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THINK TWICE BEFORE DESCRIBING A LAWSUIT AS "WITHOUT MERIT"

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WHAT HAPPENED

A public company and its CEO lost motions to dismiss securities fraud claims based on:

- Statements in 10-Qs and 10-Ks that a competitor's trade secrets lawsuit was "without merit"; and
- Assurances in the code of conduct that the company would not use "illegal or questionable means to acquire a competitor's trade secrets or other confidential information."

The claims were filed shortly after a $2 billion trade secrets verdict awarded to one of the company's competitors arising out of a corporate espionage campaign.

TAKEAWAYS

Although the company is appealing the judgment, the decision provides some lessons to consider:

- Review disclosure controls and procedures relating to litigation.
  - Be sure mechanisms are in place for input from relevant officers and employees.
- Be cautious about using boilerplate language characterizing litigation as "without merit".
  - Consider alternatives such as "the company plans to assert vigorous defenses" or, if reasonably supported, "the company believes that it has substantial defenses".
- Review codes of conduct and evaluate in light of corporate practices and stock exchange requirements

DEEPER DIVE

The plaintiff in City of Fort Lauderdale Police and Firefighters' Retirement System v. Pegasystems Inc. Alan Trefler and Kenneth Stillwell brought securities fraud claims against Pegasystems following a $2 billion trade secrets verdict awarded to Appian Corporation, one of its competitors, arising out of a corporate espionage campaign against Appian.

Statement of alleged facts. Pegasystems hired an employee of a government contractor to spy on Appian, using his open access to Appian's software and documentation. From 2012 to 2014, it used the information to enhance its products and win business over the competitor and took active steps to conceal its activities. Members of senior management were involved with the efforts, including the CEO, chief product officer, chief technology officer, as well as various marketing and product management officers.

When the contractor's employer assigned him to another project, he lost access to Appian technology. Unable to find another contractor, from 2019 to 2022, the company directed its own marketing and operational employees to use "front or fake companies" to pose as customers to infiltrate Appian's platform. The company never disciplined those employees, instead paying cash bonuses to them for achieving company objectives, including for "presenting information regarding competing platforms."

In early 2020, Appian filed its trade secrets lawsuit against the company in Virginia state court, seeking $90 million in damages as well as punitive damages, treble damages and injunctive relief.

Between May 2020 and February 2022, the company filed its 10-Q and 10-K reports without mentioning the Virginia action – only generic statements that "we have received, and may in the future receive, notices that claim we have misappropriated, misused, or infringed other parties' intellectual property rights."

In early 2022, Appian amended its complaint, increasing its damages claim to $3 billion. A few days later, the company filed its 10-K, which discussed the lawsuit in detail, stating that the claims "are without merit," that it "has strong defenses to these claims," and that "any alleged damages are not supported by the necessary legal standard of proximate cause." The next day, its stock price fell 16%.

In early May 2022, the jury awarded compensatory damages of $2 billion for willful and malicious misappropriation of Appian's trade secrets. The company's stock price dropped 28% over the next two days. After denying a motion to set aside the verdict, the court awarded $24 million in attorney's fees and post-judgment interest of $122 million per year.

Later that month, the plaintiff filed a securities fraud class action alleging violations of Section 10(b) and 20(A) of the Exchange Act and Rule 10b-5.

Court's findings.

The U.S. District Court (D. Mass) held that:

- The alleged facts support the "strong inference" that the CEO "was aware of, involved in, and directed" the company's corporate espionage against Appian.
- In light of his involvement, the CEO "knew or was reckless in not knowing" that his and the company's statements posed a "substantial danger to mislead investors" by falsely reassuring investors that Appian's $3 billion claim has no merit.
  - The relief sought "amounted to almost four times [the company's] current assets and roughly three times [the company's] revenues in 2021."

- The false and misleading statements included:
  - The company's assurances in its code of conduct that it would: "Never 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 "
    - The code was specifically directed to investors, as the 10-K directed investors to the location of its website in the 10-K.
    - The statement was not merely "aspirational" because it committed the company to avoid the specific course of conduct.
    - The espionage campaign involved more than "a few bad apples," as it was "organized and directed by the very 'nerve center' of the organization" and included senior management.
    - The failure to discipline participants "foster[ed] a corporate culture that promoted and harbored precisely the kind of behavior that [the company] promised investors it would prohibit."
  - The CEO's statement that Appian's claims were "without merit" amounted an "actionable opinion" under the Supreme Court's *Omnicare* standard:
    - It omits material information about the company's knowledge, as it amounts to a denial of the facts underlying those claims -- as opposed to a mere statement that the company had legal defenses.
    - The statement also did not "fairly align" with "substantial information about the viability of those claims" in his possession.

- A company is not obligated to “confess wrongdoing” – but it must take care not to mislead investors and may not make misleading “substantive declarations regarding its beliefs about the merits” of litigation. Appropriate disclosures could include:
  - Validly asserting its intention to oppose the lawsuit, such as 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.
  - Stating it has “substantial defenses” if it reasonably believes that to be true.

- The plaintiff adequately alleged loss causation, in light of the concealment of the corporate espionage campaign, false assurances in the code of conduct and the statements of market analysts tying the drop in stock price to the verdict and misappropriation of trade secrets by the company.

MEET THE TEAM

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