

10th Circuit Rejects Scheme Liability Claim, Finds Presumption of Reliance Rebutted on the Pleadings – A Significant Cooley Win

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On October 15, 2024, the US Court of Appeals for the Tenth Circuit [affirmed the district court's dismissal of all claims in *In re Overstock Securities Litigation*](#). In doing so, the Tenth Circuit decided an issue of first impression, holding that an open-market transaction **must** be “accompanied by plausibly alleged deception” to qualify as a “manipulative act” under Securities and Exchange Commission (SEC) Rules 10b-5(a) and (c) – and here, it was not. The Tenth Circuit also dismissed the plaintiff’s alleged misstatements claims under Rule 10b-5(b) for failure to plead reliance. The court agreed that the plaintiff could invoke the *Basic* presumption of reliance, but held that the defendants successfully rebutted this presumption through the plaintiff’s own admission that it would have purchased the shares at issue “no matter the price.” With this precedent-setting decision, Cooley secured a complete win on behalf of its clients – including Beyond (formerly Overstock).

Background

The plaintiffs alleged that Overstock’s former-CEO, Patrick Byrne, had a well-known animus toward short sellers, repeatedly and publicly denouncing them for causing declines in Overstock’s stock price. According to the complaint, his solution was to create a new digital marketplace that would exclude short sellers. So, in 2014, Overstock launched Medici Ventures, and through Medici, developed an alternative, blockchain-based trading platform called tZero. In 2019, Overstock announced that it would issue an unregistered dividend in the form of a digital security token, tradeable on the tZero platform. Because it was not registered with the SEC, the dividend became nontransferable for six months.

This spelled trouble for short sellers, who trade on borrowed shares and therefore have contractual obligations to immediately transmit any paid dividend to the lender of those shares. Unless the short seller returned the borrowed shares before the dividend’s record date, it would receive an untransferable security that it was contractually obligated to transfer. Although the short sellers (and the market generally) knew of the dividend record date well in advance, many waited until the days leading up to that date before scrambling to purchase the shares needed to cover their short positions. The last-minute buying frenzy among short sellers caused a short squeeze that increased Overstock’s stock price.

The plaintiff, a short seller, filed a securities class action, alleging that Overstock, Byrne and other executives manipulated the market by issuing the unregistered dividend to force Overstock’s short sellers to cover their positions and drive Overstock’s stock price to artificially high levels, thus allowing Byrne to sell his shares for a massive profit.

The plaintiff further alleged that the defendants had made false and misleading statements about Overstock’s performance, including its financial guidance and the basis for that guidance.

The case presented several unique issues, including an issue of first impression – whether a fully disclosed corporate transaction can be a “manipulative act” under Section 10(b) of the Securities Exchange Act of 1934.

No manipulation where transaction was fully disclosed

[Section 10\(b\) bars the use of any “manipulative or deceptive device or contrivance”](#) in violation of rules and regulations promulgated by the SEC to protect investors. [SEC Rules 10b-5\(a\) and \(c\)](#), in turn, prohibit the use of “any device, scheme, or artifice to defraud,” and any “act, practice, or course of business which operates or would operate as a fraud or deceit.” As the Tenth Circuit explained, to state a claim for market manipulation, a plaintiff must allege: “(1) that the defendant committed a deceptive or manipulative act, (2) in furtherance of the alleged scheme to defraud, (3) with scienter, and (4) reliance.”

When evaluating whether a fully disclosed corporate transaction can be “manipulative” under the Exchange Act, the Tenth Circuit held that “acting in a manner that results in an artificial price, on its own, is not enough to constitute manipulative conduct.” Collecting cases from other circuits, the court further distilled the following principle: “For market activity to ‘artificially’ affect the price of securities, the manipulative conduct must be ‘aimed at **deceiving** investors as to how other market participants have valued a security’” (emphasis added). Thus, an open-market transaction may qualify

as manipulative conduct, but only if accompanied by plausibly alleged deception. Here, the defendants fully disclosed the terms of the dividend, and the market immediately recognized the impact it would have on short sellers – i.e., that short sellers would “buy Overstock stock to cover their positions before the dividend’s record date.” Accordingly, there was no deception.

Presumption of reliance is indeed rebuttable at the pleading stage

The court also affirmed dismissal of the plaintiff’s claim under Rule 10b-5(b) on reliance grounds.

Plaintiffs can only recover damages in a private securities action if they establish that they relied on the defendant’s misrepresentation in deciding to buy or sell a company’s stock. There are multiple ways to show reliance. One is through actual reliance – i.e., alleging that the plaintiff was aware of the alleged misstatement and relied on it to buy or sell the stock at issue. This approach, however, does not work in a class action setting because individual questions of reliance would predominate.

Instead, plaintiffs seeking to represent a class typically rely on the *Basic* presumption – so named for the case that established it: [Basic Inc. v. Levinson, 485 U.S. 224 \(1988\)](#). To invoke the *Basic* presumption, a plaintiff must allege that:

1. The alleged misrepresentation was publicly known.
2. It was material.
3. The stock traded in an efficient market.
4. The plaintiff traded the stock between the time the misrepresentation was made and when the truth was revealed. (*Basic*, 485 U.S. at 248, n.27)

Like any presumption, however, the *Basic* presumption is rebuttable.

Here, the Tenth Circuit agreed that a defendant can rebut the *Basic* presumption by showing that the plaintiff would have bought or sold the stock “even if he was aware that the stock’s price was tainted by fraud.” This is often difficult to do at the pleading stage, but as the Tenth Circuit confirmed, not impossible. And here, although the plaintiff was entitled to the *Basic* presumption, the court found that the defendants had successfully rebutted that presumption with the plaintiff’s own admission that it would have purchased the shares at issue “no matter the price.”

The plaintiff itself conceded that its pre-existing contractual obligations and Overstock’s looming digital dividend – not the alleged false statements, nor the fair market price – caused it to buy company stock. As the Tenth Circuit noted, “Plaintiff cannot have it both ways: if Plaintiff bought its shares to avoid breaching its lending contracts, it cannot also have bought its shares because of Defendant’s alleged misstatements.” Thus, the court rejected the plaintiff’s claim of actual reliance **and** its attempt to rely on the *Basic* presumption. Without any other showing of reliance, the plaintiff’s claims relating to the alleged misstatements failed.

Takeaways

- This case highlights a trending claim among the plaintiffs’ bar – a scheme claim. While this type of claim has been available under the securities laws for years, few have alleged it, and case law on it is quite sparse. *In re Overstock* may serve as helpful new precedent in this emerging area.
- The Tenth Circuit has revealed a crack in the presumption of reliance that was previously considered largely un rebuttable at the pleading stage. Creative approaches, like employing plaintiff’s own admissions, may be key to rebutting the presumption in the early stages of litigation.

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