

Federal Judge Refuses to Dismiss Tobacco and Cannabis Company's Class-Action SEC Disclosure Suit Based on 10b-5(b) Scienter and Loss Causation Requirements

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On January 6, a federal judge for the Western District of New York denied a cannabis and tobacco engineering company's attempt to dismiss claims that it concealed a U.S. Securities and Exchange Commission (SEC) investigation to bolster stock prices, finding that investors bringing the suit sufficiently alleged that the company both had the opportunity and motive to hide the investigation and made public statements about the investigation it knew to be false.

Background

According to the complaint, between February 2016 and July 2019, the defendants — the company, along with its former CEO and former CFO — allegedly failed to disclose it was in the middle of an ongoing SEC investigation in its SEC filings and public-facing statements. The company also allegedly issued multiple press releases solely to deny the investigation's existence.

In 2016, the company executed multiple stock offerings to raise funds. However, at some point before these offerings, the SEC began to investigate the company for allegations of material weaknesses in its internal accounting practices. Yet, despite its execution of the multiple stock offerings, the company failed to disclose the SEC investigation in any of its 2016 10-K and 10-Q filings or statements to the public regarding the stock offerings. Indeed, even though the defendants disclosed in the SEC filings that issues existed with the company's accounting practices, they failed to disclose the existence of the SEC investigation.

In October 2018 and April 2019, an anonymous source published reports, alleging that the company failed to disclose the SEC's investigation in periodic filings with the SEC. In response to these allegations, the company issued press releases that discredited the author's allegations, while still denying the existence of the SEC's investigation.

In November 2019, investors filed an amended class-action complaint. The complaint was initially dismissed in its entirety in January 2021, then partially revived on appeal by the Second Circuit in May 2022. The Second Circuit vacated the dismissal of the plaintiffs' Rule 10b-5(b) material misrepresentation claim, holding that the defendants had a duty to disclose the SEC investigation because the company addressed its accounting weaknesses in its

10-Ks and 10-Qs, and “therefore, disclosing the SEC Investigation was necessary to tell the whole truth.”

The company’s most recent motion to dismiss argued that the plaintiffs did not meet the scienter requirement of their 10b-5(b) claim, having failed to establish that the company had motive to hide the SEC’s investigation or had engaged in conscious misbehavior or recklessness. Additionally, the motion asserted that the plaintiffs had failed to sufficiently plead the loss causation element of their 10b-5(b) claim, which requires a showing that the defendants “concealed something from the market that, when disclosed, negatively affected the value of the security.”

The court disagreed with the defendants’ submission, finding that the plaintiffs had alleged sufficient facts to meet the scienter and loss causation requirements for the 10b-5(b) claim. Specifically, the court found that the company’s three 2016 stock offerings were sufficient motive to omit the SEC investigation in its 10-K and 10-Q filings, reasoning that notice of the SEC investigation likely would have negatively affected the company’s share prices. The court also found that the plaintiffs’ allegations that the company issued press releases denying the existence of the SEC investigation were sufficient circumstantial evidence of conscious misbehavior or recklessness. Finally, the court found that the plaintiff’s allegations that the disclosure of the previously concealed SEC investigation negatively affected the company’s share prices sufficiently established loss causation.

Takeaways

This case serves as a reminder to companies and their directors and officers that their legal and ethical obligations to their shareholders are persistent, regardless of circumstance. Indeed, the very thing that incentivizes the reluctance to disclose a particular event or item can, at times, provide fuel for a plaintiff’s claims. Companies should engage in thorough and particularized due diligence to assess the specific circumstances of the potential disclosure and the risks the company faces both in the event of disclosure *and* nondisclosure. These disclosure assessments should include a review as to what a company previously said to avoid having a misleading impression. The vigilance is particularly important because, as happened here, potential liability can be pervasive and subject subsequent management groups to scrutiny caused by the acts of previous directors and officers. When faced with an issue that may require disclosure, companies should engage counsel as a resource at the onset of the assessment process.

Our Cannabis Practice provides advice on issues related to applicable federal and state law. Marijuana remains an illegal controlled substance under federal law.

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