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Skadden

Inside the Courts

A Quarterly Update From Skadden Securities Litigators

Trends and Filings That Matter

Spotlight

Supreme Court Mulls What PSLRA's Particularity Standard Requires

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Key Points

- During its 2024 term, the U.S. Supreme Court is poised to provide important guidance on the Private Securities Litigation Reform Act's (PSLRA's) particularity requirement in *NVIDIA Corp. v. E. Ohman J:or Fonder AB*.
- In *NVIDIA*, the Court will decide two related issues: (i) whether plaintiffs seeking to allege scienter under the PSLRA based on allegations about internal company documents must plead with particularity the contents of those documents, and (ii) whether plaintiffs can satisfy the PSLRA's falsity requirement by relying on an expert opinion to substitute for particularized allegations of fact.
- The justices heard arguments in the *NVIDIA* case on November 13, 2024, and expressed concern about adopting any bright-line rules.
- The justices' skepticism seemed to carry over from arguments that they heard a week earlier in another securities case, *Facebook, Inc. v. Amalgamated Bank*, for which, on November 21, 2024, the Court concluded *certiorari* was improvidently granted.

The Private Securities Litigation Reform Act (PSLRA) was enacted to heighten the pleading standards that apply to securities fraud cases. This term, the U.S. Supreme Court is poised to provide important guidance on the PSLRA's particularity requirement in *NVIDIA Corp. v. E. Ohman J:or Fonder AB*, Case No. 23-970.

In *NVIDIA*, the Court will decide two related issues: (i) whether plaintiffs seeking to allege scienter under the PSLRA based on allegations about internal company documents must plead with particularity the contents of those documents, and (ii) whether plaintiffs can satisfy the PSLRA's falsity requirement by relying on an expert opinion to substitute for particularized allegations of fact.

Background

The *NVIDIA* case emerges from a recurring pattern in securities litigation: the announcement of disappointing revenue results and downward guidance revisions following a sustained period of success. In the case under review, the plaintiffs alleged that NVIDIA fraudulently understated the extent to which its revenues for its graphics processing units (GPUs) depended on sales for crypto mining, rather than for gaming. When cryptocurrency prices fell in 2018, demand for GPUs declined, and NVIDIA's stock price also declined. In the stock price decline's wake, a securities class action was filed.

In support of their securities fraud claim, the plaintiffs alleged that contemporaneous internal NVIDIA reports regarding GPU sales contradicted public statements about them. The plaintiffs did not, however, allege the contents of any internal NVIDIA report. Instead, the plaintiffs sought to bolster their fraud claims by retaining an expert firm — the Prysm Group — which purported to estimate the amount by which NVIDIA's quarterly gaming revenues were driven by cryptocurrency miners, rather than gamers. Using generic market research, Prysm (i) estimated the overall amount of computing power needed during the relevant time period to mine cryptocurrencies, (ii) estimated how many GPUs that would require, (iii) estimated NVIDIA's market share and then (iv) multiplied the number of units implied by that market share times an estimated revenue per unit. The plaintiffs alleged that the amount by which the estimated revenue exceeded the amount NVIDIA reported in its original equipment manufacturer (OEM) segment for sales of its crypto-specific GPU product was the amount by which NVIDIA fraudulently understated its exposure to cryptocurrency mining demand.

Divided Ninth Circuit Panel Approves Use of Expert Reports

After the district court dismissed the securities fraud claim, a divided panel of the Ninth Circuit reversed in relevant part. The panel majority held that falsity was sufficiently alleged based on the revenue estimates generated by Prysm. The panel majority also held that there was a strong inference of scienter because internal NVIDIA documents "would have" reflected Prysm's *post hoc* calculations, and that NVIDIA's CEO "would have" known about those internal documents given allegations about his "detail oriented" and "meticulous" oversight of company operations. The panel majority credited the Prysm report's conclusion that NVIDIA underreported its crypto revenues by $1.126 billion to observe that a "CEO who does not know the source of $1.126 billion is unlikely to exist."

Judge Gabriel Sanchez dissented. He opined that "the majority essentially concludes that Plaintiffs have adequately alleged falsity merely by showing that Defendants' statements concerning cryptocurrency related revenues diverged from Prysm's *post hoc* revenue estimates." The PSLRA, he added, does not "allow an outside expert to serve as the primary source of falsity allegations," especially where the expert is "without any personal knowledge of the facts on which its opinion is based." With respect to scienter, he pointed out that the plaintiffs failed to allege the "contents" of "any internal report or data source that would have put NVIDIA's executives on notice that their public statements were false or misleading when made, much less any internal source that corroborated Prysm's revenue estimates."

Circuit Split

The Ninth Circuit's rule conflicts with the Second Circuit's rule in *Arkansas Pub. Emps. Ret. Sys. v. Bristol-Myers Squib Co.*, 28 F. 4th 343, 354 (2d Cir. 2022), which holds that expert opinions "cannot substitute for facts under the PSLRA" unless the opinion "was based on particularized facts sufficient to state a claim for fraud." In accord with the Second Circuit, the Fifth Circuit has held that "opinions cannot substitute for facts under the PSLRA." *Fin. Acquisition Partners LP v. Blackwell*, 440 F.3d 278, 285-86 (5th Cir. 2006). Evidentiary complications relating to the admission of expert reports in connection with a pleading stage analysis have also supported their rejection by courts. *See id*.

NVIDIA and its *amici* have argued that the Ninth Circuit's rule dilutes the PSLRA's pleading standards and thereby undercuts the congressional goal of eliminating fishing expeditions brought with the hope of discovering a fraud after litigation is commenced. The PSLRA's ability to serve as a "check against litigation by private parties" could be thwarted by a rule that permits expert opinions in lieu of particularized facts. Allowing the Ninth Circuit's ruling to stand could, they argue, allow enterprising plaintiffs' lawyers to manufacture disputes based on expert opinions that could not be challenged. Equally problematic is the Ninth Circuit's apparent endorsement of allegations about internal reports without pleading details about their contents. Such lax standards threaten to render the PSLRA a weak check on lawyer-driven litigation.

Supreme Court Hears *NVIDIA* Arguments

The Supreme Court heard arguments in the *NVIDIA* case on November 13, 2024. NVIDIA and its *amici* argued to the Court that the Ninth Circuit's ruling dilutes the PSLRA's pleading standards and provides a roadmap for plaintiffs to skirt dismissal under the PSLRA's pleading standards by paying an expert to supposedly validate fraud claims. The PSLRA requires complaints to "state with particularity all facts" supporting the belief that a challenged "statement is misleading" and "facts giving rise to a strong inference of scienter." NVIDIA has argued that an expert opinion is not a fact; therefore, it follows, that the expert opinion does not satisfy the PSLRA's heightened pleading standards.

The justices expressed concern about adopting any bright-line rules. Several justices expressed skepticism towards NVIDIA's arguments and even questioned why the Court agreed to review the case when it sounded like NVIDIA was merely seeking "error correction" rather than a new rule. Other justices wondered exactly how demanding the PSLRA's particularity requirement is and whether the plaintiffs could be expected to plead as much detail about internal reports as NVIDIA was demanding.

Justices Toss *Facebook* Risk Disclosure Case

The justices' expressed skepticism in the *NVIDIA* case seemed to carry over from arguments that they heard a week earlier in another securities case, *Facebook, Inc. v. Amalgamated Bank*, Case No. 23-98. In *Facebook*, the Court was asked to decide whether risk disclosures are false or misleading when they do not disclose that a risk has materialized in the past, even if that past event presents no currently known risk of ongoing or future business harm. Following argument, the Court issued an order stating that it had improvidently granted *certiorari* in the case. As a result, the decision on review from the Ninth Circuit in *Facebook* will stand.

The Court's decision not to rule in the *Facebook* case will allow a circuit split to persist. In the case that had been under review, the Ninth Circuit reversed dismissal of a securities fraud claim against Facebook alleging that Facebook's risk disclosures in its annual report — mandated by Item 105 of Regulation S-K — were materially misleading for failing to disclose that its data had been improperly harvested by Cambridge Analytica in connection with political campaigns in 2016. In a split decision, the Ninth Circuit reversed in relevant part. The majority opinion criticized Facebook for representing the risk of improper access to or disclosure of Facebook data "as purely hypothetical when that exact risk had already transpired." A reasonable investor, the majority opinion concluded, "would have understood the risk of a third party accessing and utilizing Facebook user data improperly to be merely conjectural." The majority opinion reasoned that it was irrelevant that Facebook "did not yet know the extent of the reputational harm it would suffer as a result of the breach" by Cambridge Analytica.

In conflict with the Ninth Circuit's materialized risk standard, the First, Second and Tenth Circuits have adopted a "virtual certainty test." Under that test, those circuits hold that a company's disclosures about risks that "could" or "may" come to fruition are potentially actionable where defendants "omitted known risks of severe magnitude" that had either materialized at the time of disclosure or where it was a "virtual certainty" that they would materialize.

In light of the Court's decision not to rule in *Facebook*, public companies will need to proceed with caution in the face of a circuit split relating to the circumstances that will trigger securities fraud liability for statements and alleged omissions in risk factor disclosures. Companies will need to decide whether more or less risk disclosure creates a greater risk of being sued down the road.

Automotive

Northern District of Ohio Grants Motion To Dismiss Securities Class Action Against Officers of Electric Vehicle Manufacturing Company

Lim v. Hightower (N.D. Ohio Sept. 30, 2024)

What to know: The Northern District of Ohio dismissed a securities class action complaint against executive officers of an electric vehicle manufacturing company, alleging that the defendants misled investors about the state of a failed partnership with an electronics manufacturer.

Judge Benita Y. Pearson of the U.S. District Court for the Northern District of Ohio dismissed a securities class action complaint against executive officers of Lordstown Motors Corp. (LMC), an electric vehicle manufacturing company. The plaintiffs alleged that the defendants misled investors about the state of LMC's partnership with electronics manufacturer Foxconn by failing to disclose problems in the partnership that led to Foxconn's repudiation of its agreement with LMC and LMC's subsequent bankruptcy. The plaintiffs claimed that, by failing to disclose the problems prior to bankruptcy, the defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78j(b) and § 78t(a), and Rule 10b-5 of the Securities and Exchange Commission (SEC).

In May 2022, LMC and Foxconn signed a joint venture agreement (JVA) to combine resources and develop the next generation of electric vehicles. After Foxconn allegedly breached the JVA, the companies restructured their agreement, entering instead into a direct investment agreement on November 7, 2022. Between December 2022 and March 2023, LMC completed several manufacturing milestones. Foxconn, however, delayed providing promised funding to LMC and, as a result, suppliers backed out of deals with LMC. In March 2023, LMC's stock dropped below $1 per share. On April 21, 2023, Foxconn sent LMC a notice of default and stated the company would terminate the investment agreement if the stock price did not rise in 30 days. LMC publicly reported the termination and, on June 27, 2023, LMC filed for bankruptcy. LMC also filed an adversary complaint against Foxconn alleging a material breach of the investment agreement.

The plaintiffs alleged that between August 4, 2022, and March 6, 2023, the defendants made multiple misleading statements on earnings calls, in press releases, in a presentation and on a Form 8-K regarding Foxconn and LMC's partnership. The plaintiffs alleged these statements were misleading because they omitted significant problems between the companies and characterized Foxconn and LMC's relationship as collaborative and thriving, while the defendants privately believed that Foxconn was trying to sabotage their business. The defendants argued that they had no knowledge of the impending failure of the relationship until Foxconn repudiated the agreement, which then caused them to reevaluate Foxconn's motive.

The court agreed with the defendants and dismissed the complaint. In assessing the sufficiency of the plaintiffs' claims, the court first agreed to take judicial notice of several public filings evidencing Foxconn's stated commitment to the partnership and LMC's public warnings about the uncertainties surrounding it.

Applying the heightened pleading standards required by the PSLRA, the court then examined whether the plaintiffs had pled any actionable material misrepresentations or omissions. The court first found that the majority of alleged misstatements relayed the defendants' beliefs, goals and hopes for the future and did not contain definite, material information necessary to trigger a duty to disclose.

Second, the court found that the breaches under the abandoned JVA, delays and other minor issues did not render the statements describing the partnership misleading, especially because of the totality of the state of affairs and the public warnings of risk.

Third, the court held that the safe harbor doctrine protected the defendants' forward-looking statements about the partnership because the statements were qualified by cautionary language in LMC's SEC filings.

Fourth, with respect to scienter, the court held that many of the plaintiffs' allegations rested on hindsight following Foxconn's repudiation of the investment agreement and that, "[w]hen viewed holistically, Plaintiffs' allegations fail[ed] to give rise to a strong inference of scienter, especially in light of more compelling opposing inferences."

Finally, the court held that because the plaintiffs' Section 10(b) and Rule 10b-5 claims failed, the plaintiffs' Section 20(a) claim failed, too.

Cybersecurity and Data Privacy

SDNY Sustains Fraud Claims Against Software Developer for Misrepresentations on Cybersecurity Practices, Dismisses Post-Attack Disclosure Claims

SEC v. SolarWinds Corp. (S.D.N.Y. July 18, 2024)

What to know: The Southern District of New York denied, in part, the defendants' motion to dismiss fraud claims where marketing materials touted cybersecurity practices while company leaders knew of porous systems and hacking vulnerabilities. Separately, the court dismissed the SEC's novel application of Section 13(b)(2) to hacking events, holding that 13(b)(2) applies only to financial accounting internal controls and *not* to cybersecurity.

Judge Paul A. Engelmayer of the U.S. District Court for the Southern District of New York partially denied the software company SolarWinds Corp. and Timothy Brown's motion to dismiss fraud claims related to marketing materials that promoted cybersecurity practices, despite company leaders being aware of security weaknesses and hacking risks. Separately, the court dismissed the SEC's novel application of Section 13(b)(2) to hacking events, ruling that this section pertains only to financial accounting internal controls, not cybersecurity.

SolarWinds designs and sells software that allows IT professionals to manage networks, and Mr. Brown served as the company's vice president of security and architecture. Based on investigative discovery, the SEC alleged that in 2017, Mr. Brown conducted security audits revealing poor cybersecurity practices and presented these vulnerabilities to the company. Meanwhile, the company published materials, including a "Security Statement," touting purported cybersecurity strengths in conflict with Mr. Brown's assessments.

In 2019, SolarWinds' flagship product, Orion, was infiltrated by Russian state-sponsored hackers. Thereafter, two of SolarWinds' clients reported malicious activity. SolarWinds did *not* disclose those events. After a third customer was similarly breached and identified the means of attack, SolarWinds disclosed the Orion vulnerability.

As to fraud claims based on events preceding the attacks, the court sustained the claims, finding that the company's Security Statement made material misrepresentations and that scienter was imputed to the company through Mr. Brown. Because the company promoted its security in blogposts, podcasts and press releases during this period, the court also sustained a theory of scheme liability. The court noted that a private securities claim based on similar allegations was settled by the company for $26 million. As to statements following the attacks, the court dismissed the SEC's fraud claims that the 8-K disclosures omitted material information, finding that the SEC's theory was based on hindsight.

The court also rejected the SEC's novel application of Section 13(b)(2)'s internal control requirements to cybersecurity. It held that the text of Section 13(b)(2)(B)(iii) covers *accounting* controls relating to financial transactions and not cybersecurity controls, which fall "outside the scope" of the statute.

E-Commerce

Tenth Circuit Upholds Dismissal of Securities Claims Against E-Commerce Company Executives in Market Manipulation and Misrepresentation Case

In re Overstock Sec. Litig. (10th Cir. Oct. 15, 2024)

What to know: The Tenth Circuit affirmed the dismissal of securities claims that a short seller brought against an e-commerce company for alleged false statements and a "short squeeze" market manipulation scheme.

The Tenth Circuit affirmed the district court's grant of the defendants' motion to dismiss claims brought under Section 10(b) and 20(a) of the Exchange Act. The plaintiff, a short seller of Overstock stock, alleged that defendant Overstock and its executives made false and misleading statements by misrepresenting the past and projected performance of Overstock's Retail Division. The plaintiff also claimed that the defendants manipulated the market in a "short squeeze" scheme by announcing an unregistered dividend that inflated the Overstock stock price and forced short sellers to close their positions by buying stock at a loss.

The court affirmed the dismissal of claims based on the allegedly false and misleading statements about Overstock's Retail Division. In the complaint and on appeal, the plaintiff admitted that it purchased Overstock stock to satisfy their own contractual obligations that were triggered by the unregistered dividend, not because of the statements on Overstock's Retail Division. Thus, the court found that the plaintiff failed to plead reliance on the allegedly false and misleading statements.

Next, the court affirmed the dismissal of the market manipulation claim based on the "short squeeze" scheme, holding that an "open-market transaction may qualify as manipulative conduct, but only if accompanied by plausibly alleged deception." While Overstock's then-CEO showed manipulative intent — stating publicly that he "designed [the unregistered dividend] carefully" to "put legitimate short sellers in a bind" — Overstock disclosed the unregistered dividend well in advance of the dividend record date. The court reasoned that given the advance disclosure, the market had sufficient information to form judgments about how the dividend would impact the stock price. Unlike other violations of securities laws based on manipulative intent, the court found that the necessary element of secrecy was absent here and that investors were not deceived.

EDNY Partially Dismisses Securities Claims Against Online Clothing Rental Company and Underwriters in IPO Misrepresentation Case

Sharma v. Rent the Runway, Inc. (E.D.N.Y. Sept. 25, 2024)

What to know: The Eastern District of New York granted in part, and dismissed in part, certain securities fraud claims against an online clothing rental company, holding that the defendants' public statements regarding consumer demand were not actionable.

Judge Orelia E. Merchant of the U.S. District Court for the Eastern District of New York dismissed in part, and granted in part, certain claims brought by a purported class of individuals against an online clothing rental company, certain of its officers and the underwriters involved in connection with the company's October 2021 initial public offering (IPO) under Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 (Securities Act). The complaint alleged that the defendants made misrepresentations and omissions in its public documents by misleading investors on customer demand metrics and failing to disclose the significant transportation issues that the company was facing.

The plaintiffs alleged that the defendants' offering document statements violated Item 303 and 105 because the defendants misrepresented the "state of demand for [the online clothing rental company]'s subscription service." The defendants argued that the statements concerning consumer demand were not actionable because the defendants' disclosures regarding their historical performance figures were accurate. The court agreed and noted that the defendants' disclosures of its historical performance data in its public disclosures showed that both revenues and subscriber numbers were trending upward.

The plaintiffs further alleged that the defendants' failure to disclose that the company was not meeting "internal subscriber enrollment projections" violated Item 303. The court disagreed, holding that though such information would be of interest to a reasonable investor, under Second Circuit precedent, the "[d]isclosure of an item of information is not required simply because it may be relevant or of interest to a reasonable investor."

Lastly, the plaintiffs alleged that the defendants failed to disclose the "significant" and "then-existing" material events or uncertainties that the defendants were facing at the time of the IPO. Specifically, the plaintiffs alleged that the statements regarding the defendants' shipping costs were misleading because of their failure to disclose material uncertainties or significant risks that existed at the time. The court agreed, holding that the increasing shipping costs that prompted the defendants to switch shipping carriers were required to be disclosed. The court further noted that the fact that shipping costs by a shipping vendor used by the defendants doubled for at least 30 days "should have been disclosed to make the statement not material misleading under Section 11."

Energy

Northern District of California Dismisses Section 10(b) Claims Brought in Wake of Lahaina Fire

Bhangal v. Hawaiian Elec. Indus., Inc. (N.D. Cal. Oct. 15, 2024)

What to know: The Northern District of California granted a motion to dismiss a putative securities class action alleging violations of Section 10(b) of the Exchange Act in the wake of the Lahaina wildfire that occurred on August 8, 2023, on the island of Maui.

Judge Jacqueline Scott Corley of the U.S. District Court for the Northern District of California granted Hawaiian Electric Industries, Inc.'s (HEI's) motion to dismiss a putative securities class action alleging Exchange Act violations, finding HEI was not liable. HEI is a publicly traded Hawaii-based corporation whose subsidiaries collectively provide utility services to 95% of Hawaiian residents. One of its subsidiaries is Hawaiian Electric Company, Inc. (HECO). HEI's stock price declined after the August 8, 2023, wildfire in Lahaina, on the island of Maui. Shortly thereafter, HEI's shareholders filed a securities class action asserting that HEI and its subsidiaries made statements that misled investors about their fire mitigation efforts between February 2019 and September 2023.

As to the alleged statements made by HECO, the defendants argued that they were not the makers of those statements merely because HEI wholly owned HECO. The district court agreed. Under *Janus Capital Group, Inc. v. First Derivative Traders*, a defendant "must have 'made' the material misstatements" to be liable for securities fraud under SEC Rule 10b-5(b), and a statement is "made" by one who has ultimate authority over the statement, including its content and dissemination. The court in *Bhangal* found that the investors failed to allege any facts showing that HEI "'actually participated in and had authority over' statements made by HECO." Therefore, HEI and its officers could not be held liable for those statements.

The court also rejected the plaintiffs' allegations that HEI's public statements were false when made. The court concluded that the "factual allegations Plaintiffs rely on fall short of a plausible inference of falsity." Some of the challenged statements included opinions, for which the plaintiffs failed "to meet the first hurdle of plausibly alleging subjective falsity." The court also found allegations of objective falsity inadequate.

Finally, the court held that the plaintiffs failed to plead facts giving rise to a strong inference that HEI and its executives acted with scienter. The plaintiffs' allegations of an intent to deceive were not "stronger than the competing inference posed by Defendants: 'that the Lahaina Wildfire happened despite HECO's best efforts to prevent it and without Defendants trying to hide that risk' . . . . Or even: while HECO's efforts to mitigate wildfire risk proved insufficient, there was no attempt by Individual Defendants to misrepresent HECO's efforts." The court's conclusion that scienter was inadequately alleged was bolstered by "the lack of alleged motive, which tips the scale in favor of Defendants on scienter."

Financial Institutions

Second Circuit Vacates Dismissal of Investment Adviser's Half-Truth Claims, Affirms Dismissal of Pure Omission Claims Under Rule 10b-5

Moab Partners, L.P. v. Macquarie Infra. Corp. (2d Cir. Aug. 19, 2024)

What to know: On remand, the Second Circuit applied the U.S. Supreme Court's ruling in *Macquarie Infrastructure Corp. v. Moab Partners, L.P.* to hold that an investment adviser's Exchange Act claims under Section 10(b) and Rule 10b-5(b) relying on a "pure omission" theory must be dismissed because, as the Supreme Court held, "[p]ure omissions are not actionable under Rule 10b-5(b)."

The Second Circuit considered the U.S. Supreme Court's decision in *Macquarie Infrastructure Corp v. Moab Partners, L.P.* as well as supplemental briefing by the parties to apply the Supreme Court's ruling to Moab's claims. The Second Circuit held that the Supreme Court's ruling did not disturb the Second Circuit's previous analysis with respect to Moab's claims under Rule 10b-5(b) pertaining to "half-truths" or under Rules 10b-5(a) and 10b-5(c). Additionally, the parties did not dispute that Moab's Exchange Act claims under Section 10(b) and Rule 10b-5(b) relying on a "pure omission" theory should be dismissed based on the Supreme Court's ruling that "[p]ure omissions are not actionable under Rule 10b-5(b)."

Ultimately, the Second Circuit vacated the district court's judgment dismissing Moab's claims under (i) count one as to the claims under Rule 10b-5(b) resting on half-truths, as well as those under Rules 10b-5(a) and 10b-5(c); and (ii) counts two, three, four, five and six. The court affirmed the district court's judgment dismissing Moab's count one claims under Rule 10b-5(b) resting on pure omissions.

Financial Services

First Circuit Affirms Summary Judgment and Disgorgement Order Against Investment Advisers for Misrepresentation of 'Back-Tested' Strategy

SEC v. Navellier & Assocs. (1st Cir. July 16, 2024)

What to know: The First Circuit affirmed a district court's (i) grant of summary judgment to the SEC on the commission's claims that investment advisers violated the Investment Advisers Act, (ii) order requiring the advisers to disgorge more than $22 million and (iii) decision not to reduce the amount of the supersedeas bond.

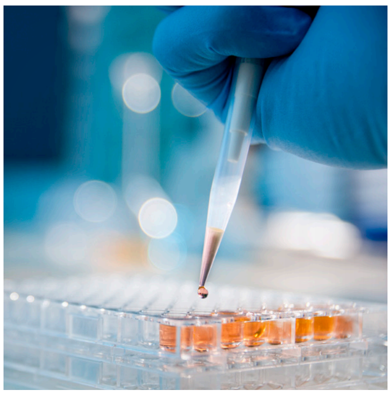
The First Circuit affirmed the U.S. District Court for the District of Massachusetts' (i) grant of summary judgment, (ii) order of disgorgement against various investment advisers and (iii) decision not to reduce the supersedeas bond in a case alleging Investment Advisers Act violations. In 2009, investment advisers licensed an investment strategy (the Strategy). The advisers distributed materials to their clients stating that the Strategy was "active," meaning its performance was based off of "*actual* performance figures" that "reflect investment decisions [made] at the time of execution." But the Strategy was "back-tested," meaning it was "retro-actively applied to historical market data" that reflect "*hypothetical* performance figures and benefit from hindsight." In 2013, the advisers sold their Strategy business. The SEC alleged that the advisers violated Investment Advisers Act Sections 206(1) and 206(2), which prohibit "employ[ing] any device, scheme, or artifice to defraud any client or prospective client" and "engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."

The First Circuit held that the advisers violated the Investment Advisers Act by making "a material misrepresentation with a culpable mental state." First, the advisers made misrepresentations by distributing materials wrongly describing the Strategy as "active." As support, the court cited internal emails stating that the Strategy "smell[ed] like FRAUD." Second, the statements were material because it was "obviously important to an investor" to know whether a strategy was back-tested. Further to that finding, the court noted SEC letters warning the advisers about their "failure to adequately disclose performance figures as back-tested." Third, the advisers acted with the requisite mental states, scienter for Section 206(1) and negligence for Section 206(2). The advisers' failure to disclose that the Strategy was back-tested was "an extreme departure from the standards of ordinary care," satisfying both mental states. The First Circuit rejected the advisers' selective enforcement and "class of one" affirmative defenses.

The First Circuit then affirmed the district court's disgorgement order. The court explained that "[t]he amount of disgorgement 'need only be a reasonable approximation of profits casually connected to the violation.'" The advisers' "causally connected" profits were (i) "the advisory fees [the advisers'] clients paid" for the Strategy and (ii) "the proceeds from" the Strategy business sale. Consistent with recent U.S. Supreme Court precedent, "legitimate expenses" (*i.e.*, "research expenses, other non-marketing expenses, and non-marketing salaries") were appropriately deducted from the profit amount.

Finally, the First Circuit found that the district court did not abuse its discretion by not reducing the amount of the supersedeas bond.

Life Sciences and Health Care



Court of Chancery Dismisses 'Hybrid' *Malone/Caremark* Claims at Pleadings Stage

In re FibroGen, Inc. Derivative Litig. (Del. Ch. Oct. 2, 2024)

What to know: The Court of Chancery dismissed the stockholder plaintiffs' "hybrid" *Malone/Caremark* claims under Court of Chancery Rule 23.1, holding that the plaintiffs failed to establish that a majority of the demand board faced a substantial risk of liability.

Vice Chancellor Sam Glasscock III of the Delaware Court of Chancery dismissed stockholder plaintiffs' claims under Court of Chancery Rule 23.1 against FibroGen, Inc., a biopharmaceutical company developing a drug to treat anemia. After receiving and disclosing negative results from the Federal Drug Administration (FDA), certain FibroGen directors and officers were sued for violations of federal securities laws related to prior positive — and allegedly false — disclosures regarding FibroGen's FDA approval process. After a motion to dismiss those claims was denied in part and the litigation was settled, the stockholder plaintiffs brought derivative claims against FibroGen's directors and officers for "hybrid" claims under *Malone* and *Caremark* theories of fiduciary liability. The plaintiffs also asserted related *Brophy* claims.

The court analyzed the plaintiffs' claims as a hybrid between (i) a *Malone* claim: a claim that "fiduciaries knowingly disseminated materially false information to stockholders"; and (ii) a *Caremark* "prong two" claim: a claim that fiduciaries "knew of evidence of corporate misconduct — the proverbial 'red flag' — yet acted in bad faith by consciously disregarding its duty to address that misconduct." The court explained the theory behind the alleged hybrid claim: "Management communicated false and misleading statements to investors and the FDA; even if Plaintiffs have not adequately alleged that a majority of the Director Defendants participated in that dissemination knowingly or intentionally, these Director Defendants' failure to investigate and intervene, in the face of 'red flags' indicating management wrongdoing, amounts to bad faith under a *Caremark* analysis."

The plaintiffs pointed to three types of communications allegedly containing false disclosures: (i) conference calls and press releases, (ii) Form 10-Q statements and (iii) Form 10-K statements. The court found, consistent with the hybrid claim theory, that the plaintiffs failed to sufficiently plead that a majority of the demand board had knowledge of the allegedly false statements when made or that the board disseminated knowingly false information. The court also rejected the plaintiffs' argument that the information presented to the directors rose to a level of a "red flag" of wrongdoing. Separately, the court held that even if the board had been presented with "red flags," there was no sufficient allegation of bad faith conduct because "none of the wrongdoing alleged against FibroGen itself caused the FDA's rejection of [the drug] — that is, a failure of oversight did not lead to a 'mission critical' corporate trauma."

Because the court held that the plaintiffs failed to establish demand futility under *Malone* or *Caremark*, the court also rejected the plaintiffs' *Brophy* claims.

Northern District of Illinois Grants Motion To Dismiss Pharmaceutical Company Derivative Action

Treppel Family Trust v. Gonzalez (N.D. Ill. Oct. 4, 2024)

What to know: The Northern District of Illinois granted a motion to dismiss a shareholder derivative action relating to the FDA's actions evaluating a pharmaceutical drug.

Judge Georgia N. Alexakis of the U.S. District Court for the Northern District of Illinois dismissed a consolidated shareholder derivative action against defendant officers and directors on behalf of AbbVie Inc. The plaintiffs alleged that the defendants breached their fiduciary duties in connection with the company's marketing of the drug Rinvoq and violated § 14(a) of the Exchange Act by including materially false and misleading statements in a proxy statement. The court held that the plaintiffs failed to allege facts that would support their assertion that making a pre-suit demand upon the AbbVie board would have been futile.

As AbbVie's most profitable drug Humira came close to the expiration of its patent, AbbVie began to focus on other potential sources of revenue. In 2020, AbbVie requested that the FDA approve its drug Rinvoq — a newer anti-inflammatory drug — to treat inflammatory diseases beyond that for which Rinvoq was initially approved. At the same time, the FDA issued safety warnings for a similar drug, Pfizer's Xeljanz, due to the results of a safety test that demonstrated an increased risk of blood clots. Between April and July 2021, the defendants made numerous statements differentiating Rinvoq from Xeljanz and expressing optimism that the FDA would approve Rinvoq for market in the increased disease areas. In June 2021, AbbVie announced that the FDA would not complete its review of Rinvoq for additional conditions in AbbVie's publicly predicted timeline due to the ongoing Xeljanz safety test. Ultimately, however, on September 1, 2021, the FDA announced that as a result of the potential for serious side effects as shown in the Xeljanz trial, it would require updated warnings for both Xeljanz and Rinvoq and limit further approved uses of the drugs.

Following the FDA's announcement, the plaintiffs brought a derivative action asserting that, among other things, the defendants breached their fiduciary duties of oversight by allowing allegedly false and misleading statements about Rinvoq's research and development prospects and expected FDA approval to be made. The plaintiffs alleged that the defendants violated Section 14(a) of the Exchange Act by making false and misleading statements in AbbVie's 2021 proxy statement, which recommended voting for an amended incentive stock program to encourage proper risk oversight and against an independent board chair, citing the company's "other robust corporate governance practices" as a reason. The plaintiffs asserted these statements were misleading because the stock program encouraged the defendants to inflate the stock price by making overly optimistic statements about Rinvoq and because the corporate governance practices did not prevent the defendants' breaches.

The plaintiffs did not make a pre-suit demand on the board before filing the derivative action — instead, they argued that demand was excused as futile because at least half of AbbVie's board members were named as defendants in the lawsuit and faced a substantial likelihood of liability. Following its assessment of the allegations, the court held that the plaintiffs had failed to allege particularized facts supporting a conclusion that at least half of the board faced a substantial likelihood of liability on any of the claims asserted, and thus had not shown demand futility. With respect to the breach of oversight claim, the court based its decision on the fact that the FDA announced the final results of the Xeljanz trial and the effect of those results on Rivoq more than a month after the last alleged misrepresentation. Because there was no allegation that any of the director defendants had prior knowledge of FDA actions or that anyone otherwise misrepresented internal AbbVie data, the director defendants had no reason to doubt any public statements about Rinvoq.

In evaluating the § 14(a) claim, the court determined that the plaintiffs failed to plead sufficient facts that would allow an inference that anything in the proxy statement was actually false or misleading at the time it was issued — a requisite for liability under § 14(a). The court emphasized that allegations of later misbehavior did not support the conclusion that the statements were false when made, nor had the plaintiffs alleged sufficient facts to support that the statements were actually false as opposed to merely overly optimistic. Because the plaintiffs did not allege facts to support that demand would be futile for any of their claims, the court granted the defendants' motion to dismiss.

Northern District of California Holds Defendants May Introduce Evidence of Truth on Market To Rebut Price Impact at Class Certification Stage

Pardi v. Tricida, Inc. (N.D. Cal. Sept. 27, 2024)

What to know: The Northern District of California granted investors' motion for class certification after allowing a biopharmaceutical company's CEO to present evidence that the company's disclosure of a drug application's rejection had no revelatory impact on its stock price due to the company's prior disclosures.

Judge Haywood S. Gillam, Jr. of the U.S. District Court for the Northern District of California addressed claims against clinical-stage biopharmaceutical company Tricida and its CEO, centering on allegations that misleading statements about the company's kidney disease drug veverimer inflated the company's stock price.

In August 2019, Tricida submitted a New Drug Application (NDA) to the FDA for veverimer. Between July 2020 and February 2021, Tricida issued press releases disclosing concerns that the FDA had expressed to Tricida about veverimer's demonstrated efficacy, including an August 24, 2020, announcement that the FDA had denied the NDA, and a February 25, 2021, announcement that the FDA had denied appeal

Stockholders sued Tricida and its CEO, alleging that the CEO knew about specific concerns with veverimer but instead made misleading statements during a May 7, 2020, earnings call, which artificially inflated Tricida's stock. The investors moved for class certification, arguing that they could prove reliance on a classwide basis under the fraud-on-the-market presumption arising out of *Basic, Inc. v. Levinson*. Under *Basic*, reliance is presumed when the alleged misrepresentations were publicly known and material, the stock is traded in an efficient market, and the investor traded the stock between when the purported misrepresentations were made and when the alleged truth was revealed.

The CEO argued that the *Basic* presumption could not apply to the entire putative class period because four public disclosures between July and October 2020 fully corrected any alleged misrepresentations made during the May 7 call, which, from that point on, disconnected Tricida's stock price from any presumed inflationary effect from those alleged misrepresentations.

Interpreting U.S. Supreme Court precedent, the district court held that the defendant could present this evidence at the class certification stage. It found that courts may examine, at class certification, facts relating to a truth-on-the-market defense involving both whether and when a fully corrective disclosure was made because such a disclosure could rebut *Basic*'s principle that misrepresentations affect stock prices in efficient markets — that is, a misrepresentation cannot impact an efficient market if the related truth is already public. However, because truth-on-the-market evidence overlaps with a misrepresentation's materiality — a merits issue — the district court cabined its findings to class certification. The court found that the CEO's asserted disclosures were not fully corrective of the alleged misrepresentations, so the *Basic* presumption applied to the entire class period.

M&A

Court of Chancery Dismisses Demand Refusal Derivative Case Under Rule 23.1

In re Kraft Heinz Demand Refused Derivative S'holder Litig. (Del. Ch. July 19, 2024)

What to know: The Court of Chancery dismissed with prejudice a demand-refused stockholder derivative lawsuit, finding the plaintiffs failed to allege particularized facts creating a reasonable doubt that the board investigated and rejected their demands in good faith and with due care.

Vice Chancellor Lori W. Will of the Delaware Court of Chancery dismissed claims by stockholders against Kraft Heinz's board, finding no wrongful refusal of demands related to a stock sale and impairment disclosures. Six months after 3G Capital Inc. sold part of its ownership interest in Kraft Heinz, Kraft Heinz announced a $15.4 billion impairment charge. Stockholders claimed 3G's stock sale occurred based on material nonpublic information while Kraft Heinz fiduciaries concealed the looming impairment from the market. Stockholders sent litigation demands to Kraft Heinz's board about the stock sale and impairment-related disclosures.

The board formed an administrative working group of two directors to consider the demands. The working group hired independent legal counsel and a forensic accountant to assist with its investigation. Together, they reviewed more than 150,000 documents, interviewed a dozen people and considered a detailed prior investigation led by outside counsel. After a two-year process, the working group authored a 110-page report. It recommended the demands be rejected, and the full board agreed.

The plaintiff stockholders sued, alleging the board wrongfully refused their demands. The Court of Chancery dismissed the claims under Rule 23.1 for failure to adequately plead that the demands were wrongfully refused.

The court began its analysis by identifying the plaintiffs' "heavy burden" of pleading "particularized facts which, taken as true, raise a reasonable doubt that the refusal was a valid exercise of business judgment." The court recognized that by making the demands, the plaintiffs waived any claim they might have had that the board could not act independently on the demands. The court then rejected the plaintiffs' two-part argument that the working group was structurally and procedurally flawed.

First, the court reviewed the plaintiffs' allegations that the board was required to form a committee of independent directors, not a working group. The court held that the "concededly unconflicted" board was empowered to decide how to investigate the demands as a matter of business judgment and that it was not required to form a "committee." In addition, the court rejected the plaintiffs' argument that one member of the working group was not independent and faced a "substantial likelihood" of liability merely because he signed the Form 10-Ks containing the relevant impairment-related disclosures.

Second, the court reviewed the plaintiffs' critiques about, among other things, the working group's conclusions and its failure to request certain documents and to speak to certain individuals. The court stated that there is no prescribed procedure that a board must follow when responding to a demand, and the working group's determinations regarding who to interview and which documents to review were discretionary. The plaintiffs' speculation about potentially overlooked information and "mere disagreement" with the working group's conclusions was insufficient to sustain a claim that the board breached its fiduciary duties.

DC Federal District Court Applies Novel Market Efficiency Analysis To Deny Class Certification Involving Claims Under Securities Law

Bratya SPRL v. Bed Bath & Beyond Corp. (D.D.C. Sept. 27, 2024)

What to know: The federal District Court for the District Columbia denied class certification for a putative class of investors alleging securities fraud, holding that reliance issues did not predominate across the class because the lead plaintiff did not prove that the stock, which was listed on the Nasdaq, traded in an efficient market during a "short squeeze."

Judge Trevor N. McFadden of the U.S. District Court for the District of Columbia denied class certification in a lawsuit against defendant investor Ryan Cohen and his investment firm RC Ventures. A plaintiff investor alleged that in March 2022, Mr. Cohen and RC Ventures bought a nearly 10% stake in Bed Bath & Beyond (BBBY), creating buzz in the meme stock community. That summer, amid a "short squeeze" of BBBY, Mr. Cohen tweeted a "to the moon" emoji responding to a negative BBBY article. However, within a week, Mr. Cohen sold his entire stake in BBBY and its price collapsed. The plaintiff filed suit against Mr. Cohen, RC Ventures and others, seeking to represent a class of investors who bought BBBY stock and suffered losses when the stock price collapsed.

In opposing class certification, Mr. Cohen argued that the putative class could not prove that it relied on his tweeted emoji and SEC filings relating to his holdings because BBBY did not trade in an efficient market during the class period. The court agreed — citing *Basic, Inc. v. Levinson*, the court explained that reliance can be rebuttably presumed if the plaintiff proves that the stock traded in an efficient market. According to the court, a stock trades in an efficient market if prices respond so quickly to new information that traders cannot make profits on the basis of that information. The court found that while indirect indicators of market efficiency would have been evidence that BBBY operated in an efficient market under normal circumstances, the circumstances surrounding the class period here were not normal.

During the class period, BBBY underwent a "short squeeze" where its price unexpectedly rose. BBBY's trading volume was also unusually high during this period. The court, therefore, found that "BBBY's hyperactive trading volume seem[ed] less an indication that traders [were] responding to new value-relevant information than that they [were] reacting to (or participating in) market manipulation." Per the court, "direct [e]vidence of a cause-and-effect relationship between unexpected news and market price ... is the critical factor — the *sine qua non* of efficiency." Even if the putative class could invoke *Basic*, the court found that Mr. Cohen rebutted the presumption of reliance by demonstrating that his statement did not have a statistically significant impact on BBBY's price. Because there was no evidence of market efficiency, the court held that reliance was not a common element that predominated across the putative class.

Web3 and Digital Assets

Northern District of California Allows Securities Claims Against Digital Asset Trading Platform To Proceed

SEC v. Payward, Inc. (N.D. Cal. Aug. 23, 2024)

What to know: The Northern District of California denied a digital asset trading platform's motion to dismiss claims brought by the SEC, holding that the trading platform could be liable under the securities laws for secondary-market transactions of digital assets promoted by third parties when those assets constitute investment contracts.

Judge William H. Orrick of the U.S. District Court for the Northern District of California denied digital asset trading platform Kraken's motion to dismiss claims brought by the SEC. The commission alleged that Kraken is an unregistered broker-dealer, exchange and clearing agency for digital-asset securities, violating Sections 5, 15(a) and 17A of the Exchange Act. Kraken's platform allows users to buy and sell digital assets created and promoted by third-party blockchain developers, acting as an intermediary between users. Kraken also can act as a direct counterparty to transactions.

Kraken moved to dismiss the action for failure to state a claim, arguing that third-party digital assets that are sold, exchanged and traded on the Kraken platform cannot constitute investment contracts, and therefore are not securities.

The district court concluded that, as to two particular digital assets sold on Kraken's trading platform, the SEC stated a plausible claim against Kraken because those assets could constitute investment contracts under the test developed in *Securities & Exchange Commission v. W.J. Howey Co.* Under *Howey*, an investment contract exists when there is (i) an investment of money (ii) in a common enterprise (iii) with an expectation of profits produced by the efforts of others. The court held as a threshold matter that *Howey* applies even to secondary-market transactions of digital assets issued or promoted by third parties. It reasoned that whether a transaction constitutes an investment contract depends on the totality of the circumstances and on the economic reality surrounding the contract, transaction or scheme at issue. Although digital assets *themselves* may not constitute investment contracts, the *circumstances of their sale* can constitute an investment contract if the *Howey* test is met. Here, the court found that the *Howey* elements were sufficiently alleged as to Kraken's sales of two digital assets because the SEC had alleged that the assets formed the *basis* of investment contracts, such that they met the *Howey* elements. The court left open Kraken's opportunity to rebut the SEC's pleadings through discovery.

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