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Lending Club Decision Provides Guidance For Bringing Section 11 Claims Based on Weaknesses in Internal Controls

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We have been following defendants' motions to dismiss in the *In re Lending Club Securities Litigation* class action, No 3:16-cv-02627-WHA, in the United States District Court for the Northern District of California ("the Lending Club Litigation"). Plaintiffs brought claims under both Section 11 of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934, alleging that Lending Club misled shareholders about (1) the company's internal controls over financial reporting, (2) its relationship with Cirrix—a company formed for the sole purpose of purchasing loans from lending club, (3) its data integrity and security, and (4) its loan approval process. The Court's decision on defendants' motions to dismiss provides a roadmap for plaintiffs' bringing Section 11 claims based on failure to disclose weaknesses in internal controls.

Pleading Standard

As the Supreme Court noted in Omnicare, generally a plaintiff pursuing a claim under Section 11 "need not prove . . . that the defendant acted with any intent to deceive or defraud." However, defendants in the Lending Club Litigation argued that plaintiffs' claims under Section 11 sounded in fraud because they employed the same factual allegations to allege fraudulent conduct under Section 10(b), and therefore needed to satisfy the heightened pleading standard of Rule 9(b), which requires plaintiffs alleging fraud to state with particularity the circumstances constituting fraud.

Plaintiffs argued that their Section 11 claims were not grounded in fraud and therefore did not need to satisfy the heightened pleading standard of Rule 9(b). Plaintiffs' complaint expressly stated that its Section 11 claim was "not based on and does not sound in fraud." Consolidated Compl. ¶ 137. However, the Court noted that merely disclaiming an allegation of fraud in contention with a Section 11 claim is insufficient, and found that "lead plaintiff makes no effort to distinguish the factual bases for its Section 11 claim and its Rule 10b-5 claim." Order at p. 8. The Court therefore concluded that the Lending Club Litigation plaintiffs "must meet the heightened pleading requirements with respect to pleading a false or misleading statement." *Id.* citing *In re Rigel Pharma. Inc., Sec. Litig.*, 697 F.3d 869, 885 (9th Cir. 2012).

Section 11 Claims Based on Weak Internal Controls

Despite this holding, the Court found that lead plaintiff had "met that heightened pleading standard with respect to three of its Section 11 claims." *Id.* In particular the court held that lead plaintiff adequately pleaded its Section 11 claims relating to representations at the IPO regarding (1) the strength of Lending Club's internal controls and financial reporting, (2) its relationship with Cirrix, and (3) its data integrity and security.[1] While the Court performed its analysis under Rule 9(b)'s heightened pleading standard, portions of that analysis suggest how to allege a material misrepresentations under Section 11.

The Court held that lead plaintiff had adequately alleged a Section 11 claim based on misrepresentations regarding the strength of Lending Club's internal controls.[2] A number of courts have rejected similar attempts by plaintiffs to bring Section 11 claims based on weakness in internal controls.

Lending Club's December 2014 registration statement and documents incorporated therein included a number of representations about its internal control procedures for financial reporting, which would have prevented self-dealing, processing of improper loan applications, and irresponsible lending practices. In particular, the registration statement stated that Lending Club had evaluated the effectiveness of its disclosure controls and procedures, and concluded they "were effective at a reasonable assurance level."

Despite admitting months after Lending Club's December 2014 IPO that its internal controls suffered from various material weaknesses, defendants argued that lead plaintiff failed to plead facts showing that Lending Club's statements regarding the adequacy of its IPO were false *at the time of the IPO*. Order at pp. 8-9. In short, defendants argued that lead plaintiff had failed to connect the dots between Lending Club's internal controls at the time of the December 2014 IPO and December 2015—the time Lending Club first admits that problems existed with its internal controls.

However, the Complaint alleged that prior to Lending Club's admission that its internal controls were inadequate it issued consecutive quarterly reports stating that there had been no material changes to its "internal controls over financial reporting" from its IPO in December 2014 through December 2015. In addition, Lending Club admitted that its control deficiencies were related to its "tone at the top," and it disclosed no changes to leadership between the IPO and the time those weaknesses in its internal controls emerged.

The Court held that these factual allegations supported lead plaintiff's contention that that the control systems in place between December 2015 and March 2016—which Lending Club conceded were deficient—also existed at the time of the IPO in December 2014, and that their inadequacies should have been discovered. The Court therefore concluded that lead plaintiff had adequately pleaded its Section 11 claim relating to Lending Club's representations regarding its internal controls and financial reporting at its IPO.

The Court's decision suggests that plaintiffs may be able to adequately allege Section 11 claims based on weaknesses in internal controls by tying statements made at the time of an IPO to later negative disclosures by alleging that interim reports did not note any material changes to internal controls or leadership (particularly where the weaknesses relate to the company's tone at the top).

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[1] The Court held that lead plaintiff failed to allege "*particularized* facts supporting its claim that Lending Club made materially false representations at the time of its IPO regarding the transparency and sophistication of its loan approval process," but allowed lead plaintiff to seek leave to amend the claim. Order at p. 17. Finally, the Court dismissed lead plaintiff's 10(b)(5) claims relating to data integrity and the loan approval process finding that "there is no basis for a strong inference of scienter." *Id.* at p. 18.

[2] The Court also held that lead plaintiff's Section 10(b) claim based on the same conduct was adequately pleded.