

[Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION— S.D.N.Y.: Statute of repose bars plaintiffs later-brought fraud claims, \(Feb. 23, 2021\)](#)

Securities Regulation Daily Wrap Up

[Click to open document in a browser](#)

By [Jay Fishman, J.D.](#)

Neither the statute of repose-barred new claims nor the realleged claims from earlier complaints evidenced *material* misrepresentations or omissions.

New York's Southern District Court granted the defendant company's motion to dismiss the plaintiff shareholders Securities Act Section 11 fraud claims because those claims, newly added to the plaintiffs third amended complaint, were barred by the statute of repose. The re-pleaded claims from the first and second amended complaint were likewise dismissed because: (1) the Exchange Act Section 10(b) alleged misstatements were not material; (2) additional information was not provided to render the claims sufficiently pleaded under the heightened Federal Civil Procedure Rule 9(b) standard; and (3) the individual defendants did not act with scienter. Lastly, the Exchange Act Section 20(a) control person liability claims against the individual defendants were dismissed because the primary liability claims were dismissed ([Xu v. Gridsum Holding Inc.](#), February 22, 2021, Ramos, E.).

Events surrounding a 2016 IPO. A private Chinese software holding company, prior to conducting a September 2016 initial public offering (IPO) of \$6.7 million American Depository Shares (ADS) at \$13 per share, filed a registration statement the SEC declared effective and then filed a prospectus to begin the IPO. The SEC-filed registration statement included the company's audited financial statements and balance sheets for 2013, 2014, and 2015, all documents represented as having been "prepared in accordance with GAAP" and showed the company's net revenue, loss, and income tax expenses. Similarly, an unaudited interim consolidated financial statement for the six months ending on June 30, 2016 was filed with the Commission. The registration statement identified a Public Company Accounting Oversight Board (PCAOB)-defined material weakness and other accounting deficiencies in the company's internal control over financial reporting, specifically stating that the company lacked accounting personnel with appropriate U.S. GAAP and SEC reporting knowledge. Lastly, the registration statement represented how the company recognized revenue; over the course of the relevant period, the company changed when its recognized revenue, first at the time of sale and later when the money was collected.

The IPO resulted in the company selling over \$7.7 million ADS, amounting to approximately \$87.1 million in proceeds.

2017, 2018, and 2019 events. The following significant events occurred from 2017 into 2019:

In March 2017, the company issued a press release of the audited financial results for the end of 2016, reporting a 2016 income tax expense of 28,387,000 yen that was later adjusted to 14,801,000 yen. When asked about the tax expense, one of the individual defendants said it came from a sub-optimal structure initially in place to move offshore capital to onshore entities post-IPO but that a more efficient structure was now in place, rendering the tax liability a one-time occurrence;

In April 2017, a 2016 filed Form 20-F confirmed the 2016 tax liability, and reiterated the company's GAAP-prepared statements, its revenue recognition practices, and its lack of expert accounting professionals with financial reporting knowledge, but also said that it had taken a number of steps to improve the company's internal controls;

In April 2018, the company issued a press release announcing that the audit report for the year ending December 31, 2016 should not be relied on; that 2016 revenue could be impacted by 2 million yen and that 2016 expenses could be impacted by 6 million yen. As a result of these statements, the company's NASDAQ-listed ADS dropped significantly over several days. The company subsequently notified the SEC that its Form 20-F for 2017 would be delayed, with its audit committee conducting an investigation.

In May 2018, the company announced a proposed purchase of all outstanding shares to bring the company private, but while having announced a committee to evaluate the proposal, the company did not make a decision about the proposal by the time the plaintiffs filed their third amended complaint;

In January 2019, the company filed its 2017 Form 20-F with the SEC, which included both 2017 financial information and restatements of the company's 2015 and 2016 revenue, tax expenses, and accounts receivable payable for 2015 and 2016.

First, second, and third amended complaints. The plaintiffs first and second amended complaints filed in 2018 and 2019, respectively, alleged that the company's above-mentioned press releases, Form 20-F revised filings, and restatements contained material misstatements or omissions that violated Securities Act Section 11 and Exchange Act Sections 10(b) and 20(a). In March 2020, however, the court dismissed the plaintiff's second amended complaint on grounds that the alleged line item amounts which varied between initial and later-filed revised filings were actually small numerical amount differences deemed immaterial when compared to the company's overall financial operation.

The plaintiffs filed their third amended complaint in May 2020 alleging new claims, along with restating old claims from the second amended complaint but with additional information.

Statute of Repose bars newly added claims. The plaintiffs newly alleged claims pertained to either the company's 2016 interim financial statement or to the company's failure to disclose certain business strategies. But the court agreed with the company's contention that these claims were barred by the statute of repose. In relying on the ruling from the 2019 *Barilli v. Sky Solar Holdings* case, the court said that under Securities Act Section 11, new claims must be asserted "in no event...more than three years after a security was bona fide offered to the public" and that the statute of repose is a "substantial right of those protected to be free from liability after a legislatively-determined period of time."

Here, proclaimed the court, the plaintiff had from the September 22, 2016 filing of the company's IPO registration statement with the SEC until September 23, 2019 (three years from that date) to file their newly added claims. By not filing them until May 2020, those claims were barred by the statute of repose.

Realleged claims also dismissed. Regarding a realleged claim from the second amended complaint about a discrepancy between the company's 2016 interim financial statement and its 2016 year-end statement due to the above-mentioned sub-optimal structure initially in place to move offshore capital to onshore entities post-IPO, the plaintiffs argued that the company knew a tax liability would ultimately be incurred by the end of 2016, and this fact obligated it to disclose the anticipated liability on a proportionate basis rather than representing it as zero. The plaintiffs additionally declared that this undisclosed change was material because it resulted in a 24.9 percent understatement on the company's reported net losses.

But the company contended that: (1) the zero tax liability amount was accurate at the time it was stated because the relevant restructure did not occur until after the IPO; and (2) the misstatement was not material because the understated tax liability amounted to only 4.9 percent of the company's reported net revenue as of June 30, 2016 (or 2.03 percent compared to the company's net revenue for the end of 2016). On this and similar realleged claims, the court dismissed them for the same reason it dismissed them in the second amended complaint, namely that the alleged misstatements about numerical amount differences were immaterial when compared to the company's overall financial operation.

On the realleged claims pertaining the company's internal control issues, the court determined that the additional information the plaintiffs provided to enhance their proof of actionable omissions was as conclusory as it when pleaded in the second amended complaint. Specifically, the plaintiffs allegations based on line items revealed

in the company's 2016 and 2017 Forms 20-F that the company failed to: (1) disclose its lack of written policies and procedures sufficient to timely record revenues and expenses in its financial statements; and (2) cite internal control deficiencies pertaining to the lack of those written policies and procedures, were mere recitations of the 2017 Form 20-F without sufficient facts supporting the substance of the control deficiencies or explaining why omitting the deficiencies would communicate information materially different from the company's prior disclosure that it lacked accounting personnel familiar with GAAP who could address complex accounting issues.

No scienter or control person liability. The court also held that the individual defendants lacked scienter because the plaintiff could not provide any evidence showing the defendants state of mind. And since there was no primary liability, said the court, there could not be any control person liability against the individual defendants.

The case is [No. 1:18-cv-03655-ER](#).

Attorneys: Joseph Alexander Hood, II (Pomerantz LLP) for Peifa Xu. Lawrence P. Eigel (Bragar Wexler Eigel & Squire, PC) for William R. Barth. William J. Foley (Orrick, Herrington & Sutcliffe LLP) for Gridsum Holding Inc.

Companies: Gridsum Holding Inc.

LitigationEnforcement: AccountingAuditing AlternativeInvestmentFunds DirectorsOfficers Enforcement
FraudManipulation InternationalNews IPOs NewYorkNews