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Litigation Alert

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Key Points

- The U.S. Court of Appeals for the 9th Circuit affirmed the dismissal of a securities fraud claim alleging that Yelp fraudulently inflated its stock price by misleading investors about its practices concerning the business reviews hosted on its site.
- The 9th Circuit held that the allegation that complaints were filed with the Federal Trade Commission (FTC) regarding Yelp's practices were insufficient to establish loss causation because there was no indication that the drop in stock price was caused by revelation of **actual** fraud, as opposed to the mere **potential** of fraud.
- The 9th Circuit also held that the revelation of the FTC complaints was insufficient to establish that the defendants acted with the requisite scienter.

The 9th Circuit Rejects Securities Class Action Premised on Businesses' Complaints About Yelp's Practices

Last Tuesday, in *Curry v. Yelp Inc.*, the 9th Circuit affirmed the dismissal of a securities fraud action alleging that Yelp misled investors by concealing that a number of the business reviews hosted on its site are not genuine, but instead are designed to coerce businesses into purchasing advertising space on Yelp's platform. The court's decision stressed that the mere allegation that thousands of complaints against Yelp were lodged with the Federal Trade Commission (FTC) was insufficient to establish that the investors' loss was caused by Yelp's misrepresentations. The court also held that the allegation was insufficient to show that Yelp acted with the requisite state of mind.

Background

On August 6, 2014, Yelp investors brought an action under Section 10(b) of the Securities Exchange Act alleging that Yelp made material misrepresentations regarding the authenticity of the reviews hosted on its site, thereby artificially—and fraudulently—inflating Yelp's stock price. Specifically, the plaintiffs alleged that, during the class period, Yelp represented that all of its online reviews were authentic and denied that Yelp manipulated businesses' reviews in exchange for payment. According to the plaintiffs, these representations were false, and, in fact, Yelp used the threat of negative (often fake) reviews as a means to coerce businesses into using Yelp's advertising platform.

The case against Yelp was premised on a 6 percent decline in Yelp's stock price that occurred following the publication of a 2014 *Wall Street Journal* article that disclosed the existence of approximately 2,000 complaints against Yelp filed with the FTC by businesses alleging manipulative tactics associated with reviews on Yelp. Notably, the article did not disclose the existence of any governmental investigation into Yelp, and there had been no finding by any administrative body of any wrongdoing by Yelp.

The district court granted Yelp's motion to dismiss the complaint on several grounds, including that the plaintiffs failed to adequately plead loss causation and scienter. The plaintiffs appealed the decision to the 9th Circuit.

The 9th Circuit's Opinion

On appeal, the 9th Circuit affirmed the lower court's order on both grounds. First, the 9th Circuit held that the plaintiffs had failed to adequately allege loss causation. Referencing its earlier decision in *Loos v. Immersion, Corp.*, 762 F. 3d 880, 889 (9th Cir. 2014), the 9th Circuit reiterated that, to show loss causation, a plaintiff cannot merely point to the **potential** of fraud, but must allege facts that, if true, show that fraud was **actually** revealed to the market. While the 9th Circuit stopped short of requiring an actual admission of wrongdoing by a defendant, it held that the mere filing of complaints—even thousands of complaints—regarding a company's practices was clearly insufficient to demonstrate loss causation. The court reasoned, "The element of loss causation cannot be adequately made out merely by resting on a number of customer complaints and asserting that where there is smoke, there must be fire.

Second, the 9th Circuit held that the plaintiffs failed to show a strong inference of scienter, or knowledge of the falsity of its statements, by Yelp or the individual defendants. The court rejected the plaintiffs' suggestion that scienter should be surmised from Yelp officers' sales of stock during the class period, since there were no allegations that such trading was out of line with historical practices. It similarly dismissed the argument that Yelp officers were aware of its advertisement practices through their interactions with businesses, reasoning that, even if the defendants were aware of the existence of the complaints, the 2,000 complaints disclosed in the *Wall Street Journal* article represented only a tiny fraction of the total reviews on Yelp's platform.

Takeaways

The plaintiffs' bar is often eager to file securities fraud complaints at the earliest hint of corporate wrongdoing. The 9th Circuit's decision should serve as a warning to plaintiffs' attorneys that, if they choose to file a lawsuit based on only allegations of potential fraud, they risk having their complaint dismissed for failure to allege loss causation or scienter.

The 9th Circuit's decision in *Curry* reinforces the court's prior holding in *Loos* that the revelation of the mere potential of fraud—even if it leads to a stock price drop—is insufficient to establish loss causation. The decision affirms that the court remains skeptical of securities fraud cases premised solely on the revelation that allegations of wrongdoing have been leveled against issuers. To use the court's words, plaintiffs are required to allege that there is fire, not merely that there is smoke.

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