

## Circuit Court Decisions Addressing Section 11 Claims

12.23.19



(Article from *Securities Law Alert, Year in Review 2019*)

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### **Second Circuit: Duty to Disclose Under Item 303 of Regulation S-K Is Limited to Known Trends or Uncertainties That Have Had, or Are Reasonably Expected to Have, a Material Impact on a Company's Overall Revenue**

On December 16, 2019, the Second Circuit affirmed the dismissal of a securities fraud action against an online hotel search platform operator and the underwriters of its IPO. *Shetty v. Trivago*, 2019 WL 6834250 (2d Cir. 2019) (per curiam).[1] The Second Circuit found that defendants had no obligation under Section 11 of the Securities Act of 1933 (the "Securities Act") to disclose (i) violations of the company's landing page standards by the company's largest advertiser, or (ii) a modification to the company's market algorithm known as the "relevance assessment" that imposed financial penalties on advertisers that failed to adhere to the company's landing page standards.

The Second Circuit rejected plaintiffs' contention that defendants had a duty to disclose pursuant to Item 303 of Regulation S-K, which requires the disclosure of "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues." 17 C.F.R. § 229.303(a)(3)(ii). With respect to the landing page violations by the company's largest advertiser, the Second Circuit noted that the complaint was "silent as to the extent of the financial impact" of these violations. The Second Circuit determined that a court could not "plausibly and reasonably infer" that these violations "had any negative financial impact at all, let alone a material impact on [the company's] overall revenue such that Item 303 would require disclosure."

The Second Circuit further found that the complaint did not "permit the inference" that "it was reasonably foreseeable . . . that implementing the [r]elevance [a]ssessment would have a material impact [on the company's] revenue." The court found the allegations "suggest that [d]efendants expected advertisers to conform their landing pages to the stated standards to avoid paying the penalty" and thus anticipated that the "impact on revenue, if any, would be minimal." Although several advertisers ultimately "ended up paying significant penalty fees for several months," the Second Circuit found that this "merely highlights the benefits of hindsight." The court explained that this "does not mean that outcome was reasonably foreseeable when the [r]elevance [a]ssessment was implemented."

### **Third Circuit: Nonvoting Board Observers Affiliated With an Issuer's Placement Agent Are Not Subject to Liability Under Section 11**

On July 23, 2019, the Third Circuit held that “a nonvoting board observer affiliated with an issuer’s placement agent” is not subject to liability under Section 11 of the Securities Act as a person who “perform[s] similar functions” to a “director.” [Obasi Inv. Ltd. v. Tibet Pharm.](#), 931 F.3d 179 (3d Cir. 2019) (Hardiman, C.J.) (quoting 15 U.S.C. § 77k(a)(3)). 15 U.S.C. § 77k(a)(3) provides that Section 11 claims may be brought against “every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner.” The Third Circuit held that “deciding whether a person is a proper § 77k(a)(3) defendant . . . is a question of law for the court, not a question of fact for the jury.” The court further held that the inquiry is limited to a review of “the description provided” in the registration statement of the person’s role, and does not extend to extrinsic evidence concerning the person’s actual functions.

In the case before it, the Third Circuit determined that “[t]hree features differentiate [the nonvoting board members] from directors” based on the description of their roles in the registration statement. First, the nonvoting board members “cannot vote for board action” and thus have no “ability to manage the company’s affairs,” which is the “directors’ most basic power.” Second, the nonvoting board members are “aligned with the placement agent” rather than the company. The court explained that the nonvoting board members’ “loyalties aren’t with [the company’s] shareholders—and loyalty to the shareholders is as vital to directorship as the power to manage.” Finally, the nonvoting board members’ “tenures are set to end automatically, with no opportunity [for shareholders] to vote them out.” The Third Circuit therefore concluded that the nonvoting board members could not face Section 11 liability pursuant to § 77k(a)(3).

**Fifth Circuit: Grant of Stock Options Pursuant to an Employee Stock Option Plan Is Not a “Sale” of Securities**

On May 24, 2019, the Fifth Circuit held that a grant of stock options pursuant to an employee stock option plan was not a “sale” of securities, as required to state a claim under Sections 11 and 12 of the Securities Act. [Lampkin v. UBS Fin. Servs.](#), 925 F.3d 727 (5th Cir. 2019) (Higginbotham, C.J.). The court reasoned that “participation in the [plan] was compulsory and employees furnished no value, or tangible and definable consideration in exchange for the option grants.”

The Fifth Circuit noted that in *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979), the Supreme Court held that “‘participation in a noncontributory, compulsory pension plan’ is not the equivalent of purchasing a security” because “the ‘purported investment is a relatively insignificant part’ of the employee’s total compensation, and the decision to accept and retain employment likely had only an attenuated relationship to the investment.” *Lampkin*, 925 F.3d 727 (quoting *Daniel*, 439 U.S. 551). The Fifth Circuit found that the key inquiry under *Daniel* is “whether employees made an investment decision that could be influenced by fraud or manipulation.”

Applying *Daniel*, the Fifth Circuit held that plaintiffs “failed to demonstrate that the grant of” the options at issue “amounted to the sale of a security.” The court found that it was “of no consequence” that plaintiffs “would eventually make an affirmative investment decision—whether to exercise the option or let it expire,” since plaintiffs’ claims were “based explicitly on the grant of the option, not the exercise of that option.”

[1] Simpson Thacher represents the underwriters of Trivago’s initial public offering in this matter.

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