

# Securities Litigation under the Securities Act of 1933 and the Securities Exchange Act of 1934 – Venture Capital

By Sundeep Patel<sup>†</sup>

## Introduction

Venture capital is a type of private equity capital typically provided to smaller, high-potential, companies in the interest of generating a large return through an eventual realization event such as an initial public offering (“IPO”) or sale of the company.<sup>1</sup> Venture capital investments generally exchange cash for shares in the invested company.<sup>2</sup>

The venture capital industry has played a significant role in the growth of the U.S. economy.<sup>3</sup> Venture capital is widely accepted as an important process in the nurturing of entrepreneurs and the establishment and growth of start-up firms.<sup>4</sup> Venture capital provides enterprises with a life-line—the cash that they need to grow.<sup>5</sup> Because so many of these companies offer innovative products and services, venture capitalists perform a vital function for the economy: allocating funds, through expert selection and management, in order to bring the most promising inventions to life.<sup>6</sup> Since start-up companies lack an established operating record, standard commercial sources of financing are typically unavailable.<sup>7</sup> Because of this, entrepreneurs seek the assistance of venture capital to obtain financing for their start-up companies.<sup>8</sup>

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The primary objectives of U.S. securities laws, as administered by the Securities and Exchange Commission (“SEC”), “are to protect investors and ensure that securities markets are fair, efficient, and transparent.”<sup>9</sup> The Securities Act of 1933 (“Securities Act”) and the Securities Exchange Act of 1934 (“Exchange Act”)



allow the SEC to create rules to protect investors.<sup>10</sup> The primary purpose of both the Securities Act and the Exchange Act is to ensure that institutions that offer securities provide full and fair disclosure to the investing public.<sup>11</sup> The Securities Act requires that such disclosure be made in the registration statement that a company must file with the SEC as part of the company’s public offering process.<sup>12</sup> Pursuant to Section 5 of the Securities Act, it is unlawful to sell or offer to sell any security unless a registration statement has been filed with and declared effective by the SEC or unless the transaction is exempt from the registration requirements.<sup>13</sup> The Exchange Act requires full and fair disclosure for companies engaged in securities trading and requires periodic reporting by registered companies.<sup>14</sup> Such companies are traditionally ones that are publicly traded on exchange markets like the New York Stock Exchange and the NASDAQ.<sup>15</sup>

## Litigation

Securities laws govern the methods of raising capital for business purposes. The federal securities laws, specifically the Securities Act and the Exchange Act, have traditionally been problematic for established public companies and their major institutional investors.<sup>16</sup> Once considered untouchable, venture capitalists are finding themselves increasingly embroiled in litigation relating to

their business activities. Plaintiffs' lawyers are increasingly using the federal securities laws to go after venture capital funds. This is usually because of the increased participation of venture capital funds in financing public companies, and the increased importance of private transactions in the financial marketplace.<sup>17</sup> Venture capital firms and their



general partners have been sued for fraud, breach of contract and securities law violations relating to their firm's investments in, or dealings with, portfolio companies. This article offers examples of the types of emerging litigation involving venture capital firms brought under the Securities Act and Exchange Act.

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### Securities Act Liability

One of the most common lawsuits relating to the Securities Act is the allegation that a company and its directors have made material misstatements in the company's prospectus and registration statement. A venture capital manager who served as a director of a company at the time the company went public may be liable for material misstatements included in the company's prospectus and registration statement. In *Warman v. Overland Data*,<sup>18</sup> several venture capital funds that had representatives serving on the board of Overland faced allegations in a class action that alleged that the company's IPO prospectus and registration statement were false and misleading. The court denied the defendants' motion to dismiss because the court did not believe the funds were in substantial control of the company through their representatives.<sup>19</sup> In *In re Stac Elec. Sec. Litig.*,<sup>20</sup> several members of the Stac board faced allegations that Stac did not disclose the fact that Microsoft was about to release a competing product at the time of the company's IPO. The court affirmed the dismissal of the claims against the venture capital fund.

### Exchange Act Liability

In fraud cases arising out of misstatements in corporate financial statements, plaintiffs commonly allege that venture capital funds and their representatives are "control persons," over a company being financed. Plaintiffs also commonly assert a "group pleading" theory. Plaintiffs allege that given the position of control of the fund or its representatives over the financed company, the fund is responsible for any fraud committed by the company. In *Strassman v. Fresh Choice*,<sup>21</sup> a venture capital fund was among other defendants sued in a class action where it was alleged that the venture capital fund, the largest shareholder of Fresh Choice and a representative on the board, knew the company issued false and misleading statements in order to inflate the stock price. The suit against the venture capital fund was dismissed because the court held that the fund was not a controlling person.<sup>22</sup> In another case, *Robbins v. HomeTown Buffet*,<sup>23</sup> four different venture capital funds were defendants in a class action suit against HomeTown. The plaintiffs alleged HomeTown made false and misleading statements in its SEC filings as well as in comments to research analysts.<sup>24</sup> The court dismissed the case because the venture capital funds were not deemed controlling persons.<sup>25</sup>

Shareholders of a target company have also sued venture capital funds under Sections 10(b) and 20(a) of the Exchange Act, alleging misrepresentations and omissions in financial statements. Specifically, in *Dresdner v. Utility.com*,<sup>26</sup> the founders and shareholders of a private company acquired in a stock-for-stock merger sued the acquirer, its officers and directors, and several venture capital investors for alleged misstatements and omissions in the merger negotiations and the subsequent agreement. The court dismissed the claims against the venture capital funds and their representatives on the Utility.com board, holding that plaintiffs could not use the "group pleading" doctrine to attribute company statements to non-management directors.<sup>27</sup> Recently, in *JSMS Rural v. GMG Capital Investments*,<sup>28</sup> JSMS sued GMG alleging fraud under Section 10(b) of the Exchange Act. JSMS claimed that it purchased a partnership interest from GMG based on misleading financial statements.<sup>29</sup> The court granted GMG's motion for summary judgment, stating that the plaintiff could not recover damages because it was unable to prove a loss of value attributable to the alleged fraud.<sup>30</sup>

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### Insider Trading Allegations

Many lawsuits against venture capital funds allege insider trading. Plaintiffs accuse funds of trading on non-public, material information. In these cases, courts sometimes are reluctant to dismiss the suits. In the case *In re Worlds of Wonder Sec. Litig.*,<sup>31</sup> several venture capital funds and their representatives on the company’s boards faced charges by shareholders that Worlds of Wonder stock was sold prior to the announcement of bad news being released. The plaintiffs alleged that the sales were made based on material, non-public information.<sup>32</sup> The court declined to dismiss the insider trading claims asserted against the venture capital defendants because the court believed a nexus existed between the funds and the directors.<sup>33</sup> However, in *Mitzner v. Hastings*,<sup>34</sup> shareholders of Netflix brought a derivative suit against the company’s directors, which included a venture capital fund representative. The plaintiffs alleged the defendants breached their fiduciary duty by trading on adverse, material, non-public information.<sup>35</sup> The court dismissed the complaint, stating that the plaintiffs failed to make a proper demand on the board.<sup>36</sup>

### Conclusion

Due to the greater influence exerted by venture capital funds in the world of high-finance, litigation is increasing. Plaintiffs’ lawyers are increasingly using the Securities Act and the Exchange Act to sue venture capital firms for alleged abuses. The trend will probably increase in the future in order to hold venture capital firms more accountable for the positions they take in companies. Thus, venture capital firms must assess their liability when deciding whether to invest and what types of companies to invest in. Venture capital funds must now keep a vigilant eye not only on the bottom line but also on the verity of statements and documents filed with the SEC and communicated to investors. In this litigious environment, venture capital funds must be able to recognize and prevent untoward behavior by company officials. **BLB**

## ENDNOTES: Sundeep Patel

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- <sup>1</sup> See William A. Sahlman, *The Structure and Governance of Venture Capital Organizations*, 27 J. FIN. ECON. 473, 473 (1990) (noting that venture capital contracting practices are well adapted for environments characterized by uncertainty and information asymmetries).
  - <sup>2</sup> See Bentley J. Anderson, *Venture Capital and Securities Market Development in Malaysia: The Search for a Functioning Exit Mechanism*, 12 WIS. INT’L L.J. 1, 6 (1993) (noting that “[e]quity is preferred because it allows the entrepreneur to share the risk with the investor, and does not commit the entrepreneur to repay the investment.”).
  - <sup>3</sup> WILLIAM D. BYGRAVE & JEFFRY A. TIMMONS, *VENTURE CAPITAL AT THE CROSSROADS* 228-40 (Harvard Business School Press 1992).
  - <sup>4</sup> Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 245 (1998) (recognizing that venture capital is an essential form of financing for high-risk companies).
  - <sup>5</sup> See VENTURE IMPACT: THE ECONOMIC IMPORTANCE OF VENTURE CAPITAL BACK COMPANIES TO THE U.S. ECONOMY 4 (National Venture Capital Association 2007).
  - <sup>6</sup> *Id.* at 8 (noting that “[t]he data demonstrates the enormous contribution of venture capital backed companies to U.S. jobs, sales, economic growth, and technological progress.”).
  - <sup>7</sup> *Id.*
  - <sup>8</sup> *Id.*
  - <sup>9</sup> Roberta S. Karmel, *Stock Markets and the Globalization of Retirement Savings—Implications of Privatization of Government Pensions for Securities Regulators*, 33 INT’L LAW. 955, 962 (1999).
  - <sup>10</sup> See *id.* at 971 (describing the purpose and necessity of the Securities Act of 1933 and the Securities Exchange Act of 1934).
  - <sup>11</sup> Elizabeth Glass Geltman, *The Pendulum Swings Back: Why the SEC should Rethink Its Policies on Disclosure On Environmental Liabilities*, 5 VILL. ENVTL. L.J. 323, 330 (1994).
  - <sup>12</sup> 15 U.S.C. § 77e(c) (2006).
  - <sup>13</sup> *Id.* at § 77d, f.
  - <sup>14</sup> 15 U.S.C. § 78 (i) (2006).
  - <sup>15</sup> Securities Exchange Commission, “Laws that Govern the Securities Industry,” available at <http://www.sec.gov/about/laws.shtml>.
  - <sup>16</sup> Elaine A. Welle, *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 56 WASH. & LEE L. REV. 519, 533-34 (1999).
  - <sup>17</sup> *Id.* at 528-31.
  - <sup>18</sup> No. 97cv833, 1998 U.S. Dist. LEXIS 2009, at \*1-2 (S.D.Cal. Feb. 20, 1998).
  - <sup>19</sup> *Id.* at \*15-16.
  - <sup>20</sup> 89 F.3d 1399, 1401-02 (9th Cir. 1996).
  - <sup>21</sup> No. C-95-20017, 1995 U.S. Dist. LEXIS 19343, \*3-4 (N.D.Cal. Dec. 7, 1995).
  - <sup>22</sup> *Id.* at \*48-49.
  - <sup>23</sup> No. 94-1655-J, 1995 U.S. Dist. LEXIS 17870, \*1-2 (S.D.Cal. Mar. 16, 1995).
  - <sup>24</sup> *Id.*
  - <sup>25</sup> *Id.* at \*25.
  - <sup>26</sup> 371 F. Supp.2d 476, 481 (S.D.N.Y. 2005).
  - <sup>27</sup> *Id.* at 501.
  - <sup>28</sup> No. 04 Civ. 8591 (SAS), 2006 U.S. Dist. LEXIS 46080 (S.D.N.Y. July 5, 2006).
  - <sup>29</sup> *Id.*
  - <sup>30</sup> *Id.* at \*16.
  - <sup>31</sup> 721 F. Supp. 1140, 1142 (N.D.Cal. 1989).
  - <sup>32</sup> *Id.* at 1147.
  - <sup>33</sup> *Id.* at 1145.
  - <sup>34</sup> No. C 04-3310, 2005 U.S. Dist. LEXIS 835, \*1-2 (N.D.Cal. Jan. 14, 2005).
  - <sup>35</sup> *Id.* at \*6.
  - <sup>36</sup> *Id.* at \*10, \*21.