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Securities Litigation Alert: Second Circuit Applies Fraud-on-the-Market Presumption to Section 10(b) Claims Based on Missed Appraisal Opportunity

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On February 3, 2025, in *In re Shanda Games Limited Securities Litigation*, a divided panel of the U.S. Court of Appeals for the Second Circuit, allowed a putative investor class to proceed with securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934 based on their acceptance of an allegedly undervalued tender price in a freeze-out merger. Notably, the Court determined that at the pleadings stage, investors could utilize the fraud-on-the-market presumption (applicable to securities traded in efficient markets) to establish that they relied on defendants' alleged misrepresentations in failing to seek a fair market value determination of their shares through appraisal.

In re Shanda signifies a novel use of the fraud-on-the-market presumption, which typically arises in putative class actions alleging that investors relied on a stock's artificially inflated (or deflated) market price in purchasing or selling shares at a loss. Under *In re Shanda*, the presumption applies equally where an investor decides to hold shares and receive contractually set merger consideration instead of opting for judicially determined appraisal. The decision arguably expands the Section 10(b) cause of action in the Second Circuit, and could prompt some investors to look to Section 10(b) as an alternative to more traditional appraisal remedies available under state law.

Background

Shanda Games Limited ("Shanda") was a video games business registered in the Cayman Islands and headquartered in China. Shanda's shares were publicly traded as American Depository Shares ("ADS") on the NASDAQ. Shanda's main asset was the right to market a computer game, "Mir II," in China. In mid-2013, Shanda began developing a mobile version of Mir II called "MIIM." Shanda invested substantial resources in MIIM, and initial testing proved successful.

In 2014, Shanda's CEO, Yingfeng Zhang, joined a group of potential company suitors that collectively owned over 70% of Shanda's outstanding shares and controlled over 90% of its voting power. In April 2015, Shanda's board of directors approved a freeze-out merger, whereby Shanda would purchase all shares held outside the buyer group and merge with an entity wholly owned by the buyer group. Minority shareholders stood to receive $3.55 per share, or $7.10 per ADS, in the freeze-out merger.

The buyer group held enough shares to approve the merger unilaterally under Cayman Islands law. Shanda, however, was still required to put the merger up for a shareholder vote to allow dissenters the opportunity to object prior to seeking appraisal (*i.e.*, a determination of the fair market value of their shares) in a Cayman Islands court. The vote was held in November 2015, and the merger was approved. Like most other minority shareholders, David Monk did not object, instead cashing out his 6,500 ADS at $7.10 per ADS. Meanwhile, three dissenting shareholders objected and pursued appraisal in the Cayman Islands. On March 6, 2018, a Cayman Islands court found that the merger price did not reflect the fair

value of the shares and awarded the dissenting shareholders $6.43 per share or $12.84 per ADS.

Shareholder litigation followed in the U.S. District Court for the Southern District of New York. There, minority shareholders asserted putative class claims against Shanda, Zhang, the former CFO, and Shanda directors under Sections 10(b), 20A, and 20(a) of the Securities Exchange Act of 1934. As alleged, in the lead up to the freeze-out merger, defendants misled investors by downplaying the company's financial prospects, including the anticipated success of MIIM. The scheme allegedly deflated Shanda's market price and induced minority investors to accept an artificially low tender price, rather than selling their shares in the open market or seeking appraisal. Monk was appointed lead plaintiff.

The district court (Hon. Andrew L. Carter, Jr.) granted defendants' motion to dismiss the Section 10(b) claims. The court held that plaintiff adequately alleged misrepresentations, as well as scienter, as defendants had the motive and opportunity to depress Shanda's stock to "secure a low transaction price."[1] The court further held that plaintiff adequately alleged reliance based on the fraud-on-the-market presumption, which presumes that "'the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.'"[2] The district court concluded that plaintiff demonstrated that Shanda's shares traded in an efficient market, a prerequisite to pleading reliance through the fraud-on-the-market presumption.[3]

Nonetheless, the district court dismissed the Section 10(b) claims for failure to plead loss causation. In the district court's view, plaintiff failed to substantiate that the alleged misrepresentations caused economic loss to the class, given that the only issue for ADS holders to decide was whether to hold the shares (and receive the merger price, not the market price) or object and seek appraisal.[4] Monk timely appealed.

The Second Circuit's Decision

A divided Second Circuit panel affirmed in part and vacated in part, permitting Monk's Section 10(b) claims to proceed. In particular, the majority (Chief Judge Debra Livingston, joined by Judge Raymond Lohier) agreed with the district court that plaintiff could utilize the fraud-on-the-market presumption to establish reliance. The court explained that it is reasonable to presume that most investors who acquire or divest themselves of stock rely upon a stock's market price to ascertain that stock's value. Thus, in the majority's view, it is also reasonable to presume that investors "rely on the market price as an accurate measure of his stock's value when deciding to tender."[5] The majority placed particular weight on the allegation that absent defendants' misrepresentations and with a higher market price, Monk would have dissented from the merger and exercised his appraisal rights.[6]

Unlike the district court, however, the majority held that Monk sufficiently pled loss causation. The majority explained that, under Second Circuit precedent, a shareholder's failure to exercise appraisal rights may constitute cognizable loss under the securities laws: a minority shareholder may be injured in the freeze-out merger not only from the occurrence of the merger itself, but through "the loss of his appraisal right."[7] Here, the majority observed, Monk sufficiently alleged that he suffered loss when he accepted the tender price as a result of misleading statements in the proxies, as opposed to achieving a higher value for his shares through judicial appraisal.[8]

Judge Dennis Jacobs dissented, primarily taking issue with the majority's reasoning on reliance. Judge Jacobs stressed that the fraud-on-the-market theory presumes reliance when an investment decision is made to purchase or sell a security at a market price tainted by fraud. Here, however, there was no indication of any investment decision—Monk simply held onto his shares, which, upon consummation of the merger, were canceled in exchange for $7.10 per ADS. Judge Jacobs pointed out that Monk did not allege that he even read the proxy statements or voted at the shareholder meeting.[9] In Judge Jacobs' view, the fraud-on-the-market presumption was not available on these facts, as there was no

plausible connection between Shanda's market price and "an investor's trading decision."[10] Judge Jacobs also expressed concern that the majority's decision would erode state law appraisal rights, effectively giving investors a second bite at the appraisal apple under Section 10(b).[11]

Implications

In re Shanda is arguably a significant deviation from traditional tenets of Section 10(b) securities fraud jurisprudence. Since the 1975 Supreme Court decision in *Blue Chip Stamps*, a requirement for any private Section 10(b) securities fraud claim has been showing an actual purchase or sale premised on the defendant's allegedly false or misleading statement.[12] It is widely recognized that plaintiffs do not satisfy the purchase-or-sale requirement if they simply decide "not to purchase or sell stock as a result of the misrepresentation."[13] Rather, "one must demonstrate that the alleged fraud and the securities transaction 'coincide.'"[14]

The fraud-on-the-market presumption presumes that a stock's *market price* reflects all available information.[15] Consistent with *Blue Chip Stamps*, courts typically have applied the presumption where investors actually purchased or sold securities at the market price.[16] The situation in *In re Shanda* is quite different: Monk did not engage in a market price transaction, instead holding his ADS until they were canceled in the merger. In other words, even if Monk's tendering of his ADS technically qualifies as a "sale" under the securities laws,[17] it was not a sale at a "market price."

The key to the majority opinion is its premise that the market price still matters in this scenario. In the majority's view, although investors like Monk ultimately receive only the agreed merger price, to reach that point, they must first decide (1) not to sell to the market and (2) not to seek appraisal. Shanda's market price—allegedly deflated by misrepresentations—was an essential reference point for that decision.[18] The arguable flaw in this reasoning, highlighted in Judge Jacobs' dissent, is that the decision not to seek appraisal is an entirely "hypothetical" transaction, effectively allowing a Section 10(b) claim to proceed based on a decision to "hold" a security contrary to *Blue Chip Stamps*. [19]

At bottom, *In re Shanda* could significantly expand the Section 10(b) cause of action in the Second Circuit, allowing investors who tender shares in a freeze-out merger to assert claims, absent any allegation that investors even considered defendants' alleged misleading statements. Nevertheless, the decision's fate is by no means certain, given the Supreme Court's admonition against expansion of a "narrow" Section 10(b) cause of action that Congress did not expressly authorize. [20] *In re Shanda*'s survival even within the Second Circuit is not guaranteed, as Shanda filed its petition for rehearing *en banc* on March 19, 2025.[21] In all events, *In re Shanda* will shape the Section 10(b) cause of action in the Second Circuit, and potentially beyond.

[1] *In re Shanda Games Limited Sec. Litig.*, No. 1:18-cv-02463-ALC (S.D.N.Y. Sept. 30, 2019), ECF No. 57, at 14.

[2] *In re Shanda Games Limited Sec. Litig.*, No. 1:18-CV-2463-ALC, 2022 WL 992794, at *4 (S.D.N.Y. Mar. 31, 2022) (citing *Eric P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 804, 811 (2011) (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1988)).

[3] *See id.* at *5.

[4] *See id.* at *6.

[5] *In re Shanda Games Limited Sec. Litig.*, 128 F.4th at 55. On appeal, Shanda did not dispute the efficiency of the market for Monk's ADS.

[6] *See id.* (underscoring that Monk retained the choice whether to permit his shares to be sold in the merger or to dissent and exercise his appraisal rights, even though his decision to dissent would not have blocked the merger).

[7] *Id.* at 57 (citing *Wilson v. Great American Indus., Inc.*, 979 F.2d 924, 931, 931 (2d Cir. 1992)).

[8] *See id.* (stating that Monk sufficiently alleged that "he suffered an economic loss when he accepted the tender price due to the misleading statements in the Proxies instead of receiving a higher value" in an appraisal suit).

[9] *See id.* at 63.

[10] *Id.* at 67.

[11] *See id.* at 70 ("I worry that (at least in the freeze-out merger context) minority shareholders who fail to exercise their individual right to appraisal under state law in the first instance will now have a second-chance claim via a class action under the federal securities law.").

[12] *See, e.g.*, *Sarafianos v. Shandong Tada Auto-Parking Co.*, Ltd., No. 13-cv-3895 (SAS), 2014 WL 7238339, at *4 (S.D.N.Y. Dec. 19, 2014) ("One reason the conduct alleged in the Complaint is not actionable under section 10(b) is that the alleged fraud does not relate to an investment decision made by Shandong."); *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir. 1984) (stating that "[t]he purpose of [Section] 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions—to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be").

[13] *See, e.g.*, *In re Turquoise Hill Resources Ltd. Sec. Litig.*, 625 F. Supp. 3d 164, 196-97 (S.D.N.Y. Sept. 2, 2022) (discussing the purchase or sale requirement as articulated in *Blue Chip Stamps*); *see also Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 80 (2006) (noting that the Supreme Court in *Blue Chip Stamps* decided to strictly limit the private remedy under Rule 10b-5 to "plaintiffs who were themselves purchasers or sellers," in part due to policy considerations).

[14] *Schwartz v. Sensei, LLC*, No. 17-CV-04124 (SN), 2020 WL 5817010, at *5 (S.D.N.Y. Sept. 30, 2020) (citing *S.E.C. v. Zandford*, 535 U.S. 813, 823-25 (2002)).

[15] *In re Shanda Games Limited Sec. Litig.*, No. 1:18-CV-2463-ALC, 2022 WL 992794, at *4 (S.D.N.Y. Mar. 31, 2022) (citing *Eric P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 804, 811 (2011) (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1988)).

[16] *See Basic, Inc.*, 485 U.S. at 246-47 ("Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b–5 action.").

[17] *See Madison Consultants v. Fed. Deposit Ins. Corp.*, 710 F.2d 57, 61 (2d Cir. 1983) ("This Circuit has repeatedly held . . . that an owner of securities who is forced to sell them against his will has standing as a 'seller' for purposes of Rule 10b-5.").

[18] *See In re Shanda Games Limited Sec. Litig.*, 128 F.4th at 55.

[19] *Id.* at 68. Plaintiff did not argue that it had statutory standing under the "forced sale" doctrine as laid out in *Vine v. Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967) (providing a limited exception to the purchase or seller requirement and is only applicable when the plaintiff's investment position has been fundamentally altered by a forced sale). In any event, the forced sale doctrine—assuming that it is still viable after *Blue Chip Stamps*, which is an open question—would be inapposite here because, like Shandong in *Sarafianos v. Shandong Tada Auto-Parking Co., Ltd.*, Monk cannot allege that his investment position had been "fundamentally altered by an alleged forced sale." *See Sarafianos*, 2014 WL 7238339, at *4.

[20] *Janus Cap. Grp. v. First Derivative Traders*, 564 U.S. 135, 142 (2011) (internal quotations and citations omitted).

[21] *In re Shanda Games Limited Sec. Litig.*, Case No. 22-3076 (2d Cir. Feb. 12, 2025), Dkt. No. 115.