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Securities Litigation Update

Second Circuit Opines on Pleading Standards and Statutory Standing for Claims Under Section 10(b) of the Securities Exchange Act of 1934

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On November 24, 2021, the U.S. Court of Appeals for the Second Circuit issued a pair of decisions addressing threshold requirements for securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5: (i) pleading a material misstatement or omission, and (ii) demonstrating standing to sue as a "purchaser" or "seller" of a security. In *Altimeo Asset Management v. Qihoo 360 Technology Co. Ltd.*,[1] the Court reinstated Section 10(b) claims premised on the defendants' alleged failure to disclose in proxy materials a plan to relist the post-merger company on a foreign exchange. In so ruling, the Court parted ways with the district court, which concluded that the proxy materials adequately disclosed the "possibility" of a relisting, and the plaintiffs failed to allege a "concrete" pre-merger relisting plan so as to render the disclosure misleading. In *Aiello v. Brown*,[2] the Court clarified that holders of unexercised preemptive rights to acquire securities—absent "irrevocable liability" to acquire a security—lack standing to assert Section 10(b) claims. We discuss these decisions and the implications for securities litigants below.

I. *Altimeo Asset Management v. Qihoo*: Court Reinstates Section 10(b) Claims Based on Alleged Failure to Disclose Post-Merger Relisting Plan Prior to Shareholder Vote

A. Background

Qihoo 360 Technology Co. Ltd. was an internet security company headquartered in Beijing, China, which, since 2011, had listed American Depositary Shares (ADSs) on the New York Stock Exchange.[3] In June 2015, a group of investment funds and Qihoo shareholders, including Honyi

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[1] -- F.4th --, No. 20-3074, 2021 WL 5499455 (2d Cir. Nov. 24, 2021).

[2] No. 21-0987, 2021 WL 5505107 (2d Cir. Nov. 24, 2021).

[3] Equity securities of foreign corporations traded in the United States typically take the form of ADSs, which are negotiable certificates issued by a depositary bank that evidence an interest in equity securities of the issuer deposited with the

Zhou, its chairman and CEO, proposed to take Qihoo private by acquiring all outstanding shares not owned by members of the company's board of directors. In December 2015, the Qihoo board approved the transaction, and the company executed a merger agreement with the buyer group, subject to a vote of the company's shareholders.

In advance of the shareholder vote, Qihoo issued proxy materials stating that, after completion of the merger, the surviving company "will become a private company beneficially owned solely by the Buyer Group," and "the Buyer Group does not have any current plans, proposals or negotiations that relate to or would result in an extraordinary corporate transaction . . . such as a merger." The proxy materials, however, noted that after the transaction the surviving company's management or board "may propose or develop plans and proposals, . . . including the possibility of relisting the Surviving Company . . . on another internationally recognized stock exchange." Qihoo's shareholders ultimately approved the merger with 99.8% of the votes cast, and the transaction closed on July 15, 2016.

On November 2, 2017, SJEC Corporation, an elevator-manufacturing company listed on the Shanghai Stock Exchange, announced that it would be conducting a "backdoor listing"—*i.e.*, a reverse merger—with then-private Qihoo's main business.[4] The transaction was completed on February 28, 2018, at which time the merged entity—360 Security Technology Inc.—began to trade on the Shanghai Stock Exchange.

In August 2019, two investment companies that traded Qihoo ADSs prior to the 2016 merger filed a putative class action against Qihoo, Zhou, and two directors in the Central District of California, asserting violations of Sections 10(b), 20(a), and 20A of the Exchange Act and Rule 10b-5 thereunder. The complaint alleged that Qihoo's proxy materials were materially misleading because, at the time of the merger, the buyer group intended to relist Qihoo in China at a higher valuation, and defendants' failure to disclose that information caused plaintiffs to sell their shares at artificially deflated prices. To support these allegations, the complaint cited statements by a confidential witness (a former Qihoo employee who worked in its PR department) and contemporaneous news articles from Chinese publications, and contended that the timing of the relisting would not have been feasible unless defendants had conceived of the plan pre-merger. After the case was transferred to the Southern District of New York, the defendants filed a motion to dismiss, which the district court (Engelmayer, J.) granted in full. In the district court's view, the

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bank. *See* Victor I. Lewkow, *American Depositary Shares*, *in* 1 MANUAL OF FOREIGN INVESTMENT IN THE U.S. § 6:26 (3d ed. 2013).

[4] An alternative for companies seeking to avoid the costs and regulatory barriers associated with IPOs, a "backdoor listing" is typically effected either through a reverse merger or reverse takeover. In either case, a private company is transformed into a publicly traded company by combining directly or indirectly with a listed company. *See* Erik P.M. Vermeulen, *High-Tech Companies and the Decision to "Go Public": Are Backdoor Listings (Still) an Alternative to "Front-Door" Initial Public Offerings?*, 4 PENN ST. J.L. & INT'L AFF. 421, 422 (2015).

complaint failed to plead the factual premise that underlay its claims: that defendants, pre-merger, had "a concrete plan to relist Qihoo."[5] Rather, the complaint at most pled that, at the time of the merger, defendants "envision[d] a possible future relisting," and the proxy materials explicitly advised of such "possibility."[6] The plaintiffs appealed the dismissal order.

B. The Decision

A unanimous three-judge panel of the Second Circuit reversed, holding that plaintiffs adequately alleged that Qihoo's proxy materials contained material misstatements and omissions under Section 10(b) of the Exchange Act and Rule 10b-5.[7] In contrast to the district court, which focused on whether the complaint adequately pled the premise of its claims (a "concrete plan to re-list Qihoo"), the Second Circuit reframed the question as a two-part inquiry: (1) Did the complaint adequately allege a misstatement or omission? (2) If so, did the complaint adequately allege that the misstatement or omission was "material"?

As to the first question, the Court held that plaintiffs plausibly alleged that the statement in the proxy materials that "the Buyer Group does not have any current plans" to relist Qihoo was not accurate.[8] In this regard, the Court emphasized allegations that it "typically takes companies at least a full year on the quickest timeline and usually longer, from the time they first start to consider a backdoor listing until they reach agreement with a shell company to conduct a reverse merger."[9] Based on this allegation, the Court found it plausible to infer that, given the sixteen-month time frame between close of merger and relisting, defendants already had begun to implement the relisting plan when they issued the proxy materials. The Court also highlighted two 2015 news articles from Chinese publications reporting a plan to relist the company on a stock market in China. Collectively, the

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[5] *Altimeo Asset Mgmt. v. Qihoo 360 Tech. Co. Ltd.*, 19 CIV. 10067 (PAE), 2020 WL 4734989, at *17 (S.D.N.Y. Aug. 14, 2020).

[6] *Id.*

[7] The panel consisted of Circuit Judges Guido Calabresi, Rosemary Pooler, and Steven Menashi.

[8] The opinion arguably took liberties in describing the allegedly misleading statement as "'the Buyer Group does not have any current plans' to relist Qihoo." *Altimeo*, 2021 WL 5499455, at *4. The full statement, disclosed elsewhere in the opinion, was "the Buyer Group does not have any current plans, proposals or negotiations that relate to or would result in an extraordinary corporate transaction involving the Company's corporate structure, business, or management, such as a merger, reorganization, liquidation, relocation of any material operations, or sale or transfer of a material amount of the Company's assets." *Id.* at *2. The Court's characterization of that language as a specific statement about a relisting plan not only amplified the apparent falsity of the statement, but also undercut the force of the accompanying disclaimer about the "possibility" of a relisting. *Id.*

[9] *Id.* at *4.

Court found that these allegations created a plausible inference of a "concrete plan" to relist Qihoo.[10]

As to the second question, the Court held that plaintiffs adequately alleged that omission of the relisting plan was "material"—*i.e.*, disclosure "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available."[11] In so ruling, the Court relied on a 1985 decision of the Second Circuit, which held that a complaint should not be dismissed on materiality grounds unless the alleged misrepresentation is "so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of [its] importance,"[12] and a 1974 precedent noting that merger negotiations may be material even when "negotiations ha[ve] not jelled to the point where a merger was probable."[13] Inferring that Qihoo's relisting process "would have similarly required negotiations" at the time of the shareholder vote, the Court could "not find the negotiations 'so obviously unimportant to a reasonable investor'" as to allow dismissal.[14]

C. Implications

- *Altimeo* demonstrates that, in high-stakes securities litigation, subtle gradations in the factual allegations matter, and reasonable jurists may differ on the case-dispositive question of whether a complaint has adequately pled a material misstatement or omission. In this case, Judge Engelmayer conducted a thorough, 38-page analysis of plaintiffs' theory of liability, ultimately concluding that plaintiffs had not adequately pled the factual premise of their claims, *i.e.*, that, pre-merger, the "Buyer group already planned to relist Qihoo at a far-higher valuation" in China.[15] In particular, Judge Engelmayer highlighted that defendants' proxy materials "explicitly disclosed the possibility of a future relisting," and plaintiffs failed to plead that, at that time, defendants had adopted "an actual, concrete plan to relist in China."[16] In Judge Engelmayer's view, this disclosure heightened plaintiff's pleading burden, requiring allegations of "a specific and definite" relisting plan to survive a motion to dismiss, and the complaint at most alleged that, at the time, defendants "envision[ed] a *possible* future relisting"—*i.e.*, the very scenario disclosed in the proxy materials. The Second Circuit, by contrast, did not mention the disclaimer in its analysis. Instead, citing the plaintiff-friendly motion to dismiss standard requiring it to draw all inferences in plaintiffs' favor, the Court gave the benefit of the doubt to

[10] *Id.* Because the Court found these allegations sufficient for its finding of a misrepresentation, it did not consider the plaintiff's confidential-witness allegations, which the district court had deemed unreliable. *Id.* at *4 n.3.

[11] *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 38 (2011) (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988)).

[12] *Goldman v. Belden*, 754 F.2d 1059, 1067 (2d Cir. 1985).

[13] *SEC v. Shapiro*, 494 F.2d 1301, 1306-07 (2d Cir. 1974).

[14] *Altimeo*, 2021 WL 5499455, at *5 (quoting *Goldman*, 754 F.2d at 1067).

[15] *Id.* at *8.

[16] *Id.* at *9.

plaintiffs, inferring "a concrete plan" to relist and permitting discovery and the class-certification process to proceed.

- The decision upends what was a developing consensus in the Southern District of New York that, absent a specific allegations of a "concrete" pre-take private plan to relist, a disclosure about the "possibility" of a future relisting will suffice to protect the issuer from Section 10(b) liability if such a plan eventually materializes. Two other Southern District judges—Hon. Alison Nathan and Hon. Andrew Carter—recently followed Judge Engelmayer's lead on this question, describing his decision in *Altimeo* as "thorough and thoughtful"[17] and explaining that, as in that case, where "Defendants disclosed the possibility of relisting after the go-private transaction, Plaintiffs could not survive a motion to dismiss absent some plausibly alleged facts that Defendants failed to disclose an actual, concrete plan to relist."[18] The Second Circuit's willingness to allow claims to proceed despite such disclosures raises a conundrum for issuers in the increasingly common scenario of a going-private transaction where a future relisting is possible, and perhaps discussions are underway, but the transaction remains only theoretical when proxy materials are issued: What more can the issuer do than identify the *possibility* of a relisting, without affirmatively misleading investors by overstating the probability of a yet-to-materialize future transaction? How much detail about ruminations of a possible relisting, and possible preliminary discussions, must be publicly disclosed? Post-*Altimeo*, the answers to these questions are unclear. Issuers should consider making disclosure about a possible relisting as complete and specific as possible, always bearing in mind the risk of (and taking pains to avoid) going too far in the other direction and overstating the chances of such a future transaction.

- *Altimeo* is the second time this year that the Second Circuit has reinstated Section 10(b) claims where, in the view of a Second Circuit panel, the district court wrongly held that corporate disclaimers negated the existence of a material misrepresentation or omission. In *In re Synchrony Financial Securities Litigation*,[19] Judge Victor Bolden of the District of Connecticut, in a published decision, held that a credit-card company CEO's statement that it did not receive "any pushback on credit" from retail partners in response to changes in underwriting standards did not constitute a material misstatement, despite allegations that Wal-Mart (the company's principal retail partner) had objected at the time and ultimately ended its relationship with the company. Judge Bolden rested this conclusion, in part, on the company's contemporaneous warnings about increased competition for renewals, including the CEO's own statement that the environment around renewals was "competitive."[20] As in *Altimeo*, the Second Circuit brushed aside these warnings, stating that a "general disclosure about the competitive nature of the consumer finance market" did not "properly contextualize[]" the

[17] *Altimeo Asset Mgmt. v. WuXi PharmaTech (Cayman) Inc.*, No. 19-CV-1654 (AJN), 2020 WL 6063539, at *5 (S.D.N.Y. Oct. 14, 2020).

[18] *ODS Cap. LLC v. JA Solar Holdings Co.*, No. 18-CV-12083 (ALC), 2020 WL 7028639, at *10 (S.D.N.Y. Nov. 30, 2020).

[19] 450 F. Supp. 3d 127 (D. Conn. 2020).

[20] *Id.* at 156.

CEO's "pushback" statement.[21] Rather, in the Court's view, the complaint "specifically allege[d]" that the statement was false at the time it was made, including by citing confidential witnesses and news articles contradicting the "pushback" statement, as well as the fact that Wal-Mart eventually ended its relationship with the company.[22] As for materiality, as in *Altimeo*, the Court did not conduct a searching inquiry, noting simply that the district court "did not fully grapple" with whether the "pushback" statement—"if assumed false"—was something "a reasonable investor would have considered significant."[23]

- It would be difficult to attempt to divine a hard-and-fast rule for what aggregation of factual allegations suffices to plead a material misstatement or omission under Section 10(b) and Rule 10b-5. The lesson from *Synchrony* and *Altimeo*, however, is that the Second Circuit, as currently constituted, very well may focus mainly on whether the complaint adequately alleged a misstatement or omission, not on whether it was "material." The decisions set seemingly lofty standards for a motion to dismiss on materiality grounds, with *Synchrony* stating that materiality "is a mixed question of law and fact"[24] and *Altimeo* that materiality "will rarely be dispositive in a motion to dismiss"[25] and dismissal is inappropriate unless the misstatements or omissions "are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance."[26] It would be a step too far, however, for courts to *assume* materiality at the pleadings stage upon any well-pled misstatement or omission. While the Supreme Court has recognized that materiality is a fact-intensive question,[27] it also has cautioned that the standard—whether the information would have been viewed by a reasonable investor as significantly altering the "total mix" of information made available—is not a breeze. A lower standard—*e.g.*, defining a "material fact" as any "a reasonable shareholder might consider important"—would motivate corporations to "bury the shareholders in an avalanche of trivial information[,] a result that is hardly conducive to decisionmaking."[28] On that basis, the Ninth Circuit, for instance, has held that that a plaintiff's materiality allegations must "suffice to raise a reasonable expectation that discovery will reveal evidence satisfying the materiality requirement,"[29] and the Second Circuit, in a 2013 decision, observed that "the materiality hurdle remains a meaningful pleading obstacle."[30]

- While plaintiffs may view *Synchrony* and *Altimeo* as blueprints for pleading a material misstatement or omission in the Second Circuit, the decisions are distinguishable depending

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[21] *In re Synchrony Fin. Sec. Litig.*, 988 F.3d 157, 168 (2d Cir. 2021).

[22] *Id.* at 168-69.

[23] *Id.* at 170.

[24] *Id.* (quoting *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1466 (2d Cir. 1996).

[25] *Altimeo*, 2021 WL 5499455, at *5 (quoting *In re Morgan Stanley Info. Fund Sec. Litig.*, 592 F.3d 347, 360 (2d Cir. 2010)).

[26] *Id.* (quoting *Goldman*, 754 F.2d at 1067).

[27] *Basic*, 485 U.S. at 250 ("Materiality depends on the facts and thus is to be determined on a case-by-case-basis.").

[28] *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448 (1976).

[29] *In re Atossa Genetics Inc Sec. Litig.*, 868 F.3d 784, 794 (9th Cir. 2017) (citation omitted).

[30] *In re ProShares Tr. Sec. Litig.*, 728 F.3d 96, 102 (2d Cir. 2013).

on the allegations in the complaint in question. In both, the Court emphasized detailed circumstantial evidence offered by plaintiffs in the complaints suggesting the contemporaneous falsity of specific factual assertions made by defendants—in *Synchrony*, confidential witness statements, news articles, and the undisputed fact that Wal-Mart eventually parted ways with the company, and in *Altimeo*, contemporaneous news articles and specific allegations (allegedly supplied by an "expert in Chinese and United States M&A and capitals market transactions") concerning the amount of time it takes to complete a "backdoor listing." It is doubtful that many plaintiffs will be able to adduce comparable evidence, without the benefit of discovery, in a typical Section 10(b) case. In all events, the sufficiency of a plaintiff's "materiality" and "misrepresentation" allegations are certain to remain hotly contested in the vast majority of Section 10(b) cases, in the Second Circuit and beyond.

II. *Aiello v. Brown*: Court Denies Section 10(b) Standing to Holders of Unexercised Preemptive Rights

Over 45 years ago, in *Blue Chip Stamps v. Manor Drug Stores*, the Supreme Court held that only "purchasers" or "sellers" of securities, as those terms are defined in the Exchange Act, have standing to assert a private cause of action under Section 10(b) and Rule 10b-5.[31] In determining whether this requirement is met, the Supreme Court looked to the statutory language of Section 3(a) of the Exchange Act, which defines "purchase" and "sale" to mean "any contract" to acquire or dispose of a security.[32] The Court observed that, while a person who has "no contractual right or duty" to purchase or sell a security lacks standing, "holders of puts, calls, options, and other contractual rights or duties to purchase or sell securities" meet the purchase-sale requirement "because the definitional provisions of the 1934 Act themselves grant them such a status."[33]

The question in *Aiello* was whether, by analogy, holders of preemptive rights—the right of shareholders to purchase additional shares when offered for sale by the company in proportion to the share of ownership already held[34]—have standing to assert Section 10(b) claims, even if they have not exercised those rights. The Second Circuit's answer was no. It is of no moment, as the plaintiffs argued unsuccessfully, that preemptive rights may not be "so analytically different" from put and call options; Section 3(a) expressly defines the latter as "securities," but says nothing about preemptive rights.[35] Further, plaintiffs did not actually acquire a "contractual right or duty" to acquire a security, since they did not "incur irrevocable liability."[36] Indeed, plaintiffs *rejected*

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[31] 421 U.S. 723, 754-55 (1975).

[32] *Id.* at 750-51 (citing 15 U.S.C. § 78c(a)(13), (14)).

[33] *Id.* at 751. Section 13(a) defines "security" to include, among other things, "any put, call, straddle, [or] option." 15 U.S.C. § 78c(a)(10).

[34] RICHARD A. BOOTH, FINANCING THE CORPORATION § 4:36 (Dec. 2020 update).

[35] *Aiello*, 2021 WL 5505107, at *2 (citing 15 U.S.C. § 78c(10)).

[36] *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 67 (2d Cir. 2012).

defendants' preemptive offer to sell them securities, and never "committed" to any transaction.[37] The Second Circuit therefore affirmed the district court in dismissing plaintiffs' Section 10(b) claims.

Aiello illustrates that, at least according to one Second Circuit panel, it is inappropriate to endorse novel expansions of the Section 10(b) "purchase" or "sale" requirement. The Court will strictly construe the definitions contained in Section 3(a) of the Exchange Act and limit standing to persons who "commit" to transactions in those specific, enumerated instruments. Holders of preemptive rights, unexercised, are not entitled to relief, regardless of the reason for not exercising those rights. The decision forestalls a potential expansion of Section 10(b) liability that could have encompassed untold numbers of preemptive-right holders, both for business entities whose governing documents explicitly provide for preemptive rights, and for those organized in states (such as New York and Illinois) where preemptive rights are the default rule.[38] Under *Aiello*, it is not enough for investors to hold preemptive rights to assert Section 10(b) claims; those rights must be exercised, such that "irrevocable liability" to acquire a security is incurred, to confer Section 10(b) standing.

Despite the brevity of the decision, the outcome of *Aiello* was not necessarily obvious. The Second Circuit had not previously addressed the question, and a court in the District of Nevada previously reached the opposite conclusion, holding that plaintiffs had standing to sue based on alleged actions of defendants in preventing them from exercising their preemptive rights.[39] In that case, the court grounded its ruling in the Ninth Circuit's "aborted purchaser-seller doctrine"—*i.e.*, a holder of a contract to buy or sell who is prevented from consummating the transaction has standing to sue—as well as a 1968 Second Circuit decision—*Schoenbaum v. Firstbrook*—which, as the district court characterized it, held that "the mere issuance of new stock by a corporation can constitute a 'sale' for the purposes of the 1934 Act."[40] Though not mentioning the District of Nevada decision, *Aiello* implicitly rejected both grounds. Under *Aiello*, preemptive rights do not constitute a "contract" to buy or sell a security and, thus, failing to exercise those rights cannot constitute an "aborted" purchase or sale (there was no purchase or sale to begin with). Further, without exercising preemptive rights, there is no "issuance" of stock to the plaintiff that a court can deem a constructive "sale" under the *Schoenbaum* doctrine. While we see no reason for the Second

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[37] *Aiello*, 2021 WL 5505107, at *2. In their complaint, plaintiffs did not dispute that they failed to exercise their preemptive rights. Rather, the theory of liability was that defendants' fraudulent statements *induced* their forbearance. Am. Compl. ¶¶ 176, 192-93, *Aiello v. Brown*, 19 Civ. 9647(AT) (S.D.N.Y. Apr. 24, 2020). The Court did not address the theory, implicitly holding that the reason for a rights-holder's forbearance is irrelevant absent a cognizable "purchase" or "sale."

[38] BOOTH, *supra* n.34, §§ 4:36, 4.44.

[39] *See Brennan v. EMDE Med. Rsch., Inc.*, 652 F. Supp. 255, 259 (D. Nev. 1986).

[40] *Id.* at 258-59 (citing *Mosher v. Kane*, 784 F.2d 1385, 1389 (9th Cir. 1986), and *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2nd Cir. 1968)).

Circuit to depart from *Aiello* in the future, the decision is not designated for publication and, therefore, may not be the final word on the matter.

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