Bloomberg BNA

Securities Regulation & Law Report™

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JURISDICTION AND PROCEDURE

An Uptick in IPO Litigation and Practical Takeaways from 'In re Zynga Inc. Securities Litigation'

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In recent years, the market has seen a material increase in initial public offering ("IPO") activity. Along with this uptick in offerings comes a corresponding uptick in shareholder litigation challenging statements made in offering documents when the issuer later announces bad news. According to a recent study, complaints alleging violations of Section 11 of the Securities Act of 1933 ("Securities Act") for misstatements in offering documents increased roughly 50% between 2013 and 2014.[1] There are strong defenses to such claims at the motion to dismiss stage and later.[2] In March 2015, however, a federal judge ruled that a shareholder lawsuit filed against online gaming company Zynga, alleging violations of the federal securities laws in connection with its IPO and secondary offering, satisfied the pleading requirements of the Private Securities Litigation Reform Act (the "Reform Act") and, thus, survived dismissal. This article discusses the procedural history of the case, analyzes the recent order denying Defendants' motion to dismiss, and provides insight on practical takeaways from both the litigation generally and the ruling on the motion to dismiss.

Background

Zynga Inc. ("Zynga") is a developer, marketer, and operator of online social games which are played on mobile devices and social networking websites, such as Facebook. Some of Zynga's more well-known games include *Farmville*, *Words with Friends*, and *Draw Something*.[3] Zynga generates income by selling virtual goods to players who want to enhance their in-game experience. Under Generally Accepted Accounting Principles ("GAAP"), Zynga recognizes revenue ratably over the estimated weighted-average life of the goods. Zynga also publicly reports a non-GAAP financial metric called "bookings," or the total amount of revenue from the sale of virtual goods and advertising in online games that would have been recognized in a period if

[1] *Securities Class Action Filings – 2014 Year in Review*, Cornerstone Research, at p. 8.

[2] *See generally* Todd R. David, Jessica P. Corley, and Ambreen A. Delawalla, *Heightened Pleading Requirements, Due Diligence, Reliance, Loss Causation, and Truth-On-The-Market — Available Defenses to Claims under Sections 11 and 12 of the Securities Act of 1933*, 11 TENN. J. BUS. L. 53 (2010).

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[3] Zynga Inc., Securities Registration Statement (Form S-1/A) (Dec. 15, 2011).

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Zynga recognized all revenue immediately at the time of the sale.[4] In December 2011, Zynga completed its IPO in which it issued 100 million shares and was valued at approximately $10 billion.[5] Zynga included numerous risk factors in its prospectus, including that (a) Zynga relied on Facebook to generate substantially all of Zynga's revenue; (b) Facebook had broad discretion to change its terms of service and other policies; and (c) Zynga's bookings, revenue, traffic, and operating results could vary significantly and could fail to match past performance.[6] As part of the IPO, insider holders of Zynga stock entered into lock-up agreements that prevented them from selling shares until May 29, 2012, without prior consent of the underwriters.[7]

On Feb. 14, 2012, Zynga announced its financial results for Q4 2011 and the full year. Zynga reported bookings of $306.5 million, up 7% from the prior quarter. Zynga also issued its 2012 guidance, which included projected bookings of $1.35-1.45 billion.[8]

Zynga continued to caution investors about the volatility of the social gaming industry and the company's dependence on Facebook.[9]

In March 2012, Zynga filed for an underwritten public offering of 42.9 million shares of common stock (the ''Secondary Offering''), which was completed on April 3, 2012.[10] Like the previous filings, the registration statement and prospectus included risk disclosures.[11] Zynga and the underwriters also agreed to stagger the original IPO lock-up agreements over a period of five months so that the market would not be flooded with 688 million shares in one day.[12] As a result, on April 3, several insiders (some of whom would later be named as individual defendants) sold 49.4 million shares at $11.64 per share.[13]

On April 26, 2012, Zynga announced its results for Q1 2012 and reported bookings of $329 million, up 7% from the prior quarter. Zynga raised its guidance for 2012 and projected bookings of $1.42-1.5 billion.[14]

Three months later, on July 25, 2012, Zynga announced its Q2 2012 results, which did not meet expectations. Zynga explained that this was caused by (1) declines in bookings for web-based games due in part to changes Facebook made to its platform; (2) a later-than-expected launch of a new game; and (3) underperformance of another particular game.[15] Following this news, Zynga's stock price fell $1.90, or 37%, closing at $3.18 per share.[16]

Procedural History

Hard on the heels of Zynga's July 25, 2012 announcement, plaintiffs filed suit alleging that Zynga, Chief Executive Officer Marc Pincus, former Chief Financial Officer David Wehner, former Chief Operating Officer John Schappert, and Chief Financial Officer Mark Vranesh (collectively, the ''Defendants'') made material misrepresentations and omissions about their outlook for 2012.[17] Plaintiffs asserted claims under Section 10(b) of the Securities Exchange Act of 1934 (''Exchange Act'') and Rule 10b-5 promulgated thereunder, and Sections 11, 12 and 15 of the Securities Act.

Specifically, plaintiffs alleged that (1) the IPO materials contained untrue statements regarding financial results and Zynga's focus on long-term growth; (2) the Secondary Offering materials contained untrue statements regarding financial results and the Company's plan for future development of games; and (3) Zynga failed to disclose material adverse facts about its business.[18] The complaint relied heavily on information from eleven confidential witnesses, who stated generally that the Defendants were aware of game delays, declines in bookings, and upcoming changes with the Facebook platform.[19]

Defendants filed a motion to dismiss on May 31, 2013. Defendants argued that the complaint constituted mere puzzle pleading, failed to plead a material misrepresentation or omission, and failed to plead an actionable forward-looking statement.[20] Defendants also argued that plaintiffs failed to plead facts raising the strong inference of scienter required under the Reform Act. As to the insider sales in connection with the Secondary Offering, Defendants pointed out that the lock-up period was staggered only so that 688 million shares would not all become available for sale in one day, not so that the insiders could profit before the earnings release. Indeed, the insiders' lock-up releases were designed such that 60% of the insider shares could not even be sold until *after* July 2012, the date of the second quarter results announcement.

The Court granted the motion to dismiss in its entirety with leave to amend.[21] The Court held that plaintiffs failed to include the relevant, basic factual details in support of their claims, grouped all defendants together, and improperly included by reference paragraphs in different sections of the complaint.[22] In addition, the Court held that ''the statements alleged to be

[4] Consolidated Complaint, *In re Zynga Inc. Sec. Litig.*, No. 3:12-cv-04007 (N.D. Cal.) (Apr. 3, 2013).
[5] Zynga Inc., Securities Registration Statement (Form S-1/A) (Dec. 15, 2011).
[6] *Id.*
[7] *Id.*
[8] Consolidated Complaint, *In re Zynga Inc. Sec. Litig.*, No. 3:12-cv-04007 (N.D. Cal.) (Apr. 3, 2013).
[9] Zynga Inc., Current Report (Form 8-K) (Feb. 14, 2012).
[10] An additional 6.4 million shares were sold in the Secondary Offering as a result of underwriters exercising options to purchase additional shares, bringing the total offering to 49.4 million shares.
[11] Zynga Inc., Securities Registration Statement (Form S-1/A) (Mar. 23, 2012).
[12] *Id.*
[13] Consolidated Complaint, *In re Zynga Inc. Sec. Litig.*, No. 3:12-cv-04007 (N.D. Cal.) (Apr. 3, 2013).
[14] Zynga, Inc., Current Report (Form 8-K) (Apr. 26, 2012).
[15] Zynga, Inc., Current Report (Form 8-K) (July 25, 2012).
[16] Consolidated Complaint, *In re Zynga Inc. Sec. Litig.*, No. 3:12-cv-04007 (N.D. Cal.) (Apr. 3, 2013).
[17] Plaintiffs also alleged that the underwriters of the offerings were liable for violating Section 12(a)(2) of the Securities Act.
[18] Consolidated Complaint, *In re Zynga Inc. Sec. Litig.*, No. 3:12-cv-04007 (N.D. Cal.) (Apr. 3, 2013).
[19] *Id.*
[20] Zynga Defendants' Notice of Motion and Motion to Dismiss Plaintiffs' Consolidated Complaint; Supporting Memorandum of Points and Authorities, *In re Zynga Inc. Sec. Litig.*, No. 3:12-cv-04007 (N.D. Cal.) (May 31, 2013).
[21] Order Granting Motions to Dismiss With Leave to Amend, *In re Zynga Inc. Sec. Litig.*, No. 3:12-cv-04007 (N.D. Cal.) (Feb. 25, 2014).
[22] *Id.*

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misleading and reasons for their alleged falsity have not been alleged with the requisite level of specificity.''[23]

Following this dismissal, plaintiffs filed an Amended Complaint on March 31, 2014, alleging violations of the federal securities laws on behalf of all persons who purchased or acquired Zynga securities between Feb. 14, 2012 and July 25, 2012.[24] The Amended Complaint included more detail regarding the specific alleged misstatements and Defendants' purported knowledge to the contrary. Again relying heavily on confidential witnesses, plaintiffs alleged specifically that Defendants were aware of bookings declines in late 2011 and early 2012, were aware of delays in the pipeline of new games, and were aware that Facebook was changing its gaming platform in a way that would harm Zynga's business.[25]

Defendants filed a motion to dismiss the Amended Complaint on May 2, 2014. Defendants argued again that (1) plaintiffs failed to plead with the requisite particularity that Zynga issued misleading statements; (2) plaintiffs failed to plead facts raising a strong inference of scienter; and (3) plaintiffs failed to plead loss causation.[26]

Order on Motion to Dismiss

On March 25, 2015, Judge Jeffrey White of the U.S. District Court for the Northern District of California denied in part and granted in part Defendants' motion to dismiss.[27]

The Court first reviewed the demanding pleading requirements under the Reform Act and then addressed each of the alleged misstatements or omissions by category. As to ''Representations about Bookings,'' plaintiffs alleged that Defendants misrepresented that they were experiencing solid growth in bookings and accelerating bookings growth on a sequential basis. Plaintiffs cited confidential witnesses with alleged access to daily reports who stated that bookings were, in fact, declining during the class period.[28] Despite Defendants' argument that the confidential witnesses did not have sufficient personal knowledge of the company-wide financials, the Court held that plaintiffs ''made out sufficient allegations of misrepresentations about bookings.''[29]

As for ''Representations about New Game Pipeline Growth,'' plaintiffs alleged that Defendants stated falsely that its existing game pipeline was ''strong,'' ''robust,'' and ''very healthy,'' because the game development pipeline was actually experiencing substantial delays.[30] Defendants argued that these statements were inactionable as mere puffery. The Court agreed, holding that ''[r]egardless of the ultimate veracity of the company's enthusiasm, the type of representation about the pipeline of games . . . is not actionable as a matter of law as business puffery.''[31] Thus, the Court dismissed claims regarding these representations.

Plaintiffs also alleged that Defendants made misrepresentations or omissions about ''Changes to the Facebook Platform.'' Even though plaintiffs conceded that Zynga warned investors of changes to the Facebook platform could adversely impact the business, plaintiffs contended that, according to a confidential witness, Defendants knew about a ***specific*** change to the platform that would alter Zynga's accessibility to Facebook users. The confidential witness stated that this information was included in a weekly executive summary sent to Zynga management and that management knew of the change as early as April 2012.[32] Defendants argued that they could not be required to disclose Facebook's plans because another company's plans cannot be known with certainty, but the Court held that because Defendants allegedly knew about ***specific*** changes to the Facebook platform and failed to disclose that information, plaintiffs' allegations about changes to the platform survived dismissal.[33]

Finally, as for ''Representations about 2012 Full Year Guidance,'' plaintiffs alleged that Zynga's statements that (1) ''bookings are projected to be in the range of $1.35 to $1.45 billion. We expected that growth will be weighted towards the back half of the year with slower sequential growth in the first half of the year'' and (2) the company was raising its bookings guidance to a range of $1.425 to $1.5 billion were false or misleading.[34] Defendants argued that these forward-looking statements were not actionable because plaintiffs failed to demonstrate that (1) the statements were not genuinely believed; (2) there was not a reasonable basis for the prediction; and (3) the speaker was aware of undisclosed facts tending seriously to undermine the accuracy of the prediction. In rejecting these arguments, the Court referred back to the alleged misstatements regarding bookings and failure to warn about the Facebook platform change. If the 2012 projections were premised upon those alleged misrepresentations, the Court held, the 2012 projections could constitute actionable forward-looking statements.[35]

Following its discussion of the specific misrepresentations and omissions, the Court analyzed whether or not plaintiffs had adequately pled scienter. After discussing the rigorous standard a plaintiff must meet in order to give rise to a strong inference of scienter, the Court addressed the standard for relying upon statements from confidential witnesses. ''First, the confidential witnesses whose statements are introduced to establish scienter must be described with sufficient particularity to establish their reliability and personal knowledge.''[36] Second, the statements ''must themselves be indicative of scienter.''[37] In a single paragraph analyzing scienter, the Court observed that the confidential witnesses testified at length regarding the Defendants' knowledge regarding bookings, game operations, and changes to the Facebook platform, then held

[23] *Id.*
[24] First Amended Complaint for Violation of Federal Securities Laws, *In re Zynga Inc. Sec. Litig.*, No. 3:12-cv-04007 (N.D. Cal.) (Mar. 31, 2014).
[25] *Id.*
[26] Motion to Dismiss Plaintiffs' First Amended Complaint; Supporting Memorandum of Points and Authorities, *In re Zynga Inc. Sec. Litig.*, No. 3:12-cv-04007 (N.D. Cal.) (May 2, 2014).
[27] *In re Zynga Inc. Sec. Litig.*, No. 12-04007, 2015 BL 83862 (N.D. Cal. Mar. 25, 2015).
[28] *Id.* at *5–6.
[29] *Id.* at *6.
[30] *Id.* at *7.
[31] *Id.*
[32] *Id.* at *7.
[33] *Id.*
[34] *Id.* at *8.
[35] *Id.*
[36] *Id.* at *9.
[37] *Id.*

that plaintiffs had ''sufficiently alleged particularized facts to support a strong inference of scienter under Section 10(b).''[38]

In the final section of the opinion, the Court addressed Defendants' argument that plaintiffs failed to plead loss causation. Defendants contended that the complaint must allege that (1) ''the practices that the plaintiffs contend are fraudulent were revealed to the market'' and (2) that this revelation, rather than a report of the defendant's worse-than-expected financial results, caused the plaintiffs' losses.[39] The Court rejected this argument and held that the requirements for pleading loss causation are ''not meant to impose a great burden upon a plaintiff.''[40] Plaintiffs need only provide ''a short plain statement'' that ''provide[s] a defendant with some indication of the loss and the causal connection that the plaintiff has in mind.''[41] Because plaintiffs alleged that certain misrepresentations inflated the stock price, which later fell considerably after the announcement of the company's results, the Court held that there was a triable issue of loss causation.[42]

Three points in particular are worth noting about the case and recent order. First, based on the face of the order, the statements of confidential witnesses constituted the Court's entire basis for finding that plaintiffs had adequately pled scienter. Although confidential witnesses are frequently used to corroborate allegations in securities cases, it is unusual for a court to rely solely on confidential witness statements to sustain a complaint under the Reform Act. Moreover, despite laying out the standard for analyzing scienter and, specifically, when scienter may be alleged through confidential witnesses, the Court did not explicitly entertain any competing inferences of non-fraudulent intent as required by *Tellabs*[43] , nor did it appear to engage in the two-step inquiry for analyzing complaints that rely on confidential witnesses.

Second, although plaintiffs focused heavily on the insider sales from April 3, 2012, devoting multiple pages of the Amended Complaint to the size and timing of Defendants' stock sales, the Court's order denying the motion to dismiss did not mention these sales a single time in its analysis of plaintiffs' allegations. This is also highly unusual. Insider stock sales are frequently alleged in an attempt to support a strong inference of scienter, and courts almost always engage in some analysis of whether or not the sales at issue do, in fact, support fraudulent intent. The Court here seemed to ignore the allegations completely, perhaps indicating agreement with Defendants' argument that the sales at issue did not support a strong inference of scienter.

Third, despite Defendants' argument that ''Zynga cautioned investors about the rapidly changing social gaming industry, the Company's short operating history, and its dependence on Facebook,''[44] the Court did not analyze these risk factors at all. If meaningful cautionary language accompanies forward-looking statements and those statements are not known to be false, under the ''bespeaks caution'' doctrine, those statements are not actionable.[45] Similarly, the Reform Act's statutory safe harbor provision protects certain forward-looking statements that are immaterial or are accompanied by meaningful cautionary statements.[46] Here, Defendants pointed to cautionary language and argued that the statements at issue were, thus, inactionable as a matter of law. The opinion, however, does not reveal any analysis of the risk factors or the ''bespeaks caution'' doctrine.

Practical Takeaways

Several practical lessons and takeaways can be gleaned from the procedural history of the case, the recent order denying Defendants' motion to dismiss, and this type of litigation generally.

First, *Zynga* reaffirms the fundamental principle that statements constituting mere ''puffery'' are not actionable as a matter of law. The Court in *Zynga* dismissed plaintiffs' claims regarding the company's new game pipeline growth because the statements at issue—that the game pipeline was ''strong,'' ''robust,'' and ''very healthy''—were inactionable as business puffery.[47] It is well-established that ''mildly optimistic, subjective assessment[s]'' are not actionable as a matter of law because investors '' 'know how to devalue the optimism of corporate executives.' ''[48] As another court held, ''statements of puffery or mere generalizations are not material misstatements'' because ''reasonable investor[s], by definition, [do] not rely upon general and vague statements of puffery.''[49] Soft adjectives, such as ''conservative,'' ''sound,'' or, in this case, ''robust,'' are ''nothing more than puffery, which is not actionable under the securities laws.''[50]

Second, *Zynga* provides some guidance on what issuing companies can do in order to limit potential liability in connection with public offerings. It is critical that issuing companies (and any public company) maintain and disclose up-to-date and tailored risk factors. As noted above, these risk factors, assuming that they are meaningful and specific, can provide a compelling argument on a motion to dismiss or summary judgment under the ''bespeaks caution'' doctrine.[51] Courts have long held that the disclosure of meaningful cautionary language protects forward-looking statements under the Reform Act's safe harbor and granted motions to

[38] *Id.*

[39] *Id.*

[40] *Id.* at *9-10 (citing *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 347 (2005)).

[41] *Id.* at *10.

[42] *Id.*

[43] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).

[44] Motion to Dismiss Plaintiff's First Amended Complaint; Supporting Memorandum of Points and Authorities, *In re Zynga Inc. Sec. Litig.*, No. 3:12-cv-04007 (N.D. Cal.) (May 2, 2014).

[45] *See, e.g.*, *Emp'rs Teamsters Local Nos. 175 & 505 Pension Trust Fund v. Clorox Co.*, 353 F.3d 1125, 1132 (9th Cir. 2004).

[46] 15 U.S.C. § 78u-5(c).

[47] *In re Zynga Inc. Sec. Litig.*, No. 12-04007, 2015 BL 83862, at *6 (N.D. Cal. Mar. 25, 2015).

[48] *In re Cutera Sec. Litig.*, 610 F.3d 1103, 1111 (9th Cir. 2010) (citation omitted).

[49] *Woodward v. Raymond James Fin., Inc.*, 732 F. Supp. 2d 425, 433 (S.D.N.Y. 2010) (citing *ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 206 (2d Cir. 2009)).

[50] *In re Xinhua Fin. Media, Ltd. Sec. Litig.*, No. 07 Civ. 3994, 2009 BL 37468, at *8 (S.D.N.Y. Feb. 25, 2009).

[51] *See* 15 U.S.C. § 78u-5(c)(1)(A)(i) (''meaningful cautionary statements'' should ''identify[] important factors that could cause actual results to differ materially from those in the forward-looking statement[s].'').

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dismiss for this reason.[52] In order to ensure that their risk disclosures are sufficiently meaningful and tailored to protect forward-looking statements, companies should have a regular process in place by which they review their risk factors and related disclosures. This process should include, among other things, (a) an evaluation of the specific risks within the industry in which the company operates and (b) input from all relevant divisions of the company, such as operations, risk, accounting, and legal.

Finally, it is important to keep in mind how frequently securities cases like *Zynga* are brought and eventually dismissed. Cornerstone Research's ''Securities Class Action Filings – 2014 Year in Review'' notes that 170 federal class action securities cases were filed in 2014.[53] Approximately 3.6% of companies listed on U.S. securities exchanges were the target of securities class action filings last year.[54]

Despite the number of securities class action filings, however, almost half are dismissed. Of all the cases filed between 1996 and 2013, 49 percent have settled, 41 percent have been dismissed, and 9 percent are ongoing. Less than one percent of securities cases filed during this period reached a trial verdict.[55] Recent statistics indicate a similar trend. Of the securities cases filed in 2012, 40% have been dismissed, 11% have settled, and 49% are ongoing.[56] For cases filed in 2011, 58% have been dismissed, 26% have settled, and 16% are ongoing.[57]

If a case survives the motion to dismiss, however, it is often litigated for years before it is settled, tried before a jury, or dismissed at the summary judgment stage. For example, *Halliburton Co. v. Erica P. John Fund, Inc.*[58] was first filed in 2002. The Supreme Court recently ruled on certain class certification issues in June 2014 and remanded the case for further proceedings, meaning resolution is still some time away. Although it is unusual for a securities case to be litigated for over a decade, it is not uncommon for resolution of a case to take four to six years. Of all the securities cases filed between 2009 and 2011, roughly 15% have still not yet been resolved.[59] And, as noted above, almost half of the cases filed in 2012 are still ongoing.

These figures indicate that (1) resolution of this particular type of litigation can take many years; and (2) the litigation will almost invariably be resolved via settlement or dismissal.

Conclusion

In sum, when the market sees an increase in public offerings, the plaintiffs' bar is likely to be active. Although the *Zynga* court permitted several categories of claims to proceed against Defendants, it is important to remember that defendants have strong defenses under the securities laws. As *Zynga* and similar case law teaches, certain types of statements remain inactionable as a matter of law, and companies can increase the likelihood that claims regarding their forward-looking statements will be dismissed by providing meaningful and tailored risk disclosures.

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[52] *See, e.g.*, *Cutera*, 610 F.3d at 1112-13 (affirming dismissal in part because forward-looking statements were identified as such and accompanied by meaningful cautionary statements); *In re Nokia Oyj (Nokia Corp.) Sec. Litig.*, 423 F. Supp. 2d 364, 402 (S.D.N.Y. 2006) (holding certain statements inactionable because they were accompanied by specific cautionary language).

[53] *Securities Class Action Filings – 2014 Year in Review*, Cornerstone Research, at p. 1.

[54] *Id.*

[55] *Id.* at p. 12.

[56] *Id.*

[57] *Id.*

[58] *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S.Ct. 2398 (2014).

[59] *Securities Class Action Filings – 2014 Year in Review*, Cornerstone Research, at p. 12.