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ARTICLES

Protecting Venture Capital Firms Against Securities Litigation

By Stephen L. Brodsky – August 25, 2018

Venture capital firms and their members are frequent targets of securities litigation. It is quite common for plaintiffs in securities suits to name them as defendants, along with others, to cast a wide net of liability among as many defendants as possible. Knowing the potential liability that venture capital firms and their representatives may face, the securities laws on which such liability may be premised, and how courts have construed legal doctrines typically employed against them is critical to successfully defending them and avoiding costly litigation.

Potential Liability
There are two main types of liability to which venture capital firms and their members may be subject. The first arises from securities litigation claims that seek to hold them liable for alleged misleading statements or omissions by the companies in which they have invested. Exposure to such claims often turns on the degree of involvement that a venture capital firm and its members have in the business operations of the portfolio company itself, as well as the theories of liability that ground the claims. The second arises from claims of insider trading by venture capital members in the shares of a portfolio company, based on material, nonpublic information.

Disclosure Liability
The Securities Act of 1933 (the Securities Act) imposes liability on certain entities and persons for, among other things, materially false and misleading statements or omissions in a prospectus or registration statement issued in connection with a company's initial public offering. *See* 15 U.S.C. § 77k (section 11); 15 U.S.C. § 77*l* (section 12). No intent to deceive on the part of the maker is required. Nor must a plaintiff rely on the misleading statement or omission in the offering document. The Securities Act additionally imposes liability on persons who "control" (through stock ownership, agency, agreement, or otherwise) any entity or person who made the statement or omission. *See* 15 U.S.C. § 77o (section 15). Typically, a corporation's directors are sued both as primary violators and as "control persons."

As a result, a venture capital fund member who is a director of a portfolio company at the time the company goes public may face Securities Act liability for a misstatement or omission in the company's public offering documents. The fund member may face liability, as noted, even if he or she did not "make" the statement or omission, on the basis of control over the maker. Courts have allowed Securities Act claims against venture capital firm defendants to proceed where plaintiffs sufficiently alleged control by those defendants over the company through, for example, positions as active and involved directors. Conversely, courts have dismissed such claims when the allegations of control are inadequate.

Regardless, venture capital defendants may still rely on the same legal defenses that are available to others. One such defense, commonly known as the "bespeaks caution" doctrine, may be available to protect against liability for forward-looking statements if they are sufficiently couched in adequate cautionary language. Such language may describe risk factors involving, for example, the industry, the company, and/or the investment itself. In one case, *In re Stac Electronics Securities Litigation*, 89 F.3d 1399, 1411 (9th Cir. 1996), the plaintiffs sued several

venture capital firm members who served on the portfolio company's board of directors at the time of the company's initial public offering. However, the Securities Act claims against them were ultimately dismissed, in large part, due to the cautionary language in the prospectus, the offering document at issue.

Under the Securities Exchange Act of 1934 (the Exchange Act), a company and its directors may be held liable for materially false and misleading statements or omissions made to secondary market investors. *See* 15 U.S.C. § 78j(b) (section 10(b)); *see also* Rule 10b-5 (codified in 17 C.F.R. § 240.10b-5). Unlike a Securities Act claim, a claim under the Exchange Act requires fraudulent intent by the maker (an intent to deceive) and the investor's reliance on the alleged misrepresentation or omission. The statements or omissions may be within any company document that is disseminated to the investing public, such as a periodic filing with the Securities Exchange Commission (SEC) (for example, a quarterly 10-Q report, an annual 10-K report, or current 8-K report) or a press release. The Exchange Act also holds "control persons" liable for such statements or omissions. *See* 15 U.S.C. § 78t(a) (section 20(a)).

While a venture capital fund or its members who serve on the boards of their portfolio companies typically have little to no involvement in generating and issuing these public statements, the fund or one of its members can still be targeted for securities fraud liability under either a "control person" theory or the "group pleading" doctrine. Under the first, if the fund or its member was in a position to control the affairs and operations of the portfolio company, they may be held liable for the misrepresentation or omission as a control person. Under the second, a plaintiff may rely on a presumption that statements in group-published documents are the collective work of those who are involved in the everyday business affairs and operations of the company.

The Private Securities Litigation Reform Act of 1995 (PSLRA) (15 U.S.C. § 78a) and the U.S. Supreme Court's ruling in *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011), have been interpreted to limit the "group pleading" doctrine to corporate "insiders" and "makers" of the alleged statements or omissions at issue. Courts have nonetheless rendered conflicting decisions as to whether the doctrine remains viable after *Janus* and who may have the requisite authority and control to fall within this category. *See, e.g.*, *In re Banco Bradesco S.A. Securities Litigation*, 277 F. Supp. 3d 600, 637 (S.D.N.Y. 2017) (collecting decisions). In addition, if a plaintiff makes sufficiently detailed and adequate allegations, a court may allow the claim to proceed beyond the pleading stage, through discovery and, ultimately, to trial. Thus, a venture capital firm and its members may still be required to expend significant fees to defend themselves, even if they eventually prevail in the litigation.

It should be noted that a portfolio company need not be public for a venture capital firm or its members to face potential liability under the Exchange Act. For example, if a private venture capital-backed company uses its own securities to acquire the stock of another company, the shareholders of the acquired company may assert Exchange Act claims for misrepresentations or omissions made in connection with the transaction. In *Dresner v. Utility.com Inc.*, 371 F. Supp. 2d 476 (S.D.N.Y. 2005), the shareholders of a private company that was acquired by another private company sued the acquirer, along with its officers and directors and several venture

capital investors, for alleged misrepresentations and omissions in the merger negotiations and agreement. The court dismissed the claims against the venture capital funds and their representatives, however, holding that the "group pleading" doctrine could not be used against non-management directors and that the plaintiffs additionally failed to adequately allege control person liability.

Insider Trading Liability

Securities lawsuits against venture capital firms also commonly include claims that members of the venture capital firm committed insider trading; that is, trading in a portfolio company's securities based on material, nonpublic information. These suits typically arise when venture capital fund members sell their own shares in a portfolio company shortly before a significant drop in the portfolio company's stock price. Courts are often hesitant to dismiss an insider trading suit at the outset, given the nature of the insider trading allegations. This is because a sale of large numbers of shares just prior to the release of negative news may suggest that the defendants had prior "inside" knowledge of the impending news release or the event that resulted in the downturn of the company's stock price, once the event became public.

Insider trading suits are typically asserted both against a venture capital fund itself and the fund managers who serve as directors of publicly traded portfolio companies. In *In re Worlds of Wonder Securities Litigation*, 721 F. Supp. 1140 (N.D. Cal. 1989), several venture capital firms and their representatives on the board of directors of a portfolio company were confronted with insider trading claims. The court refused to dismiss the claims against the venture capital firm defendants on the grounds that there were sufficient ties between those defendants and the company directors to support the claims. After discovery, the court ultimately dismissed the claims on summary judgment.

Strategies for Defending Venture Capital Firms

In light of the above, counsel representing venture capital firms and their members against securities litigation should take measures to mount a robust and vigorous defense. As an initial matter, it is nearly always appropriate to move to dismiss the claims asserted in the complaint against these defendants, at the outset of the litigation.

> **Motion to dismiss the complaint.** There are typically multiple grounds on which to move to dismiss. Among others, they are (1) the plaintiffs' failure to allege an actionable misrepresentation or omission, for example, due to cautionary language or other disclosures in the relevant documents or due to a lack of materiality; (2) the plaintiffs' failure to properly allege that the misrepresentation or omission can be attributed to the venture capital defendants, for example, by insufficiently alleging that the defendants had the requisite control over the makers of the alleged misrepresentations or omissions or that the defendants lacked sufficient involvement in the day-to-day operations of the portfolio company; and (3) the plaintiffs' failure to allege that the venture capital fund defendants possessed the requisite *scienter*, i.e., an intent to defraud. The frequently attenuated role that venture capital firms and their members have in the business affairs

and operations of their portfolio companies makes these defenses particularly meritorious.

Failure to plead with particularity. Due to specificity requirements of Federal Rule of Civil Procedure 9(b) for pleadings involving fraud and the stricter standards of the PSLRA and the recent decisions of the Supreme Court, plaintiffs cannot simply set forth generalized allegations, with little basis or grounding, concerning venture capital firm defendants. Plaintiffs must allege in detail how the venture capital fund or its members were responsible for the allegedly false and misleading statements and omissions. As a general matter, venture capital firms and their members do not themselves typically make public statements on behalf of the portfolio companies on whose boards they may serve. Therefore, plaintiffs must set forth a legal basis to justify holding them liable for statements made by others.

Because venture capital members are typically "outside directors" of the fund's portfolio companies, a section 10(b) securities fraud claim under the Exchange Act will often be insufficient unless the defendants actually make the misrepresentations or omissions. Given the more recent restricted availability of the "group pleading" doctrine, plaintiffs must allege in a detailed fashion that the venture capital firm directors are "insiders" of the corporation, with ultimate control and authority over the makers of the fraudulent misrepresentations or omissions. Counsel defending the venture capital firm or its members should draw on decisions that have determined that the group-pleading doctrine is no longer viable, or extremely limited in scope, after the PSLRA's heightened pleading requirements and the Supreme Court's decision in *Janus*.

Given developments in the law, the difference between corporate insiders and outside directors is only starker. Outside directors, by their very roles, do not participate in the corporation's everyday operations. As a result, it should be highly unusual, even counterintuitive, for such directors to possess the requisite authority, control, and involvement in the portfolio company to be liable either as control persons or as "makers" of the company's misrepresentations or omissions.

No intent to defraud. In addition to alleging and proving that each defendant made a material misleading statement or omission, plaintiffs asserting section 10(b) fraud claims under the Exchange Act must show, among other things, that the defendant acted with *scienter*; that is, an intent to deceive or defraud the investor. Under the PSLRA, section 10(b) claims must specify each statement alleged to have been misleading, explain why the statement is misleading, and state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind, i.e., fraudulent intent. Invariably, mere boilerplate allegations as to these elements are insufficient.

No ability to control the corporation. Plaintiffs asserting securities claims against venture capital firms and their members usually attempt to base the liability of these defendants on the "control person" provisions of the Securities Act and the Exchange

Act. To prevail, however, plaintiffs must allege and prove both an underlying primary securities violation and that the defendants had control over the entity or person that made the misleading statement or omission. If a plaintiff fails to satisfy either one of these prongs, the claim will fail as a matter of law. In asserting control person liability claims against outside directors, plaintiffs must also still plead and, ultimately prove, that these directors possessed the requisite control to succeed.

Mitigating Risk

Counsel representing venture capital firms and their members should counsel their clients to ensure that measures are being taken to undercut the ability of plaintiffs to assert securities claims against them, whether the claims are based on the Securities Act or the Exchange Act, or on insider trading claims. Venture capital firm members who serve on the board of directors of a portfolio company should take care to avoid being involved in the day-to-day operations and business of the company. Simply, the greater the responsibility and involvement that the member has in the portfolio company, the greater the risk that he or she may be held liable for securities violations by the company or that others within the company may be held liable. To guard against dubious insider trading claims, a venture capital firm should also implement a clear and detailed written trading policy (frequently referred to as a "10b5-1 plan") that allows its members to sell shares in a portfolio company only at set intervals, in set amounts. With such a plan in place, it is difficult for a plaintiff to claim that a venture capital member traded on inside information.

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