Simpson Thacher

Securities Law Alert

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– Chambers USA 2017

First Circuit: Affirms Dismissal of a Securities Fraud Action Challenging Optimistic Statements, "Replete with Caveats," Concerning FDA Developments

On August 22, 2017, the First Circuit affirmed dismissal of a securities fraud action against a biopharmaceutical company challenging its communication of a "mix of optimism and caution" to investors following meetings with the FDA. *Corban v. Sarepta Therapeutics*, 2017 WL 3599065 (1st Cir. 2017) (Kayatta, J.). The court found it significant that the company's statements were so "replete with caveats" that the company's "stock dropped nineteen percent" following certain of its disclosures.

Plaintiffs claimed the company "disclosed too little of what FDA officials said … and painted too rosy a picture of their reaction to [the company's] data." Although the court acknowledged that the company's "caveats could have been more fulsome," the court determined the company's cautionary statements "cut against the inference of scienter." The court found that "[a]t worst, there was positive spin that put more emphasis in tone and presentation on the real signs of forward movement … than it did on causes for wondering if the journey would prove successful."

The First Circuit further found that "[t]he only plausible motive for fraud identified by the plaintiffs [was] revenue generation, which [fell] short of pleading a cogent inference of scienter that [could] carry the day." The court noted the absence of any allegations "suggesting that [the company's] capital was insufficient for continued operations, much less that [the company] would shutter its doors unless it padded earnings by deceiving investors." The court concluded that this was "simply a case in which the complaint focuse[d] too much on nuance rather than false facts or material omissions to support the necessary strong inference of scienter."

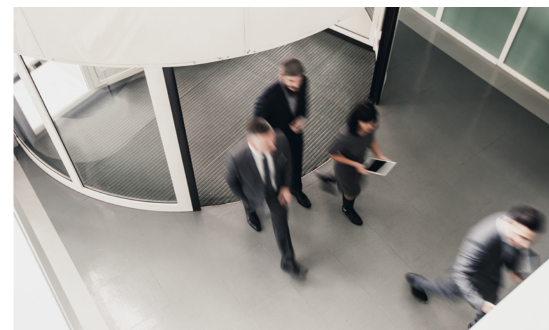
Second Circuit: Supreme Court's Decision in *Salman* Abrogated *Newman*'s "Meaningfully Close Personal Relationship" Test for Tipping Liability

On August 23, 2017, the Second Circuit held that the "meaningfully close personal relationship" test established in *U.S. v. Newman*, 773 F.3d 438 (2d Cir. 2014) for the personal benefit requirement for tipping liability "is no longer good law" in view of the Supreme Court's decision in *Salman v. U.S.*, 137 S. Ct. 420 (2016).[1] *U.S. v. Martoma*, 2017 WL 3611518 (2d Cir. 2017) (Katzmann, J.).

Neither *Dirks* Nor *Salman* Limited the Personal Benefit Requirement to Instances in Which the Tipper Had a "Meaningfully Close Personal Relationship" with the Tippee

In *Dirks v. S.E.C.*, 463 U.S. 646 (1983), the Supreme Court held that a "test" for tipping liability is "whether the insider personally will benefit, directly or indirectly, from his disclosure." The Second Circuit explained that the *Dirks* Court "gave several examples of situations in which an insider would personally benefit from disclosing inside information: disclosing inside information in a *quid pro quo* relationship, disclosing inside information with 'an intention to benefit the particular recipient,' and disclosing inside information as 'a gift … to a trading relative or friend.'" *Martoma*, 2017 WL 3611518 (quoting *Dirks*, 463 U.S. 646). The *Martoma* court found that *Dirks* "did not purport to *limit* to these examples the situations in which a personal benefit can be inferred." Rather, the court determined that "the broader inquiry underlying the examples" in *Dirks* focused on "'whether the insider personally will benefit, directly or indirectly, from his disclosure.'" *Id.* (quoting *Dirks*, 463 U.S. 646).

The *Martoma* court explained that in *Newman*, however, the Second Circuit "did view [the] examples [set forth in *Dirks*] as limiting the situations in which a personal benefit could be inferred." The *Newman* court "held that the jury was *never* permitted to infer that a tipper had personally benefited from disclosing inside information as a gift unless that gift was made to someone with whom the tipper had a 'meaningfully close relationship.'" *Martoma*, 2017 WL 3611518 (quoting *Newman*, 773 F.3d 438).



The *Martoma* court found "the examples in *Dirks*" did not "support a categorical rule that an insider can never benefit personally from gifting inside information to people other than 'meaningfully close' friends or family members." While the *Martoma* court acknowledged that it would "ordinarily be neither appropriate nor possible for a panel to reverse existing Circuit precedent," the court found the Supreme Court's decision in *Salman* "alter[ed] the relevant analysis fundamentally enough to require overruling" *Newman*'s "meaningfully close personal relationship" test.[2]

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

2. In *Salman*, the Supreme Court rejected *Newman*'s holding that the tipper "must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends" to satisfy the personal benefit requirement. 137 S. Ct. 420 (quoting *Newman*, 773 F.3d 438). The *Martoma* court found "the Supreme Court did not have occasion to expressly overrule *Newman*'s requirement that the tipper have a 'meaningfully close personal relationship' with a tippee to justify the inference that a tipper received a personal benefit from his gift of inside information—because that aspect of *Newman* was not at issue in *Salman*." 2017 WL 3611518.

In *Salman*, the Supreme Court held that tipper liability attached where the defendant "disclose[d] confidential information as a gift to his brother with the expectation that he would trade on it." 137 S. Ct. 420. The *Salman* Court stated that "when a tipper gives inside information to 'a trading relative or friend,' the jury can infer that the tipper meant to provide the equivalent of a cash gift." *Id.* (quoting *Dirks*, 463 U.S. 646).

The *Martoma* court found that *Salman* "strongly reaffirmed" "the straightforward logic of the gift-giving analysis in *Dirks*." 2017 WL 3611518. The *Martoma* court reasoned that "[n]othing in" the *Salman* opinion "supports a distinction between gifts to people with whom a tipper shares a 'meaningfully close personal relationship' … and gifts to those with whom a tipper does not share such a relationship."

The Personal Benefit Requirement Is Met Whenever the Tipper Expects the Tippee to Trade on the Information, and the Disclosure Resembles Insider Trading Followed by a Gift of the Proceeds

"[I]n light of *Salman*," the *Martoma* court "reject[ed] … [*Newman*'s] categorical rule that an insider can *never* personally benefit from disclosing inside information as a gift without a 'meaningfully close personal relationship.'" The court held that "an insider or tipper personally benefits from a disclosure of inside information whenever the information was disclosed with the expectation that the recipient would trade on it, and the disclosure resembles trading by the insider followed by a gift of the profits to the recipient, whether or not there was a 'meaningfully close personal relationship' between the tipper and the tippee." *Id.*

The *Martoma* court offered the example of "a corporate insider [who], instead of giving a cash end-of-year gift to his doorman, gives a tip of inside information with instructions to trade on the information and consider the proceeds of the trade to be his end-of-year gift." The court explained that in this situation, "there may not be a 'meaningfully close personal relationship' between the tipper and tippee, yet this clearly is an illustration of prohibited insider trading, as the insider has given a tip of valuable inside information in lieu of a cash gift and has thus personally benefited from the disclosure."

The *Martoma* court emphasized that its holding "reaches only the insider who discloses inside information to someone *he expects will trade on the information*." The court acknowledged that "'[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts.'" *Id.* (quoting *Salman*, 137 S. Ct. 420). Given the facts of the case before it, however, the court determined that it "need not consider the outer boundaries of when a jury is entitled to infer, relying on circumstantial evidence, that a particular disclosure was made with the expectation that the recipient would trade on it, and resembled trading by the insider followed by a gift of the profits to the recipient." *Id.*

In a Lengthy Dissent, Judge Pooler Opined That the Majority's Decision "Strips the Long-Standing Personal Benefit Rule of Its Limiting Power"

Judge Pooler, dissenting, expressed her view that "the majority opinion significantly diminishes the limiting power of the personal benefit rule" by holding that "an insider receives a personal benefit when the insider gives inside information as a 'gift' to *any* person." She also observed that under the majority's ruling, "[w]hat counts as a 'gift' is vague and subjective." She predicted that "[t]he result will be liability in many cases where it could not previously lie."

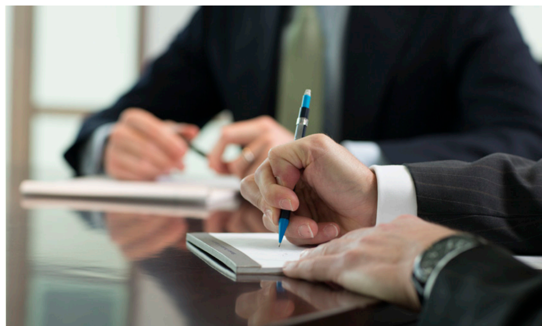
Judge Pooler strongly disagreed with the majority's interpretation of *Salman*. She emphasized that *Salman* "left untouched" *Newman*'s "holding that, in order to allow inference of a personal benefit, gifts must be exchanged within a 'meaningfully close personal relationship.'" She explained that "[a]n opinion considering a relationship between brothers does not need to rule on, or even address, how close two persons' friendship must be for them really to be 'friends.'"

In Judge Pooler's view, "*Salman* [did] not overrule the limitation described in both *Dirks* and *Salman* itself—that an inference of personal benefit may be based on an insider's gift to relatives or friends, but not a gift to someone else."

Third Circuit: Describing a Risk as Hypothetical Is Not Misleading Unless That Specific Risk Has Already Materialized

On August 23, 2017, the Third Circuit held a medical device company had no duty to disclose the materialization of a risk where the company did not portray that specific risk as hypothetical. *Williams v. Globus Medical*, 2017 WL 3611996 (3d Cir. 2017) (Scirica, J.).

At issue was the company's representation that if any of its "independent distributor[s] were to cease to distribute [its] products, [the company's] sales could be adversely affected." Plaintiffs contended that the company's disclosures were "misleading" because the company "warned that the loss of an independent distributor could have a negative impact on sales—but it omitted to warn investors … that [the company] had *in fact* lost an independent distributor."



The Third Circuit recognized that "[o]nce a company has chosen to speak on an issue—even an issue it had no independent obligation to address—it cannot omit material facts related to that issue so as to make its disclosure misleading." The court "agree[d] that a company may be liable under Section [10(b)] for misleading investors when it describes as hypothetical a risk that has already come to fruition."

In the case before it, however, the Third Circuit found "[t]he risk actually warned of [was] the risk of adverse effects on sales—not simply the loss of independent distributors generally." The court determined that "[t]he risk at issue only materialized—triggering [the company's] duty to disclose—if sales were adversely affected at the time the risk disclosures were made." Because plaintiffs did "not plead that [the company] was already experiencing an adverse financial impact at the time of the risk disclosures," the court held the company had "no duty to disclose its decision to terminate its relationship with" its independent distributor.

Ninth Circuit: Expressing a Favorable Opinion Concerning FDA Clearance May Be Misleading If the Speaker Does Not Disclose Relevant Adverse FDA Developments

On August 18, 2017, the Ninth Circuit reversed dismissal of securities fraud claims where defendants allegedly represented that "FDA clearance risk has been achieved" without disclosing that the company had not obtained clearance for one of the key products discussed. *In re Atossa Genetics Sec. Litig.*, 2017 WL 3568088 (9th Cir. 2017) (Gould, J.). The Ninth Circuit found the statement at issue to constitute an opinion, rather than a statement of fact, but found plaintiffs adequately alleged the opinion did not "fairly align[ ] with the information in [the company's] possession at the time" under the standard set forth in *Omnicare v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015).[3]

Opining That FDA Clearance Risk Has Been Achieved Is Materially Misleading If the Speaker Fails to Disclose Relevant Conflicting Facts

At the outset of its analysis, the court explained that "[t]here is a difference between saying that the [a product] was FDA-cleared, a statement of fact, and that FDA clearance risk has been achieved, which sounds more like a statement of opinion." The court observed that "[t]he former is an easily verifiable past event—either the FDA has granted clearance or it has not" while "[t]he latter is less black and white." The court noted that a statement that a risk has been "achieved" "could [either] convey that the risk has been reduced to zero" or indicate "that the risk has been reduced to an acceptable

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

level, which could mean that some degree of risk remains." The Ninth Circuit determined that "it is the speaker's personal definition of 'achieved' that … produces the opinion."

The Ninth Circuit then measured the opinion against the standard set forth in *Omnicare*. There, the Supreme Court held that when a plaintiff claims an opinion is misleading due to an omission, the plaintiff "must identify particular (and material) facts going to the basis for the issuer's opinion … whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context." *Omnicare*, 135 S. Ct. 1318.[4]

The Ninth Circuit found the "lack of [FDA] clearance" for one of the company's products "and the FDA's concerns about that lack of clearance[ ] relate[d] directly to the basis for [the] opinion that FDA clearance risk had been achieved." The court observed that "the omitted facts [were] strikingly similar to [the] hypothetical the Supreme Court offered in *Omnicare*" of "an issuer [who] publicly stated, 'we believe our conduct is lawful,' but did not disclose the issuer's knowledge that the Federal Government took the opposite view."

Expressing "Reasonable Confidence" in FDA Responses Is Inactionable Corporate Optimism Even If There Were Facts Weighing Against Such Optimism

Plaintiffs also challenged as misleading the company's representation that it was "reasonably confident in its responses" to an FDA warning letter because at the time it made that statement, the company "had already submitted and withdrawn" an FDA submission for the product at issue.

The Ninth Circuit found that "any reasonable investor would have understood [the company's] alleged statement as mere corporate optimism" because it was "unspecific, subjective, and only guardedly optimistic." The court also rejected plaintiffs' contention that "by commenting on the prospects for its responses to the FDA, without also disclosing the newly filed and withdrawn" submission, the company "materially misled reasonable investors." The Ninth Circuit explained that a company is "not obligated to disclose each and every step it took when interacting with regulators."

4. The *Omnicare* Court addressed the standard for pleading an opinion-based claim under Section 11. However, the Ninth Circuit has held that "the Supreme Court's reasoning is equally applicable to Section 10(b) and Rule 10b-5 claims." *City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Align Tech.*, 856 F.3d 605 (9th Cir. 2017). Please click here to read our prior discussion of the *City of Dearborn Heights* decision.

S.D.N.Y.: (1) Courts Must Consider Information in the Public Domain When Assessing the Adequacy of a Company's Disclosures, and (2) Allegedly Misleading Statements Must Be Viewed in Context

On August 24, 2017, the Southern District of New York dismissed with prejudice a securities fraud action against a leading hotel chain on the grounds that the company adequately disclosed each of the risks at issue, including the impact of falling oil prices, the need for renovations at certain properties, the transition of the company's call center and the sale of certain hotels. *Police and Fire Ret. Sys. of the City of Detroit v. La Quinta Holdings*, No. 16-cv-3068 (S.D.N.Y. 2017) (Nathan, J.).[5] The court also dismissed claims in connection with a statement of opinion because the court found the opinion was not misleading when considered in context.

Plaintiffs Cannot Allege Misleading Omissions If the Risks at Issue Were Disclosed by the Company and Publicly Known

The court began its analysis by underscoring that "a securities fraud claim for misrepresentations or omissions does not lie when the company disclosed the very risks about which a plaintiff claims to have been misled." "When evaluating whether a company provided sufficient disclosures," the court explained that it must "consider not only the disclosures the company ma[d]e, but also information already in the public domain and facts known or reasonably available to the shareholders."

5. Simpson Thacher represents La Quinta Holdings Inc., The Blackstone Group L.P. and certain La Quinta officers and directors in this matter.

Here, the court found "the total mix of information made available to investors sufficiently disclosed the purported risk[s]" in question. With respect to the effect of declining oil prices on the company's business, for example, the court noted that the company "made a number of disclosures related to the geographic concentration of its hotels and the impact changing oil prices could have on the company." The court also deemed it significant that "the drop in oil prices that caused the purported decline in [the company's] performance was publicly known."

Plaintiffs Must Allege a Specific Duty to Disclose to Plead an Omission-Based Claim

The court emphasized that "[u]nder federal securities law, liability for failure to disclose certain information exists only if there is an affirmative legal disclosure obligation." For several of the alleged misstatements, such as the company's alleged failure to disclose the need for renovations, the court held plaintiffs failed to identify "a specific duty or obligation" requiring disclosure. The court found, for instance, that the company "in fact had no duty to disclose" alleged challenges with the company's transition to a new call center (even though the court determined the company did in fact disclose these alleged issues).

Allegations That a Company Should Have Made Disclosures Earlier, Standing Alone, Do Not State a Claim for Securities Fraud

The court also rejected plaintiffs' contention that the company should have disclosed alleged problems with the call center transition sooner. The court found plaintiffs "fail[ed] to plausibly allege why the disclosures should have been made earlier." The court explained that under Second Circuit precedent, "'[m]ere allegations that statements in one report should have been made in earlier reports do not make out a claim of securities fraud.'" *Id.* (quoting *Acito v. IMCERA Grp.*, 47 F.3d 47 (2d Cir. 1995)). The court stated that "the timing of disclosure is a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC."

Courts Must Consider the Complete Context of a Statement When Determining Whether It Is Misleading

Finally, the court found nothing "untrue or misleading" about an executive's representation that the sale of one of the company's hotels was a "win-win-win" even though the company allegedly recorded a several-million dollar loss on the property. The court noted that the statement "was not an objective fact, but rather an expression about [the executive's] expectations for sale."

The court emphasized that the "'win-win-win' comment [was] part of a larger statement." The court explained that "[w]hen evaluating whether a defendant's statements would have misl[ed] a reasonable investor, a court should consider the representations together and in context." The court found the executive "explicitly explained the rationale behind his opinion that the sale constituted a 'win-win-win'" in statements preceding and following the opinion. The court concluded that plaintiffs "failed to plausibly allege" that the opinion constituted "a misrepresentation or omission."

C.D. Cal.: (1) Plaintiffs Must Allege "Concrete" Details to Plead Scienter Under the "Absurd to Suggest" Exception to the Core Operations Theory, and (2) Market Knowledge of the Alleged Fraudulent Practice Is a Prerequisite for Loss Causation

On August 15, 2017, the Central District of California dismissed with prejudice a securities fraud action against a Chinese solar energy company for failure to meet the "demanding standard" for pleading scienter based on the "absurd to suggest" exception to the core operations theory. *Knox v. Yingli Green Energy Holding Co.*, 2017 WL 3503358 (C.D. Cal. 2017) (Wright, II, J.).[6] The court further held plaintiffs failed to establish loss causation because there were no allegations that the market ever learned of any alleged accounting misstatement.

Plaintiffs Must Provide Detailed Allegations to Plead Scienter Based on the "Absurd to Suggest" Exception to the Core Operations Theory

"The core operations theory posits that facts critical to a business's core operations or an important transaction generally are so apparent that their knowledge may be attributed to the company and its key officers." The court explained that in the Ninth Circuit, "a securities fraud plaintiff cannot 'rely[ ] exclusively on the core operations inference to plead scienter under the [Private Securities Litigation Reform Act].'" *Id.* (quoting *S. Ferry LP No. 2 v. Killinger*, 542 F.3d 776 (9th Cir. 2008)). "The only exception is the 'rare' instance where 'the nature of the relevant fact is of such prominence that it would be 'absurd' to suggest that management was without knowledge of the matter.'" *Id.* (quoting *Killinger*, 542 F.3d 776).

In the case at hand, plaintiffs contended that the company's "executives intended to defraud [the company's] investors by touting" a Chinese government subsidy program for solar energy projects without "disclosing the risk that the government might terminate the program" due to allegedly "widespread" fraud. Plaintiffs alleged that companies in the industry had a "general 'policy' to delay construction after receiving subsidies" for solar energy projects. However, plaintiffs did not provide "facts such as how many companies had this purported policy and how many projects this policy affected."

The court found plaintiffs' reliance on "vague quantifiers and generalities" insufficient to satisfy the "absurd to suggest" exception to the core operations theory. "Without concrete numbers," the court explained that it could not "conclude that the fraud was *so* pervasive throughout the *entire* solar industry that [the company's] upper management could not possibly have been ignorant of it and its potential to shutter" the subsidy program.

Plaintiffs Must Plead Particularized Allegations Concerning the Market's Awareness of the Alleged Fraudulent Practice to Satisfy the Loss Causation Requirement

The court explained that "[l]oss causation requires that the market learn of, and react to, the company practice that the plaintiff alleges is fraudulent (although the market need not have learned that the practice was in fact fraudulent)." Here, plaintiffs alleged that the company engaged in accounting fraud by failing to write down one of its accounts. However, the two allegedly corrective disclosures neither identified the debtor by name nor indicated that the company's "problems collecting the ... debt should have been disclosed sooner."

6. Simpson Thacher represents Yingli Green Energy Holding Company in this matter.

Because "the two reports [containing the alleged corrective disclosures] did not identify [the debt at issue] and did not include any facts from which one [could] infer that the … debt should have been disclosed [as doubtful] earlier (if they even accounted for the debt [as doubtful] at all)," the court held plaintiffs could not "show that [the company's] accounting for that debt had any causal connection to the drops in stock price that followed the release of the reports." The court reasoned that "the market could not have reacted to a fact that it did not know."

Delaware Chancery Court: (1) *MFW's* Framework Governs One-Sided Controller Transactions Involving Disparate Consideration, and (2) *MFW's* Procedural Protections Must Be in Place Before the Controller Negotiates for Additional Consideration

On August 18, 2017, the Delaware Chancery Court held that "conflicted one-side controller transactions" in which the controller negotiated for disparate consideration must comport with the requirements adopted in *Kahn v M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (*MFW*)[7] "to secure pleadings-stage business judgment rule review." [*In re Martha Stewart Living Omnimedia Stockholder Litig.*, 2017 WL 3568089 (Del. Ch. 2017) (Slights, V.C.) (*MLO*)]. The court further ruled that "the correct time at which to determine if the [*MFW*] *ab initio* requirement has been met is the point where the controlling stockholder actually sits down with an acquiror to negotiate for additional consideration."

One-Sided Controller Transactions Involving Disparate Consideration Must Satisfy *MFW's* Prerequisites to Merit Business Judgment Review

The Delaware Chancery Court explained that *MFW* established a "road map by which a controlling stockholder's buyout of its subsidiary in a negotiated merger will earn the controller" the benefit of the business judgment standard of review, "even at the pleading stage."[8] *MLO*, 2017 WL 3568089.

In considering whether the *MFW* test applies to transactions in which the controlling stockholder is the seller only, the Delaware Chancery found that "the risks and incentives [do not] differ significantly as between two-sided controller transactions and one-sided controller transactions where the controller is alleged to have competed with the minority for consideration." The court further determined that "[t]he need to incentivize fiduciaries to act in the best interests of minority stockholders, likewise, is equally important in one-sided and two-sided conflicted controller transactions." The court stated that "[i]n both instances, the key is to ensure that all involved in the transaction, on both sides, appreciate from the outset that the terms of the deal will be negotiated and approved by a special committee free of the controller's influence and that a majority of the minority stockholders will have the final say on whether the deal will go forward."

Based on its finding that "[t]he potential for conflict is omnipresent in both scenarios," the Delaware Chancery Court held that "strict compliance with [*MFW's*] transactional road map … is required for the controlling stockholder to earn pleadings-stage business judgment deference when it is well-pled that the controller, as seller, engaged in a conflicted transaction by wrongfully diverting to herself merger consideration that otherwise would have been paid to all stockholders."

7. Please click here to read our prior discussion of the *MFW* decision.

8. The *MFW* court held that the business judgment standard of review governs "mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned *ab initio* upon both the approval of an independent, adequately-empowered [s]pecial [c]ommittee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders." 88 A.3d 635.

A Controlling Stockholder Must Implement *MFW's* Procedural Protections Before Negotiating for Disparate Consideration

The court then considered when *MFW*'s procedural protections must be in place in order for a one-sided controller transaction involving disparate consideration to qualify for deferential business judgment review. The court declined "to adopt a rule that would require the procedural protections to be implemented at the outset of discussions between the target and the third party even if the controller and third party have not even hinted that they might engage in separate negotiations." The court reasoned that "[s]uch a rule would make no sense for the simple reason that the [*MFW*] protections serve no purpose at the outset of discussions between a target and third party when the only proposal from the putative buyer is that all shareholders receive the same price for their shares."

Rather, the court found that "the 'get go' of the process in the disparate consideration case is the moment the controller and third party begin to negotiate the controller's side deals." The court held that the controller must "ensure that the third party and the target have agreed to both [*MFW*] procedural protections before she begins to negotiate separately with the third party for disparate or non-ratable consideration" since "[t]hat is when the potential conflict with the minority surfaces."

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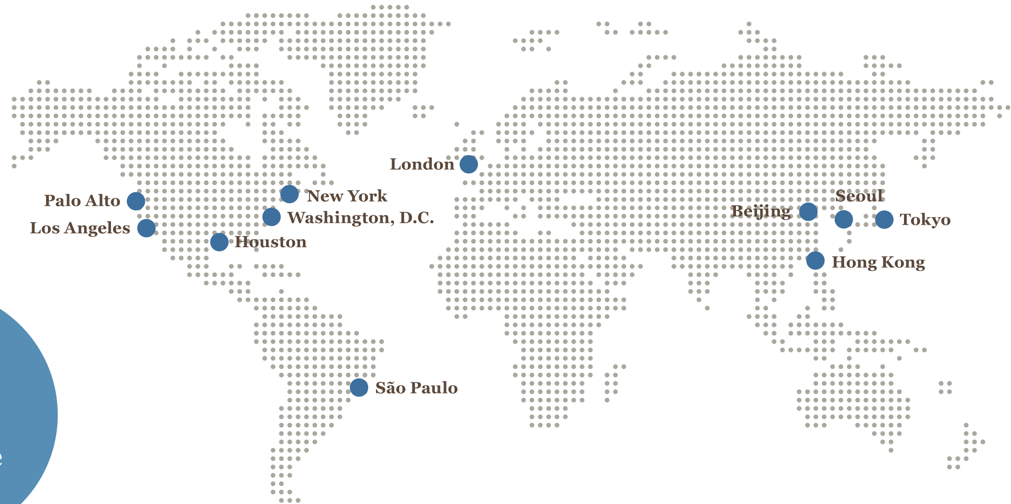

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