

MORRISON FOERSTER

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Judge Chin (00:00):

We will go ahead and proceed with the calendar. We'll hear the first case, *Altayyar v. Etsy*.

Matthew Tuccillo (00:17):

Good morning, your honors. May it please the court Matthew Tuccillo, Pomerantz LLP, representing plaintiff appellants in the securities fraud class action with exchange act and securities act claims. Here, it is undisputed that the investors had no knowledge of the undisclosed facts that were listed at length in our amended complaint that counterfeit and infringing products, or CIPs as we call them for short, were rampant on Etsy, constituting 6.3% of all listings and 8.6% of a category called handmade—

Judge Wesley (00:47):

Well if you got a 93.7 on an exam, wouldn't you get an A?

Matthew Tuccillo (00:51):

Well, this court—

Judge Wesley (00:52):

6.3%—how many items does that amount to? 2 million, didn't it? And so, therefore, the 90—there must be—I mean, there must be millions and millions of items listed, wouldn't there?

Matthew Tuccillo (01:05):

That's a fair question, your honor. And I think—

Judge Wesley (01:08):

I thought it was.

Matthew Tuccillo (01:10):

—that it was this court's decision—

Judge Wesley (01:12):

That's why I asked you.

Matthew Tuccillo (01:13):

—this court's decision, and *Christine Asia v. Ma*, which we put in on our 28 (j) letter, is squarely on point because there, this court found not only a falsity, but scienter was an exchange act case. It wasn't a securities act case and an item 303 violation. And, the undisclosed fact there was that another e-commerce

website, Alibaba, had counterfeits on its website, and it faced a risk of—a risk of just 1% of fines. So 99% of the fine of the revenue was not even in play. They had an undisclosed meeting, pre-IPO, where the SAIC, the Chinese regulator said, “Hey, if you don’t clear up the counterfeit issue, you might be fined 1%.”

Judge Chin (01:57):

The amended complaint identifies a number of purported misrepresentations, but many of the highlighted statements are in the nature of opinions, aspirations, and are those things actionable here?

Matthew Tuccillo (02:18):

For purposes of today, with our limited time, we can focus on the numerous ones that are not. In the prospectus itself, for example, it describes the responsible small-batch manufacturing partners. And it says as of December 31, 2014, we had approved more than 3000 Etsy shops with 5,000 manufacturing partnerships. Those are not aspirational. Those are facts. And the undisclosed facts that the confidential witnesses that we put in our complaint said, is that many of those manufacturers were Chinese factories cranking out counterfeits, that these had been allowed to be listed on Etsy’s website, either because they were making Etsy a lot of money, or because they had passed some handmade inquiry at the very beginning when they first signed up and that the integrity team knew this and that the integrity team was instructed to keep it up. And when the two integrity team—mind you, the integrity team had eight to 15 members. We have two of them as confidential witnesses. Could be 25% of the integrity team. When these people brought it to the attention of Etsy, one had a policy instituted that was ignored outright. The other was fired.

Judge Cote (03:25):

So Counsel, if I understand the numbers are correct, you think that the fact those numbers were listed was misleading, and it imposed upon the company to make further disclosures about the diligence of its program for rooting out people who should not be on the site.

Matthew Tuccillo (03:50):

I would say to overview, we have three categories of misstatements or omissions. Some in the prospectus or of the affirmative nature of the description of the sellers, and the description of what the integrity team was supposed to do. It was supposed to—the job of our integrity team is to remove items that do not belong in our marketplace. That is not what they did as listed in the complaint. Those aren’t numbers. There’s also the numbers and of those, I would focus you—

Judge Chin (04:14):

What was false about that statement? That was their job.

Matthew Tuccillo (04:14):

Correct, but as you’re saying that—

Judge Chin (04:14):

What’s false about that statement?

Matthew Tuccillo (04:14):

It is misleading because as 25% of the integrity team says in our complaint, they were told to not remove infringing products. They were told to leave sellers alone if they were making Etsy a lot of money. They were told to—they were disincentivized. CW1 finds an infringing product—

Matthew Tuccillo (04:40):

CW one uses the technology to figure out that that account is linked to a seller with multiple accounts, all listing, you know, hundreds and hundreds or thousands of counterfeit products. Etsy disincentivized the integrity team from doing anything about it. They just got their tick on the first one and moved on, and they left everything up there. That's in direct contrast to the eBay case that my brethren rely on so heavily. In eBay, they affirmatively ignored their own three strikes rule. If they could figure out on the first strike that somebody was there to sell counterfeits, they removed everything. So, with respect, I think that that was a misleading statement. Back to your honor's question, the numbers I would focus on aren't the gap-compliant ones, because then we get into the weeds of some of the cases that say, if you've properly recorded your revenues, you know, that's inactionable. But there are non-gap numbers, the number of active sellers, which the company identified as the key metric, that number included thousands of counterfeit sellers, unquestioned.

Matthew Tuccillo (05:41):

These facts are undisputed. And the Wedbush note at the end said, we expect that the impact on gross merchandise sales is even bigger. Because, if you think about it, you're not going to counterfeit a 50 cent item. Where your counterfeiting is Chanel products, you know, brand name things that sell at a higher premium. And here, the listing fees for Etsy, which were 20% of the revenues—this is back to your honor's question. It might be 6.3% of the total listings, but the listing fees alone were 20% of the revenues for the company. So, this is on par with the numbers that were at risk, only at risk in the Alibaba decision where an item 303 violation was found. And I would also say the third category misstatement that's even beyond what was in Alibaba is that we have post-IPO statements. So here, once the Wedbush note comes out, once the earnings reports come out, once the contemporaneous analyst reports come out, reporting alarming trends in the numbers.

Matthew Tuccillo (06:39):

Now the gross merchandise sales are stagnant. Now the cost of acquiring users of Etsy is going up. The marketing spend is going up. At that point, the CEO goes out and says "more," right? And there, the CEO says, and this is not aspirationally, said, "We have a dedicated legal support team that responds to proper take down notices by properly removing content. We also terminate the account of repeat offenders. We use technology to prevent bad actors from returning." That—that is irreconcilable with what the CW's in our complaint said they were instructed to do. The fact that one of them complained that it wasn't happening was terminated. So we have conscious misconduct and our scienter facts are even better than Alibaba. In Alibaba, the individual defendants, the Christine Ma decision, the individual defendants weren't even in that SAIC meeting, the single SAIC meeting. They just said, "Hey, there were high level people there."

Matthew Tuccillo (07:35):

There were department heads there. How could you not have known? In our complaint, we have extensive allegations of knowledge and recklessness. We've got CW4 the chief marketing officer who reported directly to the CEO saying he knew about the confidential, the counterfeit products. We've got CW4 saying—recalling that they were discussed at meetings. We've got CW6 recalling a specific meeting in early 2013. Company-wide where defendant, Dickerson and Salen were in attendance. We've got CW1 recalling an early 2014 integrity team presentation at a lunch and learn with Dickerson and Salen invited. We also have as our evidence of misconduct, the integrity team offering weekly fraud reports that detailed all of this and being told, "Hey, don't disclose that to the rank and file. Keep those to yourself." I see, my time is up.

Judge Chin (08:29):

Thank you. You have some time for rebuttal.

Matthew Tuccillo (08:30):

Yes.

Joseph Palmore (08:42):

Your honor, may it please the court, I'm Joseph Palmore here on behalf of appellees. The district court correctly concluded that there were no false or misleading statements in this case and no plausible allegation of scienter. This is not an intellectual property case. The issue is not whether there were infringing items for sale on Etsy. The question is, did Etsy follow the policies and procedures that it disclosed and it's offering documents as the district court correctly concluded? It did. I think it's important to take a step back and understand what Etsy is and is not. Etsy is a marketplace, not a retailer. It connects independent sellers, 1.4 million at the time of this complaint, with buyers and the items are sold by those independent sellers. Etsy is not selling those items. That provides critical context for the disclosures that Etsy made, which are really dispositive here. Etsy told investors that it doesn't control its sellers.

Joseph Palmore (09:37):

It told investors that it doesn't pre-screen sellers or items. It told investors that it frequently receives complaints about intellectual property infringing items. And it told investors exactly how it dealt with those complaints, which was to follow the industry standard rules of the road established by the digital millennium copyright act, the DMCA, which is to follow Congress' judgment, that the rights holder is the best in the best position to know whether something's infringing and is fully incentivized to let a marketplace know if it's intellectual property is being infringing—infringed and to provide a take-down notice. Critically here, there is no allegation in this complaint that Etsy ever failed to comply with a take-down notice. My friend on the other side spent some time talking about manufactured items, but that's really a distraction here, and there's a, both a front end problem and a back end problem with, that thread of his argument. The front end problem is that Etsy fully disclosed that it allowed its sellers to partner with manufacturers.

Joseph Palmore (10:47):

In fact, the CEO, Chad Dickerson in the offering document, discussed this in his letter to investors and explained that while a majority of Etsy sellers were one person shops, that Etsy wanted to accommodate those who grew and could no longer produce enough goods in their own home, for instance, to meet demand and that it had allowed manufacturing partnerships. This was expressly addressed in the offering documents. It was the subject of press attention at the time and, and actually a certain degree of controversy at the time in the years up to and including, the IPO. The back end problem with that manufacturing argument is that the Wedbush report, which is the kind of foundation on which the plaintiffs built their case, had nothing to do with manufactured goods. It was about infringement. And those are two separate issues, a manufactured good might or might not be infringing, a handmade good might or might not be infringing. Etsy never promised that it's handmade inquiry that it used when a seller wanted to partner with a manufacturer, had anything to do with intellectual property, or was meant to screen for intellectual property violations.

Joseph Palmore (12:01):

Instead, it repeatedly disclosed that the way it dealt with intellectual property issues was by following the industry standard practice and receiving take-down notices from rights holders. The confidential witnesses here don't change the outcome because they, at bottom, wanted different policies than the one that Etsy disclosed. The lead allegation in the complaint at A 33, paragraph 61, is that the supposed omission is that Etsy didn't pre-screen items, and instead allowed—worked after the fact when it receives a complaint from rights holders. But again, Etsy repeatedly disclosed that that's what it did. And that was fundamental to the business model that Etsy opted for here. The Alibaba case is, first of all, of course it's unpublished, but it's completely different. In that case, there was a secret meeting was the allegation, that a company ask

Chinese regulators to keep secret, to not disclose, in which crippling fines were threatened.

Joseph Palmore (13:10):

And that—this court concluded that the active disclosure of that alleged meeting with Chinese regulators, and the grave regulatory risk that it put the company in, that that was a material omission here. Here we have nothing like that at all. Of course, we have no meetings with regulators. Instead, we have the Webdush report which said there may be up to 5% infringing goods available on the site. Again, given the disclosures, that would—that was completely consistent with what Etsy disclosed. Esty said it frequently received complaints about infringing goods. So, it wouldn't have come as a surprise to anyone that there might be some there. And Judge Wesley, I agree that, you know, 94, 95% is actually a pretty good grade. I think it's actually, if you look at the—within the four corners of the report, it's probably even higher than that.

Judge Wesley (14:06):

The other thing is that the report, what I find interesting is that the Webdush report is used as a criticism of the failure to disclose, but the Webdush report is based on public information. So, it's information that any investor themselves could have gleaned, and, if, and if the web Bush report is viewed as inconsistent with the representations containing perspectives or other offerings or representation by Etsy, I don't know how an investor couldn't have had the same. If, those concerns were actually legitimate in the context of being approximate and causally related to each other—I mean, you're arguing to some degree that they weren't. Judge Chin asked whether they were aspirational and weren't really representations of fact, there's some of that concern too. But, but they're also public information.

Joseph Palmore (14:54):

Absolutely.

Judge Wesley (14:54):

So, it was knowable.

Joseph Palmore (14:56):

They scrolled the website and looked at items like anyone could have done.

Judge Wesley (15:00):

I have a minor—I want to ask a procedural matter. This—There was no oral argument on this, right? You both asked for oral argument, you didn't get it.

Joseph Palmore (15:08):

Right.

Judge Wesley (15:09):

And—and I noted in the papers when we looked at the papers, there was no request by the plaintiff for an opportunity to file an amended complaint or any representations in their initial filings. Other—there's a very brief kind of perfunctory response—and I'm going to ask you this too, Mr. Tuccillo—about a desire to refile or file an amended complaint. But I didn't see anything laid out in any, in their papers at all before the district court saying in, in the event you find this as inadequate, we'd like to offer an amended complaint, here's what we would allege. I didn't see that was that. Did I miss something?

Joseph Palmore (15:51):

You didn't. You have that exactly right. And that makes this case exactly like this court's decision in Porat,

which we cite in this portion of our brief. What this court there said was that there was no abuse of discretion when there wasn't a motion for leave to amend. There was simply one line in the opposition to a motion to dismiss, with no elaboration on what the party would do to amend or to address the deficiencies.

Judge Wesley (16:12):

Judge Chin and Judge Cote both—Judge Chin had a life in the district court. Judge Cote still does. And I didn't, I never did it. And I know I see sometimes cases where there a conference before the motion is held, and there's generally a discussion at conference about, well, is there going to be some request to amend? And then there's a discussion about what the amended complaint was going to look like. And I take it that didn't occur either here.

Joseph Palmore (16:37):

That didn't occur. There was no—

Judge Wesley (16:39):

Not meaning that as a criticism of either of you. I'm just trying to understand the context in which occurred. Lastly, was there a motion to reargue on a request for the right to amend the complaint after the decision was issued?

Joseph Palmore (16:52):

No, there wasn't your honor. And that, and that puts this case on all fours with, with Porat where this court found no abuse of discretion under materially indistinguishable circumstances. And if I could briefly move to scienter, because that was an independent basis for the district court's dismissal of the exchange act claims. It's not necessary for this court to reach it if it affirms on falsity, which takes care of everything. But the district court was correctly—correctly decided the scienter issue as well. There was no, under the kind of motive and opportunity prong of that inquiry, there was no motive here that was different from any other company wanting to have a successful IPO. And this court's cases have repeatedly held that, that generalized motive, which would be so common across companies doesn't suffice to meet the very high threshold for pleading scienter, nor is there any adequate pleading of recklessness.

Joseph Palmore (17:44):

My friend on the other side talked about their allegation of recklessness as well. There were meetings where infringement was—issues were discussed. That I would be shocked if there weren't meetings. Obviously, this was an issue, it was—they're repeated parts of the offering documents that talk about it. But just the fact that there were meetings and there were reports on infringement and enforcement efforts doesn't raise the strong inference of recklessness, which this court has said approximates, actual intent. So, for all those reasons, we would ask that the—the district court's judgment be affirmed.

Judge Chin (18:16):

Thank you. We'll hear at the rebuttal.

Matthew Tuccillo (18:23):

I'd like to return to a point—a couple points actually that you made. The first is I want to make sure you get this out. On amendment, the issue for us is we filed the—securities practice typically revolves around initial complaint, a lead plaintiff process. Then when the lead plaintiff is appointed a more robust amended complaint, which is really your first strong representation of the case, when, you know, you're the lead plaintiff, lead counsel. The problem here is the first indication we had that that was insufficient was the dismissal—

Judge Chin (18:54):

Does that make any sense? You're saying that in the first effort, you don't, you know, give it your best try?

Matthew Tuccillo (18:59):

In the first effort, we certainly meet the rule 11 standard. But, until you understand that you are the lead plaintiff, until you understand that you're the lead counsel, typically the amended complaint—and your honor you've seen this, I'm sure repeatedly—the amended complaint is far more robust. At that point, you've got the benefit of confidential witnesses. You've poured resources into the case. And so what happens is the first indication that that complaint was inadequate was the dismissal order itself.

Judge Wesley (19:25):

Well yeah, so you've got a motion to dismiss I mean it—

Matthew Tuccillo (19:32):

Yeah, but we thought our chances—we thought—

Judge Wesley (19:32):

It's like a loaded gun at your head. I would think that it would—I mean, I'm—you know, hindsight's 20/20, and I haven't practiced law in a long, long time. So I don't any tend to be critical, but it seems to me from the cases we see, why I don't understand why somebody, if somebody had something more to say, didn't tell—give the judge the benefit of those thoughts. It's hard to criticize a judge for dismissing with prejudice when one never points out to the judge what else there is to say.

Matthew Tuccillo (19:54):

There's numerous cases in this space indicating that it's a difficult space with heightened pleading, a lack of discovery, et cetera.

Judge Wesley (20:00):

There are also many cases that say where you don't ask for the amendment complaint that dismissal with prejudice is appropriate.

Matthew Tuccillo (20:06):

We did ask.

Judge Wesley (20:07):

Well, yeah. [inaudible] Perfunctorily, with one, a very short phrase. If you—if you really want to get into this, I'm happy to get into it with, you.

Matthew Tuccillo (20:15):

No, I understand.

Judge Wesley (20:15):

You didn't say much.

Matthew Tuccillo (20:17):

I understand. I think the issue is at that time, we were filing our opposition brief. We hadn't even seen the reply brief. We thought our chances were good. Until we get the dismissal, or we don't realize, oh, this is the problem that well—

Judge Weley (20:28):

You thought wrong.

Matthew Tuccillo (20:28):

Well, apparently so at the district level. What I would say though, on appeal, and this is important, is what more would we say, right? Because that's not in the record. Our investigator—I've asked our investigator since, he's identified 27 new leads of former employees.

Judge Chin (20:42):

That's not appropriate.

Judge Wesley (20:42):

I know. How could we think about that?

Judge Chin (20:43):

It's not appropriate to be telling us what your investigator found afterwards, if that stuff is not in the record.

Matthew Tuccillo (20:50):

Again, there was no way to get it in the record prior to dismissal—

Judge Chin (20:54):

You would need to make an application to the district court if you want to try to present something to expand the record. But, in any event, we have the argument. Thank you. We will reserve.

Matthew Tuccillo (21:04):

I would like to say one last thing if I may—

Judge Chin (21:06):

No, that's it. Thank you.