ALERT MEMORANDUM

Second Circuit Affirms Applicability of Section 10(b)'s Heightened Pleading Standard on Wrongdoing Underlying Misstatement or Omission

December 16, 2019

On December 10, 2019, the Second Circuit, in *Gamm v. Sanderson Farms*, held that when a securities fraud complaint alleges that statements were rendered false or misleading through the non-disclosure of illegal activity, the facts of the underlying wrongdoing must be pleaded with particularity in accordance with Federal Rule of Civil Procedure ("FRCP") 9(b) and the Private Securities Litigation Reform Act ("PSLRA").[1] The decision places a high bar on Section 10(b) claims based on undisclosed wrongdoing, requiring that the details not only of the misstatement or omission be pleaded with particularity, but also those of the underlying misconduct. It thus will make it far more difficult for plaintiffs to plead similar claims in the future.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

Carmine D. Boccuzzi Jr.
+1 212 225 2508
cboccuzzi@cgsh.com

Roger Cooper
+1 212 225 2283
rcooper@cgsh.com

Jared Gerber
+1 212 225 2507
jgerber@cgsh.com

[1] *Gamm v. Sanderson Farms, Inc.*, No. 18-0284-cv, 2019 WL 6704666 (2d. Cir. 2019).

Background

Sanderson Farms, Inc. ("Sanderson") is a chicken producer located in Mississippi. In the fall of 2016, it and several other poultry producers were named in a series of antitrust lawsuits alleging that they had conspired since 2008 to manipulate the prices of chicken in violation of the Sherman Act. Those lawsuits alleged that the defendants engaged in a conspiracy to suppress their supply when chicken prices remained high, allegedly coordinated during industry gatherings, monitored each other's supply reductions through a private publisher of chicken industry data reports, and manipulated a popular industry index, known as the Georgia Dock. The price of Sanderson shares fell in the wake of the lawsuits and securities class action litigation predictably followed. Notably, at least one of the underlying antitrust lawsuits subsequently survived a motion to dismiss after the Court concluded that the "[p]laintiffs ha[d] plausibly alleged the existence of a conspiratorial agreement" under FRCP 8.[2]

The securities plaintiffs alleged Sanderson, its CEO, its CFO, and its COO defrauded its shareholders by failing to disclose the alleged antitrust conspiracy. In particular, they claimed that defendants had repeatedly stated the company was subject to significant competition in all markets in which it competed without disclosing that it had conspired to restrain competition in the chicken market. Plaintiffs also claimed that the company's statements attributing the increase in its cash flows to improved market prices were misleading because the prices were not market prices and the cash flows were attributable to anticompetitive conduct. Plaintiffs alleged that the undisclosed anticompetitive conduct made Sanderson "vulnerable to litigation and regulatory scrutiny . . . as well as reputational damage."[3]

The defendants moved to dismiss for failure to state a claim, and the district court in the Southern District of New York granted that motion. The court concluded plaintiffs "fail[ed] to support their allegation of a chicken supply reduction conspiracy with particularized facts."[4] The plaintiffs appealed to the Second Circuit.

The Second Circuit's Decision

The Second Circuit affirmed the district court's decision, holding that the appellants failed to plead the details of the underlying antitrust conspiracy with the particularity required under FRCP 9(b) and the PSLRA.[5] More specifically, the Second Circuit held that "when a complaint claims that statements were rendered false or misleading through the non-disclosure of illegal activity, the facts of the underlying illegal acts must also be pleaded with particularity . . . ."[6]

In reaching its conclusion, the Second Circuit started with familiar ground. To state a securities fraud claim, the plaintiff must allege a misstatement or omission of material fact made with scienter in connection with the purchase or sale of securities upon which plaintiffs relied proximately causing the plaintiffs' injury. Moreover, because fraud must be plead with particularity, allegations of misstatements and omissions must be pleaded with particularity. That means that the complaint must (1) specify the statement that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent.[7]

The Court then moved to the case's central issue: whether the facts of the underlying antitrust conspiracy were subject to the pleading standard under FRCP 8,

[2] *In re Broiler Chicken Antitrust Litig.*, 290 F. Supp. 3d, 772, 802 (N.D. Ill. 2017).
[3] *Sanderson*, 2019 WL 6704666, at *3.
[4] *Gamm v. Sanderson Farms, Inc.*, No. 16 cv. 8420 (RMB), 2018 WL 1319157, at *3 (S.D.N.Y. Jan. 19, 2018).
[5] *Sanderson*, 2019 WL 6704666 at *9.
[6] *Id.* at *8.
[7] *Id.* at *6.

or the heightened standards under FRCP 9(b) and the PSLRA.[8] Relying on language from the PSLRA that a securities fraud claim based on information and belief must "state with particularity all facts on which that belief is formed"[9] and its earlier decision in *Novak v. Kasaks*,[10] the Court held that "when a complaint claims that statements were rendered false or misleading through the non-disclosure of illegal activity, the facts of the underlying illegal acts must also be pleaded with particularity, in accordance with the heightened pleading requirement of Rule 9(b) and the PSLRA."[11] The Court reasoned "appellants were required to plead with particularity sufficient facts to support their contention that Sanderson Farms' financial disclosures were misleading. This necessarily requires that facts of the underlying anticompetitive conduct be pleaded with particularity."[12] At the same time, the Court held that to satisfy that standard, a plaintiff "must plead sufficient – though not exhaustive – facts describing the essential elements of that underlying conduct."[13] The Court reasoned that this holding comported with other district court decisions within the circuit and the policy rationale behind the PSLRA's heightened pleading standard to guard against strike suits.[14]

The Second Circuit then concluded that the district court correctly dismissed the complaint under these heightened pleading standards. In doing so, the Court noted that the plaintiffs failed to provide a number of specific facts about the underlying alleged antitrust conspiracy, including "*when* Sanderson Farms decided on its course of supply reduction, *which* industry peers were part of that decision, *how* specific supply reductions were performed by each of the different poultry producers, *what* information Sanderson Farms knew about its peers' supply reductions, if any, and – perhaps most basic of all – whether Sanderson Farms *actually reduced* chicken supply, and if so, by what volume."[15] Indeed, applying standard antitrust law, the Court held that plaintiffs had not "alleged the basic elements of an underlying antitrust conspiracy."[16] Thus, because the plaintiffs "failed to plead the first element of antitrust conspiracy agreement at even a basic level, much less with particularity," the complaint was properly dismissed.[17]

Takeaways

Sanderson should be seen as one in a line of cases where plaintiffs have tried to bring securities fraud claims based on the non-disclosure of wrongful conduct and the courts have rejected those claims. In a series of cases since the Second Circuit's seminal decision in *City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*,[18] the courts have held that the non-disclosure of alleged unlawful conduct does not per se give rise to a securities fraud claim.[19] The

[8] *Id.* at *6–8.
[9] FRCP 9(b), by contrast, simply states that "[i]n alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake."
[10] 216 F.3d 300, 313–314 (2d Cir. 2000).
[11] *Sanderson*, 2019 WL 6704666, at *8.
[12] *Id.* at *7.
[13] *Id.*
[14] *Id.* Cases in other districts involving similar alleged antitrust violations against chicken producers have held similarly. *See In re Tyson Foods, Inc. Sec. Litig.*, 275 F. Supp. 3d 970, 985 (2017) (citing PSLRA to conclude particularity requirement must be met as to the details of the alleged misstatement and as to the underlying wrongdoing); *Hogan v. Pilgrim's Pride Corp.*, No. 16-cv-02611-RBJ, 2018 WL 1316979, at *7 (D. Co. Mar. 14, 2018) ("[T]hose antitrust allegations will be held to the heightened PSLRA pleading standard when, like here, they form the basis of a securities fraud claim.").
[15] *Sanderson*, 2019 WL 6704666, at *8.
[16] *Id.*
[17] *Id.* at *9.
[18] 752 F.3d 173 (2d Cir. 2014).
[19] *Employees Ret. Sys. of City of Providence v. Embraer S.A.*, No. 16 Civ. 6277 (RMB), 2018 WL 1725574, at *4 (S.D.N.Y. Mar. 30, 2018) ("It is well established that 'companies do not have a duty to disclose uncharged, unadjudicated wrongdoing.'") (quoting *In re Banco Bradesco S.A. Sec. Litig.*, 277 F. Supp. 3d 600, 650 (S.D.N.Y. 2017); *Fries v. N. Oil & Gas, Inc.*, 285 F. Supp. 3d 706, 718 (S.D.N.Y. 2018) ("Allegations that defendants concealed . . . uncharged criminal conduct are not actionable unless the non-disclosures render other statements by defendants misleading."); *In re Citigroup, Inc. Sec. Litig.*, 330 F. Supp. 2d 367, 377 (S.D.N.Y. 2004) ("[T]he federal

plaintiff must still plead a misstatement or an omission that makes an affirmative statement misleading. In the Second Circuit's words, "disclosure is not a rite of confession, and companies do not have a duty to disclose uncharged, unadjudicated wrongdoing."[20]

The Sanderson decision creates an independent, and substantial, obstacle to would-be plaintiffs. The *Sanderson* plaintiffs had identified the misstatements upon which they were relying and why they were false or misleading: Sanderson Farms had stated it faced competition in all markets while – according to the antitrust complaints – it was engaged in restraint of trade with competitors in a particularly important market. The complaint was not dismissed for failure to plead the fraudulent statements with particularity. After *Sanderson*, plaintiffs will have to plead the underlying wrongdoing with particularity – a steep ask – even where complaints concerning the underlying wrongdoing have been sustained under basic notice pleading standards. Particularly now, when in recent years companies have been hit with a slew of follow-on class action litigation suits after private plaintiffs or governmental authorities accuse a business of some wrongful conduct unrelated to the securities laws, the Second Circuit's heightened pleading standard may work to provide comfort to such companies that they need not "simultaneously defend [themselves] in an accompanying securities fraud suit based on facts not alleged with the level of particularity required by the statute."[21]

The Second Circuit's approach thus turns Section 10(b) claims predicated on allegations of undisclosed underlying wrongdoing from a question of *if* there was fraudulent disclosure into a question of the how, who, what, and when of the underlying wrongdoing. Under this regime, plaintiffs must allege not only that the company *hid* the underlying illegal conduct, but also the *details* of that underlying illegal conduct.

However, even though *Sanderson* identified a number of facts that were not adequately alleged in the complaint before it, the decision leaves to be worked out in future cases what specific facts are necessary to meet the heightened particularity standard. The Supreme Court has held that to state a claim for relief under the antitrust laws, a plaintiff need only allege facts that make out a plausible claim for relief; it need not plead those facts with particularity.[22] And, in fact, another court had concluded that the alleged conduct underlying the complaint in *Sanderson* had satisfied those pleading standards. By contrast, because of the moral opprobrium that comes with a charge of fraud and because fraud involves some degree of moral turpitude, fraud allegations must be pleaded with particularity.[23] The Second Circuit left to further development the precise extent to which parties in future cases will have to plead more facts about the underlying wrongdoing than would be required to satisfy FRCP 8 in order to plead a fraud claim based on the failure to disclose that wrongdoing, but confirmed that some additional degree of specificity is required.[24]

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securities laws do not require a company to accuse itself of wrongdoing.").

[20] *City of Pontiac*, 752 F.3d at 184 (quotations and citations omitted).

[21] *Sanderson*, 2019 WL 6704666, at *8.

[22] *See Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 557 (2007); *id.* 569 n.14 ("[O]ur concern is not that the allegations in the complaint were insufficiently 'particular[ized],' [citing FRCP (b)-(c)]; rather, the complaint warranted dismissal because it failed *in toto* to render plaintiffs' entitlement to relief plausible.").

[23] *See* 5A Fed. Prac. & Proc. Civ. § 1296 (4th ed.).

[24] This Alert Memorandum was prepared with the assistance of Pekham Pal and Morgan Miller.