JS-6

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

CIVIL MINUTES - GENERAL

Case No.	2:20-cv-06780-RGK-PLA	Date	January 25, 2021
Title	***Edward A. Berg v. Velocity Financial, Inc. et al***		

Present: The Honorable	R. GARY KLAUSNER, UNITED STATES DISTRICT JUDGE	
Joseph Remigio	Not Reported	N/A
Deputy Clerk	Court Reporter / Recorder	Tape No.
Attorneys Present for Plaintiff:	Attorneys Present for Defendants:	
Not Present	Not Present	

Proceedings: **(IN CHAMBERS) Order Re: Defendants' Motion to Dismiss First Amended Complaint [DE 45]**

I. INTRODUCTION

On November 11, 2020, Edward Berg filed a first amended complaint ("FAC") against Velocity Financial, Inc., Christopher D. Farrar, Mark R. Szczepaniak, Christopher Oltmann, Alan Mantel, Ian Snow, John Pless, Brandon Kiss, Ogden Phipps, Daniel Ballen, John Pitstick, Joy Schaefer, Snow Phipps Group, LLC, Wells Fargo Securities, LLC, Citigroup Global Markets Inc., JMP Securities LLC, and Raymond James & Associates, Inc. (collectively, "Defendants"). The Complaint is a putative securities class action. It alleges violations of: (1) Section 11 of the Securities Act of 1933 against all Defendants; and (2) Section 15 of the Securities Act of 1933 against Velocity, the individual defendants, and Snow Phipps.

Now before the Court is Defendants' Motion to Dismiss. For the following reasons, the Court **GRANTS** Defendants' Motion.

II. FACTUAL BACKGROUND

The FAC alleges the following:

Velocity is a real estate finance company that issues, manages, and securitizes loans to borrowers nationwide. The company focuses on loaning to small commercial and residential properties. The company's primary product is a 30-year amortizing loan with a three-year fixed rate to finance long-term real estate investments.

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In 2017, as a solution for borrowers who did not qualify for Velocity's 30-year, long-term loan, the company also began originating short-term, interest-only loans. Even though these short-term loans presented greater risk, Velocity assured investors that its "disciplined" underwriting process allow the company to avoid loaning to troublesome borrowers, while still maximizing profits.

As many large businesses do, Velocity went public. After more than a year and several amendments, Velocity filed its Registration Statement on Form S-1 with the SEC on January 6, 2020. The SEC declared the Registration Statement effective on January 16, 2020. And on January 17, 2020, Velocity filed its final Prospectus with the SEC.

But various statements in Velocity's offering materials were false or materially misleading. First, Defendants extoled the virtues of its underwriting practice through its use of "disciplined due diligence" and propriety data. (FAC ¶ 28). Although Velocity asserted that its underwriting practices would position the company for "sustainable, long-term growth" and offer the company key "competitive advantages," in reality, Velocity had begun issuing loans to high-risk borrowers. (FAC ¶ 37). This caused its percentage of nonperforming loans—loans that are 90 or more days past due, in bankruptcy, or in foreclosure—to be higher than other lenders. It was therefore misleading for Defendants to tout Velocity's underwriting practice, but not disclose that "those same practices were allowing riskier loans than the Company had historically issued to be made, resulting in a higher, and growing percentage of non-performing loans in Velocity's portfolio." (FAC ¶ 38).

Second, it was misleading for Defendant to laud the overall growth of its loan portfolio, but not disclose that the growth was fueled by riskier short-term interest loans—and that a significant portion of the portfolio had become nonperforming. Finally, the offering materials misleadingly touted the favorable market conditions that Velocity could seize upon, even though the coronavirus was set to disrupt the entire real estate market.

III. JUDICIAL STANDARD

A. Rule 12(b)(6)

To survive a motion under Rule 12(b)(6), a complaint must contain "sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'" *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007)). A claim is facially plausible if the plaintiff alleges enough facts to permit a reasonable inference that the defendant is liable for the alleged misconduct. *Id.* A plaintiff need not provide "detailed factual allegations" but must provide more

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than mere legal conclusions. *Twombly*, 550 U.S. at 555. "Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice." *Iqbal*, 556 U.S. at 678.

When ruling on a Rule 12(b)(6) motion, the Court must "accept all factual allegations in the complaint as true." *Tellabs, Inc. v. Makor Issues & Rts., Ltd.*, 551 U.S. 308, 322 (2007). The Court must also "construe the pleadings in the light most favorable to the nonmoving party." *Davis v. HSBC Bank Nev., N.A.*, 691 F.3d 1152, 1159 (9th Cir. 2012). The Court, however, is "not bound to accept as true a legal conclusion couched as a factual allegation." *Twombly*, 550 U.S. at 555.

IV. DISCUSSION

A. Judicial Notice

When ruling on a 12(b)(6) motion to dismiss a § 10(b) action, "courts must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, [1] documents incorporated into the complaint by reference, and [2] matters of which a court may take judicial notice." *Tellabs*, 551 U.S. at 322.

Defendants request that the Court consider certain documents referenced in Plaintiffs' FAC under the incorporation by reference doctrine and take judicial notice of certain publicly available documents. Among these documents are (1) Velocity's Form S-1 Registration Statement, which was filed with the SEC on January 6, 2020 (ECF No. 45-1); Form 10-K filed on April 7, 2020 (ECF No. 45-9); and Investor Conference Call Transcript on May 13, 2020 (ECF No. 45-11). Plaintiffs did not oppose Defendants' request for judicial notice.

"A court may take judicial notice of 'matters of public record.'" *Lee v. City of Los Angeles*, 250 F.3d 668, 689 (9th Cir. 2016) (internal citation omitted). Documents on file in federal or state courts are considered undisputed matters of public record. *Harris v. Cnty. of Orange*, 682 F.3d 1126, 1132 (9th Cir. 2012) (internal citations omitted). Federal courts routinely take judicial notice of press releases, news articles, and SEC filings in securities complaints. *See, e.g., Wietschner v. Monterey Pasta Co.*, 294 F. Supp. 2d 1102, 1108–09 (N.D. Cal. 2003) (judicially noticing SEC filings and press releases); *Brodsky v. Yahoo!, Inc.*, 630 F. Supp. 2d 1104, 1111 (N.D. Cal. 2009) (judicially noticing press releases and news articles). Thus, Velocity's Form S-1 Registration Statement, filed with the SEC on January 6, 2020 (ECF No. 45-1); Form 10-K filed on April 7, 2020 (ECF No. 45-9); and Investor Conference Call Transcript on May 13, 2020 (ECF No. 45-11) are subject to judicial notice.

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B. Plaintiff's Claim for Securities Fraud Under Section 11

Plaintiff brings his first claim for violating Section 11 of the Securities Act of 1933 against all Defendants.

Section 11 creates a private right of action for any purchaser of a security if any part of the registration statement, "when such part became effective, contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ." *In re Stac Elec. Sec. Litig.*, 89 F.3d 1399, 1403 (9th Cir. 1996) (quoting 15 U.S.C. § 77k(a)). To prove liability, a plaintiff must show "(1) that the registration statement contained an omission or misrepresentation, and (2) that the omission or misrepresentation was material, that is, it would have misled a reasonable investor about the nature of his or her investment." *In re Stac*, 89 F.3d at 1403–04. Any claim under Section 11 "must demonstrate that the omitted information existed at the time the registration statement became effective." *Rubke v. Capitol Bankcorp, Ltd.*, 551 F.3d 1156, 1164 (9th Cir. 2009). "No scienter is required for liability under § 11; defendants will be liable for innocent or negligent material misstatements or omissions." *In re Stac*, 89 F.3d at 1404.

And unlike other securities causes of action, Section 11 claims need only satisfy the ordinary notice pleading standards of Rule 8(a). *In re Daou Sys.*, 411 F.3d 1006, 1027 (9th Cir. 2005). But when the allegations are "grounded in fraud" or "sound in fraud," they must satisfy the particularity requirement of Rule 9(b). *Id.* (quoting *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1103–04 (9th Cir. 2003)).

Plaintiff bases his Section 11 claim on three alleged misrepresentations: (1) that Velocity mischaracterized the risks of its underwriting practices; (2) the Statement failed to inform investors about Velocity's rising portfolio of nonperforming loans; and (3) the Statement distorted the real estate market's conditions and Velocity's ability to capitalize on it. Plaintiffs affirm that none of their allegations are grounded in fraud, meaning Rule 8(a)'s pleading requirement applies, not Rule 9(b)'s heightened standard. (FAC ¶¶ 76, 83). The Court addresses each of these misrepresentations in turn.

1. Underwriting Practices

Plaintiff alleges that statements highlighting Velocity's underwriting prowess were misleading because, in reality, Defendants had loosened its so-called "disciplined" practice to allow a growing portion of Defendants' loan portfolio to include short-term loans to high-risk borrowers. (*Id.* ¶ 38). This left the company susceptible to economic downturns. Plaintiff identifies the following statement as misleading:

> Our underwriting approach focuses on generating attractive returns while minimizing credit losses and is enhanced by automation through the extensive use of customized systems to power automation and drive our use of data analytics. We apply the same disciplined due diligence and underwriting process to all loans we review, regardless of whether they are originated or acquired. Our asset-driven underwriting philosophy encompasses property level due diligence, including lease and rent reviews, local market liquidity and trend assessment and a rigorous valuation process. In addition, we perform individual borrower diligence, including credit review, evaluation of experience and asset verification. We believe our extensive access to proprietary data gives us a differentiated perspective and underwriting ability.

(FAC ¶ 37).

Defendants offer two arguments in retort. First, the statements are not actionable because they are mere "puffery." Second, Defendants cannot be liable because they reported that their underwriting practice included these higher-risk loans.

a. These statements constitute nonactionable "puffery"

The Ninth Circuit has held that statements of mere corporate puffery—"vague statements of optimism like 'good,' 'well-regarded,' or other feel good monikers"— are not actionable because investors "know how to devalue the optimism of corporate executives." *Police Ret. Sys. of St. Louis v. Intuitive Surgical, Inc.*, 759 F.3d 1051, 1060 (9th Cir. 2014) (quoting *In re Cutera Sec. Litig.*, 610 F.3d 1103, 1111 (9th Cir. 2010)).

Plaintiff argues that the statements are not "puffery" because they concern the crux of Velocity's business. (Opp'n at 9, ECF No. 50). Plaintiff's interpretation of this rule would seemingly insulate any statement about Velocity's underwriting practice from being considered puffery. The Court disagrees with such a broad interpretation.

Caselaw shows that even statements about a corporation's core business may be nonactionable puffery. For example, in *Lloyd v. CVB Fin. Corp.*, 811 F.3d 1200, 1206–07 (9th Cir. 2016), a loan company—like Velocity—boasted about the "overall credit quality of the loan portfolio," and that the "strong credit culture" and "integrity" of its underwriting practice allowed it to "limit its exposure to problem credits." The Ninth Circuit determined that these statements could not constitute actionable

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