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Ninth Circuit Affirms Dismissal of Securities Fraud Claims, Rejects Allegations as Nothing More Than 'Interesting Reading'

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A recent decision of the US Court of Appeals for the Ninth Circuit highlights the "heightened and demanding standard" required to plead securities fraud under the Private Securities Litigation Reform Act (PSLRA). In **affirming the district court's dismissal of securities fraud claims**, the Ninth Circuit made clear that "issatisfaction with a company's strategy, management, and approach to accounting, coupled with a stock drop, make for interesting reading but not any actionable securities fraud claim."

The court held that the plaintiff failed to plead either scienter or loss causation – thus "dooming" the appeal. The opinion is notable for its meticulous analysis of confidential witness allegations and alleged corrective disclosures. Importantly, the court also recognized that to plead scienter for an omissions-based claim, plaintiffs cannot merely allege that a defendant had knowledge of the allegedly omitted fact – they must provide "credible allegations of an intent to defraud investors." As for loss causation, the court held that two different short-seller reports did not qualify as corrective disclosures, building on a series of Ninth Circuit cases addressing short-seller reports in this context.

Background

On April 19, 2024, the Ninth Circuit affirmed the US District Court for the Central District of California's complete dismissal of a putative securities class action alleging that J2 Global (J2) and several executives misled investors about J2's financial performance.

In his complaint, the plaintiff alleged that J2 used an acquisition model to grow its business – in other words, it acquired companies then integrated them into one of its internal divisions. According to the plaintiff, in its public financial reporting, J2 used "consolidated accounting," meaning it reported the performance of these divisions as a whole rather than the performance of any individual acquisition.

The plaintiff alleged that J2 made misleading statements regarding a small 2015 acquisition of a company registered to J2's then-vice president of corporate development and, separately, its 2017 investment in a fund that had ties to multiple members of J2's leadership. In J2's proxy statement, it disclosed significant detail about the proposed 2017 investment – including the amount of the investment and the calculation of annual management fees owed – and also disclosed certain ties between J2's leadership and the fund.

The complaint also alleged that J2's use of consolidated accounting was misleading because it did not reflect that particular acquisitions and subsidiaries allegedly were underperforming.

According to the plaintiff, two short-seller reports revealed to the market that the defendants allegedly misrepresented the company's "true health as a business," and that the price of the company's stock dropped after these reports were released. The plaintiff subsequently brought a securities class action alleging claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The district court dismissed the plaintiff's claims twice for failure to plead scienter, and the plaintiff appealed.

Court affirms dismissal for failure to plead scienter and loss causation

The Ninth Circuit opened its opinion by reminding the reader of the "heightened and demanding" pleading standard required for a securities fraud claim, explaining that "issatisfaction with a company's strategy, management, and approach to accounting, coupled with a stock drop, make for interesting reading but not any actionable securities fraud claim." After a thorough analysis, the court then affirmed the district court's dismissal, holding that the plaintiff failed to adequately plead both scienter and loss causation.

Scienter

The court held that the plaintiff failed to adequately allege a strong inference of scienter – an intent to deceive – as is

required for a securities fraud claim. The court explained why the plaintiff's scienter allegations failed on an individual basis (described further below). Moreover, even viewing the allegations holistically as it was required to do under *Tellabs*, the court concluded that, at most, the plaintiff "paint a picture of a company that acquired many far-flung businesses and integrated them into a large conglomerate with mixed results."

Confidential witness allegations failed to meet pleading standard, including detailing source of knowledge

The plaintiff's complaint identified several confidential former employees, including a former managing director of J2's Australia and New Zealand divisions and J2's former global head of human resources.

Under the PSLRA, confidential witnesses must be "described with sufficient particularity to establish their reliability and personal knowledge," and "those statements which are reported by confidential witnesses … must themselves be indicative of scienter." Applying this standard, the Ninth Circuit rejected the bulk of the allegations from confidential former employees as unreliable, lacking in personal knowledge, or "simply amount to criticisms" or "negative opinions" about certain business practices.

In closely analyzing these former employee allegations, the court found that many of them were not sufficiently particularized or were merely criticisms of the company's decision-making. For instance, the court held that because one of the former employees was in human resources, her statements related to the acquisition necessarily "relie on secondhand information." While that former HR employee allegedly attended meetings where information about the acquisition was discussed, the former employee failed to provide enough detail about exactly **what** was discussed and **when**, and thus her statements could not "serve to impute to knowledge of the details" of the acquisition in question. This HR employee did have direct knowledge of the executive's compensation, but the court held that her scienter allegations related to compensation were "simply negative opinions of 's business practices or compensation structures, not statements which are themselves indicative of scienter" (cleaned up). Another former employee had direct knowledge of the acquisition, which the court expressly credited as reliable, but the court similarly rejected his statements as amounting to nothing more than criticisms of the business and therefore insufficient to demonstrate scienter.

The former employees also alleged that certain defendants were "deeply involved with the day-to-day workings of J2" and regularly received financial reports. In rejecting these statements as evidence of scienter, the court also pointed out that scienter was "particularly implausible" because these statements reflected that it was difficult for even the company's financial analysts to assess the performance of individual acquisitions – and thus it was "implausible that had better financial data about underperforming acquisitions than their own financial analysts (who were preparing the reports they allegedly pored over)."

Knowledge of allegedly omitted facts alone is insufficient; scienter requires 'credible allegations of an intent to defraud investors'

As to the plaintiff's allegations regarding the 2015 acquisition, the court held that "ven if knowledge of the claimed nature of the could be imputed to , that alone **would not indicate a strong inference of scienter** in J2's failure to disclose those details" (emphasis added). Instead, the plaintiff had to allege particularized facts showing that defendants knew that a statement was false or believed that they were misleading investors by omitting certain information. As the court put it: "What is missing are credible allegations of an intent to defraud investors."

The court also focused on the context of the disclosure, noting that the press release announcing the 2015 acquisition reported eight other acquisitions that quarter and did not discuss details about any of them individually. As the court explained, "t is more plausible that the details of the acquisition were equally unimportant to the press release as the details of the eight other acquisitions announced in that same disclosure." Further, the court noted that compared to the total capital J2 deployed to acquire businesses in 2015 ($265 million), it was not suspect that the defendants did not provide more details about the 2015 acquisition, which amounted to only $900,000 (or 0.33% of the total capital that year).

Omission of information alone does not raise a strong inference of scienter

The court also rejected the plaintiff's argument that the defendants' failure to disclose certain information about the 2017 investment required a finding of scienter. The court observed that J2 "disclosed significant detail" about the investment in its 2017 proxy statement. The court then addressed the additional information that the plaintiff alleged was not included – namely, the amount of management fees and additional alleged relationships between J2 employees and the investment fund. Regarding the management fees, the court found that the plaintiff misunderstood the source documents cited in the complaint and noted that the documents were in fact consistent with the disclosures in the proxy statement. Regarding the "additional ties" between J2 and the fund, the court found that the plaintiff did not allege that any defendant knew of these relationships and – critically – even if they did, the plaintiff failed to allege why the omission of this information

“compels a strong inference of scienter when (arguably more important) relationships with were disclosed.”

Loss causation

The Ninth Circuit confirmed that loss causation is not simply a pleading hoop to jump through, but rather that a plaintiff must “allege with particularity facts plausibly suggesting that a corrective disclosure revealed, in whole or in part, the truth concealed by the defendant’s misstatements, and that disclosure caused the company’s stock price to decline” (cleaned up). Importantly, to plead loss causation through a corrective disclosure, a plaintiff must plead allegations supporting that the “negative information” in the corrective disclosure “‘relate back’ to the alleged misrepresentation.”

Here, the plaintiff alleged that two short-seller reports served as corrective disclosures sufficient to demonstrate loss causation. In analyzing these allegations, the court referred to its prior decision in ***In re Bofl Holding, Inc. Securities Litigation***, where it held that anonymous blog posts authored by short sellers did not qualify as corrective disclosures because the authors had a financial incentive to persuade other investors to sell and disclaimed the accuracy or completeness of the information in the post, such that a “reasonable investor reading these posts would likely have taken their contents with a healthy grain of salt.” The court also referred to ***In re Nektar Therapeutics Securities Litigation***, where it had applied this reasoning to reports from anonymous authors at short-seller firms.

The court noted that the short-seller reports in this case differed from those in *Bofl* and *Nektar* – primarily because the reports here were not anonymous. Yet the court still held that neither report qualified as a corrective disclosure. One report was too attenuated from the alleged misstatements because it did not discuss any of the specific acquisitions identified in the complaint. The other did discuss the 2015 acquisition at issue, but its analysis “was based only on a careful reading of public documents,” and the plaintiff failed to plead with particularity why this publicly available information, which “requir no expertise or specialized skills beyond what a typical market participant would possess to uncover and disseminate was not yet reflected in J2’s stock price” (cleaned up).

Takeaways

- Confidential former employee allegations must be carefully assessed for reliability and personal knowledge, and they must include (among other things) particularized information about where and when the employees allegedly obtained their information.
- To plead scienter for an omissions-based securities fraud claim, it is not sufficient to allege that defendants had knowledge of contrary facts; rather, plaintiffs must provide “credible allegations of an intent to defraud” – i.e., they must allege with particularity that the defendants knew that omitting certain facts would render their statements misleading.
- Even if a short-seller report is not anonymous, it may not qualify as a corrective disclosure if it is not specifically tied to the alleged omission, or if it is based on public information and the plaintiff fails to plead with particularity that its analysis “required no expertise or specialized skills beyond what a typical market participant would possess” (cleaned up).

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