

Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION—W.D. Ky.: Failed checks showed that KFC's tests for pumped-up chicken were in place, (Dec. 30, 2014)

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By Rodney F. Tonkovic, J.D.

An action claiming that Kentucky Fried Chicken's corporate owner made false statements about KFC's food safety practices in China was dismissed by a district court. Investors alleged that they purchased securities while prices were inflated by fraudulent misrepresentations and omissions. The company's share price dropped in the wake of media reports that chicken supplied to Chinese KFC restaurants had failed tests for banned antibiotics and growth hormones, and the plaintiffs alleged that the Yum! defendants made false statements about Yum!'s food safety program and the risk of food safety problems. The court granted Yum!'s motion and dismissed the complaint with prejudice (*In re Yum! Brands, Inc. Securities Litigation*, December 23, 2014, Simpson, C.).

Background. Yum!, which is headquartered in Kentucky, operates a restaurant business with over 39,000 restaurants worldwide, including Kentucky Fried Chicken. Yum! China, headquartered in Shanghai, oversees all KFC restaurants located in China. Yum! China's growth, which can be attributed to KFC, is a major part of Yum!'s profitability.

At issue was Yum! China's spot testing of poultry shipments for veterinary drugs. In 2010 and 2011, testing indicated that samples from two suppliers showed elevated levels of certain antibiotics. Yum! China, however, did not disclose its results to either the Chinese government or the public and sold the affected chicken to consumers. According to Yum! China's CEO, spot test results were not always received before the chicken was shipped to restaurants, and problems could not be cured once the chicken entered the logistics chain.

Allegations. Yum!'s SEC filings and other public statements made in 2012 contained false statements with respect to the risk and uncertainty posed by food safety problems and the quality of Yum!'s food safety program. The complaint alleged that the defendants' misrepresentation or omission of the negative test results resulted in false or misleading statements. In late 2012, Yum! received media attention in the form of articles concerning the use of prohibited growth hormones by Yum! China suppliers. In response, Yum! stated that it watched food safety closely and that its suppliers were subject to spot checks.

In December 2012, Chinese television reported on an undercover investigation into Yum!'s food safety protocols for its suppliers, mentioning specifically the overuse of antibiotics. The next day the Shanghai Food and Drug Administration launched an investigation into Yum! China's poultry supply, which ultimately led to supervisory recommendations, but no fines. Yum!'s Form 8-K for 2012, released in early February 2013, announced a decrease in sales and profits and indicated that the company did not expect to reach its 2013 growth goals. Between November 2012 and February 2013, Yum!'s share price dropped approximately 17 percent.

Materiality. The court found that the defendants' statements regarding the risk and uncertainty posed by food safety problems did not concern material fact. The court characterized these statements as "boilerplate recitations of risk" that said nothing specific about the state of food safety within Yum! at that time. Moreover, the risk statements made no assertion that Yum! was free of any potential food safety problems that could damage its performance. The statements about Yum!'s food safety program were similarly found to be vague and subjective, mere opinions of management, or aspirational, and did not concern material fact.

The court then concluded that a reasonable jury would not find that the defendants' statements were objectively false or misleading. According to the court, the statements told investors that food safety problems could happen, that they could originate with suppliers, and that they could negatively impact Yum!'s business. The failed test results, the court said, confirmed Yum!'s assertions that safety procedures were in place. Having found no misstatements of material fact or objective falsehood, the court also determined that the defendants had no affirmative duty to disclose the omitted test results.

Scienter. Finally, the court held that the complaint failed to sufficiently plead a strong inference of scienter. The court found no smoking gun here; that is, there were no allegations of direct evidence showing that any of the individual defendants, as senior corporate officers, knew about the failed test results. While the defendants were generally familiar with the broad aspects of food safety, the probability that these officers reviewed the test results of every Chinese supplier was low, the court said.

When the allegations were taken collectively, the inference that the individual defendants lacked both knowledge of and an obligation to discover the failed test results overwhelmed the opposing inference that the results were intentionally or recklessly concealed to deceive the public, the court said. The court added that when making such general warnings and assertions of quality, a reasonable corporate officer would be unlikely to recognize any risk posed by the nondisclosure of specific test results.

The case is No. 3:13-CV-00463.

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