Attack of the Indirect Investor

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A company's indirect investors may sue the company and its principals for fraud, according to a recent federal court ruling in *Robert Colman et al. v. Theranos Inc. et al.*[1] Investment managers who syndicate investment opportunities through single purpose vehicles (SPVs) should be concerned about the ruling because it undermines their control over potential disputes with portfolio companies and their relationships with portfolio company management.

The portfolio company made false and misleading statements, according to plaintiffs

Plaintiffs Robert Colman and Hilary Taubman-Dye sued Theranos, Inc. in 2016 claiming that Theranos and its executives made false and misleading statements for the purpose of inducing the plaintiffs to indirectly purchase Theranos securities. The defendants' statements violated Section 25400(d) of the California Corporations Code[2] and constituted common law fraud, according to the plaintiffs.

Theranos is the high-profile company founded by Elizabeth Holmes in 2003 that claimed to have developed blood-testing devices that could operate accurately using much smaller samples of blood than other devices on the market. The company's technology had been described as "a groundbreaking feat of science and engineering" which had the potential to revolutionize the $50 billion blood-testing industry.

The company raised more than $400 million in venture capital financing and had an estimated valuation of $9 billion in 2014. However, the company's valuation fell precipitously after questions about the viability of its technology emerged in 2015.

The plaintiffs are not Theranos shareholders

Neither plaintiff is a Theranos shareholder. Plaintiff Robert Coleman purchased a membership interest in Lucas Venture Group XI, LLC, a California limited liability company whose purpose was to purchase newly issued Series G shares of Theranos. Plaintiff Hilary Taubman-Dye purchased a membership interest in Celadon Technology Fund VII, LLC, a Delaware limited liability company whose purpose was to acquire Theranos shares on the secondary market.

Neither plaintiff received any investment solicitation materials directly from Theranos and neither claimed to have had the opportunity to purchase Theranos shares directly. When making their investment decisions, the plaintiffs alleged that they justifiably relied upon the defendants' statements to the public, including statements in a Wall Street Journal article and statements in company press releases.

The court allowed the plaintiffs to proceed with fraud claims

The court allowed the plaintiffs to proceed with their common law fraud claims and their claims under Section 25400(d) of the California Corporations Code, even though it was undisputed that the plaintiffs did not directly own any Theranos shares and had no contractual relationship with Theranos. In denying the defendants' motion to dismiss for failure to state a claim, the court stated that the "purpose of Section 25400(d) is [to] prevent the manipulation of the market by fraud, and it focuses on the actions of the seller of the securities, not the relationship between seller and buyer."

Managers are adversely affected when SPV investors sue portfolio companies

Investment managers often use SPVs to pool investors who are participating in co-investment transactions alongside the manager's other funds. Fundless sponsors also use SPVs to pool investors for each portfolio investment.

A principal benefit of pooling investors into an SPV is that the manager retains control over the SPV's voting decisions and its interactions with the portfolio company. The *Theranos* ruling breaks down some of the barriers between SPV investors and portfolio companies by permitting indirect shareholders to sue portfolio companies.

The *Theranos* ruling adversely affects investment managers. A lawsuit by an SPV investor against a portfolio company or its management team might, for example, interfere with the manager's ability to pursue a unified litigation strategy on behalf of all of its clients who have an investment in the portfolio company, damage the manager's relationship with the portfolio company, or damage the manager's reputation among potential portfolio companies, resulting in the loss of future investment opportunities.

Investors in private funds that are not SPVs likely will not benefit from the *Theranos* ruling

The *Theranos* ruling is unlikely to invite litigation from investors in traditional multi-investment private equity and venture capital funds. Investors in these types of funds make their investment decisions before knowing the identity of the funds' portfolio companies, except where the funds have committed to acquire warehoused securities or have made investments during permitted capital raising periods. An investor that decides to invest in a fund before knowing the identity of its portfolio companies obviously will not be able to claim that it relied upon statements by potential portfolio companies when making its investment decision.

Three ways managers can mitigate risks arising from the *Theranos* ruling

To minimize the risks associated with potential lawsuits by indirect investors, investment managers should consider taking one or more of the following actions when pooling investors into an SPV:

- Disclose the risk of potential litigation by indirect investors in the SPV's offering materials;
- Limit participation in the SPV to investors that do not have a litigious history; and/or
- Include a provision in the SPV's governing documents that prohibits investors from suing the portfolio company and its management team for losses incurred in connection with their investment in the SPV.

For more information, please contact a member of our Private Investment Funds and Advisers Practice.

Footnotes.

1. *Robert Colman et al. v. Theranos Inc. et al.*, case number 5:16-cv-06822, in the U.S. District Court for the Northern District of California.

2. "It is unlawful for any person, directly or indirectly, in this state: … (d) If such person is a broker-dealer or other person selling or offering for sale or purchasing or offering to purchase the security, to make, for the purpose of inducing the purchase or sale of such security by others, any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or which omitted to state any

material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and which he knew or had reasonable ground to believe was so false or misleading." Cal. Corp. Code § 25400(d)