UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF INDIANA
INDIANAPOLIS DIVISION

SANDRA HUNTER Individually and on behalf of all others similarly situated, MARLA STRAPPE, Plaintiffs, v. ELANCO ANIMAL HEALTH INCORPORATED, JEFFREY N. SIMMONS, TODD S. YOUNG, JAMES M. MEER, R. DAVID HOOVER, KAPILA K. ANAND, JOHN P. BILBREY, ART A. GARCIA, MICHAEL J. HARRINGTON, DEBORAH T. KOCHEVAR, LAWRENCE E. KURZIUS, KIRK MCDONALD, DENISE SCOTS-KNIGHT, Defendants.	)	No. 1:20-cv-01460-SEB-MG

ORDER GRANTNG DEFENDANTS' MOTION TO DISMISS

Investors in Elanco Animal Health, Inc.—a publicly traded company based in Greenfield, Indiana—have filed this purported class action for federal securities violations on behalf of all persons who purchased or otherwise acquired Elanco stock between September 20, 2018, and May 6, 2020. Plaintiffs allege that Elanco and its officers engaged in a scheme to deceive and defraud investors of the true value of Elanco's common stock in violation of federal securities law. Specifically, Plaintiffs allege that Defendants artificially boosted Elanco's earnings and growth by "stuffing" product distribution channels "far in excess of end-user demand." This, Plaintiffs argue, combined with Defendants' false and misleading representations about Elanco's growth and financial situation, led to the artificial inflation of Elanco's stock prices during the class period. Due to Defendants' allegedly unlawful actions, Plaintiffs claim that they were injured by purchasing or acquiring Elanco stock during the class period. We consider here Defendants' Motion to Dismiss this cause of action for failure to state a claim, and failure to meet the heightened pleading standards required by these specific securities violations.

I. ALLEGATIONS OF FACT

Faced with a Rule 12(b)(6) motion to dismiss a federal securities action, "courts must, as with any motion to dismiss for failure to plead a claim on which relief can be granted, accept all factual allegations in the complaint as true," *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 551 U.S. 308, 322 (2007) ("*Tellabs II*"), and draw all inferences in Plaintiffs' favor, *Bielanski v. County of Kane*, 550 F.3d 632, 633 (7th Cir. 2008). However, "we are not bound to accept as true a legal conclusion couched as a factual allegation." *Papasan v. Allain*, 478 U.S. 265, 286 (1986). We are also not required to "cast a blind eye to 'facts alleged in the complaint that undermine the plaintiff's claim.'" *Gaines v. Guidant Corp.*, 2004 WL 2538374 (S.D. Ind. 2004) (Barker, J.) (quoting *Arazie v. Mullane,* 2 F.3d 1456, 1465 (7th Cir. 1993)). Except where explicitly noted, the facts described herein are those alleged by Plaintiffs in their First Amended Complaint.

A. BACKGROUND AND PARTIES

Plaintiffs include both those persons and entities who purchased Elanco securities between September 20, 2018, and May 6, 2020, as well as those who acquired Elanco common stock pursuant to Elanco's merger with Aratana Therapeutics on July 18, 2019. Lead Plaintiff, Sandra Hunter, filed this class action complaint alleging that Elanco, its Chief Executive Officer Jeffery N. Simmons, and its Chief Financial Officer Todd S. Young, made fraudulent misrepresentations by omitting material information relating to "systemic and undisclosed channel stuffing practices" that caused distributors to purchase inventory "far in excess of demand" from dozens of public statements.[1] Compl. ¶¶ 77, 94-96, 100-01, 103-11, 113-24, 128-29, 131-43, 145-54, 156-69, 171-81, 184-89, 191-203, 206-13. Plaintiffs argue the omission of this information made Elanco's growth and revenue figures throughout the class period materially misleading. Plaintiffs also allege that Elanco's Chief Account Officer James M. Meer and the nine members of Elanco's Board of Directors, by omitting this information regarding channel stuffing from the offering materials for Elanco's merger with Arantana Therapeutics, rendered the growth and revenue calculations within these documents materially misleading as well.[2]

[1] Because we decline to reproduce here the twenty-seven challenged statements in their entirety—which span sixty pages and consist of single-spaced, block quotations with large swathes of unchallenged portions of text—we have summarized and extracted relevant portions of the facts section of the briefs. We will address the challenged statements more thoroughly in the analysis section.

[2] The individual Defendants from the Elanco's Board of Directors are the Chairman R. David Hoover, Kapila K. Anand, John P. Bilbrey, Art A. Garcia, Michael J. Harrington, Deborah T. Kochevar, Lawrence E. Kurzius, Kirk McDonald, and Denise Scots-Knight. Compl. ¶¶ 23–33.

Formerly a business unit of Eli Lilly and Company, Elanco was spun-off into a standalone, public company after its initial public offering on September 20, 2018. Elanco develops, manufactures, and markets animal health products for both companion animals, such as dogs and cats, and food animals, i.e., cattle and poultry. Prior to its initial public offering, Elanco was the fourth largest animal health company in the world, with $2.9 billion in revenue in 2017. Docket. No. 38-1, at 7.[3] Elanco had reported net income losses for the three years preceding its initial public offering, with $310.7 million, $47.9 million, and $210.8 million net income loss in 2017, 2016, and 2015, respectively. Elanco expected to "continue to incur substantial expenditures to develop, manufacture, and market our products and implement [their] business strategies." *Id.* at 12.

Elanco generates revenue primarily through product sales to customers, who are generally not end-users, but rather third-party wholesale distributors of Elanco's products. These distributors, in turn, sell to customers like veterinary clinics for companion animal products, or cattle and dairy farms for food animal products. Consistent with generally accepted accounting principles (GAAP), Elanco generally recognizes revenue at the time the product is shipped their customers. *Id.* at 46. Payment terms "differ by jurisdiction and customer, but payment terms in most of [Elanco's] major jurisdictions typically range from 30 to 100 days from date of shipment." *Id.* at 47. Going into the IPO, Elanco had

[3] Docket No. 38-1 references Elanco's Form S-1 Registration Statement attached to the Declaration of Stacy Nettleton in support of Defendants' Motion to Dismiss. In ruling on a motion to dismiss, courts may consider judicially noticed documents, including publicly filed SEC filings, without converting the motion to dismiss into a motion for summary judgment. *See In re Guidant Corp. Sec. Litig.*, 536 F. Supp. 2d 913, 921 (S.D. Ind. 2008) (Barker, J.), *aff'd sub nom. Fannon v. Guidant Corp.*, 583 F.3d 995 (7th Cir. 2009).

eight primary customers: MWI Animal Health, Covetrus, Inc., Patterson Veterinary, Midwest Veterinary Supply, K+K Vet Supply Inc., Penn Veterinary Supply, Inc., Victor Medical Company, Veterinary Service, Inc., and Nutra Blend LLC.

Elanco's contracts with "direct and indirect customers may provide for various rebates and discounts that may differ in each contract." *Id.* To determine the appropriate transaction price for Elanco's product sales at the time it recognizes a sale to a direct customer, Elanco "must estimate any rebates or discounts that ultimately will be due to the direct customer and other customers in the distribution chain under the terms of [their] contracts." *Id.* "The rebate and discount amounts are recorded as a deduction to arrive at [their] net product sales." Elanco estimates these accruals using an expected value approach. Actual product returns were less than two percent of Elanco's net revenue between January 1, 2017, and June 30, 2018. *Id.* at 48. During the first six months of 2018, Elanco's sales rebates and discounts liability in the United States reached $88.6 million, compared to $108.2 million in liability for the first six months of the prior year, 2017. *Id.*

In the animal health sector, companion animal products generally have higher gross margins relative to food animal products. Elanco began as a food animal-focused company, but in the ten years preceding its initial public offering, it had "intentionally transformed" into a diversified global company. *Id.* at 7. In addition to Elanco's established position in Food Animal Ruminants & Swine, the company had sought to increase its profitability and grow its revenue by establishing positions in three "targeted growth categories": Companion Animal Disease Prevention, Companion Animal

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