

First Circuit: Reverses Dismissal of Action Claiming Investors Were Misled About a New—Allegedly Non-Functional—Product (Securities Law Alert)

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On December 22, 2021, the First Circuit reversed the dismissal of a securities fraud class action under Section 10(b) alleging that a software company and certain of its officers misled investors by touting a new data-backup product that they knew did not work. [Constr. Indus. & Laborers Joint Pension Tr. v. Carbonite](#), 2021 WL 6062622 (1st Cir. 2021) (Kayatta, J.). On the issue of scienter, the court held that the complaint alleged facts raising a strong inference that the CEO and CFO either inquired about the new product before deciding to promote it to investors or were reckless in failing to do so.

Background and Procedural History

Following the 2018 launch of its new data-backup product, the CEO stated in a call with investors and analysts that the new product “significantly improves our performance for backing up virtual environments and makes us extremely competitive going after that market.” Weeks later, the company’s CFO stated at an investor conference that “[t]his is a market that we haven’t been particularly strong in, in the past, we’ve been okay. I think we have completely overhauled the product and we have put something out that we think is just completely competitive and just a super strong product[.]” However, plaintiff alleged that throughout this time the new product never worked and the company had set up an internal “tiger team” focused on fixing the product. In July 2019, the company announced reduced 2019 full-year revenue projections and that the product would be withdrawn from the market, after which there was a stock drop.

Plaintiff Alleged Facts Raising a Strong Inference of Scienter

The First Circuit disagreed with the district court that plaintiff failed to successfully plead scienter. The court determined that plaintiff alleged facts raising a strong inference that the CEO and CFO either inquired about the product before deciding to promote it to investors or were reckless in failing to do so. Specifically, plaintiff asserted that defendants must have known that the product did not work because its professed importance to the company strongly implied that senior officers were following it closely and were aware of its failings. Plaintiff alternatively asserted that defendants were at least highly reckless in promoting the product because, if they were not aware of the issues, “then they repeatedly and with apparent premeditation promoted it as important to the company without at least checking that it had ever worked.”

Court Rejects Non-Culpable Inference From Efforts to Remedy the Product’s Issues

The court also rejected that the company’s efforts to remedy the issues with the product suggested “a sincere belief that [the product] could be made operational with enough work, such that [the company] believed [the product] was fixable.” The court pointed out that the CEO’s and CFO’s statements were framed in the present tense and, therefore, “were not projections of hoped-for future performance.” The court characterized the statements as “flat-out claims about the product as it then stood.”

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