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It's Hunting Season. For Unicorns? Lawsuit Against Theranos Signals Trend In Investors Going After Late-Stage Start-ups

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Last week brought more bad news for private blood testing company Theranos Inc., as San Francisco-based Partner Fund Management L.P. ("PFM") launched a **suit** (http://s3.amazonaws.com/cdn.orrick.com/files/PartnerInvestmentsvTheranosPublicComplaint.pdf) claiming that it was duped into making a $96.1 million investment in Theranos in February 2014. The complaint, filed in Delaware Court of Chancery, alleges common law fraud, securities fraud under California's Corporations Code, and violations of Delaware's Consumer Fraud Act and Deceptive Trade Practices Act, among other things, against Theranos, its Chief Executive Officer, Elizabeth Holmes, and its former Chief Operating Officer, Ramesh Balwani.

PFM claims that Theranos, Holmes, and Balwani "repeatedly and knowingly lied" to the public and to PFM in the months leading up to its 2014 investment. Specifically, PFM alleges that Theranos wrongfully claimed that it had "developed a proprietary technology" to test miniscule blood samples and was "on the cusp of receiving all necessary regulatory clearances and approvals" prior to PFM making its investment. This newest lawsuit closely follows two consumer class actions launched against Theranos in Arizona and Northern California, as well as a litany of governmental investigations into the company, including by the United States Department of Justice, the Securities and Exchange Commission, the Centers for Medicare and Medicaid Services, and the Food and Drug Administration. See ***For Theranos, Life is Not All Rainbows and Unicorns*** (http://blogs.orrick.com/securities-litigation/2016/04/26/for-theranos-life-is-not-all-rainbows-and-unicorns-government-conducting-criminal-and-civil-investigations-of-blood-testing-company-theranos/).

More than just another bad headline for Theranos, PFM's lawsuit may signal a sea change in the way that private start-ups are scrutinized not only by regulators, but also by their investors. Traditionally, start-ups have avoided many of the onerous securities regulations by remaining private, including Sarbanes-Oxley, Dodd-Frank, and Regulation FD (requiring that disclosures be made to all investors at the same time). These start-ups had also largely avoided investor lawsuits. As a result of these incentives to stay private, SEC Chair Mary Jo White estimated earlier this year that there were nearly 150 "unicorns" – private start-up companies with valuations exceeding $1 billion – worldwide.

Over the past year, however, these start-ups began receiving increasing regulatory scrutiny. For example, on March 31, 2016, the SEC announced that it would focus investigatory efforts on Silicon Valley's unicorns, cautioning that "being a private company comes with serious obligations to investors and the markets." Indeed, shortly thereafter, on

April 26, 2016, Theranos announced that it was being investigated by the SEC.

Historically, investor lawsuits against private start-ups were rare, and when they happened, it typically was an investor complaining of *missing out* on an uptick in value because it wasn't told of positive news that the company told its bigger backers. This is precisely what allegedly happened in the recent case brought by billionaire Patrick Ryan against Mu Sigma, Inc. He alleged that Mu Sigma drastically played down its prospects in order to force Ryan's investment firm to sell back its stake in the company at an artificially low price. While Theranos arguably represents an extreme situation, the rise in private company scrutiny seems real, and this suggests that the benefits of remaining private are eroding. Unicorns would be well advised to take notice of the new environment and to guard against both governmental scrutiny and private lawsuits.