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Scheme Liability: Talk is Cheap

By Brian P. O'Connell

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The Second Circuit Court of Appeals recently showed that talk is cheap when it comes to the reach of "scheme liability" claims for investors.

Pursuant to the scheme liability subsections of the federal securities laws, plaintiffs may bring claims involving "any device, scheme or artifice to defraud," and for "engag[ing] in any act, practice, or course of business which operates… as a fraud."

However, on July 15, 2022, in *Securities and Exchange Commission v. Rio Tinto PLC* ("*Rio Tinto*"), the appeals court held that the SEC could not allege a claim against an international mining company for scheme liability based only on its assertion that the mining company made false statements and failed to disclose key information about the company's acquisition of a coal mine in Mozambique. The court ruled that scheme liability claims required more than merely alleging a false statement or misleading omission.

The facts in *Rio Tinto* center on the defendants' delayed acknowledgment of a major impairment of the value of the mine. In 2011, the defendants purchased an exploratory coal mine in Mozambique for $3.7 billion. The purchase price assumed that the mine would produce high quality and large volumes of coal, that the coal could be barged down the Zambezi River, and that the rest could be transported using existing rail infrastructure. However, the defendants soon learned that the coal quality was worse than expected, that the Mozambican government would not allow transportation of coal by barge, and that the rail infrastructure would require a $16 billion upgrade. On May 11, 2012, management from the mine informed company executives in a meeting that the coal mine's net present value was negative $680 million.

In the months before and after the meeting, the defendants were issuing financial statements and preparing audit papers. The complaint alleged that these documents contained representations about transportation options and the quality and volume of coal reserves. The statements included the company's 2011 annual report, which valued the mine at the $3.7 billion acquisition price, a half-year 2012 report, bond offerings, and statements made during meetings and investor calls. The SEC alleged that none of the documents disclosed that the mine's value was impaired. Meanwhile, the company's in-house valuation team disagreed with the over-$3 billion valuation. In August 2012, the team valued the mine in the range of negative $4.9 billion to negative $300 million. On January 15, 2013, the company's board approved an 80% impairment, valuing the mine at $611 million. After once again impairing the mine, the company sold the mine in October 2014 for $50 million.

Brian P. O'Connell, Associate

In 2017, the SEC brought an enforcement action under the Securities Exchange Act's ("Exchange Act") scheme liability provisions alleging, among other claims, that the company made false statements about coal transportation options and the amount and quality of coal reserves, and the company failed to disclose that the mine's valuation was impaired. In 2019, the trial court dismissed the scheme liability claims on the grounds that the conduct constituted misstatements and omissions only, and was therefore an insufficient basis for scheme liability. In 2005, the U.S. Supreme Court had ruled *in Lentell v. Merrill Lynch* that misstatements and omissions cannot form the "sole basis" for liability under the scheme subsections.

About one week after the trial court's decision in *Rio Tinto*, the Supreme Court released *Lorenzo v. SEC*, which held that an individual who *disseminated* a false statement (but did not make it) could be liable under the scheme liability section of the Exchange Act. In *Lorenzo*, the defendant director of an SEC-registered brokerage firm, Francis Lorenzo, sent two emails to prospective investors. The content of the emails was supplied by

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Lorenzo's boss and described a potential investment in a company that had "confirmed assets" of $10 million. Mr. Lorenzo knew, however, that the company had recently disclosed that its total assets were under $400,000. *Lorenzo* held that the transmission of emails, or "dissemination," could sustain a claim under the scheme section of the Exchange Act, which prohibits a "device," "scheme," "artifice to defraud," and/or fraudulent "practice." *Lorenzo* thus concluded that the scheme subsections of the Exchange Act can cover misstatements even if the defendant was not a maker of the statement.

Citing *Lorenzo*, the SEC moved the trial court in *Rio Tinto* for reconsideration, but the court denied it. On appeal, the Second Circuit held that misstatements and omissions, on their own, cannot support a scheme liability claim under the Exchange Act and affirmed the lower court's decision dismissing the scheme liability claims. The court noted that the Supreme Court's decision in *Janus Capital Group v. First Derivative Traders* limits primary liability under the Exchange Act's false statement section to the "maker" of a statement, but that scheme liability does not require an allegation that a defendant made a statement.

The court cautioned that expanding the scope of scheme liability would lower the bar for primary liability for securities fraud claims, which requires that a complaint alleging misleading statements specify each statement alleged to be misleading, and the reasons why the statement is misleading. The court warned that "an overreading of *Lorenzo* might allow private litigants to repackage their misstatements claims as scheme claims to evade pleading requirements imposed on misrepresentation claims."

The *Rio Tinto* court concluded that because *Lorenzo* did not break "the link on which [the court] premised its prior decision," it would not reverse the trial court's decision. The appellate court's analysis was premised on the trial court's characterization of the scheme liability counts as a collection of misstatements and omissions. The court held that because *Lentell* withstands *Lorenzo*, and because the dismissal order stated that the complaint alleged misstatements and omissions only, the trial court did not abuse its discretion in declining to reconsider the dismissal of scheme liability claims. The court ruled that under *Lorenzo*, although misstatements and omissions can form part of scheme liability, an alleged "actionable scheme liability claim requires something beyond misstatements and omissions."

The court acknowledged, however, the possibility that there are ramifications from the *Lorenzo* decision that "blur the distinctions" between the misstatements subsections and the scheme liability subsections of the Exchange Act. For example, the court declined to consider whether the corruption of an auditing process or allegations that a corporate officer concealed information from auditors is sufficient for scheme liability under *Lorenzo*.

The court further noted that overreading *Lorenzo* could muddle the distinction between primary and secondary liability—as aiding and abetting liability is allowed in SEC actions but not by private plaintiffs. The court cautioned against reviving an implied cause of action against all aiders and abettors, including those who assist in the preparation of a statement.

The ramifications of *Lorenzo* remain to be fully played out, but this decision foreshadows coming battles over whether concealment claims are "omissions" under the misstatements/omissions subsections of the Exchange Act or more properly viewed as scheme claims under the scheme liability subsections, as well as the judiciary's fleshing out what constitutes dissemination. On September 2, 2022, the Southern District of New York held in *In Re Turquoise Hill Resources Ltd. Securities Litigation* that a drafter of a statement who "disseminates" the statement to another who then published the statement did not constitute "dissemination" under *Lorenzo*. On October 11, 2022, however, the Southern District of New York, in *SEC v. Stubos*, held that the SEC alleged a scheme liability claim by claiming a defendant engaged in a pump and dump stock promotion. The SEC alleged the defendant concealed his ownership in the company, broke his trades into small blocks to avoid market scrutiny, and directed other traders via encrypted messages to strategically buy stock to inflate the price—without making a false or misleading statement. In doing so, the court cited *Rio Tinto* language that "dissemination is [just] one example of something extra that makes violation a scheme."

Expect more decisions setting the parameters of scheme liability in the years to come. Plaintiffs will want to allege scheme claims as including something more than mere statements in future scheme actions. ■

The Valuation Treadmill

By Professor James J. Park
Reviewed by Marc I. Gross

This is an abbreviated version of an article to be published in Securities Regulation Law Journal.

Despite the plaintiffs' securities bar's success, over the last decades, in recovering billions of dollars for defrauded investors and effecting important corporate governance reforms, corporate securities fraud persists.

The history and current state of "cooking the books" is masterfully explored in *The Valuation Treadmill* by Professor James J. Park of UCLA Law School. Park blames the persistence of such fraud primarily on corporations' drive to meet "valuation metrics" – especially quarterly earnings projections – by fudging numbers to report results consistent with such forecasts.

Marc I. Gross, Senior Counsel

The Frauds

Park analyzes iconic cases of projection-focused frauds, recounting the motivation behind each, the methods used, and the ultimate fallout. These include frauds related to Penn Central's demise in the 1970's; Apple's failed launch of the Lisa computer in the late 1980's; Xerox's unsuccessful efforts to keep pace with computer-driven technology in the late 1990's; Enron's efforts to monetize energy supply contracts in the early aughts; Citigroup's sinking from overloaded subprime debt in the late aughts; and GE's opaque, cobbled-together conglomeration of enterprises, which (by deft skill or sleight of hand) enabled it to generate 10 years of consistent growth, until, abruptly, it did not.

The Obsession with Projections

Park decries analysts' and investors' focus on the feedback loop of the "valuation treadmill":

> [S]ecurities fraud emerged as a significant risk for public companies as investors changed how they valued stocks. As investors adopted modern valuation models and attempted to develop projections of a corporation's ability to generate earnings into the future, it became more important for public companies to meet market expectations about their short-term performance.

This focus on the future, Park asserts, has created structural incentives for companies to inflate prospects, which was not historically the case. He lays blame on money managers and outside securities analysts as well as on corporations themselves. *The Valuation Treadmill* also asserts that executive compensation has become a factor in the pressure to meet quarterly projections. In the 1970's, CEOs, missioned to maintain stable growth, were compensated primarily in cash. By the aughts, CEOs had morphed into entrepreneurial titans setting the course for expansive growth, with 66% of their compensation in stocks and options.

How They Did It -The Projections/Inflation Toolbox

Park identifies several devices management has used to inflate results and meet forecasts, including:

Skewed Unbundling – improperly allocating bundled hardware/software and service contracts in order to maximize short-term revenue recognition and minimize long-term amortizations, as in Xerox and Comverse Technologies.

Round-tripping – entering into contracts to essentially swap revenues.

Reciprocal Timing Transactions – to forestall reporting lower-than-expected results, a company "sells" goods to third parties near the end of a quarter, with the understanding that the company will buy back the goods once the new quarter begins.

Cookie Jar Reserves – manipulating results when times are good by increasing reserves which are expensed against earnings, and then releasing those reserves in less profitable times, thereby "smoothing out" reported results.

Earnings Management – an arguably more sophisticated method of smoothing out reported earnings by which companies sell assets and purchase new revenue-generating businesses when they need to produce additional income for a period. Such buying and selling enables a company to exercise discretion on how much to assign to goodwill and deferrals.

Proposed Solutions

The Valuation Treadmill also proposes several solutions to projections-triggered fraud. Rather than weaning the market from reliance on projections, Park urges that all corporations be compelled not only to provide *quarterly* projections, but also to disclose the basis for such projections. Doubling down, he further urges that companies be compelled to update their projections, considering significant intra-quarter developments. To address the risk of earnings management, Park also recommends that the SEC develop rules clarifying when companies cross the line into deceit.

A threshold question to Park's proposals remains: Will mandating quarterly projections continue to skew the focus to "short termism" and risk long-term sustainability? Such short-sightedness accounts for the significant decline in corporate investment in research and development, whose payoff is generally years down the

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Brian Calandra, Of Counsel

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line, and has led to reliance on acquisition of start-ups (only recently raising antitrust monopolization concerns). Several alternatives to Park's proposals are considered below.

The Business Roundtable Remedy – fewer projections

Park acknowledges, but rejects, the proposal forwarded by Jamie Dimon and Warren Buffet on behalf of the Business Roundtable, that companies be barred from issuing quarterly projections altogether, to enable them to voluntarily manage investor expectations during downturns, while reducing the weight investors assign analyst projections.

The UK Remedy – fewer quarterly reports

Both the Business Roundtable and Park ignore the possibility of reducing short-termism by companies issuing *historic results* less frequently. Companies listed on the London Stock Exchange file financial reports only semi-annually. From 2007-2013, the UK experimented with quarterly reports, but reversed that requirement in 2014. Quarterly reporting maximizes contemporaneous information, but increases the risk of short-termism and securities fraud, which is far less frequent in the UK.

Clawbacks

Another solution not considered by Park would be enhanced enforcement of "clawbacks." The SEC is empowered to recover compensation paid to executives for conduct underpinning whistleblower complaints. Such clawbacks remain rare, though, and there is no private right of action empowering investors to directly sue for such recompense – investors can only sue derivatively on behalf of a company. Perhaps if executives were held more accountable for the bonuses they pocket from reporting inflated results, they might think twice before "cooking the books" to meet quarterly projections.

Several Questions Raised by Park's Proposals

Which Projection Factors Should be Disclosed

If disclosure of quarterly forecasts and supporting assumptions are to be mandated, companies will need to beef up internal controls. Myriad prognostications inform forecasts: likely sales, returns, bad debts, currency fluctuations, interest rates, wages, employee turnover, etc. If each contributes to projection calculations, to what degree should each be disclosed? Moreover, is there a risk that increased costs for control-related personnel and procedures will lower profits?

Should Disclosure to Bankers Be Shared

Before reinventing the wheel, it could be helpful to understand what types of forecasts companies routinely provide their lending banks, and to consider compelling their disclosure. On the other hand, having managed a contingency fee law firm for several years, I know that forecasting is more art than science. Executives will be in a structural bind: As salespeople, they need to set goals to motivate personnel and maximize performance; but projections of likely results will need to be tempered when presented to risk-averse investors.

Should Upside Revisions Be Disclosed?

Park's proposal to impose a duty to update might be a welcome addition to the valuation tool kit. But should that duty be bilateral, i.e., if matters look better than previously projected as the quarter nears an end, should the company be compelled to disclose revised upbeat projections? The pressure to commit fraud might intensify if last-minute sales fail to materialize after such upward adjustments. Market prices tend to be volatile, particularly when companies miss consensus forecasts by even small amounts. A mandatory duty to update projections could have unintended consequences on market prices or management behavior.

Conclusion

The Valuation Treadmill is an invaluable addition to the study of securities fraud trends over the past 50 years, along with ambitious proposals to curtail such misconduct in the future. ■

Pomerantz Vindicates Defrauded DouYu Investors

By Brian Calandra

On August 9, 2022, New York State Supreme Court Justice Andrew Borrok preliminarily approved a $15 million global settlement of securities fraud claims against DouYu International Holdings Limited ("DouYu"), simultaneously resolving parallel state and federal court lawsuits arising out of DouYu's $775 million debut on the Nasdaq in 2019. The final settlement hearing will be on December 1, 2022. Pomerantz represents the federal plaintiffs in the case in the United States District Court for the Southern District of New York.

DouYu (which translates to "fighting fish") is the largest game-centric live streaming platform in China. The company's platform operates on PC and mobile apps, and enables individuals to watch, create, or share videos in real time. Users who broadcast content on DouYu's platform are called "streamers."

The federal putative class action, filed in 2020, alleged that DouYu's IPO documents touted the benefits of Chinese tech giant Tencent's 37% stake in DouYu, referring to Tencent as a "major shareholder and strategic partner," particularly "in live streaming, advertising and game distribution, which helps reinforce and solidify [DouYu's] position as a leading game-centric live streaming platform in China." But shareholders claimed that DouYu failed to mention that Tencent was simultaneously planning to invest more than $1 billion in Kuaishou, one of DouYu's direct competitors.

According to the complaint, "DouYu's ability to maintain its 'deep pool of top streamers' was, and is, absolutely critical to its success and its efforts to differentiate itself from major competitors." The company's offering documents credited DouYu's large, enthusiastic, and highly engaged user base for attracting and retaining its top streamer pool, stating:

> We believe we are the go-to platform for game-centric live streaming in China . . . Our rich and dynamic content offerings and engaging social media features bolster organic growth of our user base.

Yet DouYu withheld from its IPO investors that, in fact, many top gamers were departing en masse for competitors. Further, shareholders claimed they were unaware that DouYu's "lucky draw" gifting feature ran afoul of Chinese gambling regulations, and that one of the site's most popular streamers — a woman known as "Your Highness Qiao Biluo" — had used video software to disguise her age.

In the months after the IPO, the truth was gradually revealed, as media and analysts reported a decline in DouYu's revenue, leading DouYu's share price to plummet 47%.

The settlement is on behalf of all investors who bought DouYu American depositary shares between July 16, 2019, and Jan. 21, 2020, and resolves all claims against IPO underwriters JPMorgan Securities LLC, Morgan Stanley & Co. LLC, BofA Securities Inc. and CMB International Capital Ltd., as well as Cogency Global Inc., DouYu's U.S. representative for its offering. ■

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Q&A

Chiao Chen

The Editors recently sat down with Chiao Chen, Pomerantz's Director of Financial Analysis, for a "behind the scenes" look at damages analysis, a critical aspect of securities litigation.

Pomerantz Monitor: Please describe the path that led you to your role with Pomerantz.

Chiao Chen: Having worked in a variety of roles within investment management firms, I was looking to transition to a new environment in which I could utilize my financial experience and expand my expertise. Pomerantz, a leading global securities ligation law firm, was seeking a hands-on financial leader to oversee their damages team. This seemed a natural fit for my abilities and a path to advance my professional development.

PM: What is financial analysis in the context of securities fraud?

CC: Financial analysis in the context of securities fraud is an analysis of data related to securities transactions where fraud is suspected as a cause for loss. Securities fraud usually involves corporations misrepresenting information that investors rely on to make decisions. When companies falsely tout their financial prospects or fail to disclose adverse information to the market, the value of their securities is artificially inflated. When the truth surfaces, the value of those securities plunges and investors suffer. Most, but not all, cases at Pomerantz are litigated on behalf of an entire class of similarly damaged investors. For a class to be certified, attorneys and their clients must demonstrate, among other things, that the class is so numerous that joinder of all members is impracticable, that there are questions of law or fact common to the class, and that the claims or defenses of the Lead Plaintiffs are typical of the claims or defenses of the class. Financial analysis provides a framework to generate empirical evidence per the information available for each individual case.

PM: You are part of Pomerantz's Case Origination Team. What is your role there?

CC: The attorneys are constantly looking for red flags in the market. If there's a sudden drop in a stock price on a high volume of trading, they will investigate potential fraud. My team and I work closely with the attorneys. When they identify a case of potential interest, we immediately search our clients' portfolios to see whether they suffered losses and calculate their potential damages. In the meantime, the attorneys are investigating potential claims in the case. Our proprietary damages software allows us to instantly calculate damages for various scenarios that the attorneys propose.

PM: Describe the role your team plays when Pomerantz competes with other firms to be named Lead Counsel in securities class actions.

CC: Once a securities lawsuit is filed and published, the clock starts ticking. Investors have 60 days within which to move the court to be appointed Lead Plaintiff. All law firms must make their motions on behalf of their clients public. My team reviews all the transactions from competing firms' submissions and loss summaries. We manually evaluate competing firms' data to perform an apples-to-apples comparison. We review the transactions to identify a competitive angle for our attorneys to challenge, such as incorrect calculations and/or anything that may suggest the competing firms' client's data may be atypical.

PM: It seems like the intersection of mathematics and detective work.

CC: Yes, mathematics and detective work are an apt way to describe this part of the process. Within certain standardized calculations, my team reviews differences and/or errors to give our attorneys an advantage to help challenge competing firms' clients. We look for miscalculations, transaction prices not within the high/low range for the date, transactions that are outside of the class period and transactions that may suggest an investor was betting against the company.

PM: Your team monitors over $7 trillion in assets to identify clients' exposure to securities fraud. How do you accomplish that quickly at such a scale?

CC: We monitor our client's exposure with our proprietary software, JADA2, which uses highly sophisticated technology that has been tailored to our needs. JADA2 can handle a robust data set, based on the parameters we set, so that we may access and analyze our client's data quickly and efficiently.

PM: With your "behind the scenes" experience, what advice would you give to institutional investors to help them protect their assets from securities fraud?

CC: The best practice for institutional investors is to ensure that a comprehensive, unbiased due diligence is completed prior to investing. As Ronald Reagan said when signing the 1987 Intermediate-Range Nuclear Forces Treaty with Mikhail Gorbachev, "Trust, but verify." ■

Jennifer Pafiti

Emma Gilmore

Dr. Daniel Summerfield

Janalee Spencer

NOTABLE DATES ON THE POMERANTZ HORIZON

IF YOU WILL BE ATTENDING ANY OF THESE EVENTS AND WOULD LIKE TO MEET WITH US, SEND US A MESSAGE AT: EVENTS@POMLAW.COM.

EMMA GILMORE will be a featured speaker on a **Securities Litigation webinar** hosted by Skadden, Arps, Slate, Meagher & Flom LLP on December 8.

JANALEE SPENCER will attend **Opal's Public Funds Summit** in Scottsdale, Arizona from January 12-13, 2023.

Along with **JENNIFER PAFITI, JANALEE** will attend **NAPO's Annual Police, EMS & Municipal Employee Pension & Benefits Seminar** in Las Vegas, Nevada from January 22-24.

DR. DANIEL SUMMERFIELD will attend **The Investment Association's 2023 Stewardship & Corporate Governance Forum** in London, the United Kingdom, on January 25.

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Pomerantz is acknowledged as a global leader in securities and corporate governance litigation. Pomerantz monitors the portfolios of some of the most influential institutional investors and financial institutions worldwide, monitoring assets in excess of $8 trillion. Founded by Abraham L. Pomerantz, who was known as the "dean of the class action bar," the Firm pioneered the field of securities class actions. For 85 years and counting, Pomerantz has continued the tradition that Abe Pomerantz established, fighting for the rights of victims of securities fraud, breaches of fiduciary duty, and corporate misconduct. Prior results, however, do not guarantee a similar outcome in future cases.

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