefighters lacked standing because it bought its Six Flags' stock after the alleged October 23, 2019, corrective disclosure. Key West later moved to intervene. The district court granted Six Flags' motion for judgment on the pleadings and denied Oklahoma Firefighters' motion for leave to file an amended complaint and Key West's motion to intervene. Oklahoma Firefighters and Key West appealed.

The Fifth Circuit held that the district court erred on each motion. The Fifth Circuit clarified that while its prior decision ruled that certain alleged misstatements were inactionable, it had not dismissed the claims regarding a "number of ... claimed frauds still in play." Accordingly, because Oklahoma Firefighters had purchased shares before these other alleged misstatements were disclosed or corrected, it had standing. The court further held that Key West had standing to intervene because it was a member of the putative plaintiff class and bought Six Flags' stock before the alleged fraud was disclosed.

M&A

Fifth Circuit Adopts Loss Causation Test for First Time in Private Market Context

Cory v. Stewart (5th Cir. May 29, 2024) (*per curiam*)

What to know: A split Fifth Circuit panel reversed the lower court's grant of summary judgment in favor of the executives of a technology services company, explaining for the first time how to show loss causation under the Exchange Act in the private market context.

For the first time, a Fifth Circuit panel adopted a loss causation test in the private market context, reversing a lower court's grant of summary judgment in favor of the defendants after they acquired the plaintiffs' company. Tammy O'Connor and Michael Stewart (the Sellers) sold their company to Atherio, Inc., a company led by Jason Cory, Greg Furst and Thomas Farb (the Executives). The agreement gave the Sellers approximately half of their payment upfront with the remaining $3.5 million to be given later. The agreement also presented Mr. Farb as Atherio's CFO. However, Mr. Farb resigned before the deal closed without the Sellers' knowledge. After the deal closed, a series of events left the Executives unable to pay the $3.5 million. The Sellers consequently sued Atherio and the Executives for intracontractual fraud under Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.

The district court granted the Executives summary judgment, finding that there was insufficient evidence of loss causation. The Sellers argued that there was a genuine dispute as to whether the Executives' intracontractual misstatement that Mr. Farb was the CFO as of closing caused the Sellers' loss. In a 2-1 split decision, a panel of the Fifth Circuit agreed with the Sellers.

The Fifth Circuit adopted a test that the Third Circuit applied in the private market context: "whether [defendant's misstatement] was a substantial factor in causing the [ ] Plaintiffs' economic loss include[ing] considerations of materiality, directness, foreseeability, and intervening causes … [t]o make this substantial-factor showing, the Sellers must produce evidence that 'certain [misstated] risks are responsible for [their] loss' and that such evidence must reasonably distinguish the impact of those risks from other economic factors." Under this test, the Sellers only needed to show loss causation for "some rough proportion of the whole loss."

The Fifth Circuit held that the district court did not construe all reasonable inferences in the Sellers' favor and explained that three emails from Mr. Farb indicated that Atherio lost investment dollars because he was not the CFO. The Fifth Circuit held that this evidence plausibly supported the reasonable conclusion that the alleged misstatement about Mr. Farb's role as CFO caused the Sellers' losses and therefore sufficed to raise an issue of material fact on loss causation, precluding summary judgment.

Court of Chancery Dismisses Challenge to Lowered Purchase Price Under *Corwin*

In re Anaplan, Inc. S'holders Litig. (Del. Ch. June 21, 2024)

What to know: The plaintiff sought to recover purported damages for a stockholder class allegedly arising after a buyer renegotiated a merger agreement and lowered the purchase price. The court held that because the renegotiated transaction was approved by a fully informed and uncoerced vote of the target's stockholders, it was subject to business judgment review under *Corwin*.

The Delaware Court of Chancery dismissed a plaintiff's attempt to recover purported damages for a stockholder class arising after a buyer renegotiated a merger agreement and lowered the purchase price. In March 2022, a target company and the acquiror entered into a merger agreement, whereby the acquiror would purchase the target for $66 per share. The merger agreement also contained several interim operating covenants, including a covenant that limited the equity awards that the target could issue between signing and closing. Over the next several months, the target granted equity to existing and new employees. In May 2022, the acquiror notified the target that it had breached the merger agreement by exceeding the equity grant limit.

In June 2022, the parties agreed to amend the terms of the original merger agreement. Under the revised merger agreement, among other things, the purchase price was lowered to $63.75 per share, and the reverse termination fee was increased from $586 million to $1 billion. Shortly thereafter, the target's stockholders overwhelmingly voted to approve the revised transaction, which closed the next day.

The plaintiff brought a purported class action on behalf of the target's former stockholders, alleging that the target's directors and officers breached their fiduciary duties by issuing too many equity grants and causing the target company to breach the original merger agreement. The plaintiff advanced two theories: (i) bad faith or grossly negligent misconduct can be inferred from the breach of "clear and unambiguous" merger agreement provisions, and (ii) the defendants had a continuing *Revlon* duty to obtain and maintain the highest price reasonably available for the target's stockholders in the cash-out merger. The plaintiff also asserted a waste claim, alleging that the defendants' actions wasted the $400 million in lowered consideration arising from the renegotiated merger agreement. The defendants moved to dismiss for failure to state a claim.

Though the case raised "fascinating questions of fiduciary law," the court concluded that resolution of those questions was "unnecessary to resolve the case before [it]." Instead, the court analyzed whether the revised transaction satisfied the elements of *Corwin*. The court observed that the proxy disclosures "included eleven pages of additional background and analysis concerning the equity-related events, the [target board's] review of those events and its recommendation." Thus, the court found that the target stockholders "had the material information they needed — including, most importantly, about the price — to make an informed decision whether or not to vote in favor of the Revised Merger Agreement." The court went on to reject the plaintiff's arguments that either situational or structural coercion existed. As a result, the court concluded, *Corwin* compelled dismissal of the fiduciary duty claims.

Finally, the court found that the plaintiff failed to state a waste claim, as the revised merger agreement delivered target stockholders a 41% premium and "in exchange for agreeing to a price reduction, [target] obtained a host of concessions from [acquiror], including … nearly doubling [acquiror's] reverse termination fee."

SEC

Third Circuit Holds Preliminary Injunctions Requested by SEC Are Subject to Same Test Governing Other Preliminary Injunctions

SEC v. Chappell (3d Cir. July 9, 2024)

What to know: The Third Circuit held that district courts must apply the circuit's traditional four-factor preliminary injunction test when the SEC seeks preliminary injunctions, which analyzes (i) the likelihood of success on the merits, (ii) irreparable harm, (iii) the balance of the equities and (iv) public interest.

The Third Circuit affirmed a district court decision granting the Securities and Exchange Commission (SEC) a preliminary injunction to freeze the defendant's assets. The SEC brought a civil enforcement action for insider trading against the defendant, a former U.S. citizen and current Malta citizen, and his investment entities. It alleged that the defendant traded securities in a pharmaceutical company on the basis of material, nonpublic information, specifically FDA feedback on the unlikelihood of emergency authorization of a drug. The defendant's entities were a majority shareholder in the pharmaceutical company. The district court granted the SEC's motion for a preliminary injunction and ordered injunctive relief, disgorgement of gains, civil penalties, an officer/director bar and a restraining order to freeze all of the defendant's assets. The defendant appealed.

The Third Circuit affirmed. It first considered the proper legal test for analyzing a request for a preliminary injunction made by the SEC. The district court used a test developed by the Second Circuit, which allows a court to grant the SEC a preliminary injunction if the commission shows a substantial likelihood that its insider trading claim will succeed and that there is a high risk of repetition. The Third Circuit rejected the Second Circuit's test, instead holding that SEC requests for injunctive relief are subject to the same four-factor test governing all other requests for injunctive relief. Under the traditional *Winter* test, a court must weigh four factors before granting an injunction: (i) the movant's likelihood of success on the merits, (ii) whether the movant will suffer irreparable harm without injunctive relief, (iii) the balance of the equities, and (iv) the public interest in granting or denying an injunction.

Applying the *Winter* test, the court affirmed the district court's grant of injunctive relief. The court first held that the defendant possessed material, nonpublic information and that the SEC had made a sufficient showing that the defendant traded on that information. Next, the court held that the SEC adequately alleged that it would suffer irreparable harm without injunctive relief, and the balance of the equities tipped in the SEC's favor because the defendant had relinquished his U.S. citizenship and could easily transfer or conceal his assets, making them difficult or impossible to recover if the SEC prevailed. Finally, the court held that the injunction served the public's interest in not allowing the defendant to evade U.S. rules prohibiting insider trading.

Eleventh Circuit Affirms Summary Judgment, Finds Trader Was Unregistered Securities Dealer

SEC v. Keener (11th Cir. May 29, 2024)

What to know: The Eleventh Circuit held that an individual who engaged in "toxic" or "death spiral" financing by purchasing and selling convertible notes from microcap issuers without being registered as a securities dealer violated Section 15 of the Exchange Act.

The Eleventh Circuit affirmed the district court's grant of a motion for summary judgment against the defendant in an SEC civil enforcement action, finding that the defendant violated Section 15 of the Exchange Act by buying and selling securities as an unregistered dealer. The SEC claimed that the defendant was an unregistered securities dealer because he purchased convertible notes from microcap issuers, converting them into new issues of common stock and selling them in the public market for a profit with "highly favorable" terms for himself. This practice is also known as "toxic" or "death spiral" financing. The district court granted the SEC's motion for summary judgment, prompting the defendant to appeal.

On appeal, the Eleventh Circuit first concluded that the defendant did, in fact, operate as an unregistered dealer. In doing so, the Eleventh Circuit rejected the defendant's argument that he could not be considered a dealer because he never effectuated securities for customers. Instead, the court reasoned that if a trader's operations are extensive enough to be considered regular business, he need not have other customers and can merely trade for his own account and still be considered a securities "dealer."

The court also rejected the defendant's claim that he did not have fair notice of the SEC's enforcement theory, given that the SEC has long allowed penny-stock flipping and convertible debt lending. The court declined to apply the fair-notice principle, holding that because the SEC had never issued guidance condoning the *combination* of those activities, the defendant was not deprived of fair notice and thus has no valid due process violation. In addition, the court concluded that the defendant's equal protection right was not violated when he was not given a year-long grace period to register as a securities dealer without receiving a penalty because the defendant could not show that he was "similarly situated" to those who received the grace period.

Regarding the defendant's claim that the district court abused its discretion when it imposed an "impermissibly vague" permanent injunction largely tracking the Exchange Act's language, the court held that the permanent injunction provided more detail than was required under the Exchange Act. Because an injunction may largely track statutory language so long as it specifically describes the conduct being addressed by the injunction, the court held that the injunction issued here was proper.

Finally, the court rejected the defendant's argument that the district court abused its discretion by ordering that he disgorge the profits from his business. The defendant argued that disgorgement was improper because there was no connection between his profits and his failure to register as a securities dealer. The court disagreed, holding that because Section 15(a) of the Exchange Act bars unregistered securities dealers from effecting any securities transaction, any profits the defendant made on a securities transaction were necessarily linked to his failure to register.

SPACs

Ninth Circuit Holds Investors Do Not Have Standing To Sue Over Alleged Misstatements Made by Merger Target Before Merger Completes

In re CCIV/Lucid Motors Sec. Litig. (9th Cir. Aug. 8, 2024)

What to know: The Ninth Circuit affirmed the dismissal of a securities fraud class action, holding that the plaintiff-investors in a SPAC lacked statutory standing to challenge pre-merger misstatements by the target company in a merger.

The Ninth Circuit affirmed the dismissal of a securities fraud class action against automotive and technology company Lucid Motor and its CEO alleging Exchange Act violations. In February 2021, Lucid Motors merged with special purpose acquisition company (SPAC) Churchill Capital Corporation IV (CCIV). Prior to February 2021, while Lucid and CCIV were negotiating the merger, Lucid's CEO publicly represented that Lucid expected to produce 6,000-7,000 cars in 2021 and that production would begin in Spring 2021. On the day the merger closed, Lucid and its CEO announced that Lucid expected to produce only 577 cars in 2021 and that production would begin after Spring 2021. Following these disclosures, CCIV's stock price dropped.

The plaintiffs — investors in CCIV — sued Lucid and its CEO, alleging securities fraud under Sections 10(b) and 20(a) of the Exchange Act, and Rule 10b-5 thereunder. The defendants moved to dismiss. The district court granted the motion, finding that while the plaintiffs had standing to sue under Rule 10(b), they did not adequately allege material misrepresentations.

The Ninth Circuit affirmed the dismissal, but on the alternate ground that the plaintiffs lacked standing. In holding that the plaintiffs did not have standing, the Ninth Circuit adopted and applied the "purchaser-seller" — or *Birnbaum* — rule, which limits standing to those who purchased or sold the stock in question. Here, the plaintiffs challenged representations by Lucid made prior to the merger. At the time Lucid made the alleged misrepresentations, the plaintiffs were not Lucid stockholders, nor could they have been, as Lucid was a private company prior to the merger and its stock was not publicly listed. As a result, the plaintiffs lacked standing to sue Lucid or its CEO based on Lucid's pre-merger statements. The court rejected the plaintiffs' arguments that the "stock in question" under the purchaser-seller rule was the "security about which Plaintiffs allege injury" and that the plaintiffs had standing so long as they merely alleged the security they purchased was "sufficiently *connected* to the misstatement." By rejecting these arguments, the court refused to "vastly expand the boundaries of Section 10(b) standing."

Delaware Court of Chancery Dismisses *MultiPlan* Claim at Pleading Stage

In re Hennessy Cap. Acquisition Corp. IV S'holder Litig.
(Del. Ch. May 31, 2024)

What to know: The Delaware Court of Chancery issued the first opinion dismissing a de-SPAC "*MultiPlan* claim" at the pleading stage, holding that even under an entire fairness review, the plaintiff failed to adequately plead a breach of fiduciary duty.

The Delaware Court of Chancery dismissed a plaintiff's core claim of breach of fiduciary duty under a *MultiPlan* theory in a case involving a de-SPAC transaction. Hennessy Capital Acquisition Corp. IV was formed as a SPAC. In August 2020, the SPAC and Canoo Holdings Ltd. (the Target) executed a merger agreement. The press release announcing the merger agreement attached a presentation describing the company's three projected revenue streams. Two months later, Tony Aquila, an investor in the Target, became the Target's executive chairman. The Target also hired outside consultant McKinsey and Company to review its business.

In December 2020, the SPAC issued a proxy statement recommending its investors approve the merger. The proxy highlighted the company's projected revenue from its three anticipated revenue streams. After receiving the stockholders' approval, the merger closed later that month, and the SPAC changed its name to Canoo Inc. Three months after closing, McKinsey presented the results of its review, and Aquila announced that Canoo had determined to restructure its business to deemphasize one of the three revenue sources and focus on other business. The stock price dropped, recovered briefly, then sank over time. The plaintiff, a Canoo stockholder, sued, alleging claims of breach of fiduciary duty under a *MultiPlan* theory, unjust enrichment, and aiding and abetting.

The court began its analysis by providing an overview of *MultiPlan* claims, which it characterized as "narrow." The court explained that while entire fairness review generally applies to *MultiPlan* claims, "[e]ntire fairness is not [] a free pass to trial" and that "pleading requirements exist even where entire fairness applies." The court explained that "[t]o state a viable *MultiPlan* claim, a plaintiff is required to plead facts making it reasonably conceivable that conflicted fiduciaries deprived public stockholders of a fair chance to exercise their redemption rights." Here, the plaintiff argued that stockholders were deprived of a fair chance to exercise their redemption rights because the defendants allegedly "fail[ed] to disclose McKinsey's engagement and changes to [the Target's] business model." The court distinguished other *MultiPlan*-claim cases where "concrete facts about the merger target's prospects were kept from public stockholders" and where those facts were "known or knowable" by the SPAC's directors, explaining that the complaint here "instead address[ed] actions by Canoo's post-closing board — a body made up of directors who were (with one exception) not on [the SPAC's] board."

The court concluded that "no well pleaded facts support[ed] a reasonable inference that changes to [the Target's] business model were known or knowable by [the SPAC's] board before the merger closed" and dismissed the breach of fiduciary duty claim, noting that "[t]o allow this faulty claim to proceed would fuel perverse incentives and invite strike suits." Because the plaintiff's other claims relied on this core disclosure claim, the court also dismissed them.

Technology

En Banc Third Circuit Holds Stockholder Derivative Lawsuit Dismissals Under FRCP 23.1 Must Be Reviewed *De Novo*

In re Cognizant Tech. Sols. Corp. Derivative Litig. (3d Cir. May 3, 2024)

What to know: The Third Circuit, sitting *en banc*, overturned its prior precedent applying an abuse of discretion standard of review to a district court's dismissal for failure to plead demand futility in shareholder derivative actions, joining other courts of appeals in applying a *de novo* standard of review.

The Third Circuit, sitting *en banc*, overturned its prior precedent by applying a *de novo* standard of review in a case where plaintiff shareholders brought derivative claims against certain directors and officers of Cognizant, a Delaware-based information technology services and consulting company. The plaintiff shareholders brought suit after Cognizant disclosed its employees in India paid bribes to the Indian government from 2010-15 to secure certain permits and operating licenses. The plaintiffs alleged that Cognizant's board members breached their fiduciary duties and committed corporate waste because they knew of several red flags concerning Cognizant's compliance with federal foreign corruption law. Despite this knowledge, the plaintiffs alleged, Cognizant ignored the problems and hid their concerns, publishing sustainability reports stating that no incidents of corruption had been reported during the relevant time period.

The defendants moved to dismiss the complaint on the grounds that the plaintiffs failed to make the required pre-suit demand on the board. The District of Delaware granted the motion, holding that the complaint failed to state with particularity the reasons demand would have been futile, as required by Federal Rule of Civil Procedure 23.1 (Rule 23.1). The Third Circuit accepted review, *en banc*, to determine what standard of appellate review should apply when a district court dismisses a shareholder derivative action based on a plaintiff's failure to plead demand futility under Rule 23.1.

The Third Circuit held that the *de novo* standard of review, rather than the abuse of discretion standard, applies. In so holding, the court overruled its precedent and aligned itself with the trend in other federal courts of appeals in favor of reviewing demand futility dismissals *de novo*. The court noted that the Delaware Supreme Court had likewise abandoned the abuse of discretion standard in favor of the *de novo* review standard under Delaware's analogous Rule 23.1.

Applying the *de novo* standard of review, the court affirmed the district court's dismissal of the derivative action for failure to plead demand futility. To plead demand futility, the plaintiffs were required to demonstrate there was a substantial likelihood of the defendants' liability on the claims subject to the demand. The court concluded, however, that the plaintiffs' allegations did not sufficiently allege liability based on breach of loyalty because they did not allege the defendants knew of the purported corruption. Similarly, the court concluded that the plaintiffs did not sufficiently allege liability based on corporate waste because they did not allege "that the Director Defendants did nothing for their salaries during the relevant period."

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