

1 **UNITED STATES COURT OF APPEALS**
2 **FOR THE SECOND CIRCUIT**

3
4 August Term, 2021

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6 (Argued: September 27, 2021 Decided: December 17, 2021)

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8 Docket No. 20-1517

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12 IN RE: THE HAIN CELESTIAL GROUP, INC. SECURITIES LITIGATION

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15 SALAMON GIMPEL, ROSEWOOD FUNERAL HOME,

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17 *Lead Plaintiffs-Movants-Appellants,*

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19 JAMES SPADOLA, RODNEY LYNN,

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21 *Consolidated Plaintiffs,*

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23 BRADLEY D. FLORA, Individually and on behalf of all others similarly
24 situated,

25
26 *Plaintiff*

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28 v.

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30 THE HAIN CELESTIAL GROUP, INC., IRWIN D. SIMON, PASQUALE
31 CONTE, JOHN CARROLL, STEPHEN J. SMITH,

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33 *Defendants-Appellees.*

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36 Before:

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38 LEVAL, SACK, and PARK, *Circuit Judges.*
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1 Plaintiffs in class action alleging securities fraud appeal from grant of
2 Defendant Hain Celestial Group Inc.'s motion to dismiss for failure to state a
3 claim by the United States District Court for the Eastern District of New York
4 (Arthur Spatt, J). Plaintiffs alleged essentially that Defendants violated § 10(b)
5 and § 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78t(a),
6 and Rule 10b-5(b), 17 C.F.R. § 240.10b-5, by asserting in public statements that
7 Hain's favorable sales figures were attributable to strong consumer demand
8 for its products while failing to disclose that demand for its products was
9 declining and that a significant percentage of sales was in fact attributable to
10 the practice of channel stuffing, *i.e.*, offering large and unsustainable
11 incentives such as price reductions and an absolute right to return unsold
12 products. Held, the district court erred in granting Defendants' motion to
13 dismiss because the court relied on the erroneous assumption that Plaintiffs'
14 Rule 10b-5(b) claim was contingent on Plaintiffs successfully pleading a
15 fraudulent business scheme or practice in violation of Rules 10b-5(a) or (c).
16 The district court further erred in failing to consider the cumulative weight of
17 all of Plaintiffs' scienter allegations. The judgment is VACATED and the case
18 REMANDED for further proceedings.

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22 VILLEGAS, CHRISTINE M. FOX , Labaton
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24 *brief*), *for Lead Plaintiffs-Movants-*
25 *Appellants Rosewood Funeral Home and*
26 *Co-Lead Counsel for the Class.*

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32 *Plaintiffs-Movants-Appellants Salamon*
33 *Gimpel and Co-Lead Counsel for the Class*

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38 *Defendants-Appellees.*
39

1 LEVAL, *Circuit Judge*:

2 Lead Plaintiffs, Salamon Gimpel and Rosewood Funeral Home

3 (“Plaintiffs”), appeal from the dismissal with prejudice of their securities

4 fraud claims brought against The Hain Celestial Group, Inc. (“Hain”) and

5 four of its present or former officers, Irwin Simon,¹ Pasquale Conte,² John

6 Carroll,³ and Stephen Smith⁴ (the “Individual Defendants,” collectively with

7 Hain, the “Defendants”). Plaintiffs asserted claims under Sections 10(b) and

8 20(a) of the Securities Exchange Act of 1934 (the “Exchange Act”), 15 U.S.C. §§

9 78j(b), 78t(a), and Rule 10b-5, 17 C.F.R. § 240.10b-5. The Second Amended

10 Complaint (“SAC” or the “Complaint”), which is the operative complaint for

11 this appeal, alleged essentially that Defendants had defrauded investors by

12 making public statements attributing Hain’s growing sales levels to strong

13 consumer demand without disclosing the true facts that demand for its

¹ Simon, Hain’s founder, served as President, Chief Executive Officer (“CEO”), and Chairman of the Board until June 2018.

² Conte was Chief Financial Officer (“CFO”) and Executive Vice President of Finance from September 2015 to June 2017. He previously served as Senior Vice President of Finance from October 2014 to September 2015, and Treasurer and Vice President from July 2009 and October 2014.

³ Carroll is Hain’s Executive Vice President for Global Brands, Categories, and New Business Ventures; he previously served as Hain’s Executive Vice President and CEO for Hain Celestial North America from February 2015 to March 2017.

⁴ Smith preceded Conte as CFO, serving in this capacity from September 2013 to September 2015.

1 products was declining due to increased competition, and that Hain achieved
2 its level of sales through “channel stuffing,” whereby valuable and
3 unsustainable sales incentives—including price reductions and grants of an
4 absolute right to return unsold merchandise—were given near the end of each
5 quarter to Hain’s largest distributors to induce them to buy more product
6 than needed so that Hain would meet its quarterly sales targets and analysts’
7 estimates. Plaintiffs also claimed that—separate from these purportedly
8 misleading representations—Defendants’ use of these practices constituted an
9 unlawful scheme to defraud investors. Finally, the SAC included a control
10 person liability claim against the Individual Defendants under Section 20(a)
11 of the Exchange Act.

12 Defendants moved to dismiss the SAC pursuant to Federal Rule of
13 Civil Procedure 12(b)(6) for failure to state claim, advancing various
14 arguments, including failure to sufficiently allege scienter, actionable
15 misstatements, and a fraudulent scheme or business practice. The late District
16 Judge Arthur Spatt, in a characteristically conscientious and fastidious
17 opinion, granted the motion in its entirety and dismissed the action with
18 prejudice. Plaintiffs brought this appeal.

BACKGROUND

Hain manufactures and sells health food products in the United States and several other countries. Plaintiffs are entities and individuals who acquired interests in publicly traded common stock in Hain during the period from November 5, 2013 through February 10, 2017 (the “Class Period”). We summarize below the allegations of the Complaint. For the purposes of this appeal, we are required to treat these factual allegations as true, drawing all reasonable inferences in favor of Plaintiffs to the extent that the inferences are plausibly supported by allegations of fact. We will therefore recite the substance of the allegations as if they represented true facts, with the understanding that these are not findings of the court, as we have no way of knowing at this stage what are the true facts.

i. The Alleged Scheme

The Complaint alleges that, in the early 2010s, Hain experienced growing competition in the health food market, as other brands and chain retailers began offering their own selections of natural and organic foods. As a result of this increasing competition, demand for Hain’s products weakened and Hain risked failing to meet its sales projections. In order to boost its

1 quarterly sales figures and meet its projections, Hain resorted to what the
2 Complaint describes as fraudulent and illegal “channel stuffing” (also
3 referred to as “loading”), whereby valuable sales concessions were offered to
4 Hain’s largest customers as incentives to buy more product than needed
5 before the end of each financial quarter, in order to enable Hain to meet its
6 revenue targets and Wall Street’s projections. Through this practice Hain
7 achieved unsustainably inflated quarterly sales results. In 2016, when
8 distributors refused to buy more product despite Hain’s offered incentives,
9 Hain’s sales and stock price fell.

10 During the Class Period, Hain’s largest customer—accounting for 12%
11 of net sales—was United Natural Foods, Inc. (“UNFI”), a product distributor.
12 The concessions to UNFI and other large distributors were extra-contractual
13 and were not adequately documented or reflected in Hain’s books and
14 records. The concessions included: (1) cash incentives as high as \$500,000 for a
15 single distributor in a single quarter; (2) product discounts of up to 20%; (3)
16 extended payment terms; and, most significantly, (4) an absolute right to
17 return unsold product. “[M]ore than 15% of Hain’s quarterly sales were made

1 in the final month of each quarter from UNFI.” Joint Appendix (“App’x”) at
2 251:¶369 (emphasis removed).

3 The Individual Defendants orchestrated and concealed the channel
4 stuffing scheme. Notwithstanding the Defendants’ awareness of the scheme
5 and its role in achieving Hain’s sales results, the Defendants made repeated
6 public statements attributing Hain’s growth in sales numbers to “strong
7 consistent consumer demand” and other “organic” factors, *id.* at 213:¶257,
8 214:¶260, 216:¶266, while failing to disclose the unsustainable channel
9 stuffing practices and how they artificially inflated sales figures.

10 Carroll, the CEO of Hain North America, would review Hain’s sales
11 numbers so that he “would know of the sales shortfalls before negotiating the
12 concessions with UNFI.” *Id.* at 252:¶372. “Carroll then provided an incentive
13 for UNFI to take the amount of Hain’s inventory necessary for Hain to meet
14 its quarterly sales revenue numbers.” *Id.* On internal sales calls, Carroll
15 acknowledged having made these concessions. *Id.* Simon, Hain’s CEO, would
16 negotiate sales concessions directly with UNFI’s owner and could “always
17 make [UNFI] buy more if needed.” *Id.* at 252:¶373.

1 Hain’s Chief Operations Officer, James Meiers (who is not a named
2 defendant) would work with his team to “creativ[ely]” account for the sales
3 concessions, *id.* at 170:¶86, including by booking credits given to distributors
4 as accruals, *i.e.*, “as money that distributors owed Hain,” *id.* at 169:¶83. The
5 “size of the accruals” was “correlat[ed]” to “how Hain was doing in a
6 particular quarter.” *Id.* at 170:¶85. Smith and Conte, in their capacities as CFO,
7 signed off on Hain’s accounting statements and certified their accuracy to the
8 public. Employees who questioned the accounting practices were told to stop
9 asking questions, *id.* at 175:¶104, 177:¶113, and employees who continued
10 asking questions were fired, *id.* at 176:¶108.

11 *ii. The Alleged Scheme Comes to an End*

12 The channel stuffing scheme continued from 2013 until 2016, and ended
13 only when distributors refused to take additional inventory and Hain opened
14 an internal investigation into its financial reporting.

15 On August 15, 2016, less than a year after hiring a new Treasurer, James
16 Langrock, Hain announced that it was opening an internal investigation into
17 whether it had properly accounted for the revenue associated with the sales
18 concessions, and whether Hain had adequate internal controls over its

1 financial reporting. Ernst & Young, Hain's outside auditor, also commenced
2 an independent audit. As a result, Hain delayed the filing of its financial
3 results for the 2016 financial year. Hain's stock price fell by over 26% on the
4 news.

5 On February 10, 2017, the final day of the Class Period, Hain
6 announced it had expanded the scope of its internal investigation to
7 encompass its historical financial results, and that the Securities and Exchange
8 Commission ("SEC") was also investigating. Hain's stock price fell a further
9 8%.

10 *iii. Hain Restates Its Financials and Admits Weaknesses in Internal Controls*

11 On June 22, 2017, Hain filed its Form 10-K for the 2016 financial year. It
12 identified "material weaknesses in [its] internal control[s] over financial
13 reporting" as of June 30, 2016. App'x at 186. Specifically, Hain noted that its
14 "control environment did not sufficiently promote effective internal control
15 over financial reporting," and that its "internal controls to identify,
16 accumulate and assess the accounting impact of certain concessions or side
17 agreements on whether [its] revenue recognition criteria had been met were
18 not adequately designed or operating effectively." *Id.* Hain further admitted

1 that its documentation of agreements had been inadequate. *Id.* Hain revised
2 its financial results for the 2014 and 2015 financial years, as well as the first
3 three quarters of the 2016 financial year. According to the revisions, Hain’s
4 “net sales were overstated by 2.1%, 2.9% and 1.9% in fiscal 2014, fiscal 2015
5 and for the 9 months ended March 31, 2016, respectively.” *Id.* at 187:¶149.

6 These revisions were the result of: “(i) improperly recognized revenue related
7 to the timing of trade and promotional accruals, (ii) prematurely recognized
8 revenue on certain sales; and (iii) improperly classified promotion expenses.”
9 *Id.* at 145:¶11.

10 *iv. The SEC’s Investigation*

11 The SEC completed its investigation in December 2018 and reached a
12 settlement with Hain, concluding that “[f]rom at least 2014 until May 2016,
13 Hain U.S. sales personnel gave sales incentives to certain distributors to
14 promote sales at the end of quarters.” *Id.* at 279. While the terms of the
15 settlement included statements that none of those sales incentives were
16 “improper,” *id.* at 280, and that “[t]he vast majority of the products purchased
17 in connection with [end-of-quarter] sales to [UNFI] ultimately sold through to
18 retailers,” *id.* at 281, the SEC also determined that the incentives “had

1 potential accounting implications,” *id.* at 279, that some sales agreements
2 “were not appropriately documented,” *id.* at 281, and that Hain had
3 “insufficient policies and procedures to monitor [the sales] incentives . . .
4 which could have potential revenue recognition implications,” *id.*

5 While the settlement did not include charging Hain with securities
6 fraud, it did declare that Hain had “violated Section 13(b)(2)(A) of the
7 Exchange Act, which requires Hain to make and keep books, records and
8 accounts which, in reasonable detail, accurately and fairly reflect Hain’s
9 transactions and disposition of assets,” and had also violated “Section
10 13(b)(2)(B) . . . which requires Hain to devise and maintain a system of
11 internal accounting controls” *Id.* at 284.

12 *v. Procedural History*

13 On August 17, 2016, three plaintiffs filed separate securities fraud
14 actions against Hain. The district court consolidated the cases and appointed
15 Lead Plaintiffs. On September 7, 2017, Plaintiffs filed a Corrected
16 Consolidated Class Action Complaint for Violations of Federal Securities
17 Laws (“CAC”), adding additional individual defendants. The CAC asserted

1 claims against all Defendants under Exchange Act § 10(b) and Rule 10b-5, as
2 well as against the Individual Defendants under § 20(a) as control-persons.

3 Defendants moved to dismiss the CAC for failure to state a claim. The
4 district court issued an order directing the parties to submit additional
5 briefing on whether and how Plaintiffs' claims would be affected if the court
6 found that Plaintiffs had failed to adequately plead that the channel stuffing
7 was a violation of law.

8 After receiving the additional briefing, the court granted Defendants'
9 motion to dismiss without prejudice and granted Plaintiffs leave to amend
10 their complaint. Plaintiffs then filed the SAC asserting additional factual
11 matter, including statements from two new confidential witnesses who had
12 worked at Hain, to support the claims described above.

13 Defendants again moved to dismiss for failure to state a claim.
14 Defendants argued that the Complaint failed to adequately allege both
15 violations of the terms stated in Rule 10b-5 and wrongful state of mind. In
16 response, Plaintiffs stressed that the thrust of their complaint was not the
17 illegality of the channel stuffing as a fraudulent scheme or practice under
18 Rule 10b-5(a) and (c), but rather that the Defendants' statements that their

1 sales were attributable to strong consumer demand while omitting any
2 mention of the channel stuffing were materially misleading, as prohibited by
3 Rule 10b-5(b). The District Court granted Defendants' motion with prejudice,
4 finding insufficient allegations both of violation of the terms of Rule 10b-5(a)-
5 (c), and of wrongful state of mind. Plaintiffs brought this appeal.

6 DISCUSSION

7 Plaintiffs have appealed from the district court's ruling with respect to
8 the sufficiency of the Complaint's allegation of a violation of SEC Rule 10b-
9 5(b). They have not appealed from the dismissal of the Complaint's
10 allegations of violation of clauses (a) and (c) of the Rule.

11 Our court has said that a plaintiff pleading a violation of Rule 10b-5(b)
12 "must plausibly allege: (1) a material misrepresentation (or omission); (2)
13 scienter, *i.e.*, a wrongful state of mind; (3) a connection with the purchase or
14 sale of a security; (4) reliance; (5) economic loss; and (6) loss causation." *Singh*
15 *v. Cigna Corp.*, 918 F.3d 57, 62 (2d Cir. 2019) (internal quotation marks and
16 alterations omitted).

17 Assessing Plaintiffs' arguments requires attention to the differences
18 among clauses (a), (b), and (c). The rule prohibits three different things (if

1 done “in connection with the purchase or sale of any security” and in a
2 manner that brings the conduct within the Commerce Clause power of the
3 United States Congress). Clause (a) prohibits the “employ[ment of] any
4 device, scheme, or artifice to defraud.” 17 C.F.R. § 240.10b–5(a). Clause (c), in
5 very similar terms, prohibits “engag[ing] in any act, practice, or course of
6 business which operates or would operate as a fraud or deceit upon any
7 person.” *Id.* at § 240.10b–5(c). These two sections of the Rule thus require use
8 of a fraudulent or deceptive device, scheme, artifice, act, or practice.

9 Clause (b) is significantly different. It focuses not on schemes, devices,
10 or practices, but on statements made. This clause renders it unlawful “[t]o
11 make any untrue statement of a material fact or to omit to state a material fact
12 necessary in order to make the statements made, in the light of the
13 circumstances under which they were made, not misleading.” 17 C.F.R.
14 § 240.10b–5(b). The first part of the clause asks whether the speaker made an
15 untrue statement of a material fact. The second part asks whether the speaker
16 omitted to state a material fact in circumstances where that omission rendered
17 misleading the things that were said. Violation of clause (b), unlike violations
18 of clauses (a) and (c), does not require that the defendant have used a

1 fraudulent or otherwise illegal device, scheme, artifice, act, practice, or course
2 of business. Its focus is rather on whether something said was materially
3 misleading, either because it included a false statement of a material fact or
4 because it omitted to state a material fact which omission rendered the things
5 said misleading. The district court mistakenly imported the requirement of
6 clauses (a) and (c) of a fraudulent scheme or practice into clause (b), which
7 includes no such requirement.

8 In its ultimate consideration of the motion to dismiss, the district court
9 first analyzed whether the Complaint satisfactorily pleaded a violation of
10 clauses (a) and (c). It found that the practice of channel stuffing—increasing
11 sales by offering unsustainable incentives to customers—was not inherently
12 fraudulent. It thus concluded that the channel stuffing allegations failed to
13 assert a violation of those clauses because those practices were not, in
14 themselves, fraudulent or illegal.

15 In then considering whether the Complaint alleged a violation of clause
16 (b) the court reasoned that it “fails because its predicate is the illegitimacy of
17 the channel stuffing practices the Court already found to be legitimate.” *In re*
18 *Hain Celestial Grp. Inc. Sec. Litig.*, 2020 WL 1676762, at *12 (E.D.N.Y. Apr. 6,

1 2020). The court explained that “[s]ubsections (a) and (c) do not prohibit
2 offering such incentives, so that the Lead Plaintiffs cannot assert that
3 subsection (b) required their disclosure. . . . [T]he Defendants were under no
4 generalized obligation to disclose wholly legal sales incentives simply
5 because the Lead Plaintiffs allege those incentives to be unsustainable.” *Id.*

6 This reflects a misunderstanding of the requirements of clause (b), as
7 well as of Plaintiffs’ theory. The district court’s conclusion that the Complaint
8 could not succeed under clauses (a) or (c) because the channel stuffing did not
9 constitute a fraudulent device, scheme, artifice, act, practice, or course of
10 business (a question we do not consider as Plaintiffs have not appealed from
11 dismissal of the Complaint under those clauses) is not dispositive of Plaintiffs’
12 Rule 10b-5(b) claim. As noted above, clause (b) does not require that conduct
13 underlying a purportedly misleading statement or omission amount to a
14 fraudulent scheme or practice.

15 The theory of the Complaint in reference to clause (b) was that
16 Defendants made statements attributing Hain’s high sales volume to strong
17 consumer demand, while omitting to state that increased competition had
18 weakened consumer demand and that Hain’s high sales volume was

1 achieved in significant part by the offer of unsustainable channel stuffing
2 incentives. The success of such a complaint in alleging a violation of clause (b)
3 does not depend on whether the alleged channel stuffing practices themselves
4 were fraudulent or otherwise illegal. In light of the district court's error as to
5 the requirements of Rule 10b-5(b), we vacate its decision that the Complaint
6 failed to satisfy the Rule.

7 The district court also found the Complaint deficient with respect to its
8 allegation of wrongful state of mind, *i.e.*, scienter. We vacate that ruling as
9 well.

10 The district court's mistaken understanding of the substance of the
11 alleged offense inevitably affected the district court's view of whether it was
12 done with scienter. As the district court found that the conduct alleged to be
13 wrongful was not wrongful at all, it would be incongruous for the court to
14 have concluded that it was done with a wrongful state of mind.

15 Furthermore, the court erred in failing to weigh Plaintiffs' scienter
16 allegations as a whole. The court considered the cumulative weight of
17 Plaintiffs' circumstantial allegations of scienter, which included, *inter alia*, the
18 Individual Defendants' knowledge of and involvement in the channel

1 stuffing practices; Hain’s inadequate internal controls and inaccurate financial
2 reporting; and suspicious terminations, resignations, and demotions of senior
3 employees. These allegations, the court found, “came quite close” to
4 supporting a strong inference of scienter. *In re Hain Celestial Grp. Inc. Sec.*
5 *Litig.*, 2020 WL 1676762, at *15 (internal quotation marks omitted). Separately,
6 the court considered Plaintiffs’ allegations with respect to the Individual
7 Defendants’ motive and opportunity to commit fraud, including high-volume
8 insider trading activity by Simon and Carroll during the Class Period. The
9 court failed, however, to assess the total weight of the circumstantial
10 allegations *together with* the allegations of motive and opportunity. This was
11 error. *See ECA, Loc. 134 IBEW Joint Pension Tr. of Chi. v. JP Morgan Chase Co.*,
12 553 F.3d 187, 198-99 (2d Cir. 2009) (explaining that the strength of
13 circumstantial allegations required to plead scienter varies depending on
14 whether there are also allegations of motive and opportunity on the part of
15 corporate officers to commit fraud). On remand, the district court should
16 independently reassess the sufficiency of the scienter allegations, considering
17 the cumulative effect of the circumstantial allegations of intent together with
18 the pleaded facts relating to motive and opportunity. We express no views on

1 whether, when weighed cumulatively, these allegations are sufficient to plead
2 scienter.

3 By reason of the death of Judge Spatt, the case must be reassigned to a
4 new judge upon remand. The newly assigned judge should consider afresh
5 whether the Complaint adequately stated a claim under Rule 10b-5(b).

6 **CONCLUSION**

7 For the foregoing reasons, the judgment is VACATED and the case is
8 REMANDED for reconsideration of Defendants' motion to dismiss the
9 Second Amended Complaint.