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Securities Law Alert

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June 2020

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Supreme Court: SEC May Seek Disgorgement in Civil Enforcement Proceedings Provided the Award Does Not Exceed Net Profits

On June 22, 2020, in *Liu v. SEC*, 2020 WL 3405845 (2020) (Sotomayor, J.), the Supreme Court resolved the question it raised but left open just a few years ago in *Kokesh v. SEC*, 137 S. Ct. 1635 (2017): whether the SEC is authorized to seek disgorgement in federal court proceedings. In an 8-1 decision, the Court upheld but circumscribed the SEC's ability to seek disgorgement. Specifically, the Court held that disgorgement constitutes permissible "equitable relief" under 15 U.S.C. § 78u(d)(5), but only where disgorgement is based on net profits and ordinarily where disgorged funds are distributed to victims.

When the SEC brings enforcement actions in federal court, it is authorized by statute to seek a range of remedies, including "any equitable relief that may be appropriate or necessary for the benefit of investors." In *Kokesh*, the Court held that disgorgement of profits is a "penalty" for the purposes of statutes of limitations. However, the *Kokesh* Court explained in a footnote that "[n]othing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context."[1] In *Liu*, on the heels of *Kokesh*, the petitioners argued that disgorgement was not an equitable remedy, and therefore, not within the statutory authorization.

Although the briefing in *Liu* focused on the all-or-nothing question of whether the SEC could seek (and courts have the power to order) disgorgement in federal court proceedings, the oral argument focused instead on what aspects of a disgorgement

1. Please click here to read our discussion of the Supreme Court's decision in *Kokesh*.

award might make it punitive instead of equitable. The Justices asked petitioners' counsel if the disgorgement in the case would have been equitable if it were returned to investors (instead of turned over to the U.S. Treasury) and seemed focused on how the SEC calculates disgorgement awards, foreshadowing the focus of the Court's decision.

While petitioners argued that disgorgement is not "equitable relief" within the meaning of § 78u(d)(5), the Court said: "Not so." The Court held that a disgorgement award is proper so long as it (1) does not exceed the wrongdoer's net profits, and (2) in the ordinary case, is given to victims of the wrongdoing. The Court further questioned the practice of imposing the disgorgement remedy on a joint-and-several basis.

The Court observed that equity practice has historically allowed courts to deprive wrongdoers of ill-gotten gains and that these remedies are equitable (instead of punitive) so long as they are restricted to net profits and awarded to victims. In light of this history, the Court held the SEC is well within its statutory authority to seek disgorgement in civil suits. The Court declined to extend *Kokesh*'s conclusion that disgorgement is a penalty beyond the statute of limitations context, noting that "that decision has no bearing on the SEC's ability to conform future requests for a defendant's profits to the limits outlined in common-law cases awarding a wrongdoer's net gains." The Court did acknowledge three trends in the SEC's use of the disgorgement remedy that might not comport with a traditional equitable remedy.

First, the Court questioned the practice of depositing disgorgement awards into the U.S. Treasury, noting that § 78u(d)(5) authorizes equitable relief "for the benefit of investors." The Court explained that the equitable nature of the profits remedy would ordinarily require the SEC to return profits to wronged investors, not the Treasury. The Court allowed that the SEC might be able to send disgorgement awards to the Treasury when it is not feasible to distribute funds to the investors, but noted that this issue was not before the Court.

Second, the Court expressed concern about the SEC's practice of seeking joint-and-several liability for disgorgement awards, stating: "That practice could transform any equitable profits-focused remedy into a penalty," especially if the SEC sought to disgorge from one defendant profits earned by another defendant. The Court explained that joint-and-several liability might be appropriate in cases of concerted wrongdoing and shared profits (e.g., by partners in a partnership), but that lower courts would have to assess the facts in each case to see if equitable principles permitted such an award.

Third, the Court explained that courts must deduct legitimate business expenses from disgorgement awards. This shifts the focus from gross profits to net profits. The Court explained that courts should not deduct illegitimate personal expenses, but that ordinarily defendants should not be required to disgorge funds they spent on business expenses. The Court also acknowledged that in rare cases where the defendant's entire enterprise was fraudulent, then no business expenses would be legitimate and gross profits would be the correct measure of disgorgement.

Justice Thomas dissented, writing that he would hold that disgorgement is not an "equitable remedy" within the meaning of § 78u(d)(5). In his view, "[d]isorgement is not a traditional equitable remedy" but is instead "a creation of the 20th century."

Supreme Court: Participants in Defined Benefit Plans Lack Article III Standing to Bring an ERISA Action

On June 1, 2020, the Supreme Court held that participants in a defined-benefit plan lacked Article III standing to assert ERISA claims for alleged mismanagement of their plan. [*Thole v. U.S. Bank*, 2020 WL 2814294 (2020) (Kavanaugh, J.)]. The Court held that plaintiffs had “no concrete stake in [their] lawsuit” because even if they won, “they would still receive the exact same monthly benefits that they are already slated to receive, not a penny more.”

Plaintiffs alleged that defendants breached their fiduciary duty of loyalty by investing plan assets in their own mutual funds and collecting excessive management fees. Plaintiffs did not allege that they had “sustained any monetary injury,” as they had “received all of their monthly benefit payments” under the plan.[2] Plaintiffs’ primary theory of standing was that “an ERISA defined-benefit plan participant possesses an equitable or property interest in the plan, meaning in essence that injuries to the plan are by definition injuries to the plan participants.” In plaintiffs’ view, “a plan fiduciary’s breach of a trust-law duty of prudence or duty of loyalty itself harms ERISA defined-benefit plan participants, even if the participants themselves have not suffered (and will not suffer) any monetary losses.”

The Court found “[t]he basic flaw in the plaintiffs’ trust-based theory of standing is that the participants in a defined-benefit plan are not similarly situated to the beneficiaries of a private trust or to the participants in a defined-contribution plan.” The Court noted that “[i]n the private trust context, the value of the trust property and the ultimate amount of money received by the beneficiaries will typically depend on how well the trust is managed, so every penny of gain or loss is at the beneficiaries’ risk.” The Court explained that “a defined-benefit plan is more in the nature of a contract,” and the plan participants’ “benefits are fixed and will not change, regardless of how well or poorly the plan is managed.” The Court found it particularly significant that “the employer, not plan participants, receives any surplus left over after all of the benefits are paid.” The Court held that “plan participants possess no equitable or property interest in the plan,” and thus “[t]he trust law analogy . . . does not support Article III standing for plaintiffs who allege mismanagement of a defined-benefit plan.”

2. The Court recognized that “plaintiffs’ complaint alleged that the plan was underfunded for a period of time,” but found the “complaint did not plausibly and clearly claim that the alleged mismanagement of the plan substantially increased the risk that the plan and the employer would fail and be unable to pay the plaintiffs’ future pension benefits.” *Thole*, 2020 WL 2814294.

The Court also rejected plaintiffs’ contention that “defined-benefit plan participants must have standing to sue” because “if defined-benefit plan participants may not sue to target perceived fiduciary misconduct, no one will meaningfully regulate plan fiduciaries.” The Court explained that “employers and their shareholders often possess strong incentives to root out fiduciary misconduct because the employers are entitled to the plan surplus and are often on the hook for plan shortfalls.” Moreover, the Court pointed out that “[w]hen a defined-benefit plan fails and is unable to pay benefits to retirees, the federal Pension Benefit Guaranty Corporation is required by law to pay the vested pension benefits of the retirees, often in full.” Consequently, “the Department of Labor has a substantial motive to aggressively pursue fiduciary misconduct, particularly to avoid the financial burden of failed defined-benefit plans being backloaded onto the Federal Government.”

In a dissenting opinion, Justice Sotomayor—joined by Justices Ginsburg, Breyer and Kagan—stated that “petitioners have alleged a concrete injury to support their constitutional standing to sue.” The dissent opined that “petitioners have an interest in their retirement plan’s financial integrity, exactly like private trust beneficiaries have in protecting their trust.” The dissent argued that “[p]recisely because petitioners have an interest in payments from their trust fund, they have an interest in the integrity of the assets from which those payments come.” The dissent also opined that “a breach of fiduciary duty is a cognizable injury, regardless of whether that breached caused financial harm or increased a risk of nonpayment.”

Second Circuit: Knowledge of Employees Who Played No Role in the Alleged Misstatements Could Not Be Imputed to the Corporation

On May 27, 2020, the Second Circuit affirmed the denial of leave to amend a securities fraud complaint alleging that a corporation made misstatements concerning the quality of its surgical gowns. *Jackson v. Abernathy*, 960 F.3d 94 (2d Cir. 2020) (per curiam). Although the proposed amended complaint alleged that "three employees knew of problems with the [surgical] gown," the complaint did not specify "what role those employees played in crafting or reviewing the challenged statements." The court concluded that it could not impute the employees' knowledge to the corporation.

The Second Circuit explained that "[w]here a defendant is a corporation," a plaintiff must "plead[ ] facts that give rise to a strong inference that someone whose intent could be imputed to the corporation acted with the requisite scienter." The court noted that "[a]scribing a state of mind to a corporate entity is a difficult and sometimes confusing task," particularly because "the hierarchical and differentiated corporate structure often muddies the distinction between a deliberate fraud and an unfortunate (yet unintentional) error caused by mere mismanagement." The court observed that "the most straightforward way to raise a strong inference of corporate scienter is to impute it from an individual defendant who made the challenged misstatement." The court recognized that "[t]he scienter of the other officers or directors who were involved in the dissemination of the fraud may also be imputed to the corporation, even if they themselves were not the actual speaker." And "[i]n exceedingly rare instances, a statement may be so dramatic that collective corporate scienter may be inferred."

In the case before it, the court found the proposed amended complaint "sets forth no such allegations." The court noted that the three employees with alleged knowledge of problems with the surgical gown "did not themselves possess scienter, as the steps they took to raise concern about the [surgical] gown's testing failures belie any inference of fraudulent intent." The court explained that "while particularized allegations that senior officers ignored those employees' warnings could demonstrate that those officers acted fraudulently," the complaint "fails to make that showing" as it "offers only general allegations of warnings made to unidentified senior executives." Because the proposed amended complaint "provides no connective tissue between [the three] employees [with alleged knowledge] and the alleged misstatements," the court determined that it could "only guess" whether it would "be fair to charge the Corporate Defendants with their knowledge." The court concluded that granting leave to amend would be futile.

Ninth Circuit: Allegations That Defendants Invested in and Touted a Product Despite Knowing the FDA Would Inevitably Deny Approval Are "Implausible"

On June 10, 2020, the Ninth Circuit affirmed the dismissal of a securities fraud action alleging that a company made misrepresentations concerning the likelihood of FDA approval for one of its products. *Nguyen v. Endologix*, 2020 WL 3069776 (9th Cir. 2020) (Bress, C.J.). The court found "plaintiff's core theory—that the company invested in a U.S. clinical trial and made promising statements about FDA approval, yet knew from its experience in Europe that the FDA would eventually reject the product—has no basis in logic or common experience." The court determined that "the more plausible inference is that the company made optimistic statements about its prospects for FDA approval because its U.S. testing looked promising, not because the company was quixotically seeking FDA approval for a medical device application it knew was destined for defeat."

The Ninth Circuit emphasized that "[a]llegations that are implausible do not create a strong inference of scienter." Here, "[t]he central theory of the complaint is . . . that defendants knew the FDA would not approve [the company's product], or at least that it would not do so on the timeline defendants were telling the market" because of an "unsolvable" problem with the product. The court found this "theory does not make a whole lot of sense" because it "depends on the supposition that defendants would rather keep the stock price high for a time and then face the inevitable fallout once [the product's] 'unsolvable' . . . problem was revealed." The court observed that "the theory might have more legs" if plaintiffs alleged that "defendants had sought to profit from this scheme in the interim, such as by selling off their stock or selling the company at a premium." Because the complaint included no such allegations, the court found plaintiffs' theory of scienter "does not resonate in common experience." The court underscored that the Private Securities Litigation Reform Act "neither allows nor requires [courts] to check [their] disbelief at the door."

The Ninth Circuit found "persuasive" the Fourth Circuit's decision in *Cozzarelli v. Inspire Pharm.*, 549 F.3d 618 (4th Cir. 2008). There, plaintiffs alleged that company executives made misleading statements concerning the likelihood of success of a drug study even though they knew the study would fail. The Fourth Circuit found it "improbable that [a company] would stake its existence on a drug and a clinical trial that the company thought was doomed to failure." As in *Cozzarelli*, the Ninth Circuit determined that "[t]he more plausible inference to be drawn from the allegations in the complaint is that defendants made promising statements about the timing of FDA approval based on the initial results of the U.S. clinical trial, but then modulated their optimism when the results began to raise more questions." The court concluded that the allegations did not give rise to "a strong inference of scienter."

Southern District of New York: Syndicated Term Loan Notes Are Not "Securities"

On May 22, 2020, the Southern District of New York dismissed a state law-based securities fraud action on the grounds that the syndicated term loan notes at issue (the "Notes") were not "securities" under the "family resemblance" test set forth in *Reves v. Ernst & Young*, 494 U.S. 56 (1990). *Kirschner v. JPMorgan Chase Bank*, 2020 WL 2614765 (S.D.N.Y. 2020) (Gardephe, J.). The court rejected plaintiff's contention that "term loans now commonly contain features that mirror a high-yield bond issuance." Since no court has yet "held that a syndicated term loan is a 'security,'" the court found plaintiff's "claim of a shift in the market" with respect to the character of syndicated term loan notes was "premature at best."

In *Reves*, the Supreme Court instructed that courts must "begin with a presumption that every note is a security." The Court further stated that this presumption "may be rebutted only by a showing that the note bears a strong [family] resemblance" to certain specified categories of notes that are not securities.[3] The family resemblance test turns on four factors: (1) "the motivations that would prompt a reasonable seller and buyer to

3. These include "the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a character loan to a bank customer, short-term notes secured by an assignment of accounts receivable, a note which simply formalizes an open-account debt incurred in the ordinary course of business . . . and notes evidencing loans by commercial banks for current operations." *Reves*, 494 U.S. 56.

enter into [the transaction]"; (2) "the plan of distribution of the instrument," (3) "the reasonable expectations of the investing public," and (4) "the existence of another regulatory scheme [to reduce] the risk of the instrument, thereby rendering application of the Securities Act unnecessary."

The *Kirschner* court rejected the plaintiff's argument that "the determination of whether an instrument is a security is a fact intensive question and generally not appropriately resolved on a motion to dismiss." The court noted that "[c]ourts in this District have, on occasion . . . concluded on a motion to dismiss that a particular instrument is not a security under *Reves*."

The court found the first *Reves* factor "does not weigh heavily in either direction." The court "conclude[d] that the second *Reves* factor weighs strongly in favor of finding that the Notes are not securities." The court noted that in *Banco Espanol de Credito v. Sec. Pac. Nat'l Bank*, 973 F.2d 51 (2d Cir. 1992), the Second Circuit held that loan participations with a similar type of distribution were not securities. While "hundreds of investment managers were solicited," the court explained that "this constitutes a relatively small number compared to the general public." Moreover, "as in *Banco Espanol*, only institutional and corporate entities were solicited." The court also found the Notes were restricted to a $1 million minimum investment amount, "a high absolute number that would only allow sophisticated investors to participate."

With respect to the third *Reves* factor, the court found that the governing documents "would lead a reasonable investor to believe that the Notes constitute loans, and not securities." The court observed, for example, that "the Credit Agreement repeatedly refers to the underlying transaction documents as 'loan documents,' and the words 'loan' and 'lender' are used consistently, instead of terms such as 'investor.'" The court explained that "[i]n *Banco Espanol*, [the Second Circuit] found the use of such terms significant, concluding that buyers were given ample notice that the instruments were participations in loans and not investments in a business enterprise."

Finally, the court found "the fourth *Reves* factor weighs in favor of a finding that the Notes are not securities" because the oversight of federal banking regulators did not reduce the risk of the Notes. The court noted that "[t]he primary focus of Federal banking regulators is presumably the safety and soundness of banks, rather than protection of note holders."

Based on the *Reves* analysis, the court found that the Notes were not securities. The court explained that "it would have been reasonable for these sophisticated institutional buyers to believe that they were lending money, with all of the risks that may entail, and without the disclosure and other protections associated with the issuance of securities."

New York Supreme Court: Plaintiffs Must Parse Out the Cause of Their Losses From Macroeconomic Events

On April 2, 2020, the New York Supreme Court granted summary judgment to defendants in a state law-based fraud action arising out of a collateralized debt obligation involving subprime residential mortgages based on the plaintiff's failure to prove loss causation. [*Loreley Financing (Jersey) No 3 v. Lynch*, 2020 WL 2302989 (N.Y. Sup. Ct. 2020) (Masley, J.)]. The court found the plaintiff "fail[ed] to proffer at least some evidence of how much, if any, of its losses were caused by defendants as opposed to the 2008-2009 financial crisis, or that the alleged fraud increased the chance of [the plaintiff's] losses in the face of such a significant market-wide crisis." The court observed that the plaintiff did not "even proffer a theory about how much of their losses were caused independently of that market crisis."

The court stated that in securities fraud actions, a "plaintiff must establish both that defendant's misrepresentation induced plaintiff to enter into the transaction (transaction causation) and that the misrepresentations directly caused the loss about which the plaintiff complains (loss causation)." The court explained that "when the plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors [i.e., the 2008 financial crisis], the prospect that the plaintiff's loss was caused by the fraud decreases." In such cases, "the plaintiff must parse out the cause of its losses from macroeconomic events." The court observed that "when an investor suffers an investment loss due to a market crash . . . of such dramatic proportions that the losses would have occurred at the same time and to the same extent, regardless of the alleged fraud, loss causation is lacking."

In the case before it, defendants "present[ed] prima facie proof that [the plaintiff's] loss was proximately caused by the intervening events of the 2007-2009 financial crisis." The court explained that "[t]he burden thus shifts to [the plaintiff] to raise a triable issue of fact about whether its loss can indeed be traced to defendants' fraudulent actions independent of the adverse market conditions."

The plaintiff contended that it should be able to recover damages based solely on "the difference between the purchase price of the asset and its true value." But the court explained that "[i]n securities fraud cases, overpayment is not sufficient to prove loss causation." Although the plaintiff "submitted evidence of transaction causation," the court held that the plaintiff's "fraud claim still fails for lack of proof that the alleged misrepresentations and omissions were the cause of its loss."

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