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Skadden

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Inside the Courts
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Class Actions

Settlements

Seventh Circuit Reverses, Remands Approval of Class Action Settlement

In re Walgreen Co. Stockholder Litig., No. 15-3799
(7th Cir. Aug. 10, 2016)
Click here to view the opinion.

The 7th Circuit reversed and remanded the approval of a class action settlement arising out of a shareholder lawsuit brought against Walgreen Co. after it announced its intent to acquire a foreign company and reorganize. Soon after Walgreen filed its proxy statement for the transaction, shareholders filed suit seeking additional disclosures. Eighteen days later, the parties entered a settlement agreement that (i) provided six supplemental disclosures to the shareholders, (ii) released Walgreen from all disclosure-related liability, and (iii) authorized class counsel to seek attorneys' fees without objection from Walgreen. Despite the district court's skepticism, it ultimately found that the supplemental disclosures "may have" mattered to a reasonable investor and thus approved the settlement.

The 7th Circuit held that the proper inquiry is whether the supplemental disclosures are likely to matter to a reasonable investor, not whether they may matter. Adopting the standard cited by the Delaware Court of Chancery in *In re Trulia, Inc. Stockholder Litigation*, 129 A.3d 884, 894 (Del. Ch. 2016), the court explained that such disclosures must both address and correct "a plainly material misrepresentation or omission." Examining the six supplemental disclosures provided to Walgreen shareholders through the settlement, the court determined that the information in them was either redundant and already contained in the proxy filing, derived from the proxy filing, or had no impact on the formation or operation of the new company. Thus, the disclosures neither addressed nor corrected a plainly material misrepresentation or omission. The court went on to criticize the litigation altogether, stating, "[t]he only concrete interest suggested by this litigation is an interest in attorneys' fees, which of course accrue solely to class counsel and not to any class members." Accordingly, the court reversed and remanded the case and directed the district court to give serious consideration to appointing new class counsel or dismissing the suit.

Demand Futility

Eighth Circuit Affirms Dismissal of Shareholders' Derivative Suit for Failing to Establish Demand Futility

Cottrell ex rel. Wal-Mart Stores, Inc. v. Duke,
No. 15-1869 (8th Cir. July 22, 2016)
Click here to view the opinion.

The 8th Circuit affirmed the dismissal of a derivative action brought by shareholders against certain past and present directors and officers of a consumer goods retailer. The shareholders brought claims for breach of fiduciary duty and violations of Sections 14(a) and 29(b) of the Securities Exchange Act, accusing the directors and officers of breaking federal and state law by acquiescing to and then covering up alleged pervasive bribery committed in the retailer's Mexican operations. The plaintiffs claimed that any demand to the board would have been futile because the board knew of the alleged bribery and was incapable of fairly determining whether to pursue the claims. The district court dismissed the case on the basis that the shareholders' explanation was not specific or detailed enough to satisfy the requirements of Federal Rule of Civil Procedure 23.1 and Delaware's heightened pleading threshold for derivative lawsuits.

On appeal, the plaintiffs offered three accounts for how the reports of alleged bribery reached the board: (i) the audit committee chair received preliminary investigation findings and alerted the rest of the board, (ii) senior officers told the board, and (iii) the bribery was so pervasive that the board must have known. The 8th Circuit rejected the first account after determining that the audit committee's obligation to report to the board alone did not make it reasonable to infer that the board actually received and read the report of the bribery investigation. The court likewise rejected the second and third theories because no specific allegations supported a reasonable inference that the board members were informed of the potential bribery before it was disclosed in the press. Therefore, the court concluded that the plaintiffs did not establish with particularity that a majority of the retailer's board was incapable of fairly considering whether to pursue the claims.

Dodd-Frank Act

DC Circuit Rules That CFPB Single-Director Structure Is Unconstitutional

PHH Corp. v. Consumer Fin. Prot. Bureau, No. 15-1177
(D.C. Cir. Oct. 11, 2016)
Click here to view the opinion.

A split panel of the D.C. Circuit held that the Consumer Financial Protection Bureau (CFPB) is unconstitutionally structured.

PHH, a mortgage lender, appealed a $109 million disgorgement order by the CFPB sanctioning PHH for engaging in a captive reinsurance arrangement. PHH raised a constitutional challenge to the structure of the CFPB, which is led by a single director who could only be removed for cause. PHH also raised statutory challenges to the retroactive application of a new interpretation of Section 8 of the Real Estate Settlement Procedures Act (RESPA) and to its application outside the law's three-year statute of limitations.

The court agreed with PHH's constitutional challenge. First, the court reasoned that there is no check on the director's power, which poses a threat to individual liberty. Second, it noted that the CFPB's structure departs significantly from historical practice, where independent agencies are led by multimember commissions and executive-agency directors are removable by the president at will. Thus, the court held that the CFPB's single-director structure is unconstitutional. As a remedy, the court severed the statute's unconstitutional for-cause provision from the remainder of the statute, effectively giving the president the power to supervise, direct and remove the CFPB director at will.

The court also agreed with PHH's statutory challenges. First, the court held that the CFPB misinterpreted Sections 8(a) and 8(c). The court held that those provisions clearly permit captive reinsurance arrangements so long as the mortgage insurer pays reasonable market value for the reinsurance provided. Second, the court held that the CFPB violated due process principles when it retroactively applied a new interpretation of Section 8 to conduct that occurred before the CFPB issued its new interpretation. Third, the court held that the Dodd-Frank Act incorporates the statutes of limitations in the underlying statutes enforced by the CFPB in administrative proceedings and, under RESPA, the three-year statute of limitations applies to all CFPB enforcement actions, whether in court or administratively.

Judge Karen L. Henderson, concurring in part and dissenting in part, wrote that the majority could have granted PHH full relief on statutory grounds alone and therefore "unnecessarily reach[ed] PHH's constitutional challenge."

Judge A. Raymond Randolph concurred in the decision, writing that the administrative law judge (ALJ) who presided over the hearing was, as the CFPB director later affirmed, an "inferior Officer" within the meaning of Article II, Section 2, Clause 2 of the U.S. Constitution. As such, the ALJ should have been appointed by the president; because he was not, the proceedings against PHH were unconstitutional.

ERISA

Second Circuit Affirms Dismissal of Claims Against Fiduciaries of ERISA Plan

Loeza v. Doe, No. 16-222-cv (2d Cir. Sept. 8, 2016)
Click here to view the opinion.

The 2nd Circuit affirmed in a summary order the dismissal of claims alleging that certain individuals associated with an investment bank and a corporate retirement plan breached their duty of prudence owed under the Employee Retirement Income Security Act (ERISA). The plaintiffs, current and former employees of the investment bank, participated in the bank's 401(k) savings plan, which, because the plan owned shares of the bank, qualified as an employee stock ownership plan under ERISA. The plaintiffs alleged that the defendants were imprudent by failing to prevent the plan from purchasing the investment bank's stock at a price that was artificially inflated by an alleged securities fraud related to trading activity by the investment bank's chief investment officer. The plaintiffs claimed that the defendants, as fiduciaries, should have publicly disclosed those alleged violations or at least frozen the fund's purchases of the investment bank's stock. The trial court dismissed the allegations, finding that the complaint "failed to plausibly allege that a prudent fiduciary could not conclude that freezing purchases or disclosing the alleged securities fraud would cause the Fund 'more harm than good,'" as required by U.S. Supreme Court precedent to state a claim under ERISA, as all the plaintiffs alleged was the unsubstantiated assertion that the longer the fraud went unreported, "the more painful the [stock price] correction would be." The 2nd Circuit agreed, concluding that the allegations were "wholly conclusory."

Exchange Act

Second Circuit Affirms Partial Final Judgment, Endorsing 'Inflation-Maintenance' Theory of Securities Fraud Liability

In re Vivendi, S.A. Sec. Litig., No. 15-180-cv(L) (2d Cir. Sept. 27, 2016)
Click here to view the opinion.

The 2nd Circuit affirmed a partial final judgment upholding a jury verdict in favor of the plaintiffs on claims that a media company violated Section 10(b) of the Securities Exchange Act by misrepresenting the company's liquidity risks prior to the company's liquidity crisis. The plaintiffs alleged that the company allegedly misled investors as to the company's prospects, especially with respect to the company's ability to meet its financial obligations stemming from numerous high-dollar acquisitions the company made within a two-year period. At trial, the plaintiffs proffered an expert who offered an event study purportedly demonstrating the extent to which the company's stock price was artificially inflated during the class period because of the market's mistaken belief that the company was not facing a liquidity crisis. The company challenged the expert's opinion on several grounds, including that the opinion was unreliable because it failed to show that 42 of the 57 alleged misstatements were associated with an immediate increase in price inflation and therefore had no impact on stock price. The company further argued that the plaintiffs' case rested on an impermissible "inflation maintenance" theory, which posited that statements merely maintaining an already inflated stock price are nevertheless actionable under the securities laws.

The court upheld the plaintiffs' inflation maintenance theory, concluding that "it is hardly illogical or inconsistent with

precedent to find that a statement may cause inflation not simply by *adding* it to a stock, but by maintaining it." Accordingly, the court determined that the district court had not abused its discretion in admitting the testimony of the plaintiffs' expert on damages and loss causation. The court first acknowledged that the expert's opinion did not purport to (i) prove that the market's misapprehension of the company's true liquidity risk was caused only by the company's alleged fraud, or (ii) attribute price inflation to any specific alleged misstatements at the time they were made. The court, however, explained that artificial inflation is not necessarily induced by fraud because a falsehood can exist in the market for reasons unrelated to the alleged fraudulent conduct. The court rejected the company's argument that a statement must be associated with an increase in inflation in order to show a price impact for purposes of showing reliance or causation. The court reasoned that the price impact requirement solely concerns whether the alleged misrepresentation affected the market price, not just whether there was an increase in inflation. Further, the court rejected the company's argument that pre-existing inflation would have persisted even if the company had been silent. Among other reasons, the court noted that the price of the company's stock could have dissipated gradually if the company's silence was perceived by the market as an admission regarding the company's liquidity position. The court therefore concluded that a material misstatement does not simply maintain inflation but rather prevents the pre-existing inflation in a stock price from dissipating.

Fiduciary Duties

Mergers and Acquisitions

Delaware Court of Chancery Dismisses *Caremark* Claims Relating to Check-Cashing Business

Reiter v. Fairbank, C.A. No. 11693-CB (Del. Ch. Oct. 18, 2016)
Click here to view the opinion.

A stockholder of Capital One Financial Corporation brought derivative claims asserting that the Capital One directors breached their fiduciary duties by disregarding their responsibility to oversee Capital One's compliance with the Bank Secrecy Act and other anti-money laundering laws (together, BSA/AML) relating to services Capital One provided to clients engaged in check cashing. After obtaining books and records pursuant to 8 Del. C. Section 220, the plaintiff filed a complaint derivatively on behalf of Capital One asserting oversight claims for breach of the fiduciary duty of loyalty. Defendants moved to dismiss the complaint pursuant to Court of Chancery Rules 23.1 and 12(b)(6).

Chancellor Andre G. Bouchard dismissed the complaint pursuant to Rule 23.1, finding demand was not excused with respect to the plaintiff's "quintessential *Caremark* oversight claim." The court rejected the plaintiff's contention that the numerous reports provided to the board over a three-year period regarding BSA/AML compliance risks constituted "a series of red flags that should have triggered a duty for the board to act." The court instead held that, "[g]iving plaintiff all reasonable inferences, the allegations of the Complaint plead at most flags of a different hue, namely yellow flags of caution concerning the Company's escalating AML compliance risk that was occurring in tandem with heightened regulatory scrutiny of AML compliance in the financial services industry," and noted that the reports to the board "explained to the directors in considerable detail on a regular basis the initiatives management was taking to address those problems and to ameliorate the AML compliance risk." The court held that "the allegations of the Complaint and the documents incorporated therein would allow reasonable minds to argue either side of a debate over whether the directors' oversight of the Company's BSA/AML compliance program was sufficiently robust or flawed. But what those allegations do not reasonably permit … is an inference that the defendants *consciously* allowed Capital One to violate the law so as to sustain a finding they acted in bad faith." Thus, the Court concluded that "plaintiff has failed to allege facts from which it reasonably may be inferred that the defendants consciously allowed Capital One to violate BSA/AML statutory requirements so as to demonstrate that they acted in bad faith," and dismissed the complaint.

Delaware Court of Chancery Dismisses Post-Closing Damages Claims Under *Corwin v. KKR Financial Holdings Framework*

In re OM Grp., Inc. Stockholders Litig., C.A. No. 11216-VCS (Del. Ch. Oct. 12, 2016)
Click here to view the opinion.

The plaintiffs, former stockholders of OM Group, Inc., challenged OM's merger with Apollo Global Management, LLC as a product of breaches of fiduciary duty by the OM board of directors. After a majority of OM stockholders approved the merger, and the merger closed, the defendants moved to dismiss.

The Court of Chancery granted the defendants' motion to dismiss, finding that, while "[t]he Complaint sets forth a disquieting narrative" of the process leading to the merger, under *Corwin v. KKR Financial Holdings, LLC*, the complaint "must be dismissed because a majority of the fully informed, uncoerced, disinterested stockholders voted to approve the merger and Plaintiffs have not alleged that the transaction amounted to waste." The court found that, post-*Corwin*, "[i]n the wake of disinterested stockholder approval of a merger not subject to the entire fairness standard, a plaintiff seeking to hold directors individually liable for approving the merger must take either or both of two paths to overcome a motion to dismiss: (1) demonstrate that the transaction amounted to corporate

waste; or (2) demonstrate that the stockholder vote was uninformed or coerced." Because the plaintiffs had not adequately pleaded that there were any materially misleading disclosures or material omissions in connection with the stockholder vote, the business judgment rule applied, and the plaintiffs failed to allege that the merger amounted to waste. Therefore, they did not overcome the presumption of the business judgment rule. In dismissing the complaint, the court concluded that the "OM stockholders' fully informed, disinterested and uncoerced approval of the Merger Agreement cleansed any failure of the OM Board to act reasonably to seek the transaction offering the best value reasonably available."

Delaware Court of Chancery Dismisses Complaint Challenging Take-Private Transaction

In re Books-A-Million, Inc. Stockholders Litig., Consolidated C.A. No. 11343-VCL (Del. Ch. Oct. 10, 2016)
Click here to view the opinion.

Vice Chancellor J. Travis Laster dismissed a stockholder complaint challenging the take-private of Books-A-Million, Inc. by its controlling stockholders through a squeeze-out merger, finding the transaction was governed by the rule set forth in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

In connection with the transaction, the company formed a special committee of independent directors to evaluate the controlling stockholders' proposal, which was made contingent at the outset on the approval of a majority of the company's minority stockholders. The special committee, assisted by financial and legal advisors, considered alternative transaction structures, including a leveraged recapitalization or special dividend, but ultimately determined to pursue the take-private transaction, which was subsequently approved by a majority of the company's minority stockholders.

Reaffirming that compliance with the standard set forth in the Delaware Supreme Court's decision in *Kahn* can be tested on a motion to dismiss, Vice Chancellor Laster concluded that the allegations of the complaint did not support a reasonably conceivable inference that any of the conditions set forth in *Kahn* were not met. In particular, the controlling stockholders conditioned the transaction upon the approval of an independent, adequately empowered special committee, as well as the uncoerced, informed vote of a majority of the minority stockholders. Moreover, the complaint failed to plead that the members of the special committee were interested in or lacked independence with respect to the transaction; that the special committee was not empowered to select its own advisors and to "say no definitively" to a transaction; or that the special committee breached its duty of care throughout the process. As a result, the business judgment rule governed. Because it [was] not possible to infer that no rational person acting in good faith could have thought the Merger was fair to the minority," Vice Chancellor Laster dismissed the complaint.

Delaware Court of Chancery Dismisses Disclosure Claims in Post-Closing Damages Action

Nguyen v. Barrett, C.A. No. 11511-VCG (Del. Ch. Sept. 28, 2016)
Click here to view the opinion.

In litigation arising out of AOL, Inc.'s acquisition of Millennial Media, Inc., Vice Chancellor Sam Glasscock III granted the defendants' motion to dismiss disclosure claims, many of which had previously formed the basis of a prior request for a preliminary injunction.

With respect to disclosure claims that had been the subject of the motion for a preliminary injunction — including that the defendants failed to disclose certain components of the unlevered free cash flow used by Millennial's financial advisor, LUMA Securities LLC, in connection with the analyses that formed the basis of its fairness opinion — Vice Chancellor Glasscock granted the motion to dismiss, noting that such claims did not "constitute a material lack of disclosure." He further explained that at the motion to dismiss stage, an argument that disclosure claims were material is even more difficult to plead than at the preliminary injunction stage, because a plaintiff must plead not only that an omitted disclosure was material, but that the defendant directors' purported breach of duty would not be exculpated, meaning "it is reasonably conceivable that the allegedly incomplete disclosure was made by the board disloyally or in bad faith. ..."

With respect to disclosure claims that had not been raised at the motion for a preliminary injunction hearing — including that defendants failed to disclose the amount of LUMA's fee that was contingent upon the completion of the transaction — Vice Chancellor Glasscock considered the defendants' argument that the claims should be deemed waived, explaining that "where a plaintiff has a claim, pre-close, that a disclosure is either misleading or incomplete in a way that is material to stockholders, that claim should be brought pre-close, not post-close," because "a stockholder's right to a fully informed vote" will be "irretrievably lost following a stockholder vote. The preferred method for vindicating truly material disclosure claims is to bring them pre-close, at a time when the Court can insure an informed vote. Because of this interest, a salutary incentive could be provided by considering claims based on disclosure, pled but not pursued pre-close, to be waived." However, Vice Chancellor Glasscock ultimately agreed with the defendants that the plaintiffs failed to state a claim and accordingly declined to reach the waiver argument.

Inside the Courts
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Forward-Looking Statements

SDNY Dismisses Putative Class Claims Against Computer Technology Company in Wake of $2.4 Billion Write-Down

Int'l Ass'n of Heat & Frost Insulators & Asbestos Workers Local #6 Pension Fund v. IBM, No. 15cv2492 (S.D.N.Y. Sept. 7, 2016)
Click here to view the opinion.

Judge William H. Pauley III dismissed claims that a computer technology company and certain of its executive officers violated Section 10(b) of the Securities Exchange Act by misleading investors prior to the company's $2.4 billion write-down incurred in connection with selling a semiconductor unit at a loss. The plaintiffs alleged that the company's financial statements did not comply with generally accepted accounting principles (GAAP) because prior to selling the semiconductor unit away, the company failed to account for the unit as an impairment. Although the company contended that it could not independently account for the semiconductor unit as an independent impairment loss because it was vertically integrated in the business, the court disagreed because the company's "own disclosures demonstrate[d] that it tracked [the semiconductor unit's] revenues" and operating losses.

However, the court dismissed the action because the plaintiffs failed to adequately plead scienter. The court rejected the plaintiffs' contention that the (i) magnitude of the write-down, (ii) unrealized forward-looking statements regarding the company's projected earnings per share, and (iii) compliance certifications signed by the company's officers pursuant to the Sarbanes-Oxley Act — considered together — demonstrated a strong inference of scienter. Judge Pauley noted that the plaintiffs "all but concede that any of those allegations, viewed in isolation, would be insufficient to allege scienter," and that the allegations fared no better collectively. The court observed that Sarbanes-Oxley certifications do not create an inference of scienter because otherwise there would be "an inference of scienter in every case where there was an accounting error or auditing mistake made by a publicly traded company." Similarly, it noted that the company's forward-looking statements regarding its earnings per share were protected by the Private Securities Litigation Reform Act's (PSLRA) safe harbor that protects such statements unless they are made with an actual knowledge of their falsity. In sum, the court concluded that the plaintiffs had failed to allege facts demonstrating that the risk of the write-down had been so apparent that the "failure to take an earlier write-down amounts to fraud."

Third Circuit Affirms Dismissal, Holding That Forward-Looking Statements Couched in 'Meaningful Cautionary Language' Fall Under Reform Act's Safe Harbor Provision

OFI Asset Mgmt. v. Cooper Tire & Rubber, No. 15-2664 (3d Cir. Aug. 22, 2016)
Click here to view the opinion.

The 3rd Circuit affirmed the dismissal of claims premised on an alleged misrepresentation to investors during a failed merger, holding that statements made by the company's officers were forward-looking and thus fell under the PSLRA safe harbor provision.

In 2013, two tire companies reached a merger agreement. Key to the merger was the defendant company's presence in China. However, the announcement of the merger led to a protracted strike at the Chinese facility. The company's subsequent 10-Q disclosed the "temporary work stoppage" and warned it could hurt future performance. As a result, the defendant company was asked to accept a price reduction, which it declined but did not disclose to shareholders. The company's stockholders later approved the merger, but the other party refused to close the deal because the company did not accept the price reduction. Ultimately, the company terminated the planned merger, and its stock price dropped.

The plaintiff investors subsequently filed this action, claiming that the defendant company made material misrepresentations regarding the merger.

The district court dismissed the claims, and the 3rd Circuit affirmed. The court held that the company's statements regarding the workers' strike were forward-looking because they concerned the impact labor issues might have on future business negotiations. And since those statements were accompanied by "meaningful cautionary language," they were protected under the PSLRA's safe harbor provision. Regarding the other statements at issue, the court held that the company's revenue projections were not statements of fact, and that the company was under no obligation to use adjectives (*e.g.*, "imperiled") to describe the state of the merger deal.

High-Speed Trading

Second Circuit Affirms Dismissal of High-Speed Trading Claims Against Securities Exchanges

Lanier v. Bats Exch., Inc., No. 15-1683 (2d Cir. Sept. 23, 2016)
Click here to view the opinion.

The 2nd Circuit affirmed the dismissal of contract claims against a group of securities exchanges. The plaintiff — a subscriber to

data feeds through which the defendants provide information about securities traded on the exchanges — alleged that the defendants had impermissibly provided a group of preferred customers with faster access to data. Those preferred customers allegedly paid to receive the data directly from an exchange's proprietary feed rather than receiving consolidated data from the processor. The defendants are regulated by Securities and Exchange Commission (SEC) Regulation NMS, which requires the defendants to file a transaction reporting plan (NMS Plan) with the SEC for approval, which must provide for the dissemination of data "on terms that are not unreasonably discriminatory." The plaintiff argued that his subscriber agreements with the defendants incorporated the relevant SEC regulations, and a breach of the SEC regulations constituted a breach of contract.

The 2nd Circuit first held that it had subject matter jurisdiction to hear the case, reversing the district court, because the Securities Exchange Act evinced no congressional intent for the SEC to review private contract disputes, an area outside the SEC's competence and expertise. Nonetheless, the court held that the complaint failed to state a claim because the contract claims were pre-empted by SEC regulations, which require only that data be sent by exchanges at the same time, not that it be received simultaneously by all users. The court declined to adopt a contrary interpretation of the defendants' duties under state law because doing so would frustrate the Securities Exchange Act's purpose of creating a uniform national market system. Further, the court reasoned that the plaintiff's contention that preferred customers should not receive data prior to the processor had no basis in the subscriber agreement, which simply required that the exchange deliver data in a manner consistent with its NMS Plan. Finally, the court held that to the extent that the complaint alleged that the defendants committed a breach because the implementation of their respective NMS Plans violated the Securities Exchange Act, that claim had to be administratively exhausted before the SEC.

Loss Causation

District Court Holds Anonymous Blog Post Comprised of Already Public Information Does Not Constitute Corrective Disclosure

Bonanno v. Cellular Biomedicine Grp., Inc., No. 15-cv-01795-WHO (N.D. Cal. Sept. 2, 2016)
Click here to view the opinion.

The Northern District of California dismissed a putative securities fraud class action, holding that an anonymous blog post that merely compiled already public information could not constitute a corrective disclosure sufficient to show loss causation.

The plaintiffs, shareholders of a biotechnology company, alleged that the company and its investor relations firms made inadequate and obfuscated disclosures regarding the company's payments for promotions in a scheme to raise the company's stock price. The plaintiffs claimed that the truth regarding this fraudulent scheme was revealed to the market in an anonymous blog post to a financial news and analysis website. In the post, the blogger collected a variety of public information regarding the company, its alleged misconduct and its paid promotion campaign, and predicted a "-94.6% near term and imminent downside" for the company's shares.

The court dismissed the complaint for failure to adequately plead loss causation. The court held that plaintiffs did not allege how the blog post constituted a corrective disclosure of "true facts" that were not previously publicly available, as is required to plead loss causation. The court emphasized that while the blog post compiled a host of information in one place, none of the information was new or nonpublic prior to the post. The court explained that aggregating and publishing old information is never sufficient to satisfy the loss causation standard because an efficient market would have already digested the information. The court found it irrelevant that information about the promotion payments came from noncompany sources rather than the company's public filings.

Sarbanes-Oxley Act

Ninth Circuit Finds Implied Truth Requirement in Rule 13a-14 Certifications, Holds Corporate Officers May Be Subject to Disgorgement Remedy Even Absent Proof of Wrongdoing

U.S. Sec. & Exch. Comm'n v. Jensen, No. 14-55221 (9th Cir. Aug. 31, 2016)
Click here to view the opinion.

The 9th Circuit reversed a district court judgment in favor of defendant corporate officers, holding that (i) Rule 13a-14 of the Securities Exchange Act provided the SEC with a cause of action against corporate officers who certified false or misleading statements, and (ii) the Sarbanes-Oxley Act's disgorgement remedy applied even if the officers were not involved in the misconduct necessitating a restatement.

The SEC brought suit against the former CEO and chief financial officer of a water treatment company, alleging that the officers defrauded investors by reporting millions of dollars in revenue that were never realized. The officers had signed SEC filings on behalf of the company containing the company's financial statements. The SEC alleged that the company's financials did not comply with GAAP and, due to the inflated revenues, the defen-

dants undeservedly earned substantial incentive-based compensation. After the defendants left the company in 2008, the company restated its financial statements for 2006 and 2007, causing a substantial drop in stock price. The SEC sought to hold the defendants liable for the misstated revenue and have their performance-based incentives disgorged pursuant to Sarbanes-Oxley.

Rule 13a-14 requires a company's principal executive and financial officers to certify in each periodic SEC report that they have reviewed the report and that, based on their knowledge, it does not contain any material untrue statement or omit any material facts. The court held that under that rule, an officer cannot comply with Rule 13a-14 simply by signing the periodic certifications; the filing must also be truthful for an officer to be in compliance. The court declined to determine what mental state was required when signing a false certification to violate Rule 13a-14, meaning that a future court will need to determine whether or not an officer must have knowledge that the filing is untruthful at the time of signing.

The court also held that Sarbanes-Oxley's disgorgement remedy simply required misconduct by the issuer; personal misconduct by the CEO or CFO was irrelevant. While numerous district courts have reached this conclusion, the 9th Circuit was the first circuit court to rule on this issue.

The court thus vacated the district court opinion and remanded the action.

Scienter

First Circuit Affirms Dismissal of Securities Fraud Claims Against Vertex Pharmaceuticals Based on Announcement of Erroneous Interim Trial Results

Local No. 8 IBEW Ret. Plan & Trust v. Vertex Pharm., Inc.,
No. 15-2250 (1st Cir. Oct. 3, 2016)
Click here to view the opinion.

The 1st Circuit affirmed the dismissal of a putative class action complaint alleging that Vertex Pharmaceuticals violated Section 10(b) of the Securities Exchange Act in connection with the announcement of interim results of a trial. The complaint alleged that the results, which involved the combination of two drugs, overstated the improvement in lung function among patients receiving the treatment. Vertex allegedly announced positive interim results but then issued a subsequent press release stating that the prior announcement had overstated results due to a "misinterpretation" of the data Vertex had received from its third-party vendor. The plaintiffs alleged that before the second announcement, five individual defendants sold $32 million worth of the company's stock. One such defendant allegedly retired shortly after the second press release and one day after a U.S. senator sent a letter to the SEC asking it to probe whether any insider trading had occurred at Vertex.

The court held that the complaint failed to allege facts giving rise to the requisite strong inference of scienter. The court reasoned that although the results demonstrated an absence of improvement in one of the two key measures of lung function, there was no allegation that this was incompatible with improvements in the second measure. Further, there was no "glaring" incongruity in the results making the need for further inquiry obvious. Importantly, there was no allegation that anyone at Vertex responsible for receiving, reviewing or reporting the results had in fact noticed an error in interpretation before the discovery that led to the second announcement or received the raw data. Although the complaint alleged that the error in the results was so fundamental that it should have been obvious to the Vertex pulmonologist reviewing the raw data, the pulmonologist had not been named a defendant, and there was no allegation that he had any responsibility for the decision to announce the interim results.

The court also rejected the argument that the timing of the defendants' sales of stock was indicative of scienter. First, two of the six individual defendants (the director and the CEO) had not engaged in any inconsistent trading behavior during the class period. Thus, the court rejected the inference that the error was obvious to all defendants because it was implausible that the director and the CEO, who did not trade, would have gone along with the decision to announce the clearly flawed results. Second, the court determined that the plaintiffs had not sufficiently alleged that the error in the results would have been apparent only to the defendants who allegedly made unprecedented sales. The court similarly declined to infer any misconduct based on the executive's allegedly sudden retirement, reasoning that there were various alternative explanations for the departure and that any inference of scienter would depend "on a degree of guesswork inconsistent with the PSLRA pleading standard."

Second Circuit Affirms Dismissal of Securities Fraud Claims Against BlackBerry but Vacates Denial of Motion for Leave to Amend Complaint

Cox v. BlackBerry Ltd., No. 15-3991 (2d Cir. Aug. 24, 2016)
Click here to view the opinion.

The 2nd Circuit affirmed the dismissal of a putative securities fraud class action against BlackBerry Ltd., arising out of allegations that the defendant made material misstatements and omissions concerning the release of the BlackBerry Z10 smartphone. The court affirmed the district court's ruling that the complaint failed to allege the requisite strong inference of scienter. The court reasoned that certain individual defendants' high ranking within the organization — the president and CEO

on the one hand and the chief financial officer on the other — was insufficient on its own to establish scienter. Even though the complaint alleged that the two had monitored the sales and returns of the Z10 smartphone, it contained no specific facts demonstrating that they in fact possessed information contrary to their public statements about the release of the smartphone. The court rejected the plaintiffs' "fraud by hindsight" theory that rested on the premise that "because the release of the Z10 ultimately turned out to be a failure, defendants must have known that it would be a failure and lied about this fact to investors."

However, the 2nd Circuit vacated the district court's denial of the plaintiffs' motion for leave to amend on the basis of two events that postdated the dismissal of the complaint. First, the U.S. Supreme Court issued its decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015), which refined the standard for liability for statements of opinion. Second, the plaintiffs discovered evidence that allegedly corroborated a third-party research report showing that customer returns of the Z10 were outpacing sales and arguably demonstrating that the defendants' statements of opinion concerning the veracity of the report had no reasonable basis. The court vacated the order denying leave to amend, finding the district court's reasoning to be vague, and directed the court to reconsider and explain the basis for its decision.

District of Connecticut Court Dismisses Claims Against Educational Financial Services Company

Perez v. Higher One Holdings, Inc., No. 3:14-cv-755(AWT) (D. Conn. Sept. 13, 2016)
Click here to view the opinion.

Judge Alvin W. Thompson dismissed putative class claims that an educational financial services company and certain of its current or former executives and/or directors violated Section 10(b) of the Securities Exchange Act by misleading investors with respect to (i) the company's legal compliance, (ii) its reporting of its financial and operating results, (iii) its termination of a certain banking partnership, and (iv) its internal controls over financial reporting and disclosure controls. The complaint did not adequately allege facts demonstrating an actionable misstatement or omission. The court found that statements about the company's legal compliance were not misleading because they amounted to "corporate puffery," even though the plaintiffs offered confidential witness statements from witnesses attesting that the company did not appropriately revise its compliance practices following a Federal Deposit Insurance Corporation consent order. The court discredited those confidential witness statements because they were not alleged to come from employees who actually worked in compliance. The court noted that the witness statements demonstrated "only that the individual CWs themselves did not know of revisions to the compliance management system, not that [the company] failed to revise the system."

Similarly, although plaintiffs alleged that the company failed in certain public filings to disclose that the company had not complied with all applicable laws, the court observed that those statements were made days before the Federal Reserve initiated an enforcement action against the company. Moreover, the court rejected the argument that "[d]efendants had a duty to disclose the existence of improper business practices prior to any indication that those practices were under scrutiny." The court likewise rejected the plaintiffs' allegation that the defendants made false and misleading statements about the reasons why the company's relationship with a certain bank was terminated, stating that even if the bank terminated its relationship with the company because the company engaged in improper conduct, "the securities laws do not impose a general duty to disclose corporate mismanagement or uncharged criminal conduct." Finally, the court rejected the plaintiffs' allegations that the company's statements about its internal controls over financial reporting were misleading, holding that the plaintiffs had failed to allege facts demonstrating that the company believed that its internal controls were ineffective, "even if this conclusion was later proved to be erroneous."

SEC Administrative Proceedings

DC Circuit Finds SEC Administrative Proceedings Constitutional

Raymond J. Lucia Cos. v. Sec. & Exch. Comm'n, No. 15-1345 (D.C. Cir. Aug. 9, 2016)
Click here to view the opinion.

The D.C. Circuit held that the administrative law judges (ALJs) working for the SEC are not "inferior Officers" subject to the requirements of the Appointments Clause under Article II, Section 2, Clause 2 of the U.S. Constitution. In so holding, the court became the first federal appellate court to rule on the merits of a constitutional challenge to the SEC's ALJs.

Petitioners, an investor and his investment companies appealed to the SEC the decision of an ALJ holding them liable for violations of the anti-fraud provisions of the Investment Advisers Act. The SEC conducted an independent review and ruled against the petitioners, rejecting their argument that the administrative proceeding was unconstitutional because the presiding ALJ was not appointed in accordance with the Appointments Clause. The SEC issued an order imposing sanctions on the companies and a lifetime ban on the investor for making misleading statements about their investment strategy.

Petitioners sought review in the D.C. Circuit, contending that the SEC's decision and order should be vacated because the ALJ who rendered the decision was an inferior Officer who was not appointed pursuant to the Appointments Clause. The court disagreed. Quoting *Buckley v. Valeo*, 424 U.S. 1, 126 (1976), the court held that an appointee is an inferior Officer under the Constitution if the appointee exercises "significant authority pursuant to the laws of the United States." Relying next on *Landry v. FDIC*, 204 F.3d 1125, 1134 (D.C. Cir. 2000), the court held that an appointee exercises "significant authority" if three criteria are met: (i) the matters resolved by the appointee are significant, (ii) the appointee exercises significant discretion in reaching decisions, and (iii) the decisions are final.

The court held that because the ALJs' decisions are not actions of the SEC unless the SEC issues a finality order, the ALJs' decisions are not independently final. Therefore, SEC ALJs do not satisfy the third criterion of the *Landry* test and thus are not inferior Officers.

Securities Fraud Pleading Standards

District Court Denies Shareholder's Claim for Relief Based on 'Newly Discovered' Evidence

Messner v. USA Techs., Inc., No. 15-5427 (E.D. Pa. Sept. 19, 2016)
Click here to view the opinion.

The Eastern District of Pennsylvania refused to vacate an earlier dismissal of a securities fraud lawsuit based on the plaintiff's claim of "newly discovered" evidence, holding that the plaintiff failed to exercise reasonable due diligence in investigating the defendant before filing the original suit.

The plaintiff initially filed suit on October 1, 2015, alleging that the defendants made false and materially misleading statements regarding the company's accounting practices and internal controls. The court dismissed his claims on April 13, 2016. Four months later, the plaintiff sought relief from the court, claiming he had discovered new evidence — a May 2, 2016, third amended complaint by another party against the company, alleging a similar lack of internal controls.

The court denied the plaintiff's request for relief. The court noted that an amended complaint in the other matter was filed on April 10, 2015, almost six months prior to the plaintiff here alleging the same shortcomings regarding the company's internal controls. The court determined that the April 10, 2015, amended complaint put the plaintiff on notice of the supposed "new" evidence. Accordingly, the plaintiff failed to "satisfy his heavy burden under [Federal] Rule [of Civil Procedure] 60(b)(2) of demonstrating he exercised reasonable diligence." Furthermore, the plaintiff failed to "demonstrate exceptional circumstances warranting relief from judgment under Rule 60(b)(6)."

Loss Causation

Sixth Circuit Reverses Dismissal of Securities Fraud Claims Against Federal Home Loan Mortgage Corporation and Its Senior Officers

Ohio Pub. Emps. Ret. Sys. v. Fed. Home Loan Mortg. Corp., No. 14-4189 (6th Cir. July 20, 2016)
Click here to view the opinion.

The 6th Circuit reversed the Northern District of Ohio's dismissal of a putative class action brought by a state pension fund against Federal Home Loan Mortgage Corporation (Freddie Mac) and four of its senior officers for alleged violations of Sections 10(b) and 20(a) of the Securities Exchange Act and SEC Rule 10b-5. The plaintiff alleged that Freddie Mac had made materially false statements and omissions that concealed (i) its overextension in the nontraditional mortgage market, (ii) its materially deficient underwriting, risk management and fraud detection practices, and (iii) its financial health. Proceeding under the "materialization of risk" theory of loss causation, the plaintiff claimed that it suffered foreseeable losses due to the drop in the market price of Freddie Mac's stock when these risks were realized. The district court granted the defendants' motion to dismiss, rejecting the plaintiff's materialization of the risk theory for loss causation and concluding that the plaintiff failed to plead loss causation.

The 6th Circuit reversed the dismissal and held that materialization of risk was a viable theory for alleging loss causation. Reasoning that its prior decisions recognized the viability of alternative theories of loss causation, the court joined the majority of other circuits in recognizing and adopting materialization of the risk as an alternative theory for loss causation. Specifically, the court adopted the materialization of the risk theory as set forth by the 2nd Circuit in the *Omnicom* case, which provides that a plaintiff may show loss causation by alleging "proximate cause on the ground that negative investor inferences," drawn from a particular event or disclosure, "caused the loss and were a foreseeable materialization of the risk concealed by the fraudulent statement." *In re Omnicom Grp., Inc. Sec. Litig.*, 597 F.3d 501, 511 (2d Cir. 2010). Applying this theory, the court concluded that the plaintiff sufficiently alleged loss causation. The court found the plaintiff's allegations that Freddie Mac disregarded its internal controls, inaccurately presented its financial reports and internally recognized that its public statements were misleading were sufficiently correlated to the risks that materialized at the end of the class period and the immediate fall in stock price to support a plausible claim of loss causation.

Lastly, the court rejected Freddie Mac's argument that the plaintiff failed to plead facts sufficient to exclude more likely explanations for its alleged losses. The court reasoned that the "[plaintiff] need only allege sufficient facts to support a plausible claim — not the most likely —" to defeat a motion to dismiss. Accordingly, the court reversed.

Statutes of Limitations

Tenth Circuit Affirms Disgorgement Damages Against Investment Adviser

Sec. & Exch. Comm'n v. Kokesh, No. 15-2087
(10th Cir. Aug. 23, 2016)
Click here to view the opinion.

The 10th Circuit affirmed the entry of judgment following a jury verdict returned in favor of the SEC involving an investment adviser who was found liable for misappropriating funds from several SEC-registered business development companies (BDCs). On appeal, the adviser argued that 28 U.S.C. Section 2462, which sets a five-year limitations period "for the enforcement of any civil fine, penalty, or forfeiture" precluded the court's imposition of disgorgement and permanent injunction from violating certain securities laws. First, with respect to the injunction, the court stated that an "order to obey the law" is not a penalty encompassed by the limitations period because "such an order is purely remedial and preventative." Similarly, with respect to disgorgement, the 10th Circuit determined that disgorgement is not a penalty under Section 2462 because it also is remedial, even though the defendant argued that the order was punitive because it required him to disgorge more than he actually gained himself. The court stated that there is "nothing punitive about requiring a wrongdoer to pay for all the funds he caused to be improperly diverted to others as well as to himself." The court also rejected the defendant's argument that the disgorgement order constituted an impermissible forfeiture within the meaning of Section 2462. The court noted a circuit split on the issue — with the 11th Circuit, for example, holding that disgorgement can constitute an impermissible forfeiture — and the court noted that "in recent years some federal forfeiture statutes have been expanded to include disgorgement-type remedies." The court examined the historical meaning of "forfeiture" as well as the historical predecessors of Section 2462 and concluded that the disgorgement order was not a forfeiture because when Section 2462 was enacted, its drafters likely did not intend for the barring of forfeitures to include "traditional disgorgement remedies."

Tolling

Eleventh Circuit Holds Tolling Under *American Pipe* Tolling Is Equitable, Not Legal, in Nature and Does Not Apply to Section 20(a)'s Statute of Repose

Dusek v. JPMorgan Chase & Co., No. 15-14463
(11th Cir. Aug. 10, 2016)
Click here to view the opinion.

The 11th Circuit affirmed the dismissal of a shareholder suit alleging a Racketeer Influenced and Corrupt Organizations Act (RICO) violation and Section 20(a) control person liability against an international bank for losses arising out of the Bernard Madoff scandal, holding that the RICO claim was barred by the PSLRA and that the Section 20(a) claim was time-barred and not subject to tolling under *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974).

Madoff was arrested on December 11, 2008, but the plaintiffs did not file this action until March 28, 2014. Section 20(a) has a five-year statute of repose, meaning that, absent tolling, the plaintiffs needed to bring suit by December 11, 2013. The plaintiffs argued that their claims were tolled under *American Pipe* due to a related class action against the international bank in the Southern District of New York.

In *American Pipe*, the U.S. Supreme Court held that "the commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class who would have been parties had the suit been permitted to continue as a class action." *American Pipe* was later extended to would-be class members who file separate actions after class certification is denied.

The 11th Circuit explained that while statutes of repose can be subject to legal tolling, they are not subject to equitable tolling. However, the court also noted that there is a circuit split as to whether tolling under *American Pipe* is legal or equitable in nature. The court ultimately concluded that tolling under *American Pipe* is equitable. As such, Section 20(a)'s statute of repose was not subject to tolling, and the plaintiffs' claims were time-barred.

The court also disposed of the plaintiffs' RICO claim, as the claims of mail and wire fraud were clearly based on violations of securities law. Thus, it was precluded by PSLRA.

The case is currently pending *certiorari* to the Supreme Court.

Inside the Courts
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