Articles + Publications | August 15, 2023

Exercise Caution Before Stating a Lawsuit Is "Without Merit

WRITTEN BY

Mary Weeks | Jay A. Dubow | Nicole E. Crossey

Many publicly reporting companies often respond to lawsuits by characterizing them as "without merit" in their securities filings. If the company does not prevail in such litigation, can it still be held responsible for making these statements when its executives had actual knowledge that the suit had validity? The answer is yes, according to a recent decision out of the District of Massachusetts.

In *City of Fort Lauderdale Police & Firefighters' Ret. Sys. v. Pegasystems Inc.*, No. CV 22-11220-WGY, 2023 WL 4706741, 2023 U.S. Dist. LEXIS 127327 (D. Mass. July 24, 2023), District Judge William G. Young allowed a proposed securities fraud class action to proceed against Pegasystems and its CEO Alan Trefler, holding that the investors sufficiently alleged the company misled them, but dismissed the case against CFO Kenneth Stillwell for lack of scienter. The securities class action came on the heels of a civil decision out of a Virginia state court requiring Pegasystems to pay $2 billion for willfully and maliciously misappropriating trade secrets of another software company, Appian Corporation. Plaintiffs in the securities action alleged that Pegasystems and its leadership were involved in the theft of Appian's trade secrets but misleadingly reassured Pegasystems investors that the Virginia case was without merit and that this was a violation of Section 10(b) and 20(a) of the Exchange Act and Rule 10b-5 promulgated thereunder. The court denied Pegasystems' motion to dismiss the claims against the company and its CEO, finding there was a sufficient factual basis for the allegations, but granted the motion to dismiss the claims against the CFO because there were insufficient allegations as to his knowledge of or involvement in the conspiracy to support a finding of scienter.

According to the plaintiffs, the alleged facts are as follows: Pegasystems engaged an employee of a government contractor to access Appian's software to learn how to better compete against Appian. Pegasystems' leadership, including the CEO and CFO, actively attempted to conceal its efforts. When the contractor was switched to another project and could no longer work with Appian, Pegasystems directed its employees to use false identities to gain access to Appian's technology.

In early 2020, Appian filed a trade secrets lawsuit against Pegasystems in Virginia state court. Between May 2020 and February 2022, Pegasystems filed its Form 10-Q and 10-K reports without mentioning the Virginia action and instead generally stated that it had "received, and may in the future receive, notices that claim we have misappropriated, misused, or infringed other parties' intellectual property rights." Securities and Exchange Commission (SEC) filings also directed investors to Pegasystems' Code of Conduct, which indicated that the company would "[n]ever use illegal or questionable means to acquire a competitor's trade secrets or other confidential information, such as … seeking confidential information from a new employee who recently worked for

a competitor, or misrepresenting your identity in hopes of obtaining confidential information."

In early 2022, after Appian amended its complaint to increase its damages claim to approximately $3 billion, Pegasystems filed its Form 10-K, which described the Virginia action in detail, stating that Appian's claims "are without merit," Pegasystems has "strong defenses to these claims," and that "any alleged damages claimed by Appian are not supported by the necessary legal standard." Pegasystems' stock dropped 16% the next day. In May 2022, the jury awarded compensatory damages of $2 billion, finding that Pegasystems "willfully and maliciously misappropriated Appian's trade secrets." The company's stock thereafter dropped 28% over the next two days.

Later in May 2022, the plaintiffs filed a putative securities fraud class action in Massachusetts federal court. Pegasystems moved to dismiss arguing that the plaintiffs failed to state a claim because they did not plead facts with particularity establishing that any of the challenged statements were false or misleading, a strong inference of scienter, and loss causation. The District Court of Massachusetts first held that plaintiffs sufficiently alleged the statements were false or misleading. The court found that the "never use illegal or questionable means" statement was not "aspirational," but instead "describe[d] with specificity a course of conduct" that the company "promised investors it would prohibit." Particularly given the allegations that the "espionage campaign" against Appian was "orchestrated and directed" by Pegasystems' senior executives, the court held that the complaint sufficiently alleged that the statement was misleading to investors.

The court further concluded that the CEO's statement that Appian's claims were without merit constituted an "actionable opinion" under the Supreme Court's *Omnicare* standard because it did not "fairly align" with the CEO's alleged "awareness of, involvement in, and direction of [Pegasystems'] espionage campaign." Additionally, the court noted that "a reasonable investor could justifiably have understood [the CEO's] message that [the] claims were 'without merit' as a denial of the facts underlying [the] claims – as opposed to a mere statement that [Pegasystems] had legal defenses against those claims." As the court explained:

This does not mean that [Pegasystems] was under the obligation to "confess to the wrongdoing" when it disclosed the Virginia Litigation. … An issuer may legitimately oppose a claim against it, even when it possesses subjective knowledge that the facts underlying the complaint are true. When it decides to do so, however, it must do so with exceptional care, so as not to mislead investors. For example, an issuer may validly assert its intention to oppose the lawsuit [by using the] "general descriptive" statement "[w]e cannot be certain of the outcome of the foregoing litigation, but do plan to oppose the allegations against us and assert our claims against the other parties vigorously," even "assuming knowledge" of the conduct underlying the litigation. It also may state that is has "substantial defenses" against it, if it reasonably believes that to be true. An issuer may not, however, make misleading substantive declarations regarding its beliefs about the merits of the litigation.

Finding that there was a "strong inference" of scienter, the court reasoned that the complaint's allegations outlined a "scheme to misappropriate Appian's trade secrets" and that the CEO was aware of and "personally involved" in the scheme, "provid[ing] direction" and "referr[ing]" to the employees involved as "spies." Consequently, the court found that the allegations, if accepted as true, left "little doubt" that the CEO knew or was reckless in not knowing that his and the company's statements "posed a substantial danger" of misleading investors because the relief sought in the Virginia action "amounted to almost four times [Pegasystems'] current assets and roughly three times [Pegasystems'] revenue in 2021." Finally, the court also ruled that the plaintiffs

sufficiently alleged that Pegasystems' and the CEO's statements were causally connected to the drop in value of Pegasystems stock in February and May 2022.

With respect to the CFO, on the other hand, the court ruled that allegations that he "must have known" about the espionage campaign were "mere speculation" and an "extension of the 'scienter by status' theory, which has been uniformly rejected." The court, therefore, dismissed the claims against the CFO without prejudice.

The Pegasystems decision provides a cautionary tale to public companies that their statements about legal matters may pose significant risks, especially where they are contrary to the actual prospect of adverse results. In response, companies facing litigation should not blindly use generic language describing a lawsuit as "without merit." Often that may be an honest belief. However, there are times when there may be merit to litigation even with valid defenses. Instead, a company might say that it "intends to contest this matter vigorously" or, if reasonably supported, "has substantial defenses" against the claims. Additionally, companies should review and/or reevaluate their litigation disclosures and processes based on this case, and may want to consider ways to seek input from the appropriate corporate leaders and employees in assessing any allegations asserted against the company, its officers, and directors in the context of litigation.

RELATED INDUSTRIES + PRACTICES

- Corporate
- Securities Litigation
- White Collar Litigation + Investigations