2017 YEAR IN REVIEW – SECURITIES LITIGATION

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MEET THE AUTHORS

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MEET THE AUTHORS

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Clients and Friends,

2017 was once again a busy year in the world of securities litigation. Federal securities class action filings hit record levels, even excluding the growing number of M&A cases that have migrated from state to federal court.

Each year our **Year in Review** comments on significant securities-related decisions by the Supreme Court, federal appellate courts and district courts, notes key developments in SEC enforcement, and summarizes significant rulings in state law fiduciary litigation against directors and officers of public companies.

We begin with a discussion of the Supreme Court's decisions in ***Kokesh*** and ***CalPERS*** addressing issues related to the timeliness of securities claims, and preview the ***China Agritech*** and ***Cyan*** cases currently pending before the Supreme Court.

Beyond the Supreme Court, there was notable activity at the Circuit Courts of Appeals and district courts, including continued disputes over the proper application of ***Halliburton II*** and significant decisions on scienter, misrepresentation issues, the safe harbor, loss causation and other securities issues. Last year also saw Delaware decisions that continue to change the landscape of M&A litigation and interesting developments in the area of SEC enforcement.

Our team spent 2017 winning early dismissals and representing clients in securities, fiduciary duty and SEC enforcement matters. Among other highlights, we obtained dismissal of a shareholder derivative suit against the Board of AT&T; obtained dismissal of a securities class action against Tenet Healthcare; defended underwriters, companies and executives in securities cases across the country; and helped companies and executives in SEC enforcement and internal investigations.

If you have any questions about the issues covered in this 2017 Review, or about our practice, please let us know. We look forward to working with our friends and clients in 2018.

Dan Gold
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I. Supreme Court Summary: Timeliness

In 2017, the Supreme Court continued its recent trend of addressing important securities litigation issues. The Court issued two decisions related to the timeliness of securities claims, and granted certiorari to consider a third in 2018.

***KOKESH*: DISGORGEMENT SUBJECT TO FIVE-YEAR STATUTE OF LIMITATIONS**

On June 5, 2017, the Supreme Court unanimously held in ***Kokesh v. Securities and Exchange Commission***, 581 U.S. ___ (2017), that the SEC's ability to recover funds through disgorgement is subject to a five-year statute of limitations. The SEC routinely seeks disgorgement as an equitable remedy in actions alleging securities law violations and asserted that disgorgement was not a penalty subject to the five year statute of limitations under 28 U.S.C. § 2462. The Supreme Court disagreed, finding that because disgorgement is a punitive sanction, it is a penalty. The decision resolves a previous circuit split regarding the application of Section 2462 to SEC disgorgement actions, and will likely impact the conduct of the SEC staff in ongoing and future investigations.

The petitioner/defendant in *Kokesh* was an investment advisor who provided advice to business-development companies. In 2009, the SEC brought an enforcement action against Kokesh alleging that he misappropriated funds from four of the development companies he advised between 1995 and 2009. Following a jury verdict in the SEC's favor, the district court imposed a civil penalty of $2.4 million and disgorgement of $34.9 million. $29.9 million of the disgorgement was attributable to conduct that occurred outside of the five-year limitation period in 28 U.S.C. § 2462, which applies to any action for the enforcement of any civil fine, penalty, or forfeiture. In awarding the entire disgorgement amount, the district court held that disgorgement was not a penalty and therefore not subject to that five-year limitation. Kokesh appealed the decision, and the Court of Appeals for the Tenth Circuit affirmed.

The Supreme Court reversed, holding that disgorgement is indeed a penalty subject to the limitation period in Section 2462. According to the Court, disgorgement (i) is imposed as a consequence for violating public laws, (ii) is imposed for punitive purposes, and (iii) in many cases, is not compensatory. In other words, it "bears all the hallmarks of a penalty."

The Court rejected the SEC's argument that disgorgement is simply remedial. Disgorgement does not "simply return[] the defendant to the place he would have occupied had he not broken the law," the Court held. In some cases, for example, SEC disgorgement can exceed the profits gained through unlawful activity, leaving the defendant worse off than he or she was prior to the unlawful conduct.

The Court's holding in *Kokesh* is a major development in the world of SEC enforcement. As demonstrated by the facts of *Kokesh*, the SEC often seeks disgorgement based in large part on alleged conduct that occurred outside a five-year limitations period. This holding limits the Commission's ability to pursue complete disgorgement in many cases involving older conduct and will likely change the Enforcement Staff's calculus in making charging recommendations. The holding could also remove some of the Commission's leverage in negotiating settled enforcement actions.

In the immediate aftermath of the decision, there has been impact in the SEC's ability to request disgorgements. For example, in ***In the Matter of Lynn Tilton*** (File No. 3-16462), the SEC reduced its requested disgorgement amount by $45 million dollars. Here, the SEC instituted proceedings against Tilton and her Patriarch Partners firms in March of 2015, alleging that she and her firms hid the poor performance of the companies that she'd invested in. The SEC alleged that Tilton and Patriarch were able to collect excessive management fees and retain control over their funds' operation by failing to follow the valuation methodology that was laid out in their

investment documents. The SEC originally sought $208 million dollars in disgorgement for Tilton's conduct. Following *Kokesh*, the SEC wrote a letter to the court indicating that $45,447,417 of the requested disgorgement stems from conduct that occurred more than five years before the initiation of the action.

As a practical matter, the decision likely will encourage the Commission's enforcement staff to push the pace of investigations. A recent decision from the U.S. District Court for the District of New Jersey may further complicate matters. In ***SEC v. Gentile***, No. 16-1619 (D.N.J.)(Dec. 13, 2017), the court held that Section 2462's five-year statute of limitation period applies to SEC claims for permanent injunctions. With additional pressure to bring a case within five years of an action occurring, we have already seen more frequent requests for tolling agreements to suspend the running of that five-year statute of limitations. Companies responding to Staff investigations may also experience accelerated timelines and less flexibility in responding to subpoenas and information requests.

CALPERS: SECURITIES ACT STATUTE OF REPOSE NOT SUBJECT TO EQUITABLE TOLLING

In ***California Public Employees' Retirement System v. ANZ Securities, Inc.*** (*"CalPERS"*), 582 U.S. ___ (2017), the Supreme Court held that the three-year time limit in the Securities Act of 1933 is a statute of repose that is not subject to equitable tolling.

The background of the case dates back to a putative class action filed on June 18, 2008 relating to over $31 billion of debt securities issued by Lehman Brothers Holdings Inc. between July 2007 and January 2008. The class action asserted claims pursuant to Section 11 of the Securities Act alleging the registration statement contained material misrepresentations or omissions. CalPERS was not one of the named plaintiffs in the class action.

In February 2011, more than three years after the offering, CalPERS opted out of the class and filed a separate complaint asserting identical securities law violations as alleged in the class action complaint. The district court dismissed CalPERS' complaint as untimely under the three-year time limit in Section 13 of the Securities Act. CalPERS appealed, asserting that its individual suit was timely because the three-year time limit was subject to equitable tolling pursuant to *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974). CalPERS also asserted that its individual claims were "essentially filed in the putative class action complaint" and therefore, timely. The Second Circuit rejected both arguments and affirmed the district court's ruling. *In re Lehman Brothers Securities & ERISA Litigation*, 655 F. App'x 13, 15 (2d Cir. 2016).

The Supreme Court affirmed the Second Circuit, indicating that the "nature and purpose of the 3-year bar and the tolling rule [CalPERS] seeks to invoke" was the determining factor. The Court first discussed the differences between statutes of limitations and statutes of repose, explaining that former begin to run when a cause of action accrues, and the latter begin to run on the date of the last culpable act or omission of the defendant. Statutes of limitations are intended to encourage plaintiffs to diligently pursue the prosecution of claims, while statutes of repose are legislatively enacted and reflect a judgment "that a defendant should be free from liability after the legislatively determined period of time." Accordingly, the Court held the three-year bar in section 13 is a statute of repose because it "admits of no exception and on its face creates a fixed bar against future liability." This determination was critical because "statutes of repose are not subject to equitable tolling."

The Court emphasized the equitable nature of *American Pipe* tolling, indicating that those principles could not alter the express language of the statute of repose. The Court held the tolling rule extolled in *American Pipe* was based on "the judicial power to promote equity, rather than to interpret and enforce statutory provisions." The Court further found that the legislative purpose of a statute of repose supersedes equitable tolling.

The Court also rejected CalPERS' argument that it had timely filed its individual complaint because it was a member of the putative class that filed the original lawsuit. The Court held the filing of a class action lawsuit is not equivalent to the filing of a suit by unnamed proposed class members.

In her dissent, Justice Ginsburg, asserted that the majority decision "disserves the investing public" and would "gum up the works of class litigation."

CalPERS provides a level of certainty for defendants regarding the scope of their potential liability and litigation costs in class actions subject to statutes of repose. No longer will plaintiffs be able to opt out of a class or file their own suits after the repose period has run.

While CalPERS involved the three-year statute of repose for Securities Act claims, it is already being applied to claims under the Exchange Act. In ***North Sound Capital LLC v. Merck & Co.***, 702 Fed. Appx. 75 (3d Cir. 2017), the plaintiffs conceded that *CalPERS* extended to their Exchange Act claims and accordingly, their claims were time-barred. In an opinion designated nonprecedential, the Third Circuit held that "[i]t is now clear that in light of [CalPERS], that the American Pipe tolling rule cannot be invoked to toll the running of time under the statutes of repose at issue in the cases and that appellees' Exchange Act claims therefore were untimely."

The *CalPERS* decision is likely to cause plaintiffs to file suits more quickly and try to move their cases along faster with the goal of reaching a class certification decision before the repose period expires. It also has the potential to increase the number of individual suits that defendants will have to face alongside class litigation, as putative class members may feel compelled to file protective suits within the repose period to preserve their right to litigate apart from the class proceedings.

Finally, the *CalPERS* decision will confront litigants and courts with new issues related to its application, notice to putative class members, and certification of a class after the repose period has run. For example, one of the issues raised in an currently pending before the Fifth Circuit is whether the district court erred in certifying a class because the claims of absent class members are barred by the three-year statute of repose. ***St. Lucie County Fire District v. Joseph Bryant***, No. 17-20503 (5th Cir.)

CHINA AGRITECH: SUPREME COURT TO CONSIDER TOLLING FOR SUCCESSIVE CLASS ACTIONS

In ***Resh v. China Agritech, Inc.***, 857 F.3d 994 (9th Cir. 2017), the Ninth Circuit held that *American Pipe* tolling extends to subsequent class actions. After class certification was denied in an earlier case, Resh, an unnamed member of the putative class, filed another putative class action related to the same allegations. The district court dismissed the Resh putative class action as barred by the two-year statute of limitations.

On appeal, the Ninth Circuit overruled the district court, holding that *American Pipe* tolling not only applied to allow the Resh plaintiffs to assert their individuals claims, but also to assert claims on behalf of a putative class. In so holding, the Ninth Circuit split with the First, Second, Fifth and Eleventh circuits, which have definitively rejected the position that *American Pipe* tolling extends to otherwise untimely class actions and the Third and Eighth circuits which have held that *American Pipe* tolling applies to subsequent class actions but does not apply where the class was not certified based on deficiencies in the purported class.

China Agritech filed a petition for writ of certiorari with the Supreme Court on the issue of applicability of *American Pipe* tolling to successive class actions, asserting that the Ninth Circuit's ruling would extend the statute of limitations indefinitely, "casting aside Congress's effort to cut off stale claims through clear time bars and inviting facially abusive litigation without any appreciable benefit to anyone other than the plaintiffs' bar." On December 8, 2017, the Court granted China Agritech's petition and will review the Ninth Circuit's decision.

The Supreme Court has agreed to consider another issue related to the timeliness of securities claims.

II. Jurisdictional Issues under SLUSA

In 1998, Congress passed the Securities Litigation Uniform Standards Act ("SLUSA") in an effort to force most securities class actions into federal court. During 2017, courts continued to address significant issues regarding the application of SLUSA to certain types of cases related to the purchase or sale of securities.

In ***Cyan, Inc. v. Beaver County Employees Retirement Fund***, the Supreme Court is considering whether class actions alleging only violations of the Securities Act of 1933 can be brought and maintained in state court. The plaintiffs, investors in Cyan's initial public offering, brought a class action in California state court alleging that Cyan's offering documents contained misrepresentations in violation of the Securities Act. Arguing that SLUSA eliminated state courts' jurisdiction over class actions that only assert Securities Act claims, the defendant moved to dismiss. After the California trial court denied the defendant's motion to dismiss, and the California Court of Appeal and Supreme Court denied interlocutory review, defendant successfully petitioned the Supreme Court of the United States for certiorari.

The dispute arises out of ambiguous statutory language added by SLUSA. Historically, the Securities Act expressly provided for concurrent jurisdiction in federal and state courts. SLUSA amended that provision, adding the language "except as provided in section 77p … with respect to covered class actions." *See* 15 U.S.C. § 77v(a). The meaning of this language is unclear. It is unclear whether, as Cyan argues, Congress intended to prohibit state courts from presiding over all "covered class actions," including those that only assert federal securities violations or, as the investors argue, the provision only bars securities class actions that include claims under state law. At the Supreme Court's invitation, the United States Office of the Solicitor General filed a brief as amicus curiae. The Solicitor General offered a third interpretation of the statute, arguing that only claims involving state law are barred, but that defendants can remove purely federal actions to federal court. The Supreme Court struggled with the statutory language during oral arguments in November 2017, with Justice Alito referring to the statutory language as "just gibberish."

Given that state courts are generally more amenable to securities class actions than federal courts, the practical effect of the *Cyan* dispute is enormous. *See* Brief of the Securities Industry and Financial Markets Association, et al., as Amicus Curiae in Support of Petitioners (Sept. 5, 2017), at 9 (noting that nearly 32% of class action securities complaints are dismissed in federal court, while securities class actions filed in California since 2011 are only dismissed at a 5% rate). If states can hear securities class actions, forum shopping might abound and defense costs will rise.

The Seventh Circuit addressed the application of SLUSA to class actions nominally asserting breach of contract and fiduciary duty claims in ***Holtz v. JPMorgan Chase Bank, N.A.***, 846 F.3d 928 (7th Cir. 2017), cert. denied, 138 S. Ct. 170, 199 L. Ed. 2d 41 (2017) and ***Goldberg v. Bank of America, N.A.***, 846 F.3d 913 (7th Cir. 2017), cert. denied, 138 S. Ct. 173, 199 L. Ed. 2d 42 (2017). At issue in both cases was SLUSA's requirement that federal district courts dismiss any "covered class action" brought under state law if the plaintiff alleges misrepresentation, omission, or fraud "in connection with" the purchase or sale of a security. *See* 15 U.S.C. § 78bb(f)(1)(A). In each case, the plaintiffs sued under state law alleging the banks violated contractual promises and fiduciary duties. A trial court held that SLUSA barred the plaintiffs' claims, despite the plaintiffs' insistence that their contract and fiduciary allegations were not "in connection with" the purchase or sale of securities. Due to factual and legal similarities between *Holtz and Goldberg*, the Seventh Circuit issued these opinions on the same day.

In *Holtz*, Judge Frank H. Easterbrook clarified that plaintiffs cannot sidestep SLUSA by omitting the disfavored claims from pleadings and that an alleged nondisclosure was a linchpin of plaintiff's lawsuit no matter how framed. In *Goldberg*, the Seventh Circuit cited the 2006 case *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 82 (2006), where the Supreme Court ruled that SLUSA covers all claims arising from securities transactions, and reasoned that SLUSA applies even if the claim is being pursued under a state law theory.

The Ninth Circuit addressed the impact of a dismissal under SLUSA in ***Hampton v. Pacific Investment Management Co. LLC***, 705 Fed. Appx. 558 (9th Cir. 2017). Like in *Holtz* and *Goldberg*, the plaintiff in *Hampton* brought a class action alleging state law breach of contract and fiduciary duty claims. The district court found the claims were barred by SLUSA and dismissed the action with prejudice under Federal Rule of Civil Procedure 12(b)(6). On appeal, the Ninth Circuit affirmed the ruling that the claims were barred by SLUSA but vacated the ruling that dismissal be with prejudice. The court held that when a class action is barred by SLUSA, the dismissal is "jurisdictional" under Rule 12(b)(1) rather than "on the merits" under Rule 12(b)(6). The dismissal should therefore be without prejudice to the plaintiff asserting claims that are not barred by SLUSA, such as individual claims or claims under federal law, neither of which are barred by SLUSA.

III. Class Certification Issues: Applying *Halliburton II* and Beyond

APPLYING HALLIBURTON II

In ***Halliburton Co. v. Erica P. John Fund, Inc.***, 573 U.S. ___, 134 S. Ct. 2398 (2014), referred to as *Halliburton II*, the Supreme Court held that defendants may rebut the fraud-on-the-market presumption of reliance at the class certification stage by showing that the alleged misrepresentations did not impact the stock price. Since that ruling, courts have grappled with a number of issues relating to the proper application of *Halliburton II*.

> Courts continue to grapple with interesting issues at the class certification stage.

One of the recurring issues is the nature of defendants' burden in rebutting the presumption. Federal Rule of Evidence 301, which applies to presumptions in civil cases unless a federal statute or the rules provide otherwise, provides that "the party against whom a presumption is directed has the burden of producing evidence to rebut the presumption. But this rule does not shift the burden of persuasion, which remains on the party who had it originally." FED. R. EVID. 301. Pointing to this rule, defendants often argue that their burden is merely one of production, to provide evidence that the misrepresentations did not impact the stock price, rather than one of persuasion. The presumption having been rebutted, the plaintiff would have the burden of persuasion to prove price impact by a preponderance of the evidence. The Eighth Circuit, the first court of appeals to consider this issue, appears to have adopted this position by citing Rule 301 and characterizing defendants as having the "burden to come forward with evidence showing a lack of price impact." ***IBEW Local 98 Pension Fund v. Best Buy Co.***, 818 F.3d 775, 782 (8th Cir. 2016). The Second

Circuit disagreed during 2017, taking the view in ***Waggoner v. Barclays PLC***, 875 F.3d 79 (2d Cir. 2017) that the fraud-on-the-market presumption is a creature of substantive securities law outside the scope of Rule 301 and requires defendants to disprove price impact by a preponderance of the evidence. The burden issue is currently among those pending in the ***Willis v. Big Lots, Inc.***, No. 17-3871 (6th Cir.) appeal before the Sixth Circuit, and was raised in two Fifth Circuit cases—***Erica P. John Fund, Inc. v. Halliburton Co.*** (No. 15-11096) and ***Marcus v. J.C. Penney Co.*** (No. 17-40422)— that settled before decisions were rendered. It thus remains to be seen how other circuits will interpret the defendants' burden.

Another recurring *Halliburton II* issue relates to how a defendant can rebut the presumption. In *Halliburton II*, the Supreme Court stated that presumption could be rebutted by "evidence that the asserted misrepresentation (or its correction) did not affect the market price of the defendant's stock." Based on this disjunctive language, some defendants have argued that all that is required to rebut the presumption to is to show a lack of a price increase when the alleged false statement was made (sometimes referred to as "front-end" price impact). The Eighth Circuit in *Best Buy* found that defendants rebutted the presumption by proving the absence of front-end price impact, as did the Northern District of California in ***In re Finisar Corp. Securities Litigation***, No. 5:11-cv-01252, 2017 WL 6026244 (N.D. Cal. Dec. 5, 2017) (motion for reconsideration pending). In contrast, a Sixth Circuit panel rejected that argument in an unpublished decision denying interlocutory review in ***In re BancorpSouth, Inc.***, No. 17-0508, 2017 U.S. App. LEXIS 18044 (6th Cir. Sept. 18, 2017), writing that "price impact may be demonstrated either at the time that the alleged misrepresentations were made, or at the time of their correction." The Sixth Circuit will have an opportunity to review that issue on the merits in the pending ***Willis v. Big Lots, Inc.***, No. 17-3871 (6th Cir.) appeal, as will the Fifth Circuit in ***Laborers Pension Trust Fund v. Conn's Inc.***, No. 17-20525 (5th Cir.).

Interesting issues have also been raised related to stock price declines when the alleged truth is disclosed, sometimes referred to as "back-end" price impact. A question pending before the Fifth Circuit in ***St. Lucie County Fire District v. Bryant***, No. 17-20503 (5th Cir.) (*"Cobalt"*) is whether a defendant can challenge the connection between the alleged misstatement and the alleged corrective disclosure causing the stock price decline. Plaintiffs typically argue that a stock price decline following a revelation of the truth, also known as a corrective disclosure, is evidence that the misstatement impacted the stock price when it was made (such as by preventing the stock price from falling). At issue in *Cobalt* is whether a defendant can argue the alleged corrective disclosure is not actually corrective, and therefore the stock price decline does not suggest any price impact from the alleged misstatement. Other challenges to back-end price impact include efforts to show that the stock price declined for reasons other than the revelation of information about the alleged misstatement. For example, in ***Waggoner v. Barclays PLC***, 875 F.3d 79 (2d Cir. 2017) the Second Circuit found that defendants' evidence only showed that other factors contributed to the stock price decline. The evidence was not viewed as showing that revelation of the alleged misstatement did not contribute in some part to the stock price decline. It was accordingly held insufficient to carry defendants' burden of showing the absence of price impact.

MARKET EFFICIENCY

2017 also saw interesting decisions out of the Second Circuit regarding market efficiency. To invoke the fraud-on-the-market theory, a plaintiff must show that the market for the company's stock was efficient in the sense that it quickly incorporates new public information. Courts typically use a set of factors, referred to as the *Cammer* factors, to make this determination. Most of the *Cammer* factors, such as trading volume and level of analyst coverage, are indirect proxies for market efficiency. The fifth *Cammer* factor, the existence of a cause-and-effect relationship between unexpected material information and the stock price, is a direct measure of market efficiency established with an event study and is often considered the most important factor.

In ***In re Petrobras Securities***, 862 F.3d 250 (2d Cir. 2017), the Second Circuit considered defendants' criticisms of the evidence submitted by plaintiffs in support of the fifth *Cammer* factor. More specifically, defendants criticized plaintiffs' evidence for failing to examine whether the stock price reacted to news in a directionally appropriate manner: up in response to positive news and down in response to negative news. Applying the deferential abuse of discretion standard, the Second Circuit held it was permissible for the district court not to have required directionally appropriate movement. The court reasoned that the other, indirect *Cammer* factors supported a finding of market efficiency, and that a holistic analysis was permissible without discounting the indirect evidence in favor of the direct evidence.

Building off its decision in *Petrobras*, the Second Circuit later held in ***Waggoner v. Barclays PLC***, 875 F.3d 79 (2d Cir. 2017) that "a plaintiff seeking to demonstrate market efficiency need not always present direct evidence of price impact through event studies." While recognizing that direct evidence of price impact under the fifth *Cammer* factor is often the most important factor, and may be critical in cases where the other factors are not compelling, the court declined to hold that such evidence is always required.

ASCERTAINABILITY AND RELATED PREDOMINANCE ISSUES

Over the past few years, one of the hot topics in consumer class action litigation has been ascertainability. An implied prerequisite for class certification, this doctrine generally requires that the members of a putative class be sufficiently ascertainable using objective criteria. The precise contours of this requirement has split the circuit courts, and was the subject of a cert petition in *Conagra Brands, Inc. v. Briseño* that was denied by the Supreme Court in October 2017.

In the securities context, the Second Circuit issued an important ascertainability decision in ***In re Petrobras Securities***, 862 F.3d 250 (2d Cir. 2017). The district court certified classes encompassing purchasers of certain notes in "domestic transactions," a requirement to assert claims under the U.S. securities laws under ***Morrison v. National Australia Bank Ltd.***, 561 U.S. 247 (2010). Defendants argued that such a class was not ascertainable because there was no administratively feasible way to determine class membership without individual examinations of each purchaser's claim. On appeal, the Second Circuit "took the opportunity to clarify" its prior case law, which appeared to support an administrative feasibility requirement, and held that ascertainability "requires only that a class be defined using objective criteria that establish a membership with definite boundaries." The court held that standard was met by the class as certified by the district court.

Applying the predominance requirement of Rule 23(b)(3), however, the Second Circuit essentially found that the concerns raised by defendants nonetheless posed a significant issue for class certification. The court noted that on the available record, the analysis of domestic transactions appeared to be an individual question requiring evidence from each putative class member, and plaintiffs had not suggested a form of class-wide proof. Because the district court did not meaningfully address how the domestic transaction issue impacted whether common issues predominate over individual issues, the Second Circuit vacated that aspect of the class certification order. The court also

The Second Circuit's decision in *Petrobras* suggests a focus on predominance rather than ascertainability.

noted that the class included investors who purchases notes in the secondary market (rather than directly in an offering), meaning that they would need to show their shares were traceable to a challenged offering to have standing to pursue claims under Section 11 of the Securities Act.

Similar issues regarding domesticity and tracing have been raised in the *Cobalt* appeal pending in the Fifth Circuit. ***St. Lucie County Fire District v. Bryant***, No. 17-20503 (5th Cir.). There, among other challenges to the district court's certification of a class, defendants argue that common issues do not predominate because individual inquiries and evidence will be required to show (i) whether stock purchases are traceable to the secondary offerings at issue in the case, and (ii) whether the notes at issue were purchased in domestic transactions.

APPLYING COMCAST

In 2013, the Supreme Court held in ***Comcast Corp. v. Behrend*** that the predominance requirement was not met in a proposed antitrust class action in which the plaintiffs' damages model did not attempt to identify the damages attributable to the plaintiffs' only viable theory of liability. 569 U.S. 27, 36-38 (2013).

In 2017, the Second Circuit considered a *Comcast* challenge to a plaintiffs' damages model in ***Waggoner v. Barclays PLC***, 875 F.3d 79 (2d Cir. 2017). The defendants argued that the model submitted by plaintiffs' expert (i) did not disaggregate confounding factors that could have caused the stock price decline that plaintiffs attributed to revelation of the alleged fraud, and (ii) failed to account for variations over time in stock price inflation. The Second Circuit rejected these challenges, finding that the model tracked plaintiffs' theory of liability and therefore complied with *Comcast*. The court appears not to have viewed the confounding information as being unrelated to the alleged fraud, avoiding any issue of disaggregation. The court also concluded that the damages model did not need to be exact enough at the class certification stage to account for variations in inflation.

Comcast issues have also been raised in ***Laborers Pension Trust Fund v. Conn's Inc.***, No. 17-20525 (5th Cir.) pending before the Fifth Circuit. There, defendants argue that plaintiffs' damages methodology is not adequately tailored to their theory of liability, has not been shown to permit disaggregation of confounding information, does not distinguish between the impact of known risks and allegedly concealed risks, and suffers from other infirmities.

IV. Scienter

An essential element of a securities fraud claim under Section 10(b) and Rule 10b-5 is scienter—the mental state to deceive, manipulate, or defraud, including severe recklessness. To sufficiently plead scienter, a plaintiff is required to state with *particularity* facts giving rise to a "strong inference" that the defendant acted with this mental state. A strong inference arises when the inference of scienter is at least as compelling as any plausible, opposing inference that the court must take into account. In 2017, decisions from six circuits shed light on how scienter is and should be analyzed in those jurisdictions.

FIRST CIRCUIT

In a spate of decisions involving allegations against pharmaceutical companies, the First Circuit routinely affirmed dismissals for not containing facts giving rise to a "cogent and compelling" inference of scienter—as opposed to one that was just plausible or reasonable—as required under the PSLRA.

In ***Brennan v. Zafgen, Inc.***, 853 F.3d 606 (1st Cir. 2017), the company publicly disclosed two "serious," but not two "superficial," adverse patient events during clinical

drug trials, which the plaintiffs contended was materially misleading. In ***Corban v. Sarepta Therapeutics, Inc.***, 868 F.3d 31 (1st Cir. 2017), the plaintiffs alleged it was materially misleading for the company to issue overly optimistic statements about the likelihood that the FDA would agree to review the company's novel gene therapy—which the FDA ultimately did, but at a later date than stated and anticipated. In ***In re Biogen Inc. Securities Litigation***, 857 F.3d 34 (1st Cir. 2017), although the defendants disclosed the death of a patient during clinical drug trials, the plaintiffs alleged the defendants fraudulently failed to disclose the repercussions of that event on the company's sales. Lastly, in ***Harrington v. Tetraphase Pharmaceuticals Inc.***, No. 16-10133, 2017 WL 1946305 (D. Mass. May 9, 2017), the plaintiffs alleged the defendants knew the drug they were testing would fail long before they disclosed such to the public. The Court of Appeals affirmed dismissal in all three cases, and the district court in *Harrington* likewise dismissed the complaint.

These opinions highlight that subsequent adverse developments are insufficient, on their own, to demonstrate that a defendant possessed the requisite scienter when a statement was made. In *Corban*, a material adverse development (the FDA's rejection of a competitor's similar application), which occurred after the company's optimistic predictions of FDA acceptance, was insufficient to show the defendants knew they would suffer a setback at the time they made their predictions. In *Biogen*, that drug sales declined following the announcement of a patient death was insufficient to show what the defendants knew about future sales at the time they made their public statements—especially where the complaint lacked adequate allegations that the decline in sales was attributable to the adverse event.

Similarly, *Corban* and *Harrington* also reaffirmed that although false statements of opinion can create liability, the plaintiffs must show more than that the opinions turned out to be wrong. For example, in *Harrington*, the defendants incorrectly opined that its drug would be effective as an oral therapy. However, the Court found this incorrect prediction insufficient for scienter because there was no assertion that the company knew, at the time it made its prediction, that the drug would not be effective as an oral therapy.

Further, these decisions held that the plaintiffs' allegations of motive and opportunity were insufficient indicia of scienter, particularly given the competing inference that favored the defendants. As a general rule, the usual motive to improve financial results does not support scienter. Instead, as *Corban* explained, there must be something more—*e.g.*, that the fate of the company was hanging in the balance. The Court stated in *Brennan* that the inference from motive allegations depends on the facts, and that inference can range from marginal to strong. In *Brennan*, the inferences from insider trading allegations were weak because the insiders retained a large majority of their holdings. In *Biogen*, the scienter inference was also weak because the insiders increased their stock holdings during the relevant time and lost money as a result of the stock price decline. And in *Brennan* and *Harrington*, the insider stock sales came before the company learned of the negative news regarding its clinical trials, which weighed against scienter. Moreover, in *Harrington*, the insider trades were made pursuant to Rule 10b5-1 trading plans, which rebutted the inference of scienter because those plans were executed before the negative news was known.

In *Corban*, the Court stated that the admittedly rosy opinions about the chance of FDA acceptance were replete with cautionary caveats, which, even if they could have been more fulsome, lessened the inference of scienter.

Lastly, *Brennan* reiterated a theme discussed in our 2015 Year in Review, which is that the marginal materiality of allegedly misrepresented information weighs against a strong inference of scienter. In *Brennan*, for example, the Court held that the limited materiality of the two "superficial" adverse events—as determined by what a reasonable investor would consider important—undermined a finding of scienter.

SECOND CIRCUIT

In ***Christine Asia Co. Ltd. v. Ma***, 16-2519-CV, 2017 WL 6003340 (2d Cir. Dec. 5, 2017), the Second Circuit Court of Appeals vacated and remanded the lower court's dismissal of the complaint, finding that the plaintiffs had adequately pled scienter.

The complaint alleged that Alibaba Group Holding Limited and its executives failed to disclose a material adverse meeting that Alibaba had with the Chinese government just two months prior to Alibaba's IPO, which was the largest in history. According to the complaint, Chinese officials conducted an administrative guidance proceeding, which are typically public, in secret with Alibaba to avoid impacting the upcoming IPO. In that meeting, Chinese officials allegedly told Alibaba that is must cease to sell counterfeit goods on its website or face significant reoccurring fines. According to the plaintiffs, Alibaba was therefore faced with either abandoning an important revenue stream or subjecting itself to enormous fines—both of which would adversely impact the company. Alibaba did not disclose this meeting to the public prior to its IPO, but once the market finally learned of the meeting, Alibaba's stock dropped 13% (or $33 billion).

The Court of Appeals found that the plaintiffs had adequately pled strong circumstantial evidence of scienter. *First*, high-level Alibaba officers, as well as senior managers of each of Alibaba's primary business units, attended the meeting. *Second*, those executives reported directly to Alibaba's CEO and CFO. *Third*, based on the important nature of the meeting, those who attended, the potential negative implications for Alibaba's business, and that it was conducted secretly, "it is virtually inconceivable that this threat was not communicated to the senior level of Alibaba's management." The Court held that the failure to disclose this meeting was, at the very least, "a reckless disregard of a known or obvious duty to disclose," which "powerfully supports a strong inference" of scienter.

In contrast to *Ma*, the Second Circuit affirmed the lower court's dismissal for failure to adequately plead scienter in ***Wyche v. Advanced Drainage Systems, Inc.***, No. 17-743-CV, 2017 WL 4570663 (2d Cir. Oct. 13, 2017). The Court found as insufficient indicia of scienter the plaintiff's three motive allegations. *First*, that the defendants had a motive to engage in fraudulent accounting practices because the company would have breached financial covenants with lenders had it complied with GAAP failed to suffice because the complaint did not include particularized facts to support this allegation—*e.g.*, that default was imminent or inescapable. *Second*, the allegation that the company's employees were motivated to inflate stock prices for performance-based bonuses (which they received) failed because "[b]onus compensation is not the type of 'concrete and personal' benefit upon which a finding of motive to commit securities fraud can be based." *Third*, an employee's sale of shares did not support a motive allegation because the sales were not unusual: "the percentage of shares sold was small, the timing was not suspicious, and no other insiders were alleged to have sold stock." As a result, the Court affirmed dismissal.

THIRD CIRCUIT

In ***Fain v. USA Technologies, Inc.***, No. 16-2436, 2017 WL 3727435 (3d Cir. Aug. 30, 2017), the Court held that the plaintiff failed to adequately plead scienter. The company and its two CFOs issued a press release in September 2015 announcing its bad debt. Three weeks later, the company announced it would have to restate its bad debt due to a newly-identified material

> Scienter continues to be the most fruitful ground for motions to dismiss.

weakness—failing to identify uncollectable small-balance accounts. The plaintiff subsequently filed suit alleging the defendants fraudulently understated bad debt and thereby artificially inflated the company's financial health.

To support an inference of scienter, the plaintiff primarily argued that the CFOs must have known about the misreported bad debt given their positions, the size and simplicity of the error, and subsequent actions to remediate it. The Court addressed these allegations in turn, and noted "the difficulty of establishing a 'they-must-have known' type inference."

First, it was not enough to support scienter that the CFOs were in top positions. The complaint lacked allegations that the CFOs regularly dealt with bad debt or small accounts. According to the Court, the likely inference was that lower-level employees misclassified these bad debts, of which the CFOs were unaware. *Second*, although the initial bad debt announcement missed the mark by 900%, the actual correction was less than 4% and 2% of quarterly and year-end revenue amounts, respectively—which was less indicative of scienter. *Lastly*, that the company terminated the CFOs and underwent remediation efforts merely suggested prior corporate mismanagement or possible negligence. This, according to the Court, did not show that the danger of misleading investors was either actually known to the defendants, or obvious to the extent the defendants must have been aware of it.

FOURTH CIRCUIT

In ***Maguire Financial, LP v. PowerSecure International, Inc.***, 876 F.3d 541 (4th Cir. 2017), the Fourth Circuit upheld the district court's determination that the plaintiff failed to adequately plead scienter. In August 2013, PowerSecure's CEO informed analysts that the company—which provided utility and energy technologies—had secured a large contract "renewal and expansion" that significantly added to the company's revenue backlog. Nine days later, and after the stock had risen 10%, the company and CEO sold millions of shares. Nine months thereafter, the company announced a quarterly loss due in part to complexities with its previously-reported renewed and expanded contract, and disclosed that the contract involved changing its service area from one region of Florida to another one. The stock price fell more than 62%. The plaintiffs filed suit alleging the CEO knew at the time he made his statement the contract had not been extended, but instead the company had been awarded a less profitable region in Florida.

The Court rejected the plaintiff's argument—that the CEO must have known his statement was false—because it conflated the scienter and falsity analysis. The Court stated that inferring the CEO knew his statement was false may indicate a material misrepresentation, but the Court refused to "infer from that inference that [the CEO] acted with scienter," because "stacking inference upon inference in this manner violates the statute's mandate that the strong inference of scienter be supported by facts, not other inferences." After concluding the plaintiff could not rely on the existence of a material misrepresentation to satisfy scienter, the Court next considered whether the complaint as a whole adequately alleged scienter. According to the Court, the plaintiff failed to identify numerous misleading statements and omissions not caused by imprecise language or legitimate business decisions. Instead, the CEO used "a single *possibly ambiguous* word [renewal] on a live analyst call that purportedly mischaracterized an agreement that had historically accounted for [only] 4.1% of the company's annual revenue."

The Court explained that the CEO's statement was insufficient to show the requisite intent to deceive investors, particularly because the complaint lacked facts demonstrating the CEO knew at the time that the contract would be less profitable—even if it ultimately was.

FIFTH CIRCUIT

In ***Neiman v. Bulmahn***, 854 F.3d 741 (5th Cir. 2017), the Fifth Circuit affirmed the dismissal of the plaintiffs' complaint for its failure to adequately plead scienter. In *Neiman*, shareholders sued a company engaged in oil and gas production. The plaintiffs alleged several

misrepresentation, including that: (i) the CFO twice overstated the production of a well, as revealed when the company later told investors its well production was much lower than initially stated; and (ii) the company stated it had sufficient liquidly to meet its capital needs, but three months later filed for bankruptcy due to a liquidity crisis.

Regarding the well's production, the Court held that the disclosure of the lower-than-expected output mere weeks after the initial statements cut against an inference of scienter and motive to mislead. This was particularly true because the plaintiffs could not explain what specific motive the CFO had, other than a general and insufficient desire to perform well. The Court also rejected allegations (of confidential witnesses) that because company reports containing the true numbers were available to the CFO, he must have known about them. According to the Court, the plaintiffs did not allege that the CFO actually read those reports, or that he was otherwise aware of the lower production numbers.

Regarding the liquidity assurances, the company's public statements, on the whole, weighed against scienter. While the company told investors it had sufficient liquidity, which turned out to be incorrect, it also continuously disclosed its worsening cash position and warned of the risks associated with its inability to obtain financing or support liquidity through adequate well production. Moreover, because there was no indication the liquidity beliefs were not honestly held, and because the company routinely updated the market on its risks and concerns, the fact that the company filed for bankruptcy mere months after making its liquidity assurances was inadequate to support an inference of scienter.

Fifth Circuit case law continues to require particularized scienter allegations.

SIXTH CIRCUIT

In ***IBEW Local No. 58 Annuity Fund v. EveryWare Global, Inc.***, 849 F.3d 325 (6th Cir. 2017), the Sixth Circuit affirmed the lower court's dismissal of the plaintiffs' complaint for failure to adequately plead scienter. Plaintiffs filed a lawsuit against EveryWare Global, Inc., a kitchenware manufacturer, and its officers and directors, among others. The plaintiffs alleged that EveryWare's CEO released false financial projections, and that the CEO and CFO misleading stated that the company was on track to meet its financial projections.

Regarding the first allegation, the Court held that the plaintiffs failed to plead facts giving rise to a strong inference that the CEO had actual knowledge that those projections were wrong. Regarding the second allegation, the plaintiffs failed to plead facts that gave rise to a strong inference that the defendants intended to deceive, manipulate or defraud the public.

The Court held that although the plaintiffs made plausible allegations to support scienter, the defendants' competing allegations were more persuasive. The plaintiffs alleged that the defendants sold stock at opportune times, that those executives who did not sell stock were motived to retain their jobs, that the company's positive statements regarding its financials preceded the company's collapse by only several months, and that the defendants knew the company was running out of money for various reasons, including that orders were down and costs exceeded revenue.

The defendants, on the other hand, more persuasively demonstrated that the defendants' actually wanted the company to succeed. For example, most defendants did not sell shares in the at-issue offering, some

defendants actually increased their holdings, and the defendant that did sell shares only sold 10% of its holdings. Further, once the stock price plummeted and the company was in crisis, the defendant that had sold shares actually invested an additional $20 million (which was more than the proceeds from the stock sale) to support the company. Moreover, when the company filed for bankruptcy, the defendants lost all of their shares.

In the end, the Court held that the defendants had a greater motive to see the company succeed than they did to fraudulently inflate stock prices and let the company fail. Regarding the defendants who sold no shares, the Court held that the plaintiffs failed to show motive to commit fraud as opposed to motives common to executives generally—*e.g.*, to run a successful company and retain their position at the company.

SEVENTH CIRCUIT

In ***Pension Trust Fund for Operating Engineers v. Kohl's Corp.***, 266 F. Supp. 3d 1154 (E.D. Wis. 2017), *appeal filed* (7th Cir. Aug. 18, 2017), the Court held that access to information and insider stocks failed to demonstrate a strong inference of scienter, and the Court dismissed the case against Kohl's and two of its officers and directors.

In February 2005, and before the class period at issue in the case, Kohl's disclosed that its accounting for lease agreements had not complied with GAAP, and it would have to restate its financial statements for nearly 6 years prior. Thereafter, from 2005 to 2010, Kohl's publicly represented that its financials were GAAP compliant, its internal controls were effective, and the prior errors announced in 2005 were not material. However, in August and September 2011, Kohl's announced material weaknesses in its internal controls, once again primarily relating to its accounting for lease agreements, and issued restatements covering fiscal years 2006 through 2011. The plaintiffs filed a putative class action lawsuit shortly thereafter covering the restated financials from 2006 through 2011. In the complaint, the plaintiffs argued that the executives possessed the requisite scienter for securities fraud because (i) they had access to information that demonstrated the falsity of their financials, and (ii) they were motivated to provide false information to reap gains from insider stocks sales.

To support the first assertion, the plaintiffs alleged the executives had knowledge of applicable accounting rules, had previously identified these same errors in 2005, and were obligated to certify Kohl's financial statements. The Court held that these allegations were insufficient for scienter. First, "[k]nowing an accounting rule and knowing that it is not being followed … are two different things." The Court rejected the complaint's group pleading, finding the complaint lacked information showing the individual defendants—as opposed to the company generally—knew about the accounting errors and that their financial statements were false. Second, it was not enough that the certified financials turned out wrong, absent allegations that those executives were aware of the material weaknesses or inaccuracies at the time.

Regarding the insider stock sales, the Court held that personal financial gain may support an inference of scienter, but because executives frequently sell stock, the plaintiffs were required to demonstrate how those sales were unusual or suspicious—which they did not. Thus, merely identifying the amount the executives made from their sales during the class period—even though nearly $51 million—was insufficient. In the end, although the plaintiffs alleged with particularity the accounting errors that Kohl's made, they did not allege with particularity that the defendants knew or should have known that Kohl's accounting personnel and the company's outside auditor were committing such errors. The plaintiffs have appealed the Court's dismissal of their complaint for failing to adequately plead scienter.

EIGHTH CIRCUIT

In ***In re Stratasys Ltd. Shareholder Securities Litigation***, 864 F.3d 879 (8th Cir. 2017), the Eighth Circuit affirmed the lower court's dismissal of the plaintiffs' complaint for failure to adequately plead scienter. In *Stratasys*, the plaintiffs filed a lawsuit against Stratasys Ltd., a company that manufactured 3D printers for commercial use, and alleged that the company's promotional statements were false. According to the complaint, the company introduced a new printer to the market, which the company claimed was "'unmatched' in quality, reliability, ease of use, speed, and performance." Thereafter, the printers experienced serious problems, and sales declined while returns rose, leading to a stock drop. The plaintiffs alleged that the company knew its printers were faulty but nevertheless rushed them to market and made optimistic statements about their performance.

The Court held that these allegations did "not adequately tie Stratasys's knowledge of the product quality issues or their financial repercussions to the timing of the statements." The confidential witnesses, who proclaimed that Stratasys knew its printers were faulty, did not also explain with particular details when Stratasys knew of these issues. Because the plaintiffs did not adequately show that the company knew its statements were false when those statements were made, the plaintiffs failed to adequately plead scienter.

NINTH CIRCUIT

In ***Knox v. Yingli Green Energy Holding Co. Ltd.***, 242 F. Supp. 3d 950 (C.D. Cal. 2017), the plaintiffs sued a corporation that manufactured and sold solar energy products in China, and its officers, alleging the defendants made false statements about business risks. The Court held that the plaintiffs failed to adequately plead scienter.

The Court rejected the plaintiffs' argument that the defendants acted with scienter in failing to disclose the risks that the Chinese government could clawback subsidies for projects not completed on time, or withdraw subsidies if it discovered fraud. According to the Court, the plaintiffs failed to show that the risk of clawbacks was sufficiently material when the corporation made optimistic statements about its involvement in the subsidy program. Moreover, there were no specific facts demonstrating that the company knew about untimely projects or the alleged fraud. Instead, the plaintiffs relied on uncorroborated allegations, and allegations of knowledge within the company and industry as a whole, as opposed to knowledge of specific individuals.

The Ninth Circuit also issued a number of opinions addressing the sufficiency of the "core operations" approach for pleading scienter, where one infers scienter to commit fraud from an individual's senior management position and the importance of the information allegedly known. In ***Cutler v. Kirchner***, 696 F. App'x 809 (9th Cir. 2017), the Ninth Circuit held that the plaintiff adequately pled scienter as to three of four executives. The plaintiff adequately alleged that the executives held important roles in the company, as well as the importance of the information about which the misstatements were allegedly made. However, the plaintiff only added detailed allegations about three of the four executives' exposure to that factually-important information, and therefore only adequately pled scienter as to those three.

In ***Curry v. Yelp Inc.***, 875 F.3d 1219 (9th Cir. 2017), the Court rejected the plaintiffs' core operations approach. The plaintiffs claimed that Yelp manipulated customer reviews of businesses on its website, despite stating that those reviews were authentic. The Court held that the plaintiffs' allegations of executives' knowledge of core operations and day-to-day workings of the company, and of the importance of the information, did not show that they had knowledge of the manipulated reviews or the practices of lower-level employees. And in *Knox*, the Court held that the plaintiffs' core operations allegations were insufficient because the plaintiffs used vague and generalized statements regarding widespread fraud, rather than specific facts demonstrating its prevalence and that the executives should have been aware of it.

Further, in *Yelp*, we once again saw a Court reject plaintiffs' allegations that insider stock sales—which netted $81.5 million in proceeds—supported scienter. The Court stated that to create an inference of scienter, the stock sales must be drastically different from prior trading patterns and at opportune times to maximize returns. Here, the plaintiffs provided no data showing historical insider stock sales before the class period, for comparison purposes.

In contrast to *Yelp* and *Cutler*, the Court in ***In re Juno Therapeutics, Inc.***, No. C16-1069, 2017 WL 2574009 (W.D. Wash. June 14, 2017) held that the plaintiffs adequately pled scienter through the core operations approach and motive allegations. In *Juno*, the plaintiffs alleged a company developing a new drug withheld material information that undermined the prospect of FDA approval—namely, patient complications during clinical trials—while racing against competitors to be first-to-market. The plaintiffs alleged—and the Court agreed—that it sufficiently pled scienter because (i) facts critical to a business's core operations are known to key officers, and (ii) the defendants were motivated to beat competitors to market and to capitalize on suspicious insider stock sales.

The opinions from these six circuits in 2017 demonstrate that courts stringently apply the PSLRA's heightened standards when assessing scienter. Courts routinely rejected as sufficient indicia of scienter that prior statements turned out to be wrong, or that motive and opportunity, without more, supported scienter. Instead, Courts required specific and detailed facts that the defendants knew their statements were false when made, or that the individuals making the fraudulent statements were aware of the facts allegedly revealing the fraud and/or demonstrating scienter.

V. Material Misstatements or Omissions

STATEMENTS OF OPINION OR BELIEF

In 2015, the Supreme Court set standards for evaluating allegedly false or misleading statements of opinion or belief in ***Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund***, 135 S. Ct. 1318 (2015). The Supreme Court held that statements of opinion or belief in a registration statement can form the basis of a fraud claim under Section 11 of the Securities Act when (1) the speaker did not actually believe the opinion at the time it was offered; (2) the statement contained "embedded statements of fact" that were false or misleading; or (3) the speaker "omit[ted] material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict[ed] with what a reasonable investor would take from the statement itself." This past year, courts applied the standards from *Omnicare* in several cases.

In ***City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align Technology, Inc.***, 856 F.3d 605 (9th Cir. 2017), the plaintiffs brought fraud claims under Section 10(b) of the Exchange Act for statements in SEC filings regarding goodwill value associated with a company Align Technology recently acquired. Because the calculation of goodwill value was based on subjective inputs and management's opinion regarding fair value, the Ninth Circuit evaluated the alleged misstatements as statements of opinion and held that *Omnicare* applied to claims brought under the Exchange Act. The plaintiffs argued that Align Technology did not honestly believe the goodwill value assigned to the acquired company because Align Technology was aware that the acquired company engaged in "channel stuffing" prior to acquisition, thereby artificially inflating revenue. Similarly, the plaintiffs argued that the goodwill value was misleading because Align Technology did not disclose

material facts regarding its knowledge of "channel stuffing." The Ninth Circuit rejected both arguments because the plaintiffs failed to plead that Align Technology deliberately ignored the inflated nature of the revenue figures in setting goodwill value or that the assigned goodwill value was objectively false. Lastly, the plaintiffs argued that statements in SEC filings asserting "there were no facts and circumstances" indicating impairment to goodwill value contained an embedded statement of fact that no such facts or circumstances existed. The Ninth Circuit agreed, but held the plaintiffs did not identify any facts not already incorporated into the goodwill valuation and thus had not adequately pled the statement was false or misleading.

In ***Cutler v. Kirchner***, 696 Fed. App'x 809 (9th Cir. 2017), the Ninth Circuit again applied *Omnicare* to Section 10(b) claims. The plaintiffs alleged that statements made by UTi that a computer system and software rollout was going well were false and misleading. The plaintiffs conceded that the statements were statements of opinion, but were false or misleading because the company knew, but did not disclose, the roll out was causing a serious decline in cash collections. Citing to the *Align Technology* case, the Ninth Circuit held that to allege a materially misleading omission about knowledge concerning the opinion statement, the plaintiff must allege that the omission would make the opinion statement "misleading to a reasonable person reading the statement fairly and in context." The Ninth Circuit held that a reasonable investor that heard statements about rollout of the system going well would have an impression of the rollout that was "materially different from reality." Thus, the plaintiffs adequately pled a false or misleading statement of opinion or belief.

The Southern District of New York also applied *Omnicare* to Exchange Act claims in several cases in 2017. In ***In re Pretium Resources Inc. Securities Litigation***, 256 F. Supp. 3d 459 (S.D.N.Y. 2017), the plaintiffs brought claims under Section 10(b) the Exchange Act alleging that Pretium's statements regarding potential production from a mining project were misleading. Plaintiffs asserted that the statements were misleading because the defendants did not disclose that a consultant advised the company that bulk mining was not economically viable, that there were negative results from a bulk sample program, and that there were geologic abnormalities where mining was expected to occur. Citing to *Omnicare*, the court held that statements regarding potential production were opinion statements because they did not contain then existing objective facts and because Pretium disclosed in its SEC filings that projections were subjective. Noting that the plaintiffs alleged the company invested heavily in the mining project, the court stated it was implausible to infer that the company did not honestly believe the mining project would be successful. Moreover, the court held that the plaintiffs did not sufficiently allege that failure to disclose information Pretium received from its consultant made the projections misleading because Pretium had disclosed the consultant would provide a report after all the data had been compiled. The advisor never provided a report because it resigned prior to compilation of all the data. The court stated that reasonable investors would not have expected estimates to be based on a non-existent report. The court also noted that the bulk sampling program was not yet complete when the alleged misleading statements were made, and the plaintiffs pointed to no facts that the company did not believe the final sampling results would align with expectations. With respect to the geologic abnormalities, the court held that previous disclosures already provided sufficient information.

Omnicare is now regularly relied on in assessing falsity in the Section 10(b) as well as the Section 11 context.

In ***Police & Fire Retirement System of the City of Detroit v. La Quinta Holdings Inc.***, No. 16-cv-3068, 2017 WL 4082482 (S.D.N.Y. Aug. 24, 2017), the plaintiffs alleged that the CEO for La Quinta made a material misstatement when describing the benefits of a sale of a particular hotel property as a "win-win-win" because La Quinta later recorded a $4 million loss on the property. The court held that the statement was an opinion because it was "an expression about [the CEO's] expectations for the sale." Applying *Omnicare* and other cases from the Second Circuit interpreting *Omnicare*, the court dismissed the claims because the allegations did not show the opinion was not an honestly held belief or that the opinion was misleading in any way due to an omission. Separately, the court dismissed the claims because the plaintiffs failed to allege that the "win-win-win" statement was untrue since it was equally plausible that the transaction truly benefitted all the parties involved, even though La Quinta recorded a loss.

STATEMENTS OF ASPIRATION OR "MERE PUFFERY"

Several cases from 2017 dealt with plaintiffs bringing securities fraud claims based on a company's statements promoting internal policies. Many of these cases were brought in wake of government investigations and enforcement actions. Courts analyzed whether these statements were actionable misstatements or "mere puffery" too general or aspirational in nature to be actionable.

In ***In re Volkswagen "Clean Diesel" Marketing, Sales Practices, & Products Liability Litigation***, MDL No. 2672, 2017 WL 66281 (N.D. Cal. Jan. 4, 2017), the plaintiffs, holders of Volkswagen ADRs, brought securities fraud claims under the Exchange Act for allegedly false statements regarding Volkswagen's "clean diesel" vehicles. The plaintiffs identified specific statements about compliance of Volkswagen's "clean diesel" vehicles with U.S. and European emissions regulations. The court held the statements were actionable because Volkswagen knew the vehicles were not in compliance. The plaintiffs also argued that statements about Volkswagen being "environmentally friendly" were actionable misstatements as opposed to mere puffery because the environmental features of Volkswagen cars, and in particular "clean diesel" vehicles, were central to the company's core business strategy. The court stated that taken alone, the "environmentally friendly" statements could be interpreted as puffery or aspirational. However, the court held that taken as a whole, the allegations in the complaint showed that "Volkswagen focused on environmental friendliness as a core aspect of its business," and thus, the statements were misleading.

In ***In re Vale S.A. Securities Litigation***, No. 1:15-cv-9539, 2017 WL 1102666 (S.D.N.Y. Mar. 23, 2017), the plaintiffs brought securities fraud claims for allegedly false and misleading statements about Vale's commitment to health, safety, and the environment ("HSE") before and after a dam operated through a joint venture collapsed and caused environmental harm. The defendants argued that these alleged misstatements were "inactionable puffery" and "lack[ed] objective criteria on which to judge their accuracy." The plaintiffs argued that the alleged misleading statements about the company's commitment to HSE policies were "anchored" in "misrepresentations of existing fact," evidenced by the alleged failure to address critical HSE issues with respect to the dam. The court held that that the alleged misstatements were a set of "aspirational generalizations which are … 'precisely the type of puffery' that the Second Circuit has 'consistently held to be inactionable.'" The court also noted that the verbiage used in statements regarding HSE commitments, such as "seeking," "committed," "focused on," "aiming," and "priorities," provided further confirmation that the statements were puffery.

In ***In re Banco Bradesco S.A. Securities Litigation***, -- F.Supp. 3d --, 2017 WL 4381407 (S.D.N.Y. Sept. 29, 2017), the plaintiff alleged that statements about the implementation, design, and monitoring of internal controls were false or misleading because senior management was engaged in an illegal bribery scheme. The court held that the plaintiff did not adequately allege that the statements were false or

misleading because the statements did not provide a guarantee those internal controls would perform perfectly. Moreover, the court noted that plaintiffs did not plead that the internal controls did not exist, that they were not designed for the purposes stated, or that the internal controls were not monitored by management. The plaintiffs also argued that statements in the company's code of conduct regarding corruption and statements made in press releases about fighting and preventing corruption were false and misleading. The court held that the statements in the company's code of conduct were puffery and not actionable, but also held that the other statements discussing effectiveness of and commitment to anti-corruption polices were false or misleading because senior officers of the company were knowingly engaged in bribery. Even if the statements were aspirational, the court stated that investors could rely on the company at least having those aspirations, whereas the facts pled indicated the company did not. The court held that by choosing to speak about effective anti-corruption polices and a strong commitment to them, the statements were rendered misleading when the company did not disclose the bribery scheme.

In ***In re VEON Ltd. Securities Litigation***, No. 15-cv-08672, 2017 WL 4162342 (S.D.N.Y. Sept. 19, 2017), VEON entered into a deferred prosecution agreement ("DPA") in which it pled guilty to violations of the Foreign Corrupt Practices Act. The plaintiffs alleged that in its securities filings, VEON made false statements about the availability of equal protection under Uzbek law and about efficacy of internal controls. VEON argued that disclosures regarding equal protection of law reflected interpretations of law, not statements of fact. The court held that assertions regarding equal protection of law were actionable because VEON admitted in the DPA that bribes were necessary to conduct future business in Uzbekistan and the plaintiffs adequately pled that VEON knew that equal protection under Uzbek law was illusory. Additionally, the court held that the plaintiffs' allegations showed that VEON's disclosures regarding the existence and efficacy of the internal controls were false. The court cited facts admitted in the DPA that management knowingly failed to implement adequate controls and was aware that internal controls were ineffective. The court also found that statements made on the company's website regarding compliance with internal controls were more specific than what courts typically regard as puffery.

In ***Retail Wholesale & Department Store Union Local 338 Retirement Fund v. Hewlett-Packard Co.***, 845 F.3d 1268 (9th Cir. 2017), the plaintiffs brought claims for alleged misstatements in HP's code of conduct published on the company's website after findings of an internal investigation revealed that the company's CEO violated the code of conduct. The Ninth Circuit held that the statements in the code of conduct were not capable of being objectively false because they were aspirational and only expressed an opinion as to what HP hoped for from its employees. Further, the Ninth Circuit noted that "a contrary interpretation … could turn every instance of corporate misconduct into securities fraud." The plaintiff argued that the context of the statements made them materially misleading because the code of conduct was updated and published in the wake of other whistleblower complaints that resulted in criminal charges against the company's general counsel. The Ninth Circuit disagreed, stating that context factors into materiality, not falsity. And even if the background facts were relevant to the element of falsity, the Ninth Circuit stated that "the totality of the statements made within the Class Period leads only to the proposition that business ethics are important to HP." The court further held that any misstatement was material, reasoning that the code of conduct was essentially mandated by the SEC and "[i]t simply cannot be that a reasonable investor's decision would conceivably have been affected by HP's compliance with SEC regulations requiring publication of ethics standards." The Ninth Circuit also flatly rejected Plaintiff's argument that a "slump" in HP's stock price supported materiality.

In ***Ong v. Chipotle Mexican Grill, Inc.***, No. 16 Civ. 141, 2017 WL 933108 (S.D.N.Y. Mar. 8, 2017), plaintiffs alleged that the defendants made false and misleading statements about the company's food-safety programs and protocols. The court held that the statements were puffery and not actionable. However, the court found

that statements in the company's form 10-K about there being "no material changes" in certain risk factors for the year was actionable given the outbreak of four food-borne illnesses before the statement was made. The court found that these statements were "more than the declarations of 'intention, hope, or projections of future earnings' that courts in this Circuit have deemed 'the hallmarks of inactionable puffery'" because they were affirmative statements of fact that could be verified.

Courts also analyzed whether statements were actionable as opposed to non-actionable statements of optimism or puffery in other contexts. In ***In re Atossa Genetics Inc. Securities Litigation***, 868 F.3d 784 (9th Cir. 2017), the plaintiffs alleged that Atossa made false and misleading statements by stating in SEC filings that it was "reasonably confident in its responses" to an FDA warning letter about clearance for one of its products. Plaintiffs argued that the statement was false or misleading because at the time it was made, the company had submitted and withdrawn a 510(k) notification requesting clearance, knowing that the FDA would likely not grant clearance. The Ninth Circuit held that the statement was not false or misleading because it was "unspecific, subjective, and only guardedly optimistic" and in context "any reasonable investor" would have seen the statement as "mere corporate optimism."

In ***In re Stratasys Ltd. Shareholder Securities Litigation***, 864 F.3d 879 (8th Cir. 2017), the plaintiffs alleged promotional statements the company made about "the unmatched speed, reliability, quality, and connectivity" of a printer product were misleading because the product experienced quality issues resulting in a decline in sales and a high return rate. The district court held that the statements were puffery, and the Eighth Circuit affirmed because the statements were "vague and nonverifiable," and "such obvious hyperbole that no reasonable investor would rely upon them." The court held that even to the extent the claim of "unmatched speed" could be actionable, the plaintiffs failed to plead facts that any competing printers were faster. The plaintiffs argued that the statements made by the company were similar to those in *Virginia Bankshares v. Sandberg*, 501 U.S. 1083 (1991) in which the Supreme Court stated that board statements that the reason for a merger was "to achieve a high value, which [the directors] elsewhere described as a 'fair' price" were not statements of opinion or belief. The Eighth Circuit stated that the statements in *Virginia Bankshares* were distinguishable because the statements regarding the printer product were "so vague and such obvious hyperbole that no reasonable investor would rely upon them."

> Courts have not hesitated to find that statements regarding internal policies and goals are not actionable.

PLEADING FALSITY

In many instances, adequately pleading falsity can prove difficult for plaintiffs, particularly when the allegedly false or misleading statements are open to interpretation. Several courts in 2017 evaluated whether statements with multiple possible interpretations were false and misleading. In ***In re Eros International Securities Litigation***, No. 15-cv-8956-AJN (S.D.N.Y. Sept. 22, 2017), the plaintiffs alleged that Eros executives misstated the number of "registered users" in several earnings calls because the figure included people who actually never used the service offered. The court found that the term "registered users" was not defined by the company and open to interpretation. The court noted that an alternative definition of "a person who has previously been registered with a registration server" was equally plausible. Plaintiffs cited various third-party sources in

an attempt to show the term “registered user” should have only included those who made “meaningful” use of the service, but the court held that plaintiffs could not import the word “meaningful” into the term “registered user” without a representation from the defendants about how “registered users” used the service for the plaintiffs’ theory to be viable.

Cooper v. Thoratec Corp. No. 15-17369 (9th Cir. Oct. 4, 2017) involved statements made by Thoratec regarding thrombosis rates associated with one of its products. Plaintiffs alleged that the company had received data that “strongly suggested thrombosis rates were significantly higher than initially advertised” and that “the company’s affirmative statements downplayed this increase.” Thoratec argued that thrombosis rates were extremely difficult to calculate, and that the rates that Thoratec published were reasonable based on the available data. The Ninth Circuit rejected Thoratec’s arguments, restated the rule from *In re Cutera Sec. Litig.*, 610 F.3d 1103, 1109 (9th Cir. 2010) that “a statement is misleading if it would give a reasonable investor the impression of a state of affairs that differs in a material way from the one that actually exists,” and held that plaintiffs pled facts with sufficient specificity to survive a motion to dismiss.

Plaintiffs must also adequately plead that alleged misstatements are false or misleading at the time they are made. In ***Ganem v. InVivo Therapeutics Holdings Corp.***, 845 F.3d 447 (1st Cir. 2017), the plaintiffs brought securities fraud claims, alleging that the company issued a press release with misleading statements regarding the FDA’s approval of human clinical trials for a new product. The press release did not discuss the conditional nature of the approval or FDA-recommended changes. The press release also stated that the trials would begin in the “next few months” and would last “approximately 15 months.” Later that year, the company issued another press release revealing that the FDA approval was conditional and announcing a delay in the start date and an increase in the projected duration of the clinical trials. The plaintiffs alleged the initial press release was materially misleading because it did not mention the conditional nature of the approval or the FDA-recommended changes, which allegedly prevented the company from actually following through with the stated projected start date and duration. The First Circuit held that the plaintiffs did not adequately plead that the conditions imposed by the FDA resulted in a delay to or increase in the timeframe of the clinical trials. Noting that the FDA-recommended changes were not required and that the plaintiffs did not plead facts indicating that the FDA-recommended changes had any effect on the start date or duration, the First Circuit held that the plaintiffs failed to plead facts showing the statements were false or misleading at the time they were made. The First Circuit relied heavily on what the FDA approval letter actually stated in evaluating whether the plaintiffs alleged well-pleaded facts about the connection between the conditions imposed by the FDA and the announced start date and projected duration.

DUTY TO DISCLOSE

“Silence, absent a duty to disclose, is not misleading under Rule 10b-5.” *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988). There were several developments and decisions in 2017 regarding when a duty to disclose arises and when an issuer has a duty to provide updates on previous disclosures.

Prior to a settlement, the Supreme Court was slated to address a recurring disclosure issue on appeal of the Second Circuit’s decision in ***Indiana Public Retirement System v. SAIC, Inc.***, 818 F.3d 85 (2d Cir. 2016). Plaintiffs alleged that SAIC failed to comply with Item 303 of Regulation S-K by failing to disclose information that the company fraudulently overbilled on a project for the city of New York and that the fraud would expose the company to liability and reputation risks. The Second Circuit held that plaintiffs had adequately pled securities fraud claims based on SAIC’s failure to disclose information about the fraudulent scheme under Item 303. To the Supreme Court, SAIC argued that Item 303 of Regulation S-K did not create a duty to disclose enforceable through private securities fraud claims, noting that the Ninth Circuit and Third Circuit have held that Regulation S-K did not create a duty to disclose enforceable by private plaintiffs. After briefing, but prior to oral argument, the parties

reached a settlement, and the case was removed from the Supreme Court docket. Thus, the question of whether Regulation S-K creates a duty to disclose enforceable by private shareholders remains in question.

In ***Williams v. Globus Medical, Inc.***, 869 F.3d 235 (3d Cir. 2017), the plaintiffs brought securities fraud claims under the Exchange Act, alleging that Globus failed to disclose the company's decision to terminate a distributor contract when it had a duty to disclose the event to shareholders. The plaintiffs argued that Globe's risk disclosures before and after termination of the distributor contract stated that loss of an independent distributor could have a negative impact on sales, which triggered a duty to disclose. The Third Circuit stated 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" and that "a company may be liable under Section 10b for misleading investors when it describes as hypothetical a risk that has already come to fruition." However, in this case, the risk disclosure related to an impact on sales, not just the loss of an independent distributor. Thus, the court held that a duty to disclose with respect to the risk disclosure would only be triggered by adversely affected sales. Plaintiffs had not pled that sales dropped immediately after termination of the independent distributor occurred, so the Third Circuit rejected the claims. The plaintiffs argued that Globus should have known sales would eventually decrease due to termination of the distributor given the company's prior experience with distributor turnover. The Third Circuit stated that the plaintiffs pled no facts about how that compared to the loss of the distributor in this case, and therefore, had not pled sufficient facts indicating that Globus expected or should have expected similar issues to occur in this case.

Companies do not have a general duty to disclose all material information.

When an outcome is merely speculative, a duty to disclose does not attach. In ***In re Express Scripts Holding Co. Securities Litigation***, No. 16 Civ. 3338, 2017 WL 3278930 (S.D.N.Y. Aug. 1, 2017), plaintiffs alleged that Express Scripts had a duty to disclose negative information about ongoing negotiations with Anthem that ultimately resulted in a breakdown of the business relationship. Anthem had threatened to terminate the contract with Express Scripts if certain operational breaches were not cured, but there was never any notice of termination served during the negotiations period. Express Scripts argued that because there was no certainty that negotiations would fail, there was no duty to disclose. Moreover, Anthem had publicly told analysts that it was "hopeful" that it would reach resolution with Express Scripts. Because the plaintiffs failed to allege any definitive notice that Anthem intended to terminate the relationship, the court herd that no duty to disclose was triggered.

In ***Plumbers & Steamfitters Local 137 Pension Fund v. American Express Co.***, No. 15 Civ. 5999, 2017 WL 4403314 (S.D.N.Y. Sept. 30, 2017), the plaintiffs alleged that American Express had a duty to update previous statements about the company's contract with Costco in the U.S. when American Express learned that Costco may not renew the agreement. Specifically, American Express's CFO made statements in interviews and earnings calls that the relationship with Costco in the U.S. was longstanding and that both Costco and American Express were working together on an "ongoing basis to find ways to drive value for both sides going forward[.]" The court held that a duty to update arises when a statement becomes misleading because of a subsequent event, but did not extend to vague statements of optimism or opinion, non-forward looking statements, or statements that are not material. The court held that the duty to update did not apply in this case because statements about the company's relationship with Costco were statements of existing fact that did not contain forward-looking factual representations.

MATERIALITY OF INTERIM FINANCIAL INFORMATION

In order for a false or misleading statement or omission to form the basis of securities fraud claims, the statement or omission must be material. ***In Stadnick v. Vivint Solar, Inc.***, 861 F.3d 31 (2d Cir. 2017), the Second Circuit examined when failure to disclose interim financial information can be a material omission from a registration statement for purposes of Section 11 of the Securities Act. The plaintiffs alleged that Vivint Solar failed to disclose financial performance, specifically income and earnings per share, from the quarter ending the day before the IPO occurred. There was no allegation that Vivint Solar was required to disclose financial performance from the previous quarter, but the plaintiffs argued that the omission rendered Vivint Solar's financial disclosures in the registration statement materially misleading because there was a steep drop in income and earnings per share. The Second Circuit reaffirmed the test for materiality of an omission of interim financial information set forth in *DeMaria v. Anderson*, 318 F.3d 170 (2d Cir. 2003), where the Second Circuit held that the omission is material if there is a "substantial likelihood" that a "reasonable investor" would view the omitted information as "significantly alter[ing] the 'total mix' of information available." In doing so, the Second Circuit declined to adopt the "extreme departure" test that plaintiff urged set forth in *Shaw v. Digital Equip. Corp.* 82 F.3d 1194 (1st Cir. 1996) that a duty to disclose arises when interim financial information would represent an "extreme departure" from previous performance. Under *DeMaria*, the Second Circuit held that Vivint Solar's omission of the previous quarter's financial information was not material because the fluctuations in earnings per share and income were consistent with historical fluctuations as evident from the financial disclosures in the registration document. The registration statement also provided warnings that due to peculiarities in the business model, income would experience fluctuations from quarter to quarter. The Second Circuit also was persuaded that a reasonable investor would not consider the omission to be material due to other disclosures where Vivint Solar highlighted other key metrics to measure performance, and those metrics stayed consistent through the preceding quarter.

VI. The PSLRA "Safe Harbor"

In 2017, several courts grappled with whether statements qualified for protection under the PSLRA's safe harbor for forward-looking statements. Under the provision, a company is not liable for statements identified as forward-looking and accompanied by meaningful cautionary language identifying important factors that could cause actual results to differ materially from those in the forward-looking statements. The safe harbor also provides protection for forward-looking statements if a plaintiff fails to prove that the statements were made with actual knowledge of their false or misleading nature.

In two separate cases, the Ninth Circuit found that the statements at issue were not entitled to protection under the safe harbor. First, in ***Zaghian v. THQ, Inc.***, No. 15-55335 (9th Cir. Jan. 12, 2017), the court concluded that statements regarding the likely success of a new "uDraw" videogame failed to qualify for protection under either prong of the PSLRA's safe harbor. The court held that the cautionary language did not "sufficiently address the harm that resulted"—i.e., that while uDraw had tested well among elementary-age children, it may be unlikely to succeed among "hard core gamers." Although the court recognized that the cautionary language need not address the actual risk that materializes, the court held

that an evidentiary record was necessary to determine whether the risks the company disclosed were "sufficiently important" to warrant application of the safe harbor. Regarding management's knowledge, the court held that because management was allegedly aware that uDraw was unlikely to succeed with teenage PS3 and Xbox 360 users there was a "strong inference" of actual knowledge that the uDraw projections were false and misleading. The court relied heavily on Confidential Witness allegations to undermine the optimism of the forward-looking statements and preclude application of the safe harbor.

In re Quality Systems Inc. Securities Litigation, 865 F.3d 1130 (9th Cir. 2017), the second Ninth Circuit case to address the safe harbor, wrestled with the application of the safe harbor to "mixed" statements. A "mixed" statement is one that has both forward-looking and non-forward-looking elements. The court began by reaffirming the well-established principle that non-forward-looking portions of mixed statements do not qualify for safe harbor protection. At issue in this case were statements in which defendants told investors they could rely on predictions of growth in revenue and earnings because the current state of the company's sales pipeline was consistent with, or better than, the state of the pipeline in previous quarters. The court held this mixed statement was not entitled to safe harbor protection because the forward-looking portion of the statement was accompanied by a supporting statement of present fact that was allegedly materially false and misleading. Under such circumstances, the court held, "it is likely that no cautionary language—short of an outright admission of the false or misleading nature of the non-forward-looking statement—would be 'sufficiently meaningful' to qualify the statement for the safe harbor." ***In re SandRidge Energy, Inc.***, No. Civ-12-1341-W (W.D. Okla. Aug. 1, 2017), also analyzed the actionability of mixed statements, but with an arguably different result. In that case, the court held that mixed statements regarding the company's capital expenditures *were* entitled to safe harbor protection because "the non-forwarding looking parts of a statement, when read in context, cannot meaningfully be distinguished from the future projection of which they are a part." The court used this rationale to insulate from liability statements such as "[r]egarding 2012 CapEx guidance, … [the company is] increasing [its] … estimate" and ""with the success of … [the] asset monetizations to date, [the company is] … now focused on funding [its] … 2012 capital spending program."

Addressing a related issue of recurring importance, two courts held that statements regarding management's belief that the company was "on track" or "on target" to meet earnings goals were not forward-looking and therefore not entitled to safe harbor protection. In ***Bielousov v. GoPro, Inc.***, No. 16-cv-6654-CW, 2017 WL 3168522 (N.D. Cal. July 26, 2017), the court held that management's statement that "[w]e believe we're still on track to make [revenue guidance for 2016] as well" was not a forward-looking statement. Relying on *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1326 (2015), the court held that the speaker was "was representing his and GoPro's existing state of mind" when he made this statement and thus it was a "statement of present opinion," "not forward-looking," and "therefore is not covered by the PSLRA safe harbor provision." Similarly, in ***Murphy v. Precision Castparts Corp.***, No. 3:16-cv-00521 (D. Ore. June 27, 2017), the court found that defendants' statements that the company was "on target" to meet the earnings goals were not forward-looking. Because statements that the company remained "fully committed to our FY16 framework and there is no change to the [2016 EPS] framework we laid out suggested to investors" suggested that "[the company's] market share was currently where it needed to be in order to achieve the 2016 EPS target," the court found that the statements were not truly forward-looking and so not protected by the safe harbor.

Finally, ***In re Vale S.A. Sec. Litig.***, No. 1:15-cv-9539, 2017 WL 1102666 (S.D.N.Y. Mar. 23, 2017), examined the requirement that meaningful cautionary language *accompany* the alleged misstatements. Following a major accident at a Brazilian mining dam, shareholders sued based on alleged misrepresentations about accident-preparedness and safety audits in the company's safety-related plans, policies, and procedures. Defendants argued that they had made

significant and specific cautionary statements concerning the precise safety risks that materialized. The court held, however, that those cautionary statements did not "accompany" the alleged misstatements because the cautionary language appeared in the company's Annual Reports while the statements appeared in a separate Sustainability Report.

Overall, these decisions take a narrower view of what statements qualify for protection under the safe harbor. These rulings emphasize the need for care in making forward-looking statements, including when making mixed statements of future expectation and present or historical fact. As always, cautionary language should be tailored to important, company-specific risk factors and should ideally appear in the same communication as the challenged statements.

The "safe harbor" is not as safe as issuers may expect.

VII. Responsibility for Alleged Misstatements

Rule 10b-5(b) prohibits "mak[ing] any untrue statement of a material fact … in connection with the purchase or sale of a security." In *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011), the Supreme Court narrowly defined who would be responsible for "mak[ing]" an untrue statement of material fact. Specifically, the Supreme Court adopted the rule: "the maker of a statement is the entity with authority over the content of the statement and whether and how to communicate it." Under that definition, those who contribute to an untrue statement, but do not ultimately control the statement, are not subject to private 10b-5 liability. Since *Janus*, courts have continued to grapple with *Janus*' definition of "maker."

In ***Lorenzo v. SEC***, 872 F.3d 578 (D.C. Cir. 2017), the court recognized that even when a statement is written or signed by an individual, that person is not the "maker" for the purposes of Rule 10b-5(b) if he did not have "ultimate authority" over the statement. The SEC brought claims in an administrative proceeding against the defendant for allegedly sending "email messages to investors containing misrepresentations about key features of a securities offering." The messages were sent at the request of the defendant's boss, and the content of the messages was "cut and paste" from materials received from the defendant's boss. His boss also approved the messages before they were sent. The administrative law judge ("ALJ") found that the defendant "sent the emails without even thinking about the contents," likely without taking "a minute to read the text," and sent the emails only at "the request" of his boss. Despite these findings, the ALJ held that Lorenzo was the "maker" because he "authored" the emails and the emails contained his signature and phone number.

On appeal, the D.C. Circuit Court of Appeals held the defendant did not have "control" over the statements because he "cut and paste[d]" content he received from his boss and sent the messages at the request and with the approval of his boss. The court cited to the example in *Janus* that a speechwriter is not in control of a speech he drafts because the "content is entirely within the control of the person who delivers

it." Separately, the court affirmed that Lorenzo was liable under other provisions of the securities laws, over a dissent by Judge Kavanaugh.

The Court of Appeals for the Eleventh Circuit analyzed the application of *Janus* in ***In re Galectin Therapeutics, Inc. Securities Litigation***, 843 F.3d 1257 (11th Cir. 2016), decided at the end of 2016. Galectin shareholders filed suit following news reports that the company "had paid promotional firms to write flattering articles about Galectin," that led to a drop in the company's stock value. Applying *Janus*, the court held that the plaintiff had not "included sufficient allegations to support a finding that Galectin had 'ultimate authority' or 'control' over the stock promoters' statements." Citing *Janus*, the court explained that even one who "prepares or publishes a statement on behalf of another is not its maker." With this in mind, the court further reasoned that the plaintiffs' allegations that Galectin "worked in conjunction with stock promoters to promote Galectin's stock" were insufficient to support a finding that Galectin had "ultimate authority." Consequently, the court held that Galectin was not the maker of the statements. Separately, the court also affirmed dismissal of plaintiffs' claim Galectin "made material misstatements and omissions of fact by not disclosing that it had paid the promotional firms to tout [its] stock."

In ***In re Banco Bradesco S.A. Sec. Litig.***, -- F.Supp. 3d --, 2017 WL 4381407 (S.D.N.Y. Sept. 29, 2017), the court considered the impact of *Janus* on the group-pleading doctrine, which allowed a presumption that certain written statements, such as press releases and financial statements, are published by the officers and directors involved with day-to-day control or involvement in regular company operations. Reviewing a split of authority within the Southern District of New York, the court concluded that "the group-pleading doctrine does not survive *Janus*." While the court agreed that "nothing in *Janus* dictates that only one person may have ultimate authority over a statement," it reasoned that the group-pleading doctrine "was not designed to create a presumption of ultimate authority" and presumed "participation in the creation of a statement" is not enough under *Janus*. Instead of relying on the group-pleading doctrine, the court held that a plaintiff "must allege facts showing, either directly or circumstantially, that the individual defendants named in the complaint possessed ultimate authority over the statements at issue." Applying that test to the statements found to be actionable, the court concluded that some were "made" by all of the individual defendants, whereas plaintiff failed to allege facts suggesting that some of the individual defendants had ultimate authority over other alleged misstatements.

These cases demonstrate that courts are strictly interpreting "ultimate authority" under *Janus* in determining the "maker" of a false or misleading statement.

Courts continue to grapple with applying *Janus.*

VIII. Loss Causation

A plaintiff in a securities fraud case under the Securities Exchange Act of 1934 must plead and later prove loss causation—the causal connection between the fraudulent misrepresentations underlying a claim and the economic loss suffered by the plaintiff. The absence of loss causation, or "negative causation," is also a defense to claims brought under the Securities Act of 1933. While the Supreme Court did not address loss causation in 2017, several circuit and district courts addressed loss causation issues at the pleading stage.

In ***Cutler v. Kirchner***, 696 Fed. App'x. 809 (9th Cir. 2017), the Court of Appeals for the Ninth Circuit considered whether plaintiffs adequately pled loss causation as to two theories of liability. The court first held that loss causation was pled at to alleged misstatements that a new product rollout was going smoothly. A later disclosure of invoicing problems related to that product could have been understood by a reasonable investor as indicating those prior assurances were false, and was thereby sufficient to plead loss causation. In contrast, the court found a failure to plead loss causation as to alleged deficiencies in internal controls over financial reporting. While the company had later revealed internal control deficiencies in March 2014, the loss alleged by the investor occurred a month earlier in February 2014. Because the plaintiff failed to plead facts showing that the market understood the February 2014 disclosure as revealing accounting issues, the alleged misstatement could not have been a substantial factor in identified economic loss.

Two district court decisions from within the Ninth Circuit similarly addressed whether there was a sufficient connection between the alleged misstatements and the alleged corrective disclosure. In ***In re Finisar Corp. Securities Litigation***, No. 5:11-cv-01252, 2017 WL 1549485 (N.D. Cal. May 1, 2017), the district court considered allegations that Finisar defrauded investors by issuing misleading statements denying that its customers were building-up inventory. Loss causation was adequately pled because Finisar later announced that revenues were down due to inventory build-ups by customers, leading to a 39% stock price decline. It was sufficient, the court held, that the alleged corrective disclosure "relate[d] to the same subject matter as the alleged misrepresentation." In ***Knox v. Yingli Green Energy Holding Co. Ltd.***, 242 F. Supp. 3d 950 (C.D. Cal. 2017), in contrast, the court found an insufficient connection to plead loss causation in a case alleging misleading public disclosures about the collectability of a substantial debt from a specific customer. Plaintiffs pointed to alleged corrective disclosures when Yingli recorded a bad debt reserve and later wrote-off overvalued accounts receivable. The court rejected that theory, reasoning that plaintiffs pled no specific facts to show the specific customer debt was at issue in the alleged corrective disclosures or that the market learned of any alleged fraud regarding that customer debt.

Another case from within Ninth Circuit focused on whether publishing already-public information constitutes a corrective disclosure. In ***In re Banc of California Securities Litigation***, No. SACV 17-00118, 2017 WL 3972456 (C.D. Cal. Sept. 6, 2017), the plaintiffs' alleged a blog post disclosing ties between Banc of California's CEO and a convicted felon. After the blog post was published, the value of Banc shares dropped 29%. Defendants claimed the blog post was not a corrective disclosure because the information was publically available, although not all in one place. While the blog post did use publically available information, the court announced a difference between types of public information. Articles or blog posts can be corrective disclosures, even when based on public information, if they provide additional or more authoritative information to the market about the fraud. Here, the blog post added to the otherwise publically available information, so the market reacted to new information and a causal connection was shown.

Two other cases, from the Ninth and Sixth Circuits, reflect different approaches to the question of whether allegations of fraud constitute a corrective disclosure. In ***Curry v. Yelp Inc.***, 875 F.3d 1219 (9th Cir. 2017) the court agreed with the district court that the disclosure of over 2,000 consumer complaints by the Federal Trade Commission, without more, was not enough to allege loss causation. The Ninth Circuit reasoned that when alleging loss causation the "mere risk or potential for fraud is insufficient." The plaintiffs failed to adequately plead loss causation because a plaintiff is not allowed to look at a number of customer complaints and assert "where there is smoke, there must be fire." The court found the disclosure of consumer complaints was akin to the SEC announcing an investigation of a company. Without more, the market is merely speculating on an outcome. The plaintiff must plead more to link the disclosure to a fraudulent statement.

In contrast, the Sixth Circuit in ***Norfolk County Retirement System v. Community Health Systems, Inc.***, 877 F.3d 687 (6th Cir. Dec. 13, 2017) found that loss causation was adequately pled based on allegations made in a lawsuit by a competitor. There, shareholders of Community Health alleged securities fraud stemming from fraudulent Medicare practices. The district court originally found plaintiffs' loss causation theory implausible, reasoning that the market would not speculate on allegations by a competitor. The Sixth Circuit reversed, finding that here, based on the detailed nature of the competitor's allegations and later corroboration by officers of Community Health, the allegations were sufficient credible to constitute a corrective disclosure.

The Second Circuit also addressed causation in the context of the negative causation defense under Section 12 of the Securities Act of 1933. In ***Federal Housing Finance Agency v. Nomura Holding America, Inc.***, 873 F.3d 85 (2nd Cir. 2017), the Second Circuit affirmed the lower court's decision that investment banks were liable under Section 12 and rejected Defendants' negative causation defense. According to the court, the only way the defendants could break the causal link was by proving that "the risk that caused the loss[es] was [not] within the zone of risk concealed by the misrepresentations and omissions." Also, "any difficulty separating loss attributable to a specific misstatement from loss attributable to macroeconomic forces benefits the plaintiff." Defendants could not show losses were solely caused by the 2008 financial crisis and not related to misstatements about mortgage-backed securities because the misstatements were intimately intertwined with the collapse of the mortgage market.

IX. SEC Enforcement Activities

CASE LAW DEVELOPMENTS

In addition to *Kokesh*, discussed above, two federal court opinions issued this year are likely to have lasting impacts on the government's securities enforcement efforts.

In ***U.S. v. Martoma***, the Second Circuit significantly broadened potential liability for insider tippers and their downstream tippees. 869 F.3d 58 (2d Cir. 2017). In that case, a jury convicted portfolio manager Matthew Martoma of insider trading based on allegations that he had received tips from two doctors involved in clinical trials for an experimental Alzheimer's drug. Martoma appealed his conviction, arguing that the facts did not satisfy the standard for tippee liability set forth by the Second Circuit in its 2015 decision in *United States v. Newman*. In *Newman*, the court had held that to satisfy the "personal benefit" requirement for tipper/tippee liability, there must be some proof of a "meaningfully close personal relationship" that "generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."

The Second Circuit upheld Martoma's conviction. According to the court, the Supreme Court's 2016 opinion in *Salman v. U.S.*, 137 S. Ct. 420, had so significantly abrogated *U.S. v. Newman* that *Newman*'s "meaningfully close personal relationship" requirement for tipper/tippee liability was no longer good law. Instead, an insider or tipper personally benefits from a disclosure of inside information any time the disclosure is made with the expectation that the tippee will trade on the information, *regardless of whether there is a "meaningfully close personal relationship" between tipper and tippee*. Because a gift of confidential information is the functional equivalent of a cash gift—regardless of the relationship between tipper and tippee—the determination of tipper/tippee liability in insider trading cases should hinge on whether the disclosure was made "with the expectation that the recipient would trade on [it]." Because this holding expands insider trading liability, executives, directors, and other officers or employees of public companies (and those who advise them) should take note.

Separately, the Ninth Circuit Court followed the approach of other circuit courts in applying whistleblower protections not only to those who report suspected violations to the SEC, but also those who report violations internally. ***In Somers v. Digital Realty Trust, Inc.*** plaintiff Paul Somers reported possible securities law violations to his company's senior management and was soon after fired. 850 F.3d 1045 (9th Cir. 2017). Somers sued the company, alleging it violated Section 21F of the Securities Exchange Act of 1934 ("Section 21F"), which was enacted pursuant to the Dodd-Frank Act and prohibits retaliation against corporate whistleblowers.

Digital Realty Trust ("DRT") filed a motion to dismiss Somers's lawsuit. According to DRT, Section 21F does not protect internal whistleblowers, but instead protects only those who report potential violations to the Securities and Exchange Commission. As support, DRT pointed to the definition of "whistleblower" in Section 21F: "any individual who provides … information relating to a violation of the securities laws *to the Commission*." In DRT's view, only those who report violations to the SEC are thus protected.

The district court and the Ninth Circuit disagreed. Although the definition of "whistleblower" in the statute is arguably limited to internal reporters, Section 21F goes on to prohibit retaliation against whistleblowers "making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002." Sarbanes-Oxley in turn prohibits retaliation against not only employees who report suspected violations to regulators, but also those who report to "a person with supervisory authority over the employee." Recognizing the potential ambiguity between the definition and the operative text of the statute, the Ninth Circuit analyzed congressional intent and practical implications in concluding that Section 21F protects both internal whistleblowers and whistleblowers who report to the SEC.

The Supreme Court granted certiorari in this case and heard oral arguments in November 2017.

The Ninth Circuit held that internal whistleblowers are entitled to the same protections as those who report to the SEC.

SUPREME COURT TO CONSIDER ADMINISTRATIVE LAW JUDGES

The Supreme Court also has granted certiorari in a case that may resolve a circuit split regarding the constitutionality of the SEC's administrative law judges ("ALJs"). This issue has been hotly contested since Congress significantly expanded ALJs' authority in the Dodd-Frank Act and the SEC seemed to increase its use of administrative proceedings in enforcement actions as a result.

In August 2016, the D.C. Circuit ruled in *Raymond J. Lucia Cos. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016) that the Commission's process for hiring administrative law judges was constitutional and did not violate the Appointments Clause. According to the court, ALJs act as mere employees of the Commission, and their decisions are referred to the Commission for final approval. Thus, they are not "officers" whose appointments must be executed in accordance with the Appointments Clause of the Constitution.

The D.C. Circuit's holding in *Lucia* is in conflict with the Tenth Circuit's 2016 decision in *Bandimere v. SEC*, 844 F.3d 168 (10th Cir. 2016). In that case, the court held that the Commission's ALJs were in fact "inferior officers" who exercise significant discretion in their work. Thus, they must be appointed by the President, the head of the agency, or a court of law in accordance with the Appointments Clause, contrary to the practice of the Commission.

The Supreme Court has agreed to hear *Lucia*'s appeal from the D.C. Circuit, setting the stage for a decision that could have major implications for the Commission's appointments process and could call into question any decisions previously issued by sitting ALJs. In November, while *Lucia*'s petition to the Supreme Court was pending, the U.S. Solicitor General filed a brief in the case, reversing course and taking the position that ALJs are in fact inferior officers who must be appointed in accordance with the Appointments Clause. The Solicitor General went on to ask the Supreme Court to hear *Lucia*'s case in order to finally resolve the issue regarding the constitutionality of ALJs. The following day, the SEC ratified the appointments of its sitting ALJs, hoping to quell any concerns about the ALJs' authority. Oral argument has not yet been scheduled for *Lucia*.

ENFORCEMENT INITIATIVES

Outside the courtroom, the SEC remains active enforcing the securities laws and announced new initiatives in that regard. In September, the Commission announced the creation of a Retail Strategy Task Force to strengthen its protection of retail investors and a Cyber Unit to target cyber-related misconduct. According to the announcement, the Retail Strategy Task Force will prioritize strategies that target misconduct impacting retail investors, generally those who purchase securities for their own personal accounts. More specifically, the Commission intends to target the sale of unsuitable structured products and microcap pump-and-dump schemes, among other things. The task force aims to leverage data analytics and utilize enforcement personnel around the country to protect what the Commission deems the "most vulnerable market participants."

The Commission's new Cyber Unit will leverage the Enforcement Division's existing cyber-related expertise to target misconduct born of the internet, including market manipulation schemes spread through electronic and social media, hacking to obtain material nonpublic information, intrusions into retail brokerage accounts, and violations involving initial coin offerings ("ICOs") and distributed ledger technology.

We saw the new Cyber Unit file its first charges in December 2017. In a federal court complaint filed against PlexCorps, its owner, and the owner's business partner, the Commission alleged that the respondents marketed and sold securities called PlexCoin on the internet, allegedly claiming that the coins would yield a 1,354% profit in less than 29 days. The SEC alleged that this ICO constituted violations of the registration and anti-fraud provisions of federal securities laws. The SEC obtained an emergency court order to freeze the respondents' assets.

In a separate action, the SEC halted an ICO by Munchee, Inc., a California-based company that sought to sell digital tokens to investors to raise capital for its blockchain-based food review service. According to the SEC, the company told investors that its business activities would lead to an increase in value of the tokens it was selling and that the company would promote a secondary market for the tokens. This, the SEC alleged, suggested that investors in the endeavor would derive their profits from the managerial and entrepreneurial efforts of others, a basic test in

determining whether certain transactions qualify as investment contracts subject to federal securities laws. After being contacted by the Commission regarding its offering, the company immediately halted the offering, returned all investor capital, and cooperated with the staff's investigation. As a result, the SEC did not impose a penalty. Nonetheless, the Commission's view of such offerings has been made clear. It will not hesitate to characterize ICOs as securities offerings subject to registration requirements.

We can expect to see much more activity out of the Enforcement Division's new Cyber Unit in the coming years.

The SEC's new Cyber Unit halted ICOs it said violated registration provisions of federal securities laws.

X. Notable Developments in State Law Actions and Fiduciary Litigation

APPLICABILITY OF BUSINESS JUDGMENT REVIEW

Delaware courts this year continued to provide additional guidance this year on when the deferential business judgment rule will apply when transactions are challenged in courts. The courts built on the Delaware Supreme Court's landmark case of ***Corwin v. KKR Financial Holdings LLC***, 125 A.3d 304 (Del. 2015), which held that business judgment review can apply to when a transaction is approved by a fully informed, uncoerced vote of the disinterested stockholders. The law also continued to develop in the wake of ***Kahn v. M & F Worldwide Corp.***, 88 A.3d 635 (Del. 2014) ("*MFW*"), which established that an acquisition of a company by its controlling stockholder can receive business judgment review if the transaction is conditioned on approval of both the majority of the minority and an independent special committee.

In ***In re Volcano Corp. Stockholder Litigation*** 156 A.3d 697 (Del. 2017), the Delaware Supreme Court summarily affirmed the Court of Chancery's opinion applying business judgment review to a tender offer transaction. The plaintiffs sued following a tender offer and cash-out merger at a price of $18 per share that occurred only five months after the target company declined an offer of $24 per share. The merger, however, had been approved by a majority of the target's stockholders through the tender offer. Applying *Corwin*, the court dismissed the complaint and concluded that business judgment review—rather than enhanced *Revlon* scrutiny that would ordinarily apply in a cash-out merger—applied because the stockholders were informed and uncoerced. Business judgment review applied even though the stockholder approval occurred pursuant to a statutorily-required tender offer rather than a stockholder vote due to the transaction's structure. Accordingly, Delaware courts have now clarified that a tender offer has the same cleansing effect as a stockholder vote under *Corwin*. Such transactions may only be challenged on grounds of waste, which would be a difficult claim for a plaintiff to maintain in the face of an informed, uncoerced stockholder approval.

By contrast, two Chancery Court opinions demonstrate that the ability to take advantage of *Corwin* cleansing is not without its limits. In ***In re Saba Software, Inc. Stockholder Litigation***, No. 10697, 2017 WL 1201108 (Del. Ch. Apr. 11, 2017), after a series of missteps that resulted in the SEC revoking the registration of its stock, Saba was acquired in a cash-out merger. Although a majority of stockholders approved the merger, the court held that business judgment review did not apply because the plaintiff had sufficiently pled that the vote was coerced and uninformed. The vote was coercive because the stockholders had no real choice in that they either had to approve the merger or else be left with illiquid shares that had been deregistered. The vote was also uninformed because stockholders had insufficient information regarding company's prospects for having its shares reregistered in the future or what the possible alternatives to the merger might have been.

Similarly, in ***Sciabacucchi v. Liberty Broadband Co.***, No. 11418, 2017 WL 2352152 (Del. Ch. May 31, 2017), the court held that *Corwin* cleansing was not available. A company's board had tied multiple potential transactions together such that the only way that stockholders could get the benefit of an unquestionably beneficial transaction was if they also approved a separate transaction that involved issuing additional equity to a large shareholder. Although the court rejected the plaintiff's argument that the large shareholder was a controlling shareholder—which would have required both a vote of the disinterested minority and the approval of a special committee of the board to cleanse the transaction—the court found that the transaction failed to qualify for business judgment review under *Corwin*. The plaintiff had adequately pled that the stockholder vote approving the transaction was "structurally coercive" because it conditioned the receipt of the underlying transaction's benefits on approval of an extraneous agreement. Together, *In re Saba Software* and *Sciabacucchi* show that the *Corwin* standard has teeth and that courts will only apply it after giving careful scrutiny to whether stockholder approvals were truly informed and uncoerced.

In ***In re Martha Stewart Omnimedia, Inc. Stockholder Litigation***, No. 11202, 2017 WL 3568089 (Del. Ch. Aug. 18, 2017), the Court of Chancery was faced with a transaction structure that did not precisely mirror *MFW* and had to determine whether the *MFW* cleansing rules should nevertheless apply. The company was acquired by a third-party buyer rather than by the company's controlling stockholder. The plaintiffs alleged that the controller—Martha Stewart—leveraged her position to get greater consideration for herself. However, the transaction was approved by both an independent special committee and a majority of the minority. In these circumstances, the court held that *MFW* was applicable despite the fact that the controlling stockholder was a seller in the transaction rather than the buyer. Accordingly, business judgment review applied and the case was dismissed.

These cases reinforce that parties considering a merger transaction should consider making it subject to approval by disinterested stockholders, whether through a vote or a tender offer. It is also important to ensure that stockholders are fully informed and uncoerced. When a controlling stockholder is involved, the transaction should also be made subject to the approval of an independent special committee. These steps should provide the parties with a more deferential standard of review if the transaction is challenged in court and make post-closing damages cases more difficult to bring.

APPRAISAL CASES PROVIDE ADDITIONAL GUIDANCE ON APPLICABILITY OF MERGER PRICE

When a company is acquired, its shareholders who do not believe the price was fair generally have the right to have their shares appraised by a court under certain circumstances and receive the appraised "fair value" rather than the negotiated merger price. Some investors have sought to take advantage of appraisal statutes by investing in to-be-acquired companies for the sole purpose of seeking appraisal. In 2017, Delaware courts continued to wrestle with the relevance of the merger price to "fair value" under the appraisal statute.

In ***In re Appraisal of SWS Group, Inc.***, No. 10554, 2017 WL 2334852 (Del. Ch. May 30, 2017), the Court of Chancery rejected the merger price as indicative of fair value. Significantly, neither side argued for the deal price, with the plaintiff asking for a premium of 50% and the company arguing for a valuation 50% below the deal price. While the court acknowledged that deal price is often the best indication of fair value, it found that due to certain structural issues at the company and issues that arose in the sale process, a discounted cash flow analysis would be the best way to determine fair value in the case before it. After that analysis, the court concluded that the fair value was $6.38 per share, less than the deal price of $6.92. This case demonstrates to potential plaintiffs that there is risk in exercising appraisal rights and that they should not presume that the deal price is a floor or their worst case scenario.

In ***DFC Global Corp. v. Muirfield Value Partners, L.P.***, 172 A.3d 346 (Del. 2017), the Delaware Supreme Court provided more clarity on the appraisal standards, but did not set any bright line rules. The court rejected a rule that would establish a presumption that the transaction price in an arm's-length merger is the best estimate of fair value, instead holding that that the appraisal analysis must consider "all relevant factors." On the facts before it, however, the court reversed the Chancery Court's decision to deviate from the merger price, holding that it had given too little weight to the merger price. The arm's-length transaction included a robust market check with no deal protections and no suggestion of self-interest. On these facts, the lower court's unexplained decision to give only a one-third weight to the deal price was inappropriate. The Supreme Court remanded the case for a re-appraisal and strongly suggested that the deal price should be given more, or even exclusive, weight, but in any event held that appraising courts "must explain [their] weighting in a manner supported by the record." While *DFC Global* may be disappointing to companies who would have preferred a bright-line rule, it nevertheless can provide strong support for using the merger price as the fair price in future cases, particularly where there are no concerns with the transaction's process.

Similarly, the Delaware Supreme Court reversed the Chancery Court for failure to appropriately consider the deal price in ***Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.***, -- A.3d --, 2017 WL 6375829 (Del. 2017). The trial court relied exclusively on its own discounted cash flow analysis to reach a fair value of $17.62 per share, a significant increase over the deal price of $13.75, which itself already reflected a 37% premium over pre-deal trading prices. The trial court gave no weight to the deal price upon concluding that the market for Dell shares was inefficient. The Supreme Court disagreed and concluded that because the market was efficient, the deal price was "likely a possible proxy for fair value." There were other flaws with the trial court's analysis as well, but essentially the Supreme Court held that it was error for the trial court to rely "exclusively" on its own analysis while giving no weight at all to the deal price.

While the case law continues to develop, these cases demonstrate that appraisal litigation from opportunistic investors who seek a premium for their shares in excess of a fairly negotiated merger price will likely continue. Although defendants do not have the certainty they would prefer of a bright-line rule favoring deal price as fair value, the development of the law may make it increasingly difficult for investors to obtain a premium.

Appraisal cases may be less common after 2017's decisions.

BATTLES OVER CORPORATE CONTROL AND APPOINTMENT OF A CUSTODIAN

The Delaware Supreme Court in ***Shawe v. Elting***, 157 A.3d 152 (Del. 2017), was faced with litigation involving "dysfunction and deadlock" in a profitable, closely-held company. It was undisputed that the owners were unable to elect directors due to the deadlock and that the company faced serious risk of harm unless the status quo changed. One side in the dispute favored appointing a custodian pursuant to a Delaware statute to sell the business and distribute the proceeds to the owners. The other side wanted the courts to fashion a less drastic remedy. The Supreme Court ultimately affirmed the lower court's decision to appoint a custodian. The court held that a custodian may properly sell a company even over a stockholder's objections if a court has ordered the custodian to do so. On the facts before it, no less drastic remedy would have been feasible.

One takeaway from *Shawe* is to be aware of the risks of corporate structures that allow for the possibility of deadlock. Those forming corporations and other entities should consider having procedures in place in their organizational documents to prevent deadlock if possible. Otherwise, parties can find themselves at the mercy of the courts in deciding what happens to a company they own.

CLARIFIED STANDARDS REGARDING EXCUSING PRE-SUIT DEMAND DUE TO LACK OF DIRECTOR INDEPENDENCE

Before shareholders in Delaware corporations can bring a derivative suit on behalf of the company, they generally must first make a demand on the company's board to bring the action. This requirement can be excused only if the shareholder pleads particularized facts demonstrating that a majority of the board is not disinterested or independent with respect to the challenged corporate action. Shareholder plaintiffs often bring suit without making a demand and argue that demand would have been futile. Thus, litigating demand futility at the pleading stage is often the whole ballgame in derivative suits.

At the very end of 2016, the Delaware Supreme Court provided additional guidance on the applicable demand-futility pleading stage standards. ***Sandys v. Pincus***, 152 A.3d 124 (Del. 2016). The shareholder plaintiff brought a derivative suit premised on alleged insider trading. The defendants moved to dismiss due to the plaintiff's failure to make a pre-suit demand. The company's board consisted of nine members, two of which participated in the challenged transaction. One of those two directors was also the company's controlling stockholder, so the company's CEO, who was also on the board, lacked independence. Therefore, the inquiry as to whether a majority of the board was disabled from considering a demand turned on whether the plaintiff could establish that two additional directors lacked independence. The Court of Chancery held that the additional directors were all independent and dismissed the complaint.

The Supreme Court reversed, finding that plaintiff had met its burden to plead that a majority of the board was disabled from considering a demand. A fourth director was held not to be independent because she and her husband co-owned an airplane with one of the interested directors. This arrangement "signaled an extremely close, personal bond" between the two directors and their families. Two additional directors also lacked independence. They were partners in an entity that both (1) owned approximately 9% of the company's equity, and (2) invested in another company founded by the wife of one of the interested directors. Significantly, they were also classified as non-independent directors under NASDAQ rules, and the Supreme Court relied heavily on that fact in concluding that they were not independent for demand futility purposes.

Sandys serves as a reminder that directors and companies who wish to end derivative suits early would do well to structure their boards to avoid entangling relationships between directors. Although there is nothing wrong with having overlapping personal and professional ties among directors, companies should consider the risk that such ties could lead to the company being bogged down in expensive derivative litigation.

COLLATERAL ESTOPPEL IN DEMAND FUTILITY CONTEXT

In recent years, courts have struggled with whether collateral estoppel should bar future derivative suits based on the same allegations when one shareholder has already had a case dismissed for failure to plead facts that would establish demand futility. The situation usually arises when one shareholder has a derivative complaint dismissed after filing without first seeking the company's books and records pursuant to 8 Del. C. § 220, and then another shareholder seeks to bring a derivative suit with the benefit of the company's internal documents. In this scenario, given that both suits were nominally brought in the company's name, is the second suit barred by the doctrine of collateral estoppel, particularly the decision in the first suit that demand was not futile?

The Delaware Supreme Court began to provide guidance on this issue in ***California State Teachers Retirement System v. Alvarez***, 2017 Del. LEXIS 34 (Del. Jan. 18, 2017). Several shareholder plaintiffs sued in Arkansas regarding an alleged Wal-Mart bribery scandal. They did not seek books and records before suing. Other plaintiffs did seek books and records—as the Delaware Supreme Court has repeatedly advised derivative plaintiffs to do—and sued in Delaware. An Arkansas federal judge dismissed the Arkansas plaintiffs' complaint for failure to plead demand futility. The defendants then argued that that decision had collateral estoppel effect in Delaware, and the Court of Chancery agreed. The Supreme Court criticized both groups of plaintiffs for failing to coordinate their efforts, which resulted in the potential preclusive effect of the Arkansas judgment. Nevertheless, the Supreme Court remanded for additional proceedings, finding that there may be an argument that the Delaware plaintiffs' federal due process rights would be violated if the Arkansas judgment were to be given collateral estoppel effect. Accordingly, the federal due process clause could "arguably prevent[] a judgment from binding the corporation or other stockholders in a derivative action until the action has survived" a motion to dismiss based on demand futility. However, because its analysis was based in large part on Delaware law rather than the applicable federal law, the Supreme Court remanded (rather than reversing) for the Court of Chancery to more fully consider the federal due process issues.

On remand, the Court of Chancery concluded that under existing law, the Delaware plaintiffs' claims were arguably precluded by the dismissal of the Arkansas plaintiffs' claims, but recommended the Delaware Supreme Court had adopt a new bright line rule that a dismissal on demand futility grounds does not bind other stockholders bringing the same claims. ***In re Wal-Mart Stores, Inc. Delaware Derivative Litigation***, 167 A.3d 513 (Del. Ch. 2017). The issue is again pending before the Delaware Supreme Court.

The *Wal-Mart* litigation will likely change the landscape for derivative litigation when more than one suit is brought. When there is both a first-filed complaint that is relatively weak and a later-filed complaint with stronger allegations, defendants and public companies will no longer have an incentive to try litigate the demand futility issue as quickly as possible in the weaker suit. It remains to be seen whether defendants will be faced with an increase in duplicative litigation or if the plaintiffs' bar will heed the courts' admonitions to coordinate their efforts.

Late-breaking news: in January 2018, the Delaware Supreme Court held in *Wal-Mart* that the Delaware case was precluded by the prior Arkansas case.

SHAREHOLDER ACCESS TO A CORPORATION'S BOOKS AND RECORDS

This year the Delaware courts continued to develop the law regarding when a shareholder can access the corporation's books and records pursuant to Section 220, which generally gives shareholders a right to inspect internal documents when they make a demand and identify a "proper purpose." Litigation frequently focuses on whether the shareholder in fact has a proper purpose.

In ***Weingarten v. Monster Worldwide, Inc.***, No. 12931, 2017 WL 752179 (Del. Ch. Feb. 27, 2017), the court considered whether a stockholder who makes a books and records demand and thereafter has his ownership interest extinguished pursuant to a merger has standing to receive books and records. At the time of the books and records demand, the stockholder owned shares and sought to investigate potential claims against members of the board in connection with the announced merger, which is generally a proper purpose under Delaware law. The merger then closed before the stockholder's demand could be resolved and before the stockholder filed a Section 220 action. Relying on the plain language of Section 220, which provides that a stockholder show that it "is" a stockholder to be entitled to books and records, the court held that the merger extinguished the plaintiff's standing. Therefore, the parties' policy arguments were largely irrelevant. Other cases that had permitted post-closing inspection were also inapplicable because in those cases the plaintiffs had actually filed their Section 220 complaints before closing. Although defendants can use *Weingarten* to look for opportunities to challenge a former stockholder's standing in merger cases, the plaintiffs' bar is likely to learn their lesson and will try to avoid a repeat of the *Weingarten* scenario by making sure they have their Section 220 complaints on file before mergers close.

The Chancery Court in ***City of Cambridge Retirement System v. Universal Health Services, Inc.***, No. 2017-0322, 2017 WL 4548460 (Del. Ch. Oct. 12, 2017), dealt with the issue of what conditions a court may permissibly place on a shareholder's access to Section 220 books and records. The statute permits courts to "prescribe any limitations or conditions" on a Section 220 inspection. The court accepted the defendants' request that a Section 220 inspection be conditioned on a requirement that any complaint in subsequent litigation relying on documents from the inspection be deemed to have incorporated by reference all documents made available in the inspection. This rule is advantageous to defendants in derivative suits, who can then potentially have claims dismissed on the pleadings by using documents outside the complaint in cases where plaintiffs cherry-pick the documents they use in the complaint to create a misleading impression. In light of this case, when faced with a books and records demand, corporations should, in consultation with outside counsel, strongly consider refusing to provide documents unless and until the shareholder agrees that all documents provided will be deemed incorporated by reference into any future complaint. Such a step can greatly increase the likelihood of a successful motion to dismiss.

In ***Lavin v. West Corp.***, No. 2017-0547, 2017 WL 6728702 (Del. Ch. Dec. 29, 2017), the Court of Chancery analyzed whether defendants can use the *Corwin* doctrine to prevent otherwise proper Section 220 inspections. The company had entered into a merger agreement, and it contended that a majority of the disinterested stockholders approved the merger in a fully informed, uncoerced vote. A stockholder made a Section 220 demand to investigate possible breaches of fiduciary duties in connection with the merger, and the company declined to permit an inspection. In the company's view, because the disinterested stockholders approved the merger, business judgment rule applied, and therefore the stockholder could only state a "proper purpose" to inspect books and records if he challenged the merger on grounds of waste. The court rejected this argument, holding that *Corwin* cannot be used in this manner because applying it to prevent a Section 220 inspection would require the court to prematurely adjudicate a merits defense. It would defeat the purpose of stockholder access to books and records to permit companies to prevent inspection by litigating merits defenses to the potential claims that a stockholder seeks to investigate. While *Corwin* has been a powerful new tool for companies and directors to obtain business judgment review, *Lavin* shows that attempts to extend the doctrine into other contexts will not necessarily be successful.