

Southern District of New York: Dismisses Securities Fraud Class Action Due to Conclusory Factual Allegations and Unidentified Sources (Securities Law Alert)

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On January 10, 2023, the Southern District of New York dismissed with prejudice a putative securities fraud class action alleging that an online sports betting company and certain affiliated executives made false and misleading statements concerning a target company in advance of a three-way business combination between the company, the target, and a SPAC, with the resulting company becoming public. *In re Draftkings Sec. Litig.*, 2023 WL 145591 (S.D.N.Y. 2023) (Engelmayer, J.). Noting that plaintiffs' allegations were based almost entirely on a short seller report, which itself was based largely on unsourced or anonymously sourced allegations, the court held that the complaint's "threadbare sourcing and the conclusory quality of these factual allegations and attributions are ultimately fatal" to all of its claims.

The target developed software for online and retail sportsbook and casino gaming products. Following the business combination, a published short seller report claimed that the target operated in certain foreign jurisdictions where gambling was illegal (so-called "black-market" jurisdictions). Within weeks, plaintiffs commenced this action and asserted claims under Section 10(b) and Rule 10b-5, alleging that the company had made materially false and misleading statements about the target's violations of foreign law and their potential consequences. Specifically, plaintiffs alleged that while the company had stated in the merger agreement, the proxy statement, other public filings and press releases that the target was in compliance with the gaming laws of six black-market foreign countries, that the target had, in fact, secretly and illegally operated in these jurisdictions. Defendants moved to dismiss.

Noting that the complaint relied almost entirely on the short seller report, the court found that two features of the report were problematic, in compounding ways. First, the court explained that it must consider the complaint's allegations with caution because the short seller has an economic motivation to drive down the company's stock price. *See Long Miao v. Fanhua, Inc.*, 442 F. Supp. 3d 774 (S.D.N.Y. 2020). Second, the short seller report was based on "confidential sources," rather than identifiable and/or verifiable sources. The court explained that while "a confidential source need not be identified for his or her statements to be credited on a motion to dismiss, such a source must be 'described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.'" *Emps.' Ret. Sys. of Gov't of the V.I. v. Blanford*, 794 F.3d 297 (2d Cir. 2015). Putting these factors together, the court noted that "[a]s the case law further reflects, where these two problematic features coincide—when a complaint's factual attributions to

unidentified sources derive not from interviews by plaintiffs’ counsel, but from a short-seller report’s attributions to such sources—there is still greater need for care.” *In re Draftkings Sec. Litig.*, 2023 WL 145591, at *56.

The court further explained that if plaintiffs’ counsel has not interacted with the unidentified source and was ignorant of the source’s name, position, and other attributes tending to bear on the source’s credibility, “and instead extracted and pled as true statements from a report by a short seller attributing adverse facts to unidentified persons, these aspects of the complaint, if not corroborated, are fairly discounted or put aside altogether as ill-pled.” *Long Miao*, 442 F. Supp. 3d. The court found that such was the case here, noting that the complaint relied on statements from the short seller report attributed to unidentified former employees to support plaintiffs’ claim that the target engaged in black-market operations. The court noted that the statements of attribution were general in nature and “devoid of details lending themselves to corroboration” such as where, when, and how the target operated in each jurisdiction at issue.

Explaining its denial of plaintiffs’ request to amend, the court noted that plaintiffs had already amended the complaint twice (once before and once after a motion to dismiss). The court had warned plaintiffs then that if they chose to amend rather than oppose a motion to dismiss, then no further opportunities to amend would ordinarily be granted. Further, the court stated that plaintiffs failed to: (i) identify additional factual allegations that would cure the deficiencies noted in the motion to dismiss; (ii) explain how further investigation or diligence would rectify the deficiencies; or (iii) offer any reason for the court to disregard its earlier warning.

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