

Litigation Department

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Private Company Litigation: Hunting for Unicorns?

It has been widely reported that the SEC is investigating (along with federal prosecutors) whether former media darling Theranos Inc. misled investors about the state of its supposedly industry-disrupting blood testing technology and operations. At first glance, it would appear unusual for the SEC to be taking such a keen interest in a private, venture capital-backed company like Theranos. However, the Theranos investigation appears to be the tip of the iceberg, and a warning to other high-flying, high-value start-ups, often referred to as “unicorns.”¹

The SEC Takes Notice

In her Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative on March 31, 2016, U.S. Securities and Exchange Commission Chair Mary Jo White spoke of the challenges and risks the financial markets are now facing as a result of the rapid innovation and advancement in technology, and the means by which private start-up companies are being funded.² Noting that “protecting investors is at the core of the SEC’s mission,” Chairwoman White made the agency’s views, that transparency and candor with investors applies with equal force to start-ups, clear:

Being a private company obviously does not mean that you can disregard the interests of investors. Indeed, being a private company comes with serious obligations to investors and the markets. Whether the source of the obligation is the federal securities laws or the fiduciary duty that is owed to shareholders, the resulting candor and fair dealing should be fundamentally the same. And beyond any specific regulatory requirements, some of the principles that characterize public companies – transparency with investors, controls on financial reporting, strong corporate governance – have applicability and relevance to private companies, especially those pre-IPO companies that aspire to go public, and should not be overlooked or avoided, whether or not mandated by federal law or an SEC regulation.

For the new and evolving markets to be successful, all investors need confidence that they are being treated fairly and that the full range of risks are transparently disclosed. We must work together to

¹ “Unicorn” commonly refers to a venture-capital backed technology startup with a valuation generally exceeding \$1 billion.

² See <https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html>

ensure that this confidence is well-placed, so that investors feel comfortable providing the capital essential for business development and growth. Only then can we reap the full rewards of the creativity, genius, and innovation for which this Valley is famous.

Tellingly, less than three weeks later, on April 18, 2016, news broke that Theranos Inc. – a private, Silicon Valley-based medical laboratory services company that sought to upend the medical diagnostics business using inexpensive tests with just a few drops of blood – was under investigation by the SEC. The investigation is reported to be focusing on Theranos’ disclosures to its investors, including what it disclosed about its blood testing methods, difficulties it was experiencing, and its underlying corporate practices.³ Theranos, a quintessential “unicorn” with a \$9 billion valuation, appears to be exactly the type of company that Chairwoman White was referring to in her speech. Indeed, referencing “unicorns” specifically, Chairwoman White expressed the SEC’s “worry that the tail may wag the horn, so to speak, on valuation disclosures. The concern is whether the prestige associated with reaching a sky high valuation fast drives companies to try to appear more valuable than they actually are.”

Themes From The Past

While it is true that the SEC’s anti-fraud provisions cover virtually any kind of securities misrepresentation, it is also true that the types of investors who put millions of dollars into private companies like Theranos are usually sophisticated and tend to do their due diligence. Without a doubt, a common refrain the SEC will likely hear from Theranos, and companies like Theranos, in their defense is that their investors were all big boys and girls who knew the risks of what they were getting into and had the means to fully vet their investments. Chairwoman White even addressed this point specifically, acknowledging that venture capital investors “are sophisticated and generally … are aware that most of their investments will fail”. However, Chairwoman White also made clear that this will not end the inquiry. Noting that “Exchange Act Section 10(b) and Rule 10b-5 apply to all companies” and that “all private and public securities transactions, no matter the sophistication of the parties, must be free from fraud,” Chairwoman White stated that the issue is ultimately “whether the information supplied to investors is accurate and complete – that is, whether it accurately reflects the performance and prospects of the company.”

We have certainly seen this before, most recently in connection with the fall-out from the 2007-08 financial crisis. The financial instruments at the center of that crisis – products like RMBS, CDOs, and CDS – were typically bought and sold only by the most sophisticated of investors. When the parties involved in structuring, selling, and managing those transactions were investigated by the SEC or confronted in litigation with claims by investors, it should have come as no surprise that the sophistication of the investors in these transactions was a central theme of the defense. Nevertheless, the SEC and investors were able to recover

³ Recently, it was reported that Theranos was voiding all tests conducted using its “Edison” machine in 2014 and 2015. See Theranos Voids Two Years of Edis Blood-Test Results, *The Wall Street Journal*, May 18, 2016. The company stopped using the machine, central to its \$9 billion valuation, in June 2015.

billions of dollars from many of the defendants involved in the structuring, selling, and managing of those transactions on the basis of core claims that, whatever the investors' sophistication, the documents used to sell these deals to them were materially false and misleading.⁴ Principally, this was because, as Chairwoman White pointed out, the notion that a party is "sophisticated" in the abstract is not conclusive. Even sophisticated entities can justifiably rely on fraudulent statements, and these cases largely turned on whether the information supplied to investors was accurate and complete.⁵

Looking Forward

It is the dream of nearly every entrepreneur to turn his or her start-up idea into the next great market disruptor that punches their ticket into the Billionaires Club. Technology has fueled the race to innovate, and the models for funding these companies continue to evolve almost as quickly as the ideas these entrepreneurs dream up. New approaches and strategies for accessing secondary market liquidity continue to emerge, as have new types of investors, spurred on by potentially lucrative returns in our current low-interest rate environment. But with an increase in the number of these high-value start-ups following the now all-too-familiar pattern of launch, media hype-cycle, and demise, the SEC has taken notice of the potential for a more meaningful impact on the wider investing world. These companies will not be able to rely too heavily on the purported "sophistication" of their investors if their founders' visions don't pan out. And if history is a guide, once the SEC starts, private litigation is not likely to be far behind.

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⁴ See Summary of SEC Enforcement Actions, available at <https://www.sec.gov/spotlight/enf-actions-fc.shtml> (announcing the recovery of nearly \$2 billion in penalties, and the disgorgement of approximately another \$1.5 billion in fees, from parties involved in structuring and managing those transactions).

⁵ See, e.g., *Natl. W. Life Ins. Co. v Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 89 Fed App'x 287, 294 (2d Cir 2004) ("Sophisticated" entities can justifiably rely on fraudulent statements," and whether such entities did so in particular case "is a genuine issue of material fact"); *ACA Fin. Guar. Corp. v Goldman, Sachs & Co.*, 25 N.Y.3d 1043, 1045 (2015) (typically, "the question of what constitutes reasonable reliance is not generally a question to be resolved as a matter of law on a motion to dismiss"); *Basis Yield Alpha Fund Master v. Stanley*, 136 A.D.3d 136 (1st Dep't 2015) (allowing claim to proceed where "sophisticated investor has sufficiently alleged that it justifiably relied on credit ratings of securities that defendants, the organizers of the offering, allegedly had manipulated and otherwise knew, from nonpublic information, to be inaccurate.")