February 2017 / Volume 9 / Issue 1

Skadden

Inside the Courts
An Update From Skadden Securities Litigators

1 / **US Supreme Court**
Salman v. United States (U.S. Dec. 6, 2016)

1 / **Auditor Liability**
In re DNTW Chartered Accountant Sec. Litig. (2d Cir. Dec. 15, 2016)
Se. Pa. Transp. Auth. v. Orrstown Fin. Servs., et al. (M.D. Pa. Dec. 7, 2016)

2 / **Class Actions — Settlements**
Gordon v. Verizon Commc'ns, Inc. (1st Dep't Feb. 2, 2017)

3 / **Collateral Estoppel and Due Process**
Cal. State Teachers' Ret. Sys. v. Alvarez (Del. Jan. 18, 2017)

3 / **ERISA**
Tibble, et al. v. Edison Int'l, et al. (9th Cir. Dec. 16, 2016)

4 / **Fiduciary Duties**
Horman v. Abney (Del. Ch. Jan. 19, 2017)
In re Solera Holdings, Inc. Stockholder Litig. (Del. Ch. Jan. 5, 2017)

4 / **Forward-Looking Statements**
Zaghian v. Farrell, et al. (9th Cir. Jan. 12, 2017)

5 / **Initial Public Offerings**
Lowinger v. Morgan Stanley & Co., LLC, et al. (2d Cir. Nov. 3, 2016)

5 / **Loss Causation**
Youngers v. Virtus Inv. Partners Inc., et al. (S.D.N.Y. Jan. 6, 2017)

6 / **Misrepresentations**
Ganem v. InVivo Therapeutics Holdings Corp. (1st Cir. Jan. 9, 2017)
Fosbre v. Las Vegas Sands Corp., et al. (D. Nev. Jan. 3, 2017)

6 / **Registration Statement Liability**
In re Jumei Int'l Holding Ltd. Sec. Litig. (S.D.N.Y. Jan. 10, 2017)
Rudman v. CHC Grp. Ltd. (S.D.N.Y. Nov. 7, 2016)

7 / **Scienter**
In re ARIAD Pharm., Inc. Sec. Litig. (1st Cir. Nov. 28, 2016)

8 / **Securities Exchange Act**
Ave. Capital Mgmt. II, L.P. v. Schaden (10th Cir. Dec. 13, 2016)

8 / **SLUSA**
Rainero v. Archon Corp. (9th Cir. Dec. 21, 2016)
Fernandez v. UBS (S.D.N.Y. Dec. 7, 2016)

9 / **Statutes of Repose/Statutes of Limitations**
W. Va. Pipe Trades Health & Welfare Fund v. Medtronic, Inc. (8th Cir. Dec. 28, 2016)
The Most Worshipful Grand Lodge of Free & Accepted Masons of the State of Arkansas v. DCG/UGOC Equity Fund, LLC (E.D. Ark. Oct. 19, 2016)

Inside the Courts
An Update From Skadden Securities Litigators

US Supreme Court

US Supreme Court Reaffirms That Insider's Gift of Confidential Information to Relative or Friend Can Establish Personal Benefit Under Insider Trading Laws

Salman v. United States, No. 15-628 (U.S. Dec. 6, 2016)
Click here to view the opinion.

The U.S. Supreme Court reaffirmed its holding in *Dirks v. SEC*, 463 U.S. 646 (1983), that an insider's gift of confidential information to a relative or friend can establish "personal benefit" under Section 10(b) of the Securities Exchange Act and Rule 10b-5. In this case, an investment banker shared confidential information with his brother, who in turn passed it on to his friend (and the banker's brother-in-law), who traded on it. A jury convicted the brother-in-law of securities fraud, and the Ninth Circuit affirmed, reasoning that the banker's "disclosures to [his brother] were 'precisely the gift of confidential information to a trading relative that *Dirks* envisioned.'" 137 S. Ct. 420, 425 (quoting *United States v. Salman*, 792 F.3d 1087, 1092 (9th Cir. 2015)).

The Supreme Court affirmed, explaining that *Dirks*' rule that a tipper breaches a fiduciary duty (and a personal benefit to the tipper can be inferred) when he makes a gift of confidential information to a "trading relative" controlled the case. The banker's disclosure of confidential information to his brother, and his brother-in-law's subsequent trading, achieved the same result that would have transpired had the banker traded on the confidential information himself and then given the proceeds to his brother — which would have been a clear breach of fiduciary duty. The banker's disclosure of confidential information to his brother thus breached his duty of trust to his employer, a duty that the brother-in-law acquired and also breached by trading on the information with knowledge of the impropriety. In so ruling, the Court abrogated *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014), a Second Circuit decision that held that the *Dirks* inference of personal benefit required proof that the tipper gained something of a "pecuniary or similarly valuable nature" in exchange for a gift to family or friends.

Auditor Liability

Second Circuit Affirms District Court's Dismissal of Securities Fraud Claims Against an Auditor for Lack of Scienter

In re DNTW Chartered Accountant Sec. Litig., No. 16-1168 (2d Cir. Dec. 15, 2016)
Click here to view the opinion.

The Second Circuit has affirmed the dismissal of claims under Section 10 of the Securities Exchange Act against an auditor of a publicly traded company because the plaintiffs failed to sufficiently allege scienter. The plaintiffs claimed that the defendants recklessly issued clean audit reports for the company, even though the company allegedly had "no real business operations." The court determined that to allege recklessness under Section 10, plaintiffs were required to plead that the auditor had disregarded signs of fraud so obvious that it must have been aware of them. Mere allegations of generally accepted accounting principles (GAAP) violations or accounting irregularities, or even a lack of due diligence, are insufficient to state a claim. Although the plaintiffs alleged that the auditor had recklessly ignored the company's deficient internal controls, the Second Circuit affirmed the dismissal, finding that defendants had expressly avoided providing an opinion with respect to the internal controls and sought outside opinions on the company's finances. Although the auditor allegedly relied only on documents provided by the company and accepted financial information from the company's bookkeeper, they were not reckless in doing so. The court also affirmed the dismissal of claims against certain individual defendants under Section 20 of the Securities Exchange Act because the plaintiffs had failed to allege a primary violation.

Independent Auditor Not Liable for Sincerely Held Opinion on Issuing Company's Internal Controls That Was Later Proven False

Se. Pa. Transp. Auth. v. Orrstown Fin. Servs., et al., No. 1:12-cv-009933 (M.D. Pa. Dec. 7, 2016)
Click here to view the opinion.

The Middle District of Pennsylvania dismissed in part a putative securities class action filed after the company announced it had a "material weakness" in its internal controls. The court held that the company's independent auditor was not liable for a "clean" audit opinion where the auditor sincerely believed its opinion was correct.

The plaintiff claimed that 2010 offering documents contained false and misleading statements regarding the effectiveness of the company's internal controls over underwriting of loans, risk management, financial reporting, and compliance with banking regulations. In 2011, the company reported significant losses, and, in early 2012, disclosed in its 2011 Annual Report that it had a "material weakness" in its internal controls, had failed to update loan ratings to properly calculate allowance for loan losses and had failed to "fully remediate its material weakness in its internal control over financial reporting." One week later, the issuing company announced that it entered into agreements with the Federal Reserve and the Pennsylvania Department of Banking requiring it to revise its underwriting and credit administration policies and strengthen its credit risk management practices.

The plaintiff named the company's independent auditor as a defendant, based on the auditor's clean audit opinion in the company's 2009 Annual Report, which was incorporated into the company's 2010 Registration Statement. The plaintiff alleged that if the auditor had conducted the audit in accordance with applicable accounting standards, it would have uncovered the "material weakness" in the issuing company's internal controls. Applying the U.S. Supreme Court's decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015), the court held that the independent auditor was not liable under Section 11 of the Securities Act for its sincerely held opinions that ultimately proved to be incorrect with hindsight. The plaintiff failed to identify actual and material steps taken or not taken by the independent auditor or knowledge that it did or did not have in the formation of its opinion. Thus, the independent auditor was not liable, and the claim was dismissed.

Class Actions — Settlements

New York Appellate Division Establishes New Standard for Reviewing Nonmonetary Settlements

Gordon v. Verizon Commc'ns, Inc., No. 653084/13
(1st Dep't Feb. 2, 2017)
Click here to view the opinion.

The New York Appellate Division of the Supreme Court, First Judicial Department, approved the settlement of stockholder litigation for nonmonetary consideration and in doing so articulated a new test for evaluating the fairness of nonmonetary settlements.

Stockholder litigation challenging Verizon's acquisition of subsidiaries of Vodafone Group PLC was filed in New York state court three days after the transaction was announced. The parties reached an agreement to settle the action in exchange for (i) additional disclosures to be issued in connection with the stockholder vote on the acquisition and (ii) the agreement that if Verizon engaged in a transaction in the next three years involving the sale or spin-off of assets with a book value over $14.4 billion, it would obtain a fairness opinion from an independent financial advisor. The New York Supreme Court declined to approve the settlement or award attorneys' fees, finding the settlement provided "no legally cognizable benefit to the shareholder class."

On appeal, the New York Appellate Division reversed, stating that "[i]n its capacity as gatekeeper, a court conducting a settlement review in a putative shareholders' class action has a responsibility to preserve the viability of those nonmonetary settlements that prove to be beneficial to both shareholders and corporations, while protecting against the problems with such settlements ... in order to promote fairness to all parties." The court determined that the proposed settlement should be evaluated under the five factors enumerated in *In re Colt Industries Shareholders Litig.*, 155 A.D.2d 154 (1st Dept 1990): "the likelihood of success, the extent of support from the parties, the judgment of counsel, the presence of bargaining in good faith, and the nature of the issues of law and fact." However, in light of the "need to curtail excess not only on the part of corporate management, but also on the part of overzealous litigating shareholders and their counsel," the court added an additional two factors that must be evaluated when reviewing nonmonetary settlements: "the agreed-upon disclosures, corporate governance reforms and any other forms of nonmonetary relief in a proposed settlement should be in the best interests of all the members of the putative class of shareholders," and "the proposed settlement should be in the best interest of the corporation and should not be merely a vehicle for the generation of fees for plaintiffs or class counsel." Applying these seven factors, the court held that the settlement should be approved and that an award of fees to plaintiffs' attorneys was warranted, and remanded to the lower court to determine the appropriate amount of fees.

The Appellate Division's decision stands in contrast to the Delaware Court of Chancery's recent decision in *In re Trulia, Inc. Stockholder Litigation,* 129 A.3d 884 (Del. Ch. 2016). In *Trulia*, the Court of Chancery stated that disclosure-based settlements containing broad releases would be met with "disfavor" and would not be approved unless the supplemental disclosures were "plainly material" and the "subject matter of the proposed release is narrowly circumscribed to encompass nothing more than the disclosure claims and fiduciary duty claims concerning the sale process, if the record shows that such claims have been investigated sufficiently."

Collateral Estoppel and Due Process

Delaware Supreme Court Remands Decision Dismissing Derivative Action Based on Collateral Estoppel Effect of Prior Dismissal

Cal. State Teachers' Ret. Sys. v. Alvarez, No. 295, 2016
(Del. Jan. 18, 2017)
Click here to view the opinion.

The Delaware Supreme Court remanded to the Court of Chancery its decision dismissing a derivative action based on the collateral estoppel effect of a prior dismissal of a derivative action based on the same underlying factual allegations, to consider whether the dismissal violated the derivative plaintiffs' due process rights.

Upon learning of a potential bribery scandal at a Mexican subsidiary of Wal-Mart, plaintiffs in Delaware sought to inspect the company's books and records pursuant to 8 Del. C. § 220 before filing suit. Plaintiffs in Arkansas federal court, however, did not and filed suit. The Arkansas district court dismissed that suit for failure to plead demand futility. Defendants in Delaware thereafter argued that the Delaware plaintiffs "were now collaterally estopped from raising demand futility in Delaware." The Court of Chancery agreed and dismissed the Delaware suit.

On appeal, the Delaware plaintiffs argued, among other things, that (i) the Court of Chancery did not consider the implication of due process in applying Arkansas collateral estoppel law, and (ii) collateral estoppel's privity requirement was not satisfied. Although the Delaware Supreme Court expressed concern about the Delaware plaintiffs' failure to intervene in Arkansas once it became evident that the Arkansas district court would likely rule first, the court did not express a final view on the preclusive effect of the Arkansas federal court's ruling. Instead, the Supreme Court stated "that the importance of the Due Process issue merits closer examination," explaining that "the preclusive effect of a federal court judgment is determined by federal common law, subject to due process limitations," and that "the general rule is that 'one is not bound by a judgment in personam in a litigation in which he is not designated as a party.'"

The Supreme Court remanded the case to the Court of Chancery with the specific instruction that the Court of Chancery focus on the question whether "[i]n a situation where dismissal by the federal court in Arkansas of a stockholder plaintiff's derivative action for failure to plead demand futility is held by the Delaware Court of Chancery to preclude subsequent stockholders from pursuing derivative litigation, have the subsequent stockholders' Due Process rights been violated?"

ERISA

Ninth Circuit Holds ERISA Fiduciaries' Ongoing Duty to Monitor Investments Can Reset Statute of Limitations

Tibble, et al. v. Edison Int'l, et al., No. 10-56404
(9th Cir. Dec. 16, 2016)
Click here to view the opinion.

On remand from the U.S. Supreme Court, the Ninth Circuit vacated a judgment in favor of a company and its benefits administrator on a breach of fiduciary duty claim regarding the administration of the company's Employee Retirement Income Security Act of 1974 (ERISA) plan.

Plaintiffs filed suit in 2007, alleging that the ERISA plan administrator breached its fiduciary duty in the selection and retention of certain mutual funds for a benefit plan governed by ERISA. The statute of limitations for the ERISA claim was six years. Here, at least three of the disputed mutual funds were purchased more than six years before 2007 ("pre-2001 funds"). The district court concluded that the claims based on the pre-2001 funds were time-barred, reasoning that there were no significant changed circumstances for those funds that would have triggered a duty to review the investment and thus restart the statute of limitations.

The Ninth Circuit initially affirmed. The Supreme Court then reversed, 135 S. Ct. 1823 (2015), rejecting the significant changed circumstances standard and instead holding that "a fiduciary's allegedly imprudent retention of an investment" restarts the statute of limitations period, even if there are no significant changed circumstances. According to the Supreme Court, "[A] fiduciary is required to conduct a regular review ... contingent on the circumstances." The Court then left it for lower courts to decide the "scope" of the fiduciary duty to monitor investments.

On remand, the Ninth Circuit emphasized a plan administrator's "continuing duty to monitor the appropriateness of the trust investments" — a standard derived from the common law of trusts. Under that standard, the relevant inquiry for statute of limitations purposes is not whether the investment was initiated within six years, but whether a breach of the duty to monitor occurred within six years. The Ninth Circuit then remanded the case to the district court for a trial on the pre-2001 funds claims.

Fiduciary Duties

Delaware Court of Chancery Dismisses Stockholder Derivative Complaint Alleging Failure of Board Oversight

Horman v. Abney, C.A. No. 12290-VCS (Del. Ch. Jan. 19, 2017)
Click here to view the opinion.

Vice Chancellor Joseph R. Slights III dismissed a stockholder derivative complaint for breach of fiduciary duty alleging failure of oversight by the board of directors of UPS because the complaint "failed adequately to plead demand futility."

In February 2015, the city and state of New York sued UPS in federal court for allegedly violating certain laws intended to prevent companies and consumers from avoiding excise taxes on cigarettes and other tobacco products. Thereafter, certain stockholders filed a derivative action, alleging that the federal suit resulted from the UPS directors' failure to comply with their oversight responsibilities under *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996). The Court of Chancery dismissed the action, explaining that the plaintiffs had failed to plead that the UPS board had "utterly failed to adopt any reporting and compliance systems" and noting that the complaint acknowledged that UPS had such systems in place. The court further explained that the complaint pleaded no particularized facts demonstrating that the UPS board consciously disregarded any "red flags" indicating that the company's compliance and reporting system was not working properly. Rather, the court concluded that the documents incorporated into the complaint "demonstrate that when red flags were waved in front of the [a]udit [c]ommittee, the [b]oard responded."

Delaware Court of Chancery Dismisses Post-Closing Action Alleging Board Breach of Fiduciary Duties

In re Solera Holdings, Inc. Stockholder Litig., Consol. C.A. No. 11524-CB (Del. Ch. Jan. 5, 2017)
Click here to view the opinion.

Chancellor Andre G. Bouchard applied the Delaware Supreme Court's ruling in *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), to dismiss a post-closing action alleging that the members of the Solera Holdings, Inc. board of directors breached their fiduciary duties in connection with Vista Equity Partners' $3.5 billion acquisition of Solera, which was approved by Solera's disinterested stockholders.

The plaintiffs alleged that *Corwin* should not apply because the stockholder vote was not fully informed in light of alleged deficiencies in the proxy statement issued to stockholders. Those alleged deficiencies included omitted information regarding the conflicts of a special committee that considered the proposed transaction and the "purpose and effect" of certain management retention and compensation decisions. The Court of Chancery determined that the plaintiffs had failed to allege a material disclosure violation and dismissed the action, explaining that under *Corwin*, and in light of the transaction's approval by a fully informed vote of Solera's disinterested stockholders, the business judgment rule applied and the plaintiffs failed to state a waste claim.

Forward-Looking Statements

Ninth Circuit Reverses Dismissal of Securities Fraud Class Action, Holds Sales Projections Were Not Forward-Looking Statements

Zaghian v. Farrell, et al., No. 15-55335 (9th Cir. Jan. 12, 2017)
Click here to view the opinion.

In an unpublished opinion, the Ninth Circuit reversed and remanded the dismissal of a securities fraud class action against two former executives of a now-bankrupt software company. The plaintiffs allege that the defendants knowingly misrepresented the potential success of a video game device the company developed.

In 2010, the company debuted a device for one video game console, the Nintendo Wii. Based on the device's success, the defendants decided to offer the device for two additional game consoles, the Xbox 360 and PlayStation 3, and expressed throughout 2011 their confidence in the device and that it would result in the strongest quarter in the company's history. In December 2011, the company lowered its expected net sales. In February 2012, the defendants disclosed that sales were even weaker than previously stated, and the company ceased production of the device. The company later declared bankruptcy.

The district court dismissed the plaintiffs' claims under the Securities Exchange Act and Rule 10b-5, determining that the defendants' statements were either forward-looking projections accompanied by meaningful cautionary language or puffery. Furthermore, there was no strong inference of scienter.

The Ninth Circuit reversed and remanded. First, the court found that the safe harbor provision of the Private Securities Litigation Reform Act (PSLRA) did not apply. According to the court, the cautionary language was insufficient to invoke safe harbor protection because it failed to disclose the risk that Xbox 360 and PlayStation 3 users might not embrace the company's device because such users were uninterested in child-focused games. The safe harbor was further inapplicable because, beyond insufficient cautionary language, the plaintiffs had also sufficiently pleaded that the defendants had actual knowledge that their publicly disclosed projections were false when made. Second, the court found that the statements at issue were not immaterial puffery

because they addressed a particular product and its anticipated profitability. Finally, the court held that the plaintiffs adequately pleaded scienter.

Accordingly, the Ninth Circuit reversed the dismissal and remanded the case back to the district court.

Initial Public Offerings

Second Circuit Affirms Dismissal of Claims Against Certain Underwriters That Participated in a Social Media Company's IPO

Lowinger v. Morgan Stanley & Co., LLC, et al., No. 14-3800-cv (2d Cir. Nov. 3, 2016)
Click here to view the opinion.

The Second Circuit affirmed the dismissal of a claim for disgorgement brought under Section 16(b) of the Securities Exchange Act against certain underwriters that participated in a social media company's initial public offering. Under Section 16(b), "beneficial owners" of 10 percent or more of an issuer's stock are subject to a claim for disgorgement of all profits from short sales or purchases of that stock within a six-month period. The plaintiff, a shareholder of the social media company, alleged that, although the underwriters alone were not beneficial owners of 10 percent or more of the stock, through lock-up agreements with the pre-IPO shareholders, the underwriters formed a group with the pre-IPO shareholders under Section 13(d) of the Securities Exchange Act and thus were "beneficial owners" under Section 16(b). The plaintiff further alleged that the underwriters had maintained improper short positions during the six-month period. The lower court dismissed the claims, finding that the lock-up agreements alone did not make the underwriters beneficial owners.

The Second Circuit agreed, stating that lock-up agreements generally do not function to group the interests of underwriters and pre-IPO shareholders, but instead "are generally one-way streets keeping certain shareholders out of the IPO market for a specified period of time or without compliance with other restrictions." The court noted that the lock-up agreements at issue in this case were publicly disclosed in the registration statement and prospectus, and provided that the underwriters could sell and purchase certain shares to stabilize the stock price. The court observed that lock-up agreements generally "limit the investment decisions of large shareholders in order to bring about an orderly, and successful, offering," and that applying Section 16(b) under this circumstance "would impair the market for public offerings" and create "tens of millions of dollars in legal exposure to the underwriters' costs."

Loss Causation

SDNY Denies Motion for Interlocutory Appeal of Ruling That Plaintiffs Need Not Plead Loss of Net Asset Value of Mutual Fund Shares to Demonstrate Loss Causation

Youngers v. Virtus Inv. Partners Inc., et al., No. 15 Civ. 8262-WHP (S.D.N.Y. Jan. 6, 2017)
Click here to view the opinion.

Judge William H. Pauley denied an investment management company's motion for interlocutory appeal from an order denying the company's motion to dismiss claims under Section 10(b) of the Securities Exchange Act for failure to plead loss causation. The plaintiffs, who were mutual fund shareholders, argued that the company had falsely represented in its registration statements and prospectuses that certain of its funds had outperformed certain index funds. The plaintiffs claimed that the purported outperformance occurred before the mutual funds were even created and was based on retroactive modeling instead of contemporaneous trades with actual assets. The plaintiffs further alleged that they relied on those misrepresentations when they purchased shares in the mutual funds, and that when they learned that the "outperformance" was based on modeling, the value of their shares declined.

The company argued in its motion to dismiss that the plaintiffs had failed to plead loss causation. Specifically, the company argued that because its statements did not pertain to the value of the company's underlying assets, the company's statements could not have affected the price of the mutual fund shares (*i.e.*, the fund's net asset value (NAV)). Judge Pauley acknowledged that the company's statements could not affect the NAV, but denied the motion to dismiss because the plaintiffs had alleged two plausible alternative theories of loss causation: (i) that the value of a mutual fund share is not necessarily equal to its price, and (ii) that the "misstatements caused a direct loss to the mutual funds' value because investors paid higher fees than they would have if they were informed of the true performance" of the funds.

The company moved for interlocutory appeal, arguing that the issue of whether plaintiffs' alleged loss causation could be based on anything other than NAV involved a controlling legal question for which there was a "substantial ground for difference of opinion" and that the immediate appeal would "materially advance the ultimate termination of the litigation." Judge Pauley denied the motion, finding that plaintiffs' theory of loss causation was consistent with Second Circuit precedent, and stated that if "Defendants truly want resolution of this issue that they assert is vexing the mutual fund industry, it should be presented to this Court, and ultimately the Court of Appeals, on a complete record."

Misrepresentations

First Circuit Affirms Dismissal of Securities Fraud Claims Against Medical Device Company Based on Press Releases Announcing Approval of Human Trials

Ganem v. InVivo Therapeutics Holdings Corp., No. 15-1544 (1st Cir. Jan. 9, 2017)
Click here to view the opinion.

The First Circuit affirmed the dismissal of a putative class action alleging that a medical device company violated Section 10(b) of the Securities Exchange Act by allegedly making false and misleading statements in press releases announcing the Food and Drug Administration's (FDA) approval of human clinical trials using biomaterials to treat patients with spinal cord injuries. The plaintiffs alleged that the company misled investors about the projected start date, duration and completion time for the FDA-approved human clinical trials because it failed to disclose certain recommendations and conditions imposed by the FDA that allegedly rendered the projections false or misleading. Specifically, the plaintiffs alleged that the company failed to disclose (i) the FDA's requirement that the company satisfy a number of conditions within 45 days before the trial could begin, (ii) the FDA's recommendation that the company modify its study design, and (iii) the FDA's requirement that the company conduct a staged study with each stage requiring separate approval.

The court held that the plaintiffs failed to allege any actionable misstatements. The court reasoned that the company's statements about when the clinical trials would begin were not false or misleading at the time they were made because the plaintiffs failed to allege any facts suggesting that the company could not have complied with the FDA-imposed requirements within the projected timeline. As to the duration of the clinical trial, the court rejected the plaintiffs' argument that it would be impossible for the company to complete the trial within 15 months because the FDA letter itself suggested that a 15-month testing period was feasible. Finally, the court determined that the plaintiffs' allegations about how long it would take the company to analyze the data before it could submit it to the FDA amounted to mere speculation. The court emphasized that the "securities laws do not make it unlawful for a company to publicize an aggressive timeline or estimate for a proposed action without disclosing every conceivable stumbling block to realizing those plans."

District of Nevada Holds There Is No Duty to Disclose Internal Project Progress Timelines

Fosbre v. Las Vegas Sands Corp., et al.,
No. 2:10-cv-00765-APG-GWF (D. Nev. Jan. 3, 2017)
Click here to view the opinion.

The District of Nevada granted summary judgment in favor of the defendant and his casino company in a securities action alleging false or misleading statements regarding upcoming development projects, finding none of the alleged misstatements qualified as deceptive and the company adequately disclosed risks associated with the projects.

The plaintiffs, a class of shareholders, brought suit against the casino company and its "control person," alleging a violation of the Securities Exchange Act and Rule 10b-5. The plaintiffs' claims were based on numerous statements made from August 1, 2007, through August 29, 2008, regarding the status and strategy of global development projects for the casino company. The statements largely described ongoing progress, development costs and expectations of success.

The court granted summary judgment for the defendants, based in part on its conclusions that defendants had no duty to disclose internal financing timelines; stating a project is "in progress" while failing to meet an internal financing deadline is not false or misleading; plans and objectives for future operations are forward-looking statements that fall within the PSLRA's safe harbor; and mixed opinions from financial advisers to the company on various financing options does not render its public statement on one particular financing option false.

Registration Statement Liability

SDNY Dismisses Putative Class Claims Against Chinese Online Retailer

In re Jumei Int'l Holding Ltd. Sec. Litig., No. 14cv9826 (S.D.N.Y. Jan. 10, 2017)
Click here to view the opinion.

Judge William H. Pauley dismissed claims that a Chinese online retailer specializing in beauty products violated Section 11 of the Securities Act and Section 10(b) of the Securities Exchange Act by allegedly making false and misleading statements in the company's initial public offering documents and a subsequent earnings report concerning the company's plan to exit one of its business lines. The plaintiffs alleged that the company's registration statement was misleading because it failed to disclose the company's intent to close its marketplace for third-party beauty suppliers. The plaintiffs alleged that the marketplace was

a major sales driver, and the company knew four months before the IPO that it was planning to shut it down. The court dismissed the Section 11 claim because the plaintiffs failed to adequately plead facts supporting an inference that the exit plan's impact on the company's financials was known or knowable at the time of the IPO. The court also dismissed the Section 10(b) claim because the plaintiffs failed to adequately plead scienter. The court determined that the plaintiffs' claim was a case of classic fraud by hindsight. The mere temporal proximity between when the company announced its financial forecasts and the company's exit from the third-party marketplace business was insufficient to show knowledge or fraudulent intent.

SDNY Holds That Complaint Alleging Registration Statement Liability Is Time-Barred and Fails to State Claim

Rudman v. CHC Grp. Ltd., No. 15-cv-3773 (LAK)
(S.D.N.Y. Nov. 7, 2016)
Click here to view the opinion.

Judge Lewis A. Kaplan dismissed a complaint alleging claims under Section 11 of the Securities Act against a commercial helicopter operator, finding that it was time-barred and also failed to state a claim. During the relevant period, the company was affected by an industrywide suspension of flights of EC225 helicopters. In response, one of the company's largest customers allegedly notified all of its EC225 providers that it would cease payments on its EC225 contracts. The company's registration statement disclosed the suspension, as well as a decline in revenue primarily due to the EC225 suspension, but allegedly failed to specifically disclose that the large customer had declined to pay fees on its EC225 contracts during the suspension. The company allegedly disclosed the fee dispute on a conference call seven months after filing its registration statement. As an initial matter, the court held that the complaint was untimely because it was filed more than one year after the time when plaintiffs could and should have discovered the alleged omission. The court reasoned that a reasonably diligent investor would have discovered the alleged omission simply by reading the registration statement: The registration statement disclosed the decline in revenue in Brazil and also that the large customer was based in Brazil. Additionally, information in other publicly available documents showed that the customer had declined to pay money owed to various other helicopter operators as a result of the EC225 suspension. The court also held that the complaint failed to state a claim under Section 11. While the company had not disclosed "which customer or 'fee stream' was affected" by the suspension, the company did not have a duty to "provide a level of detail satisfactory to plaintiffs, only to make sure that once it spoke on a matter, it did so fairly and accurately."

Scienter

First Circuit Holds That Pharmaceutical Company's Statement of Drug's Prospects for FDA Approval Supported Inference of Scienter

In re ARIAD Pharm., Inc. Sec. Litig., No. 15-1491
(1st Cir. Nov. 28, 2016)
Click here to view the opinion.

The First Circuit revived part of a putative class action asserting claims under Section 10 of the Securities Exchange Act, holding that the complaint sufficiently pleaded scienter with respect to certain statements made by the defendant in connection with a leukemia drug. The FDA had initially rejected the company's proposed label for the drug, citing cardiovascular concerns, but the complaint alleged that the company subsequently stated that it "continues to be optimistic" about the drug's prospects for FDA approval without disclosing the rejection. The company also allegedly made statements listing the rates of certain adverse events associated with the drug, but not cardiovascular events. The FDA eventually approved the label on a limited basis subject to a "black box" label warning about the risk of adverse cardiovascular events.

The court held that the complaint sufficiently pleaded scienter with respect to statements about the drug's label only, finding that the plaintiffs sufficiently alleged that it was misleading to express optimism about the drug's chances for approval just weeks after learning of the FDA's rejection of the proposed label. The court stated that "[w]hile management may have held out hope of achieving [a favorable label] result, the expression of that hope without disclosure of recent troubling developments created an impermissible risk of misleading investors." However, the court rejected the plaintiffs' claims based on the allegedly concealed cardiovascular data, stating that the theory was "fraud by hindsight." The plaintiffs failed to allege that the company was aware of the relevant cardiovascular data when it made statements about known adverse events, and allegations regarding certain trading by company insiders did not bolster the inference of scienter in this regard. The court determined that the timing of the disputed trades was not suspicious because some trades stopped more than a month and a half before the company's stock reached its highest point, and other trades occurred after the black-box warning announcement and the ensuing decline in stock price.

Securities Exchange Act

Tenth Circuit Holds That Investment During Restructuring Did Not Constitute a Security

Ave. Capital Mgmt. II, L.P. v. Schaden, No. 15-1389 (10th Cir. Dec. 13, 2016)
Click here to view the opinion.

The Tenth Circuit affirmed the dismissal of claims that a fast-food restaurant violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting the company's financial condition in connection with the company's restructuring. The plaintiffs alleged that insiders purportedly made misleading statements about the company's financial conditions in order to induce the plaintiffs to invest in the company while the company restructured its debt. The district court dismissed the claims because the transaction at issue did not involve investment contracts within the definition of "security" under the Securities Exchange Act. The court upheld the district court's determination, finding that the transaction gave the plaintiffs control over the company, and thus their interests could not constitute investment contracts as a matter of law.

The court considered multiple factors. First, the court reasoned that the plaintiffs had obtained about 80 percent ownership interest in the limited liability company (LLC) that was formed through the restructuring transaction, and thus gained the ability to amend the LLC agreement, permitting plaintiffs to directly control the company and dissolve it. Second, the court determined that the plaintiffs had acquired the power to appoint and remove the managers of the LLC and thus had the ability to direct and control the daily operations of the company, even if they intended or expected that the board and corporate officers would operate the company. The court rejected arguments based on the plaintiffs' lack of intent to control the company. Rather, the court stated that the test is objective, and that the plaintiffs retained sufficient legal interests to control the company if they had desired. Finally, the court determined that the plaintiffs were sophisticated and informed investors, allowing them to "make informed investment decisions and intelligently exercise control" over the company.

SLUSA

Ninth Circuit Joins DC Circuit in Holding That SLUSA Does Not Create an Independent Basis for Federal Question Jurisdiction

Rainero v. Archon Corp., No. 14-17106 (9th Cir. Dec. 21, 2016)
Click here to view the opinion.

The Ninth Circuit affirmed the dismissal of a putative class action brought by preferred stockholders for lack of subject matter jurisdiction, holding that the Securities Litigation Uniform Standards Act (SLUSA) does not provide an independent basis for federal question jurisdiction.

In 1993, the defendant corporation issued preferred stock, with the Certificate of Designation (Certificate) explicitly reserving the right to redeem the preferred stock at the company's election upon providing notice to the shareholders. In 2007, the company announced it would redeem all outstanding shares of preferred stock for $5.241 per share. The preferred shareholders claimed that, under the terms of the Certificate, the repurchase price should have been $8.69 per share.

The plaintiff brought suit in federal court, alleging breach of contract. Despite only bringing a state law contract claim, the plaintiff argued that the federal court had jurisdiction under SLUSA because SLUSA allows certain class actions — those "based upon the statutory or common law of the state in which the issuer is incorporated" — to be maintained in either state or federal court.

The district court rejected the plaintiff's argument, and the Ninth Circuit affirmed. The panel held that, rather than provide the plaintiffs with a forum selection option between federal and state court, SLUSA instead preserves certain state law claims when a securities case is removed to federal court to ensure that federal courts have jurisdiction to determine whether the state action is precluded. Thus, the Ninth Circuit joined the D.C. Circuit in holding that SLUSA did not create an independent basis for federal question jurisdiction.

SDNY Holds That SLUSA Does Not Preclude Investors' Claims About Misrepresentations in Closed-End Mutual Funds

Fernandez v. UBS, No. 15-Cv-2859 (SHS) (S.D.N.Y. Dec. 7, 2016)
Click here to view the opinion.

Judge Sidney H. Stein held that SLUSA did not preclude claims in connection with certain closed-end mutual funds because any alleged misrepresentations were not in connection with the purchase or sale of covered securities. The securities at issue could only be purchased by Puerto Rico residents, were not traded nationally and were not listed on a national exchange. The defendants moved to dismiss, arguing that SLUSA precludes state and federal courts from adjudicating state law class action claims alleging a "misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security," which include those traded on a national exchange.

The defendants argued that the securities at issue were "covered securities" for two reasons. First, the defendants asserted that the plaintiffs indirectly invested in covered securities through the

mutual funds, even though they did not directly hold an interest in the securities. Judge Stein rejected that argument, analogizing the case to *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058 (2014), where the U.S. Supreme Court held that investors who purchased certificates of deposits had not invested in covered securities, even though the certificates were purportedly backed by covered securities. The mutual funds in this case were similarly marketed as having invested in covered securities, but the prospectus made clear that an investment in the fund was not an investment in the underlying securities. Therefore, the court held that SLUSA did not preclude the claims because the investors had not invested directly or indirectly in covered securities. In addition, the defendants argued that SLUSA precluded the claims because some plaintiffs sold securities in order to invest in the funds or sold other securities instead of selling shares in the funds, and thus their investments in the mutual funds were in connection with the purchase or sale of covered securities. Judge Stein, however, rejected that argument, finding that the connection between the purchases and sales and the alleged misrepresentations with respect to the mutual funds were too tangential for SLUSA to apply.

Statutes of Repose/Statutes of Limitations

Eighth Circuit Vacates Summary Judgment Order in Securities Fraud Class Action

W. Va. Pipe Trades Health & Welfare Fund v. Medtronic, Inc., No. 15-3468 (8th Cir. Dec. 28, 2016)
Click here to view the opinion.

The Eighth Circuit vacated the district court's order granting summary judgment to the defendants in a class action suit brought against a medical device company and its officers and senior managers for allegedly making false statements and employing a scheme to defraud the market in violation of Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5. The plaintiffs alleged that the company and a group of physician-authors defrauded the market by, among other things, publishing clinical studies that understated the adverse effects of using one of the company's products. The district court granted the company's summary judgment motion on the basis that the plaintiffs' claims were barred by the two-year statute of limitations. The plaintiffs appealed the grant of summary judgment on their scheme liability claim.

The Eighth Circuit vacated and remanded, holding that a reasonably diligent plaintiff would not have discovered facts sufficient to plead scienter based on the public information existing prior to the two-year statute of limitations. The Eighth Circuit determined that the newspaper articles and news reports discussing the company's intent to dominate the marketplace did not create a strong inference of the company's scienter because businesses regularly achieve the same goal through legal means. Likewise, the court concluded that the facts alleged in the prior litigation were unrelated to the alleged scheme and, consequently, could not support a strong inference that the company intentionally perpetrated a scheme to defraud by manipulating clinical studies. Instead, the court determined that the plaintiffs did not have sufficient facts to plead scienter until the Senate Finance Committee, within the two-year statute of limitations, released its findings that the company had intentionally edited studies to omit unfavorable results. Thus, the two-year statute of limitations did not bar the plaintiffs' scheme liability claim.

The Eighth Circuit further rejected the company's alternative argument that Supreme Court decisions in *Janus Capital Group, Inc. v. First Derivative Trader*s, 564 U.S. 135 (2011), and *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), barred the plaintiffs' scheme liability claim as a matter of law. Rejecting the plaintiffs' *Janus* argument, the court concluded that *Janus* did not bar the plaintiffs' scheme liability claim because the plaintiffs' allegations that the company paid and induced physicians to conceal adverse clinical findings on its product constituted more than a mere misrepresentation or omission by a third party. The court likewise rejected the company's argument that the plaintiffs could not show adequate market reliance for their scheme liability claim as required by *Stoneridge*. The Eighth Circuit held that, unlike in *Stoneridge*, the causal connection between the company's alleged deceptive conduct and the information on which the market relied was not too remote to support reliance, particularly because the company's alleged payments directly caused the physicians to create the documents allegedly relied upon by investors. Accordingly, the court vacated the district court's summary judgment order and remanded the case.

Eastern District of Arkansas Grants Defendants' Motion for Summary Judgment on Securities Fraud Claims

The Most Worshipful Grand Lodge of Free & Accepted Masons of the State of Arkansas v. DCG/UGOC Equity Fund, LLC, No. 4:15-cv-219 (E.D. Ark. Oct. 19, 2016)
Click here to view the opinion.

Judge J. Leon Holmes granted the defendants' motion for summary judgment, holding that The Most Worshipful Grand Lodge of Free and Accepted Masons of the State of Arkansas' (the Lodge) claims were barred by the statute of repose. The Lodge brought claims against an investment fund and its representatives for violations of Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5, alleging that it was induced

by the defendants, through misrepresentations and omissions of material facts, to purchase limited liability company interests in the investment fund.

In granting defendants' summary judgment motion, the court held that the five-year statute of repose for securities fraud begins on the date of the alleged fraudulent act, not on the date of the relevant securities transaction. The Lodge filed its claims more than five years after the alleged misstatements and omissions were made, but argued that its claims were timely because it purchased the relevant securities relying on those statements within the five-year time period. Acknowledging a void of binding precedent from either the Eighth Circuit or the U.S. Supreme Court on the issue, the district court adopted the positions of the Third and Seventh Circuits, and held that the statute of repose for securities fraud begins on the date of the alleged misrepresentation or omission.

Attempting to avoid summary judgment, the Lodge argued that defendants had a continuing duty to correct any prior false statements and that their failure to do so prior to the transaction constituted securities fraud within the applicable statute of repose. The court rejected this argument, concluding that it was merely another attempt to argue that the statute of repose begins at the time of the transaction, a proposition the court had already rejected. Thus, the court held that the Lodge's securities fraud claims were time-barred.

On January 13, 2017, the Supreme Court granted a petition for writ of *certiorari* to review the Second Circuit's decision that the class action tolling doctrine announced in *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974) does not apply to the three-year statute of repose in Section 13 of the Securities Act. See *In re Lehman Bros. Sec. & ERISA Litig.*, 655 F. App'x 13 (2d Cir. 2016), cert. granted sub nom. *Cal. Pub. Emps.' Ret. Sys. v. ANZ Sec., Inc.*, No. 16-373 (U.S. Jan. 13, 2017).

Inside the Courts
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