

Southern District of New York: Motive to Defraud Shown by Pointing to Concrete Benefits That Could Be Realized From the Allegedly Misleading Statements or Nondisclosures, Not “Nominal Boons”

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On September 27, 2021, the Southern District of New York dismissed without prejudice a putative securities fraud class action alleging that a pharmaceutical/cannabis company, its CEO and its CFO made materially false and misleading statements to artificially inflate the company's stock price. *Kasilingam v. Tilray*, 2021 WL 4429788 (S.D.N.Y. 2021) (Crotty, J.). The court held that plaintiffs failed to adequately allege scienter through the CEO's purported motive to defraud investors, pointing to plaintiffs' failure to allege concrete benefits that the CEO could have realized from one or more of the allegedly misleading statements or nondisclosures.

Background and Plaintiffs' Allegations

After the company's 2018 IPO, the defendant CEO and his partners had an 82% ownership stake in the company and 93% voting power over the company's management through a corporation they formed to invest in the cannabis industry. In 2019, the company executed a downstream merger^[1] with the CEO's corporation (the "Share Exchange"). Plaintiffs alleged that defendants made materially false and misleading statements to inflate the company's stock price until the Share Exchange closed. Plaintiffs further alleged that the Share Exchange was part of a scheme intended to provide the CEO and his partners with: (i) ongoing voting control of the company; and (ii) a reduced tax burden if they later sold their shares. Plaintiffs also alleged that after the Share Exchange closed, the CEO engineered various company announcements prompting a stock price collapse.

Scienter Not Adequately Alleged by Mere “Nominal Boon”

Beginning with the standard for scienter, the court explained that “[t]o survive a motion to dismiss, a plaintiff must demonstrate scienter by pleading facts (1) showing that the defendants had both motive and opportunity to commit the fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness.” *ATSI Commc'ns v. Shaar Fund*, 493 F.3d 87 (2d Cir. 2007). The court further explained that “[m]otive can be shown by pointing to the concrete benefits that could be realized from one or more of the allegedly misleading statements or nondisclosures; opportunity can be shown by alleging the means used and the likely prospect of achieving concrete benefits by

the means alleged.” *In re Agnico-Eagle Mines Ltd. Sec. Litig.*, 2013 WL 144041 (S.D.N.Y. Jan. 14, 2013).

Concluding that plaintiffs failed to adequately allege scienter through the CEO's purported motive to defraud investors, the court stated that “[w]hile [plaintiffs’] narrative is perhaps not implausible, it raises as many questions as it answers.” The court emphasized that plaintiffs did not allege that the CEO had sold any of his own stock during the relevant period, or that he received any direct financial benefit from the alleged scheme prior to the company announcements, “which immediately, dramatically, and foreseeably tanked [the company’s] stock price.” The court noted plaintiffs’ position was “that the plan's aim was to allow [the CEO and his partners] to offload [company] shares free of a hefty tax bill, while hoarding voting control of the company.” However, the court stated that plaintiffs conceded that the CEO and his partners already controlled the company prior to the Share Exchange, and that the tax advantages the Share Exchange unlocked were shared by all the shareholders, not just the CEO and his partners.

The court then stated, “without articulating any theory for how these nominal boons would have been to [the CEO’s] actual benefit after [the company’s] share price foreseeably plummeted, Plaintiffs leave their motive narrative unfinished. They fail to explain how, when [the CEO] was forming his plan, there was any ‘likely prospect’ that the future post-collapse tax benefits would outweigh the foreseeable post-collapse loss in value of the stock he apparently intended to hold onto.” The court stated that plaintiffs’ “pleadings suggest that among those most harmed by the natural and intentional consequences of this purported scheme was the schemer himself.” The court observed that “[w]hen the purported fraudster ‘miss[es] the boat this dramatically,’ or in this case, opts to go down with the ship, the fraud inference is weakened.” Quoting *Ronconi v. Larkin*, 253 F.3d 423 (9th Cir. 2001).

[1] A downstream merger is a merger of a parent into its subsidiary where the subsidiary survives and the parent disappears.

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