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California Federal District Court Expands Securities Litigation Involving Private Companies by Holding that Indirect Purchasers of Privately Held Shares Have Standing to Sue Under California Securities Laws

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On April 18, 2017, a federal district court in California allowed indirect purchasers of stock in Theranos, a privately held company, to proceed with their lawsuit asserting securities violations under California law. This ruling is significant because it potentially enlarges the risk of securities litigation in California against privately held companies—particularly late-stage privately held companies—which historically have experienced far lower numbers of such cases as compared to public companies. It also raises a number of questions about the ability of private funds and their investment advisers to manage or prevent claims against portfolio companies asserted by the funds' investors.

In the Theranos case, the plaintiff-purchasers invested in funds formed for the purpose of acquiring Theranos' stock. The federal court held that even such "indirect purchasers" of Theranos securities had standing to sue as representatives of a class of both direct *and* indirect purchasers. The court allowed those purchasers to base their fraud claims on statements the company broadcast to the public, not through private placement memoranda or during due diligence. While the facts of the case are unique and therefore could limit the ruling's precedential value, the implication is that individual indirect holders—of which there may be up to two thousand for a well-established private company—can now sue privately held companies for securities fraud based on public statements never made in connection with a private offering by the company.

Background

Theranos is a privately held life sciences company founded in 2003. As alleged in the complaint, between 2013 and 2015, Theranos and its founder gave "dozens" of interviews and issued a number of press releases to "emphasize the groundbreaking possibility of their technology." The complaint alleges that this campaign was designed to raise capital, yet the publicity was consumer-facing, not aimed at investors. In October 2015, *The Wall Street Journal* published an exposé questioning the viability of Theranos' technology. The Centers for Medicare and Medicaid Services launched an investigation and hit the company with sanctions in July 2016. The complaint also alleges that Theranos is under investigation by the Department of Justice and the SEC.

Plaintiffs are indirect purchasers of Theranos stock. They invested money in two different funds—both limited liability companies—set up to invest in Theranos. One fund acquired Theranos stock directly from the issuer in a September 2013 offering; the other acquired stock in August 2015 from existing investors or employees on the secondary market.

In November 2016, more than a year after *The Wall Street Journal* ran its article, Plaintiffs sued Theranos and certain of its executives who allegedly participated in the capital-raising campaign. The complaint alleges securities fraud under California, not federal, law. We focus here on two claims: violation of California Corporations Code[1] Sections

[1] Unless otherwise noted, all statutory references are to the California Corporations Code.

25400(d)/25500 (Count I, market manipulation);[2] and Sections 25401/25501 (Count II, misrepresentations in connection with offer or sale of securities).[3]

The Court's Ruling

Theranos and the officers moved to dismiss the California securities litigation claims brought against them. On April 18, 2017, the district court ruled, denying the motion as to Count I but granting it as to Count II. This means the lawsuit will move forward into discovery, which under California law will not feature several important protections for defendants that federal law allows.

As to Count I (violation of a California statute prohibiting market manipulation), the court held that California law does not require a plaintiff to have acquired the same security offered or sold by the defendant. The court reasoned that the applicable California provision "focuses on the actions of the seller of the securities, not the relationship between seller and buyer." The court noted that California courts favor a broad interpretation of the market manipulation statute, which here meant broadening the number of potential plaintiffs who can bring such cases. *Id.* While this reading was undoubtedly broad, the court took comfort that "Plaintiffs must still prove defendants' intent to induce the purchase of securities through misleading statements, which necessarily limits the relationship between a seller and foreseeable buyers." *Id.*

By contrast, the court held as to Count II that Sections 25401/25501 require privity, meaning a direct buy-sell relationship between plaintiff and defendant. In ruling that Plaintiffs did not have such a relationship and therefore had no claims, the court followed well-established precedent in California. *See* Order at 6-7.
Finally, the court indicated that the funds were likely necessary parties to the litigation and is likely to add them as defendants in the coming weeks.

Analysis of the Court's Ruling

In our view, the court's holding as to Count I stretches California's securities laws too far, for three reasons.

First, Section 25400 is aimed at curbing manipulative practices in secondary markets, not false statements in connection with securities offerings. As numerous state and federal courts in California have noted, "market manipulation" is a term of art that covers actual conduct like wash sales, matched orders, rigging, and cornering.[4] The language of the California statute closely resembles Section 9 of the Securities Exchange Act of

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[2] California Corporations Code Section 25400 makes it unlawful for "any person, directly or indirectly," "selling or offering for sale . . . [a] security" "to make, for the purpose of inducing the purchase or sale of such security by others, any statement which was, at the time and in light of the circumstances under which it was made, false or misleading with respect to any material fact, or which omitted to state any material fact necessary in order to make the statements made, in light of the circumstances under which they was made, not misleading, and which he knew or had reasonable ground to believe was so false or misleading." Section 25500 provides an enforcement mechanism for violations of Section 25400. It provides that"[a]ny person who willfully participates in any act or transaction in violation of Section 25400 shall be liable to any other person who purchases or sells any security at a price which was affected by such act or transaction for the damages sustained by the latter as a result of such act or transaction."

[3] Section 25401 makes it "unlawful for any person to offer or sell a security in this state, or to buy or offer to buy a security in this state, by means of any written or oral communication that includes an untrue statement of a material fact or omits to state a material fact necessary to make the statements made, in the light of the circumstances under which the statements were made, not misleading." Section 25501 allows any person who purchases or sells a security to a person violating Section 25401 to sue such person for rescission or damages.

[4] *See Kamen v. Lindly*, 94 Cal.App.4th 197, 202-203 ("It is important to point out that the five subdivisions of section 25400 deal with various types of activity designed to manipulate the market price of a security, which were common during the so-called pool operations in the 1920s."); *see also Reiger v. Altris Software, Inc.*, 1999 WL 540893 (S.D. Cal. 1999) (Section 25500 "was not intended to reach defendants who did not directly participate in the sale of securities or some other 'market activity'").

1934, which was specifically aimed at prohibiting the manipulative market conduct prevalent in the 1920s. Fundamental to such conduct is participation by the defendant in secondary trading with the intent of manipulating the natural forces of supply and demand in order to produce a profit at the expense of other market participants.[5] In Theranos, however, defendants are nowhere alleged to have traded in any secondary market for Theranos' stock, let alone manipulated supply or demand.

Second, in our view, the California law at issue requires any plaintiff to have purchased the same securities as defendant was offering, which would likely disqualify the plaintiffs in the Theranos case. Departing from this sound principle could mean that any purchaser of any security that derived any value from the offered security would have standing to sue. Such an overly broad approach falls afoul of California cases holding that where the security purchased differed from the one offered by the defendant, the purchaser does not have standing to sue the defendant.[6] It follows that Plaintiffs' interests in the funds should not give them standing to sue Theranos simply because the funds owned Theranos stock.

Third, the court's ruling subverts the authority of an investment fund to make decisions that are best for itself. Typically, funds' organizational documents vest authority in a governing body to make decisions on how and in what circumstances to press claims against companies the funds invest in. The Court's decision wrests that control away from the fund and puts it in the hands of an individual interest holder.

While we take issue with the court's decision, there are ways to read the court's ruling as limited to its unique set of facts:

- First, the funds at issue had been formed for the express purpose of investing in Theranos' stock, and in one case expressly to invest in a primary offering. These funds were not set up to invest in multiple securities, nor does it appear that they had. It would be harder—though not impossible—for an indirect purchaser to establish an intent to induce reliance when an investor indirectly owned a broader portfolio of securities.
- Second, Theranos has been accused of misrepresenting the viability of its business as a whole. This is not a scenario where it missed earnings for a quarter, delayed the launch of an otherwise successful product, or made some other allegedly misleading statement about a discrete event or fact.
- Third, it is not clear that the indirect purchasers had been provided any documents, such as private placement memoranda, upon which to base their indirect investment in Theranos as well as to understand the attendant risks.

Takeaways

The court's ruling stands for now. If not limited on the basis of these facts, it raises a number of considerations, especially for private funds, their investment advisers, and the private companies in which those funds invest. We outline considerations for each below.

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[5] This history explains in part why privity is not required to make out a market manipulation claim. In the case of matched orders or wash sales, for instance, the securities violator trades with himself or his co-conspirators. That creates a false impression of market activity and drives others to trade. When the market realizes the scam, the stock price falls but those harmed by the fraud never actually purchased from the market manipulator: he only traded with himself or his confederates. Were privity of contract required, then, the market manipulator would never be liable to anyone.

[6] *See Kamen v. Lindly*, 94 Cal.App.4th 197, 203-04 (Cal. Ct. App. 2001); *see also McMahon v. Marsh & McLennan Companies, Inc.*, 2010 WL 2308437, at *13 (Cal. Ct. App. June 10, 2010)

Private Investment Funds and Their Investment Advisers

The court's ruling has potential implications for the operation of private funds and their investment advisers. We highlight three.

- First, the court's ruling allows an investor in a private fund to appropriate claims that should belong to the fund, disenfranchising the remaining investors who may not want claims asserted against the company.
- Second, it raises questions as to how far up the investment chain a plaintiff may be before he or she loses a claim. Could an investor in a fund of funds (FOF) sue a private company held by one of the funds in which the FOF is invested? How about an investor even one step further removed? While the court limited the pool of potential plaintiffs based on the intent of the defendant, intent is difficult to prove or disprove. Drawing the line based on something so subjective does not provide much comfort to private companies who have to bear the cost of meritless claims, nor to the funds invested in those companies.
- Third, it raises questions as to who controls claims belonging to the fund. Plaintiffs asserted claims on behalf of a class of both indirect and direct purchasers, the latter including the funds that directly invested. As a result, the fund may be bound by decisions the indirect purchaser and its counsel make, including over settlement, and would have to intervene in the litigation or opt out of any settlement to take back control of its claims. Perhaps just as concerning, the court suggested the funds were necessary parties to the litigation and is likely to add them as defendants, forcing them into the litigation when they may have no interest in participating.

Given these implications, private funds and their advisers may well want to consider contractual language—where permitted and not already existing—that would limit the ability of a limited partner or similar investor to bring indirect claims without the fund's approval.

To discuss potential language to address these concerns or other strategies, please contact your regular Ropes & Gray Private Investment Funds, Investment Management, Private Equity, or Asset Management contact.

Privately Held Companies, Their Officers, Directors, and Advisers

The court's ruling also raises questions for private companies and their officers, directors, and advisers. We outline three below.

- First, the court's ruling raises questions about who else besides an issuer and its officers can be sued under the California securities laws. The court allowed claims against Theranos and two officers to proceed based on a literal reading of the statute, which extends to "any person selling or offering for sale . . . the security." That language could easily sweep in other defendants—such as directors and placement agents.
- Second, it poses concerns for private companies about raising money from institutional investors and publicly traded companies. Over the past decade, many private companies, particularly larger ones, have raised money from institutional investors, such as mutual funds, and publicly held companies. The court's ruling could give standing to investors in those entities to sue the private issuer. Since the universe of those investors is much broader than those who participate in private placements—and since those investors may only be able to rely on general statements in newspapers and the public domain—this decision raises the possibility that retail investors could sue private companies with indirect claims, and highlights some of the risks that arise from those sources of funding.
- Third, similar court rulings could jeopardize the entirety of a private placement. Private placements are exempt from registration under the 1933 Act provided they do not "involve[e] any public offering."[7] Because

[7] *See* Section 4(a)(2) of the Securities Act of 1933.

the court found that statements made by Theranos to the general public through press releases and in newspapers were intended to raise capital, aggrieved investors may attempt to use the reasoning expressed in the ruling to rescind a private offering in its entirety or force the company to make a rescission offer.[8]

As a practical matter, it may be difficult for a private company to limit the ability of indirect purchasers to bring claims. That is particularly so where the private issuer does not know who the indirect investors are and cannot feasibly obtain a waiver of claims from them. Nonetheless, private issuers may want to consider contractual language in its offering documents that attempts to limit or foreclose such claims and should pay special attention to the transfer restrictions it places on its securities.

To discuss these or other strategies, please contact your regular Ropes & Gray contact.

[8] *See* Section 12(a)(1) of the Securities Act of 1933.