

# Securities Law Alert

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## Supreme Court: Grants Certiorari to Address Whether: (1) *American Pipe* Tolling Applies to Section 13's Three-Year Statute of Repose, and (2) SEC Claims for Disgorgement Are Subject to Section 2462's Five-Year Limitations Period

On January 13, 2017, the Supreme Court granted certiorari to address two significant questions involving the limitations periods for securities claims. In *California Public Employees' Retirement System v. ANZ Securities* (No. 16-373) (*CalPERS*), the Court will consider whether *American Pipe* tolling applies to the three-year statute of repose set forth in Section 13 of the Securities Act of 1933. In *Kokesh v. SEC* (No. 16-529), the Court will determine whether the five-year limitations period set forth in

28 U.S.C. § 2462 applies to SEC claims for disgorgement.

### Court Will Address Circuit Split on Whether *American Pipe* Tolling Applies to Section 13's Three-Year Statute of Repose

In *American Pipe & Construction v. Utah*, 414 U.S. 538 (1974), the 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."

The Second Circuit has previously determined that *American Pipe* tolling does not apply to Section 13's three-year statute of repose, which governs claims under Sections 11 and 12 of the Securities Act. *Police & Fire Ret. Sys. of Detroit v. IndyMac MBS*, 721 F.3d 95 (2d Cir. 2013) (*IndyMac*). The *IndyMac* court emphasized that "statutes of repose create a substantive right in those protected to be free

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from liability after a legislatively-determined period of time.” Earlier this year, the Sixth Circuit relied on *IndyMac* to find *American Pipe* tolling inapplicable to statutes of repose, including Section 13. *Stein v. Regions Morgan Keegan Select High Income Fund*, 821 F.3d 780 (6th Cir. 2016).

Both the Second and Sixth Circuits disagreed with the Tenth Circuit’s decision in *Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000), which held that *American Pipe* tolling does in fact apply to Section 13’s statute of repose. The Tenth Circuit reasoned that “[s]tatutes of repose are intended to demarcate a period of time within which a plaintiff must bring claims or else the defendant’s liability is extinguished.” The court found that in the case before it, “the claim was brought within this period on behalf of a class of which [plaintiff] was a member.” The Tenth Circuit further stated that “[t]olling the limitations period while class certification is pending does not compromise the purposes of statutes of limitations and repose” because the filing of a class action places defendants “on notice of the substantive claim as well as the number and generic identities of potential plaintiffs.”

In *CalPERS*, the Court granted certiorari to address the question of whether “the filing of a putative class action serve[s], under the *American Pipe* rule, to satisfy the three-year time limitation in Section 13 of the Securities Act with respect to the claims of putative class members.”<sup>1</sup>

### **Court Will Address Circuit Split on Whether Section 2462’s Five-Year Statute of Limitations Applies to SEC Claims for Disgorgement**

Pursuant to 28 U.S.C. § 2462, the SEC and other federal government entities may not bring any “action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture” more than five years after the claim first accrued.

In *SEC v. Graham*, 823 F.3d 1357 (11th Cir. 2016), the Eleventh Circuit held that Section 2462’s limitations period applies to SEC claims for disgorgement. The court reasoned that disgorgement is a type of “forfeiture” within the meaning of Section 2462.

1. The Court had previously granted certiorari with respect to this same question in *IndyMac*. However, the Court subsequently dismissed the writ of certiorari as improvidently granted in light of a pending settlement in the case.

Several months later, the Tenth Circuit expressly disagreed with the Eleventh Circuit and held that Section 2462 does not apply to SEC claims for disgorgement. *SEC v. Kokesh*, 834 F.3d 1158 (10th Cir. 2016). The Tenth Circuit found that when “read in the context of government causes of action,” the word “forfeiture” was intended to refer to the historical meaning of that term: “an in rem procedure to take tangible property used in criminal activity.” The Tenth Circuit concluded that “[t]he nonpunitive remedy of disgorgement does not fit” in that category.<sup>2</sup>

The Supreme Court granted certiorari to review the Tenth Circuit’s decision in *Kokesh* to determine whether Section 2462 reaches SEC claims for disgorgement.

### **First Circuit: Companies Need Not Disclose “Every Conceivable Stumbling Block” That May Interfere with Meeting Estimated Timelines**

On January 9, 2017, the First Circuit held that “[t]he securities laws do not make it unlawful for a company to publicize an aggressive timeline or estimate for a proposed action without disclosing every conceivable stumbling block to realizing those plans.” *Ganem v. InVivo Therapeutics Holdings Corp.*, 845 F.3d 447 (1st Cir. 2017) (Lipez, J.).

In the case before the court, plaintiffs alleged that a spinal therapy company’s statements concerning the projected timeline for a preliminary human study were false and misleading because defendants failed to disclose “the FDA’s conditions, recommendations, and requirement[s]” for that study. Plaintiffs contended that the FDA’s guidance “inevitably prevented [the company] from following through on its stated timeline.”

The First Circuit found plaintiffs alleged no facts demonstrating that defendants could not comply with the FDA’s suggestions and requirements “within the proposed timeline, a necessary showing for the statements to have been misleading when made.” The court

2. Both the First Circuit and the D.C. Circuit have also held that Section 2462 does not apply to SEC claims for disgorgement. See *SEC v. Tambone*, 550 F.3d 106 (1st Cir. 2008); *Riordan v. SEC*, 627 F.3d 1230 (D.C. Cir. 2010).

explained that plaintiffs were “left only with the inference that because, in retrospect, the test lagged significantly behind the proposed timeline, the timeline must have always been impossible to achieve.” The First Circuit rejected plaintiffs’ contention as an allegation of “fraud by hindsight.” The court explained that “while greater clairvoyance might have led [the company] to propose a more conservative timeline, [the company’s] failure to make such perceptions does not constitute fraud.”

## Ninth Circuit: CEO’s Failure to Comply with “Aspirational” Corporate Ethics Code Does Not Give Rise to a Claim for Securities Fraud Under Section 10(b) and Rule 10b-5

On January 19, 2017, the Ninth Circuit held that a CEO’s violation of the company’s ethics code did not give rise to a claim for securities fraud under Section 10(b) and Rule 10b-5 on the grounds that corporate ethics codes are “inherently aspirational.” *Retail Wholesale & Dep’t Store Union Local 338 Ret. Fund v. Hewlett-Packard*, 845 F.3d 1268 (9th Cir. 2017) (Christensen, J.).<sup>3</sup> The court reasoned that holding otherwise “could turn all corporate wrongdoing into securities fraud.”

### Background

The case before the court concerned the CEO’s alleged misrepresentations regarding “the nature and scope of his relationship with” an independent contractor, as well as the [alleged] falsification of company expense reports for meals he had eaten with her. These incidents ultimately led to the CEO’s resignation.

Plaintiffs subsequently brought suit alleging that the CEO’s misconduct rendered the company’s ethics code materially misleading under Section 10(b) and Rule 10b-5. The Ninth Circuit observed that “several provisions” of the ethics code were “inconsistent” with the CEO’s actions, including representations that the company “maintain[s] accurate business records” and “create[s] business records that

accurately reflect the truth of the underlying transaction or event.” The court noted that the ethics code “contains similarly worded statements regarding: honesty; cooperation with investigators; using good judgment; [and] reporting misconduct.”

### Aspirational Statements Concerning Corporate Ethics Cannot Be Objectively False

The Ninth Circuit stated that it has not previously “addressed how to determine whether statements made in or about an ethical code are actionable representations if the ethical code is violated.” The court approached the issue in the case before it “by first analyzing falsity, to determine whether an ethical code and statements made about the code contain any misrepresentations of fact, and then, if there was a misrepresentation, determining its materiality—that is, its significance to stockholder decisionmaking.”<sup>4</sup>

The Ninth Circuit next turned to the language of the corporate code of conduct at issue. The court explained that “a code of conduct is inherently aspirational” and “expresses opinions as to what actions are preferable, as opposed to implying that all staff, directors, and officers always adhere to its aspirations.” The court found that statements in the code of conduct in question were “vague,” “subjective,” and “not capable of objective verification.” The court concluded that the corporate ethics statements could not constitute affirmative misrepresentations for Rule 10b-5 purposes. Notably, the Ninth Circuit emphasized that a “contrary interpretation” would be “simply untenable” because it would allow plaintiffs to frame virtually any claim of corporate wrongdoing as a securities fraud violation.

The Ninth Circuit rejected plaintiffs’ contention that the “context” of the facts at issue “transform[ed] what would otherwise be aspirational into statements capable of objective verification.” The court stated that “context more appropriately factors into the question of whether an alleged misrepresentation was material to investors,

3. The Honorable Dana L. Christensen, Chief District Judge for the U.S. District Court for the District of Montana, was sitting on the Ninth Circuit by designation.

4. The Ninth Circuit observed that “[w]here a complaint arises from ‘soft information,’ such as representations of compliance, the Sixth Circuit applies a wholly different analysis, considering scienter alongside materiality to determine whether a representation is an actionable misrepresentation.” *Id.* (citing *In re Omnicare, Inc. Sec. Litig.*, 769 F.3d 455 (6th Cir. 2014)).

not into whether a statement itself could be a misrepresentation.”

### **Alleged Misrepresentations in Corporate Ethics Codes Are Not Material**

After addressing the question of falsity, the Ninth Circuit then considered whether the alleged misrepresentations in the company’s ethics code were material. The court found it significant that the statements were promulgated pursuant to SEC regulations. The court determined that “[i]t simply cannot be that a reasonable investor’s decision would conceivably have been affected by [the company’s] compliance with SEC regulations requiring publication of ethics standards.”



### **Publication of a Corporate Ethics Code Does Not Trigger a Duty to Disclose Ethics Violations**

The Ninth Circuit also found meritless plaintiffs’ claim that the company had a duty to disclose ethics violations by its CEO. The court underscored that the ethics-related statements in question were “transparently aspirational.” The court found that “[t]he promotion of ethical conduct at [the company] did not reasonably suggest that there would be no violations of the [corporate code of conduct] by the CEO or anyone else.” In view of its finding that the ethics statements “did not create an impression of full compliance,” the court held that the company had no duty to disclose the “misuse of CEO authority and misbehavior” in violation of those statements.

## **New York Appellate Division: Approves Nonmonetary Settlement of Verizon Shareholder Class Action, and Expands the *Colt* Test for Evaluating a Proposed Nonmonetary Settlement of a Shareholder Class Action**

In considering whether to approve proposed class action settlements, New York courts have long applied the five *Colt* factors: “the likelihood of success, the extent of support from the parties, the judgment of counsel, the presence of bargaining in good faith, and the nature of the issues of law and fact.” *Matter of Colt Indus. Shareholders Litig.*, 155 A.D.2d 154 (N.Y. App. Div. 1st Dep’t 1990), *modified on other grounds* 77 N.Y.2d 185 (1991).

On February 2, 2017, the First Department of the New York Appellate Division expanded the *Colt* test to require consideration of two additional factors when evaluating proposed nonmonetary settlements of class action litigation: “whether the proposed settlement is in the best interests of the putative class as a whole, and whether the settlement is in the best interest of the corporation.” *Gordon v. Verizon Commc’ns*, 2017 WL 442871 (N.Y. App. Div. 1st Dep’t 2017) (Kahn, J.). The First Department applied this enhanced test to find that court approval was warranted for a proposed nonmonetary settlement of shareholder class action arising out of the acquisition of Vodafone Group’s stake in Verizon Wireless by Verizon Communications.

### **Courts Must Consider the Best Interests of the Shareholders and the Corporation When Evaluating a Proposed Nonmonetary Settlement**

At the outset of its analysis, the First Department observed that settlements of shareholder class action litigation without monetary awards to class members have become “increasingly disfavored” because they often “provide[] minimal benefits either to shareholders or to their corporations.” The court noted that both Delaware and New York courts have “call[ed] for the drastic curtailment of such class action [settlements].” While “some commentators



have opined that recent decisions ... may signal the extinction of ‘disclosure-only’ settlements,” the First Department stated that other commentators have suggested that courts “take a more balanced approach in evaluating nonmonetary class action settlements.”

The First Department explained that “a court conducting a settlement review in a putative shareholders’ class action has a responsibility to preserve the viability of those nonmonetary settlements that prove to be beneficial to both shareholders and corporations, while protecting against the problems with such settlements recognized since *Colt*, in order to promote fairness to all parties.” The court found that in light of the “changing circumstances and concerns surrounding nonmonetary settlements of class actions” in the 25 years since the *Colt* decision, “a revisiting of [the] five-factor *Colt* standard [was] warranted in order to effect an appropriately balanced approach to judicial review of proposed nonmonetary class action settlements.”

The First Department “refine[d]” the *Colt* standard to require consideration of two additional factors. First, “the agreed-upon disclosures, corporate governance reforms and any other forms of nonmonetary relief in a proposed settlement should be in the best interests of all of the members of the putative class of shareholders.” Second, “the proposed settlement should be in the best interest of the corporation.” The court made it clear that “the lack of a monetary or quantifiable benefit to the corporation does not necessarily preclude such a finding.”

## Proposed Nonmonetary Settlement of the Verizon Shareholder Class Action Meets the First Department’s Enhanced Standard

“Viewing in totality the five established *Colt* factors and the two [new] factors,” the First Department held that the proposed nonmonetary settlement of the Verizon shareholder class action “meets the enhanced standard” for court approval. The court found that “each of the five factors set forth ... in *Colt* weighs in favor of the proposed settlement.”<sup>5</sup>

The court then considered “whether the key aspects of the proposed settlement would benefit the Verizon shareholders.” The court determined that the additional disclosures “provided some benefit to the shareholders.”<sup>6</sup> However, the court found the “most beneficial aspect of the proposed settlement to the shareholders ... was its inclusion of a fairness opinion requirement, mandating that in the event that Verizon engages in a transaction involving the sale or spin-off of assets of Verizon Wireless having a book value of in excess of \$14.4 billion, Verizon would obtain a fairness opinion from an independent financial advisor, or, in the case of a spin-off, financial advice from an independent financial advisor.” The court found that “having such a corporate governance reform in place to safeguard the valuation of corporate assets in the event of such a sale constitutes a sufficient benefit to the putative class of shareholders as a whole to warrant approval of the proposed settlement in this case, under the circumstances presented.”

Finally, the court addressed the question of whether the proposed settlement was in

5. With respect to plaintiffs’ likelihood of success on the merits, the court noted that “plaintiff withdrew her claims for monetary damages upon recognizing that they would be difficult to prove at trial.” As to “the extent of support from the parties for the proposed settlement,” the court noted that only 3 of Verizon’s 2.25 million shareholders filed objections to the settlement, and fewer than 250 shareholders opted out. With respect to the third and fourth factors, the court found that the parties were represented by competent and experienced counsel, and that good faith bargaining between the parties was presumed. Finally, as to the fifth *Colt* factor (“the nature of the issues of law and fact”), the court explained that the only remaining issue in dispute was “whether respondents breached their fiduciary duty by failing to make adequate disclosures to the shareholders in the preliminary proxy statement.” The court found “[t]his issue was more expeditiously resolved by the negotiated settlement process, in which the parties had the opportunity to identify and agree upon the areas in which further disclosure of information would be appropriate.”

6. The First Department expressly disagreed with the trial court’s determination that “additional information provided to shareholders in a disclosure must contradict what has been previously disclosed in order for the disclosure to be material.”

Verizon's best interests. The court found the "proposed settlement would resolve the issues in this case in a manner that would reflect Verizon's direct input into the nature and breadth of the additional disclosures to be made and the corporate governance reform to be included as part of the proposed settlement." Moreover, "by agreeing to the settlement, Verizon avoided having to incur the additional legal fees and expenses of a trial."

The First Department concluded that "approval of the proposed settlement [was] warranted" and further found that "the benefits to Verizon's shareholders achieved by plaintiff's counsel were sufficient to warrant an award of attorneys' fees." The court remanded the action to the trial court for consideration of an appropriate fee award.

### **Justice Moskowitz, Concurring, Expresses Her View That the Majority Should Not Have Expanded the *Colt* Test**

In a concurring opinion, Justice Moskowitz observed that "no party to this appeal ... argued that the existing five-factor *Colt* test is inadequate to the task of evaluating a class action settlement," and therefore "neither party ... had a chance to address" the court's new standard. Judge Moskowitz expressed her view that the First Department "should not [have] add[ed] a new factor to a long-established test without giving the parties the opportunity to brief the matter." Instead, she stated that the court should have "approve[d] the proposed class settlement under the rubric of the existing five-factor *Colt* test."

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