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Securities Law Alert

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February 2016

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– Chambers USA 2015

Supreme Court: Courts Must Apply the ERISA Pleading Standards of *Fifth Third Bancorp v. Dudenhoeffer*

On January 25, 2016, the Supreme Court reversed for the second time the decision of the Ninth Circuit not to dismiss an ERISA complaint. *Amgen v. Harris*, 136 S. Ct. 758 (2016) (per curiam) (*Amgen III*) (reversing *Harris v. Amgen*, 788 F.3d 916 (9th Cir. 2014) (*Amgen II*)). Reiterating that *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014),[1] "set[s] forth the standards for stating a claim for breach of the duty of prudence against fiduciaries who manage employee stock ownership plans (ESOPs)," the Supreme Court held the Ninth Circuit had failed to properly apply those standards in evaluating the *Amgen* complaint. After conducting its own review, the Supreme Court concluded the complaint lacked "sufficient facts and allegations to state a claim."

Background

In 2007, participants in Amgen-sponsored pension plans (the "Amgen Plans" or the "plans") brought suit in the Central District of California alleging that the plans' fiduciaries had breached their duties under ERISA by continuing to offer the Amgen Common Stock Fund as an investment option, even though the fiduciaries allegedly knew or should have known that the price of Amgen stock was artificially inflated.

On March 2, 2010, the district court dismissed plaintiffs' claims for failure to rebut the presumption of prudence established in *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995). *Harris v. Amgen*, 2010 WL 744123

1. Please click here to read our prior discussion of the Supreme Court's decision in *Fifth Third*.

(C.D. Cal. 2010). Several years later, in October 2013, the Ninth Circuit reinstated plaintiffs' ERISA claims. *Harris v. Amgen*, 738 F.3d 1026 (9th Cir. 2013) (Fletcher, J.) (*Amgen I*). The Ninth Circuit held that the fiduciaries of the Amgen Plans were "not entitled to a presumption of prudence" because they "were neither required nor encouraged by the terms of the Plans to invest in Amgen stock." Applying ERISA's "normal prudent man" standard of care, the Ninth Circuit determined that plaintiffs' allegations were sufficient to state a claim.

On June 25, 2014, the Supreme Court vacated the Ninth Circuit's decision in *Amgen I* and remanded for reconsideration in light of its opinion issued the same day in *Fifth Third*. In *Fifth Third*, the Supreme Court held that ESOP fiduciaries are not entitled to any "special presumption" of prudence but are instead "subject to the same duty of prudence that applies to ERISA fiduciaries in general, except that they need not diversify the fund's assets." Simultaneously, however, the Court provided pleading guidance to help courts "divide the plausible sheep from the meritless goats." As relevant here, the Court held that "[t]o state a claim for breach of the duty of prudence on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it."

On remand, the Ninth Circuit once again deemed plaintiffs' allegations sufficient to state breach of fiduciary duty claims under ERISA. *Amgen II*, 788 F.3d 916. The Ninth Circuit acknowledged that the Supreme Court in *Fifth Third* had "articulated certain standards for ERISA liability," but stated that it had "already assumed those standards" in *Amgen I*. Applying those standards, the Ninth Circuit determined it was "quite plausible" that defendants could have removed the Amgen Common Stock Fund "from the list of investment options" available through the Amgen Plans "without causing undue harm to plan participants." Accordingly, the Ninth Circuit held, the *Amgen* complaint plausibly alleged that the fiduciary defendants had violated their ERISA duty of care "by continuing to provide Amgen common stock as an investment alternative when they knew or should have known," based on inside information, "that the stock was being sold at an artificially inflated price."

Defendants petitioned the Supreme Court for certiorari of the Ninth Circuit's decision in *Amgen II*. The Court granted certiorari and reversed.

Supreme Court Reverses the Ninth Circuit for Failure to Properly Apply the Pleading Standard in *Fifth Third*

In its per curiam decision, the Supreme Court explained that *Fifth Third* recognized that "ESOP fiduciaries confront unique challenges given 'the potential for conflict' that arises when fiduciaries are alleged to have imprudently 'fail[ed] to act on inside information they had about the value of the employer's stock.'" *Amgen III*, 136 S. Ct. 758 (quoting *Fifth Third*, 134 S. Ct. 2459). In light of these challenges, the Supreme Court explained, courts must "consider *whether the complaint has plausibly alleged* that a prudent fiduciary in the defendant's position could not have concluded that stopping purchases—which the market might take as a sign that insider fiduciaries viewed that employer's stock as a bad investment—or publicly disclosing negative information would do more harm than good to the fund by causing a drop in the stock price and a concomitant drop in the value of the stock already held by the fund" (quoting *Fifth Third*, 134 S. Ct. 2459).

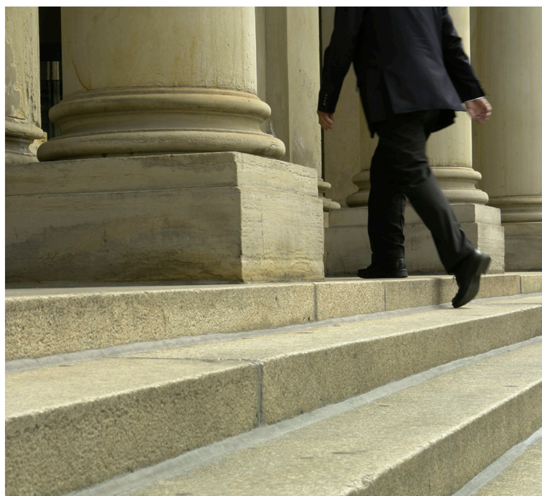
Applying this standard, the Supreme Court held the Ninth Circuit had "failed to properly evaluate the complaint." The Ninth Circuit had found it "quite plausible" that removing the Amgen Common Stock Fund as an investment option under the Amgen Plans would not have resulted in "undue harm to plan participants" (quoting *Amgen II*, 788 F.3d 916). However, the Ninth Circuit did not "assess whether the complaint . . . 'plausibly alleged' that a prudent fiduciary in the same position 'could not have concluded'" that removing the Amgen Common Stock Fund as an investment option under the plans would have done "more harm than good" (quoting *Fifth Third*, 134 S. Ct. 2459).

The Supreme Court conducted its own review of the *Amgen* complaint and determined the complaint lacked "sufficient facts

and allegations" to support "[t]he Ninth Circuit's proposition that removing the Amgen Common Stock Fund from the list of investment options was an alternative action that could plausibly have satisfied *Fifth Third*'s standards." The Court therefore reversed the Ninth Circuit's decision and remanded the action for further proceedings consistent with its opinion. The Court left it to the discretion of the district court to decide whether to permit plaintiffs to amend their complaint "in order to adequately plead a claim for breach of the duty of prudence guided by the standards provided in *Fifth Third*."

Eighth Circuit: (1) Cautionary Statements Must Provide "a Realistic Description of the Risks Applicable to the Particular Circumstances," and (2) Not All Bad Corporate News Is "Corrective" for Loss Causation Purposes

On February 10, 2016, the Eighth Circuit revived a securities fraud action alleging that The Dolan Company ("Dolan") had made material misrepresentations and omissions concerning the financial stability of its subsidiary, DiscoverReady. *Rand-Heart of New York v. Dolan*, 2016 WL 521075 (8th Cir. 2016) (*Rand-Heart II*) (Benton, J.). The Eighth Circuit held that the warnings accompanying the alleged misstatements were not "*meaningfully* cautionary" because defendants did not provide "a realistic description of the risks applicable to the particular circumstances." However, the court also found that plaintiffs had not adequately alleged loss causation as to a certain segment of the class period because one of the alleged "corrective disclosures" did not actually correct any prior misrepresentations.



Background

DiscoverReady was a litigation support business. The company's biggest customer was Bank of America, which accounted for 20% to 30% of DiscoverReady's revenues.

In late June or early July 2013, Bank of America expressed concern regarding Dolan's financial stability, and informed Dolan that it "would need to solve its financial problems" "in order for Bank of America to continue to send work to DiscoverReady." *Rand-Heart of New York v. Dolan*, 2015 WL 1396984 (D. Minn. Mar. 25, 2015) (Magnuson, J.). In July 2013, Dolan's board of directors "authorized [the company's COO] to begin to seek buyers for the DiscoverReady business."

On August 1, 2013, Dolan's CEO stated during an analyst call that the company "expect[ed]" DiscoverReady "to grow at double-digit rates over the prior year." However, he acknowledged that DiscoverReady's third quarter revenues would likely be below the prior year's. Dolan's CEO stated that he did not want "to dampen enthusiasm about . . . growth prospects for DiscoverReady" but explained that the company wanted "to set proper expectations for a business that may experience lumpiness on a quarter-to-quarter basis." Plaintiffs contended that the August 1, 2013 statements were "materially false and misleadingly incomplete, because none of the statements informed the public about 'the deterioration of the [c]ompany's relationship with Bank of America.'"

On November 12, 2013, Dolan's CEO stated in a press release that "DiscoverReady's third quarter revenues were affected not only by the quarterly lumpiness that is inherent to the e-discovery business, but also decreased primarily as the result of a period of reduced work from DiscoverReady's largest customer." Dolan's share price fell by nearly 50% following this announcement. Plaintiffs nonetheless contended that "the company's stock price 'remained artificially inflated to a material degree' until" January 2, 2014, when Dolan "announced that it had appointed a

'Chief Restructuring Officer' to attempt to restructure the company's indebtedness." Dolan's share price fell by almost 21% after the January 2 announcement.

On March 26, 2015, the District of Minnesota dismissed plaintiffs' claims. While the court found that plaintiffs had adequately alleged that the August 1, 2013 statements were materially misleading, the court determined that plaintiffs had failed to allege scienter. The court further held that plaintiffs had failed to establish loss causation for the period between November 12, 2013 (the date Dolan disclosed DiscoverReady's "reduced work" from its "largest customer") and January 2, 2014 (the end of the class period).

Eighth Circuit Finds Dolan Must Have Known That the Decline in Bank of America's Business Significantly Impacted DiscoverReady's Financial Stability

On appeal, the Eighth Circuit explained that "[s]cienter can be established by a deceitful or manipulative state of mind, severe recklessness, or motive and opportunity." *Rand-Heart II,* 2016 WL 521075. The Eighth Circuit noted that the district court had "found no motive" for defendants to misrepresent DiscoverReady's financial stability. The district court also deemed it significant that Dolan's CEO had "never sold his shares of the company stock." However, the Eighth Circuit underscored that the absence of motive "does not end the [scienter] inquiry."

Here, plaintiffs alleged that Dolan had been "severely reckless" "in failing to disclose that Bank of America had stopped sending new work to DiscoverReady" during the August 1, 2013 conference call. Plaintiffs claimed that the loss of Bank of America's business was so significant that it "prompted [Dolan's] [b]oard in June 2013 to 'authorize the marketing of DiscoverReady for sale.'" Based on these allegations, the Eighth Circuit found that "DiscoverReady's financial instability caused by the decline in Bank of America['s business] was, at the least, 'so obvious that [defendants] must have been aware of it.'" The court therefore held that plaintiffs had adequately pled scienter as to the August 1, 2013 statements.

Eighth Circuit Finds Dolan's Statements Regarding DiscoverReady's Financial Prospects Were Not Protected Forward-Looking Statements

The Eighth Circuit rejected defendants' contention that the August 1, 2013 statements regarding DiscoverReady's "double-digit" growth and the possible "lumpiness" in DiscoverReady's quarter-to-quarter revenues were protected forward-looking statements under the Private Securities Litigation Reform Act's ("PSLRA") safe-harbor provision.

Defendants stated that the August 1, 2013 statements were inactionable because they were accompanied by cautionary language from the company's SEC filings. Specifically, the company warned that "DiscoverReady's business revenues have traditionally been concentrated among a few customers and if these large repeat customers choose to manage their discovery with their own staff or with another provider and if we are unable to develop new customer relationships, our operating results and the ability to execute our growth strategy at DiscoverReady may be adversely affected."

The Eighth Circuit found that these warnings, "[e]ven if cautionary," were "not *meaningfully* cautionary." The court explained that the warnings were not "based on a realistic description of the risks applicable to the particular circumstances" affecting DiscoverReady but were instead "a boilerplate litany of generally applicable risk factors."

Eighth Circuit Finds Plaintiffs Failed to Allege Loss Causation Between November 12, 2013 and January 2, 2014

With respect to loss causation, the Eighth Circuit found that defendants had "fully disclosed on November 12, 2013" that Bank of America was no longer sending DiscoverReady any new litigation support work. The court found meritless plaintiffs' claim that the alleged fraud was "not fully revealed" until the company's January 2, 2014 announcement of a new restructuring officer.

The Eighth Circuit determined that the January 2 press release was not a corrective disclosure for loss causation purposes because "[n]othing in the January 2 press release correct[ed] previous misrepresentations."

Rather, the announcement merely "elaborate[d] on [Dolan']s previously disclosed plan to restructure."

The Eighth Circuit underscored that "[i]n the financial markets, not every bit of bad news that has a negative effect on the price of a security necessarily has a *corrective* effect for purposes of loss causation." The court explained that "[a] drop in stock price is not necessarily caused by an earlier misrepresentation." Rather, a lower stock price "may reflect . . . changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price" (quoting *Dura Pharmaceuticals v. Brodo*, 544 U.S. 336 (2005)).

In order to allege loss causation based on the drop in Dolan's stock price following the January 2 press release, the Eighth Circuit found that plaintiffs had to allege "that Dolan's fraud—and not other events—caused the price to fall." Because plaintiffs failed to do so, the Eighth Circuit held that the district court "did not err in finding no loss-causation for the period between November 12 and January 2."

Ninth Circuit: Announcement of a Government Investigation Can Serve as a Corrective Disclosure for Loss Causation Purposes If the Inaccuracy of the Misstatement at Issue Is Subsequently Confirmed

On February 1st, 2016, the Ninth Circuit revived in part a securities fraud action against CVB Financial Corporation ("CVB") alleging that the company had made material misrepresentations concerning the likelihood that its largest borrower would default on its loans. *Lloyd v. CVB Financial Corp.,* 2016 WL 384773 (9th Cir. 2016) (Hurwitz, J.). The Ninth Circuit held that "the announcement of an SEC investigation related to an alleged misrepresentation, coupled with a subsequent revelation of the inaccuracy of that misrepresentation, can serve as a corrective disclosure for the purpose of loss causation."

In the case before it, the Ninth Circuit found that the announcement of an SEC investigation into CVB's "loan underwriting methodology and allowance for credit losses" could be deemed a corrective disclosure because CVB later wrote down certain of the loans in question and designated other loans as non-performing.

Court Finds Plaintiffs Adequately Alleged Falsity and Scienter as to Two Alleged Misrepresentations

Plaintiffs challenged as materially misleading a statement in CVB's 2009 Form 10-K, filed in March 2010, representing that the company was "not aware of any . . . loans as of December 31, 2009 for which known credit problems of the borrower would cause serious doubts as to the ability of such borrowers to comply with their loan repayment terms." Plaintiffs also asserted claims in connection with CVB's "nearly identical 'no serious doubts' statement in a 10-Q filed on May 10, 2010" that "differed from the previous 'no serious doubts' statement[] only in that it was 'as of March 10, 2010.'" According to plaintiffs, both statements were misleading because Garrett Group, CVB's largest borrower had "told CVB in early January 2010 that unless modifications to loan terms were made, Garrett could not meet its obligations and might file for bankruptcy."

The Ninth Circuit acknowledged that the representation in CVB's 2009 Form 10-K may have been "[t]echnically . . . true, given that the critical meeting with Garrett did not take place until January 2010." However, the court found that "the statement was plainly misleading when made." The Ninth Circuit explained that by the time CVB filed its 2009 Form 10-K in March 2010, "CVB had known for two months that there was a basis for serious doubts about the ability of Garrett, CVB's largest borrower, to repay." The court determined that "[t]he omission of that fact, combined with the reassurance that everything was fine as of December 31, 2009, [met] the pleading standard for a material omission." The court found CVB's May 2010 "no serious doubts" statement similarly misleading, and determined that plaintiffs had adequately alleged scienter as to both statements.

Notably, the Ninth Circuit concluded that the district court had erroneously

"discounted" plaintiffs' confidential witness allegations regarding when CVB learned of Garrett's repayment challenges because those allegations were based on hearsay. The Ninth Circuit stated that "the fact that a confidential witness reports hearsay does not automatically disqualify his statement from consideration in the scienter calculus." Rather, courts must "examine a confidential witness's hearsay report to determine if it is sufficiently reliable, plausible, or coherent." Here, the Ninth Circuit determined that the confidential witness allegations were "sufficiently reliable for pleading purposes" because they were "specific in time, context, and details, and involved important communications from a chief executive officer to his [b]oard."

Court Holds CVB's Announcement of an SEC Investigation into the Company's Loan Underwriting Methodology and Allowance for Credit Losses Constituted a Corrective Disclosure

Turning to the question of loss causation, the Ninth Circuit explained that "investors must demonstrate that the defendant's deceptive conduct caused their claimed economic loss." The court noted that plaintiffs in securities fraud actions "typically" satisfy this requirement by alleging "that the defendant revealed the truth through corrective disclosures which caused the company's stock price to drop and investors to lose money."

In the case at hand, "[t]he only significant fall in CVB's share price occurred after [the company's] announcement" of an SEC investigation into CVB's underwriting methodology and its allowance for credit losses. The district court had found that this announcement did not qualify as a corrective disclosure for loss causation purposes.

On appeal, the Ninth Circuit reversed the district court's ruling. The Ninth Circuit noted that in *Loos v. Immersion Corp.*, 762 F.3d 880 (9th Cir. 2014),[2] it had previously held that "the announcement of an investigation, standing alone and without any subsequent disclosure of actual wrongdoing, does not reveal to the market the pertinent truth of anything, and therefore does not qualify as a corrective disclosure" (quoting *Loos*, 762 F.3d 880). However, the Ninth Circuit explained that it had "left open [the question of] whether the announcement of an investigation can 'form the basis for a viable loss causation theory' if the complaint also alleges a subsequent corrective disclosure by the defendant" (quoting *Loos*, 762 F.3d 880). In *CVB,* the Ninth Circuit "answer[ed] that question in the affirmative."

The Ninth Circuit observed that plaintiffs in the instant action alleged "much more" than simply the announcement of a government investigation. Plaintiffs asserted that CVB's share price "dropped over 20% the day after the announcement" of the SEC investigation, but claimed that "the market hardly reacted at all" a month later when "CVB disclosed that it was charging off millions in Garrett loans." The Ninth Circuit found that the market's response "confirm[ed] that investors understood [the announcement of the SEC investigation] as at least a partial disclosure of the inaccuracy of the previous 'no serious doubts' statements." The court concluded that plaintiffs had adequately alleged loss causation, and reasoned that "any other rule would allow a defendant to escape liability by first announcing a government investigation and then waiting until the market reacted before revealing that prior representations under investigation were false."

The Ninth Circuit noted that its decision was "consistent" with the Fifth Circuit's decision in *Public Employees' Retirement System of Mississippi v. Amedisys*, 769 F.3d 313 (5th Cir. 2014).[3] In that case, the Fifth Circuit held that announcements of government investigations into a company's Medicare billing practices could serve as corrective disclosures for loss causation purposes "when 'viewed together with the totality of the other alleged partial disclosures'" (quoting *Amedisys*, 769 F.3d 313).

2. Please click here to read our prior discussion of the *Loos* decision.

3. Please click here to read our prior discussion of the *Amedisys* decision.

Southern District of New York: (1) Defendants Do Not Have a Generalized Duty to Disclose SEC Investigations and Wells Notices, and (2) Defendants Have No Duty to Update Statements Made Prior to the Class Period

On January 22, 2016, the Southern District of New York dismissed a securities fraud action against Lions Gate Entertainment Corporation alleging that the company had a duty to disclose an SEC investigation and the issuance of Wells Notices concerning certain transactions designed to prevent a minority stockholder from gaining control of the company. *In re Lions Gate Entertainment Corp. Sec. Litig.*, 2016 WL 297722 (S.D.N.Y. 2016) (Koeltl, J.). The court held that there is no "generalized duty to disclose" SEC investigations and Wells Notices because, among other reasons, "the securities laws do not impose an obligation on a company to predict the outcome of investigations." The court further ruled that defendants have no duty to update or correct statements made prior to the class period because there would otherwise be a "never-ending duty of disclosure."

Background

In the summer of 2010, Lions Gate and several of its executives (collectively, "defendants") entered into a series of transactions allegedly designed to prevent Carl Icahn, a minority investor, from gaining control of the company. Several months later, the SEC initiated a formal investigation into these transactions. In July 2012, the SEC's Enforcement Division issued several Wells Notices[4] indicating that it was considering recommending that the SEC file a civil action against defendants.

In February 2014, Lions Gate signed a settlement agreement with the SEC pursuant to which the company agreed to pay a civil penalty of $7.5 million and admit wrongdoing under Sections 13(a) and 14(d) of the Securities Exchange Act. On March 13, 2014, the SEC both commenced and resolved administrative proceedings against Lions Gate. That same day, Lions Gate filed a Form 8-K disclosing the SEC investigation and the terms of its settlement with the SEC. Notably, the SEC did not bring any action against Lions Gate's executives.

Shareholders subsequently brought suit alleging that "the SEC staff investigation and Wells Notices from the Enforcement Division triggered a duty of disclosure." Plaintiffs contended that the failure to disclose the investigation and the Wells Notices "rendered misleading statements about the potential adverse effect of pending litigation" in the company's SEC filings between February 2013 and March 2014. Specifically, plaintiffs challenged Lions Gate's representation that it did "not believe that the outcome of any currently pending claims or legal proceedings [would] have a material adverse effect on the [c]ompany's financial statements." Defendants moved to dismiss plaintiffs' claims.

Court Finds Defendants Had No Duty to Disclose Either the SEC Investigation or the Wells Notices

The court explained that "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5." Here, the court found that "defendants did not have a duty to disclose the SEC investigation and Wells Notices because the securities laws do not impose an obligation on a company to predict the outcome of investigations." The court further explained that "[t]here is no duty to disclose litigation that is not substantially certain to occur."

The court emphasized that the issuance of a Wells Notice "does not necessarily indicate that charges will be filed." The court observed that "the Enforcement Division may not proceed with a recommendation to commence an action and the SEC may not authorize the filing of an action even if the Enforcement Division recommends it." In the instant action, the court noted that "the SEC never proceeded with a charge that Lions Gate [had] violated Section 10(b) and Rule 10b-5 and never proceeded with any litigation against individual defendants, despite the issuance

4. As the court explained, "[a] Wells Notice informs the recipient that the SEC Enforcement Division staff has decided to recommend that the [SEC] bring an enforcement proceeding, identifies alleged violations of securities law, and provides potential defendants the opportunity to make a responsive submission."

of Wells Notices discussing their potential liability."

The court found that the cases cited by plaintiffs purporting to support the existence of a duty to disclose Wells Notices and SEC investigations were "inapposite because (1) the defendants in those cases were subject to a preexisting duty of disclosure under the securities laws or [had] made express prior disclosures related to the investigation which were rendered materially misleading by omitting information about the investigation, and (2) the investigation itself was material." The court explained that those "cases stand for the proposition that when a company speaks on a subject, it cannot omit material facts about that subject, and cannot make a material misrepresentation about the existence of an investigation."

Here, plaintiffs did not allege that defendants had made any statements during the class period about the transactions in question or the SEC investigation of those transactions. As to Lions Gate's representation in its SEC filings that it did not believe that pending claims or legal proceedings would have a material adverse effect on the company's financial statements, the court found that plaintiffs did not allege that "defendants' opinions were not supported by the facts known to them at the time" as required under the Supreme Court's decision in *Omnicare v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318 (2015).[5]

The court further determined that plaintiffs had "failed to allege that the investigation itself was material" given that the final SEC penalty "was less than one percent of Lions Gate's consolidated revenue . . . for the third quarter of 2014." The court noted that this was "much lower than the five percent numerical threshold that the . . . Second Circuit has determined is a 'good starting place for assessing the materiality of [an] alleged misstatement'" (quoting *ECA, Local 134 IBEW Joint Pension Tr. Of Chicago v. JP Morgan Chase*, 553 F.3d 187 (2d Cir. 2009)).

The court rejected plaintiffs' contention that defendants had a duty to disclose the SEC investigation because there was a "reasonable likelihood that the [SEC] penalty *could have* materially affected" Lions Gate's financials." The court found that "[t]he securities laws do not require a company to hypothesize the worst results of an investigation when those results do not materialize and when the company chooses not to speak about the investigation."

Court Holds Defendants Have No Duty to Correct Statements Made Prior to the Class Period

The court found meritless plaintiffs' claim that defendants had a "duty to correct" statements they had made before the start of the class period concerning the transactions at issue. The court explained that under Second Circuit precedent, there is no "duty to correct previous misstatements" if "defendants made the original statements before the [c]lass [p]eriod and became aware of the errors in those statements before the [c]lass [p]eriod" (citing *Lattanzio v. Deloitte & Touche*, 476 F.3d 147 (2d Cir. 2007)). The court reasoned that "[a]ny other rule would undercut the meaning of the [c]lass [p]eriod and eviscerate the statute of limitations" because "[i]t could always be argued that allegedly false statements made long before the [c]lass [p]eriod and outside the statute of limitations should be corrected by a statement within the [c]lass [p]eriod." The court found that "impos[ing] a never-ending duty of disclosure would circumvent the general rule that pre[-][c]lass [p]eriod statements are not actionable."

Court Finds Defendants Have No Duty to Disclose Government Investigations and Wells Notices Under Regulation S-K

The court also rejected plaintiffs' argument that defendants were required to disclose the SEC investigation and Wells Notices under Regulation S-K. First, the court explained that "a failure to make a required disclosure under Item 303 [of Regulation S-K] in a Form 10-Q filing is an omission that can serve as the basis for a Section 10(b) securities fraud claim" only "if it satisfies the materiality requirement under *Basic*." Here, the court determined that the investigation at issue was not material under either the *Basic* test or Item 303's "distinct materiality test," which provides that "[n]o information need be given with respect to any proceeding that involves primarily a claim for damages if the amount

5. Please click here to read our prior discussion of the *Omnicare* decision.

involved, exclusive of interest and costs, does not exceed 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis" (quoting Item 303 of Regulation S-K).

Second, the court found that "an investigation alone is not a 'pending legal proceeding' or a 'proceeding [ ] known to be contemplated by governmental authorities'" within the meaning of Item 303 of Regulation S-K. The court reasoned that when the SEC conducted its investigation in the instant action, "the SEC had not yet decided whether it would charge Lions Gate and the individual defendants with securities violations." Similarly, the court found that "the issuances of the Wells Notices did not mark the beginning of a 'pending legal proceeding'" because "[a] Wells Notice only informs an individual or company that the SEC Enforcement Division staff is considering recommending that the SEC file an action."

Finally, the court found that "[a]n SEC investigation [cannot] be characterized as a 'known trend' or 'uncertainty' under Item 303," or as a "risk factor" under Item 503(c) of Regulation S-K. The court explained that the complaint did "not plausibly allege" that the civil penalty assessed "put Lions Gate's profits at risk or made the stock 'risky' as a result of Lions Gate's ongoing operations."

Court Finds GAAP Does Not Mandate Disclosure of SEC Investigations

The court further determined that defendants were not required to disclose the SEC investigation and the Wells Notices under Accounting Standards Certification Topic 450 ("ASC 450"), which addresses the disclosure of certain loss contingencies. First, the court found that the investigation was not a loss contingency for ASC 450 purposes because it "was not pending or threatened litigation." Second, the court determined that there was "no plausible allegation that the amount of the loss could have been estimated" until after Lions Gate had reached a potential settlement with the SEC.

Court Holds Plaintiffs Failed to Allege Scienter

Finding "no clear case law that would require the disclosure of the SEC investigation and the Wells Notices in the absence of a pre-existing duty to disclose," the court held that plaintiffs could not "show that the defendants [had] acted in reckless disregard of the securities laws." The court further found that "an inference against scienter" was supported by numerous factors, "including . . . the small civil penalty the SEC imposed relative to the [c]ompany's net assets, the uncertainty of whether the Commission would move forward with the proceedings against Lions Gate, and the fact [that] the Commission never brought charges against individual officers or directors." The court concluded that "[t]he more cogent inference [was] that Lions Gate did not specifically disclose the investigation until the settlement had been concluded because it did not believe that there was a requirement to do so."

Southern District of New York: Adverse Interest Exception to the General Rule Imputing an Executive's Scienter to the Corporation Does Not Apply If the Corporation Benefited From the Executive's Fraud

On February 3, 2016, the Southern District of New York held that a corporate executive's scienter could be imputed to the corporation even though the executive had personally profited from undisclosed related party transactions with the corporation. *Dragon State Int'l v. Keyuan Petrochemicals*, 2016 WL 439022 (S.D.N.Y. 2016) (Crotty, J.). The court determined that plaintiffs had adequately pled corporate scienter because the executive's misconduct allegedly benefited the corporation.

Court Finds Plaintiffs Adequately Alleged Scienter as to the Company's CEO, and Determined That the CEO's Scienter Could Be Imputed to the Company

Plaintiffs alleged that Keyuan International had falsely represented both in public filings and the company's stock purchase agreement ("SPA") that it "had not engaged in undisclosed related party transactions." The company later acknowledged that it had in fact engaged in "hundreds of millions of

dollars in previously undisclosed related party transactions" with entities connected to Keyuan's CEO, Chungfeng Tao.

The court found that the allegations were sufficient to raise a strong inference of scienter as to Tao. The court explained that because Tao signed Keyuan's SPA and its public filings, "Tao constituted a 'maker' of statements contained therein and was bound to disclose all required information." Moreover, "Tao was [allegedly] closely tied to sizeable undisclosed related party transactions that substantially impacted Keyuan's sales." The court found that a strong inference of scienter arises where, as here, "the complaint alleges that defendant 'knew facts or had access to information suggesting that their public statements were not accurate'" (quoting *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000)).

The court further held that these same allegations were also sufficient to establish Keyuan's corporate scienter. The court explained that in order to plead corporate scienter under Second Circuit precedent, "the pleaded facts must create a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter" (quoting *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital*, 531 F.3d 190 (2d Cir. 2008)). Notably, the court rejected Keyuan's contention that its CEO's "alleged misconduct [could not] be imputed to the company since Tao was motivated by self-interest, and to Kenyan's detriment." The court found that the complaint "allege[d] a possible motive (quoting Keyuan's own public filings) for Tao's misconduct that *would* benefit Keyuan: the company [had] engaged in related party transactions 'to overcome the restrictions regarding the use of certain bank loans or to satisfy the banks' internal requirements to demonstrate the usage of the loans." The court therefore held that Keyuan's CEO's scienter could "be imputed to Keyuan."

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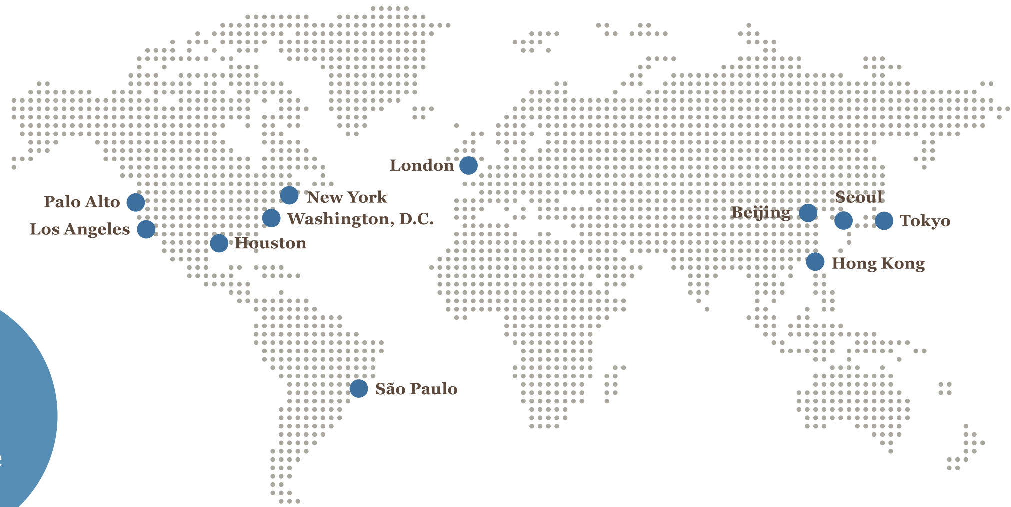

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