Simpson Thacher

Securities Law Alert

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Supreme Court: SEC Claims for Disgorgement in Enforcement Actions Are Subject to Section 2462's Five-Year Statute of Limitations

On June 5, 2017, the Supreme Court unanimously held that disgorgement in an SEC enforcement action for violation of the securities laws is a "penalty" subject to Section 2462's five-year statute of limitations. *Kokesh v. SEC*, 2017 WL 2407471 (2017) (Sotomayor, J.).

Section 2462 provides that SEC claims for civil monetary penalties must be brought within five years of the date the claim accrues. *Gabelli v. SEC*, 568 U.S. 442 (2013). Section 2462 states: "Except as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued."

The Court began its analysis by noting the history of the remedies sought by the SEC and the lack of statutory authorization for claims for disgorgement.[1] The Court then turned to Section 2462's text and determined what constitutes a "penalty." The Court defined a "penalty" as "a 'punishment, whether corporal or pecuniary, imposed and enforced by the State, for a crime or offen[s]e against its laws.'" *Id.* (quoting *Huntington v. Attrill*, 146 U.S. 657 (1892)). Applying this definition, the Court reasoned that a remedy's status as a penalty depends on two factors: first, whether the wrong it redresses is a public or private wrong and, second, whether the remedy is imposed to punish and deter, rather than to compensate a victim for his or her loss.

The Court found that disgorgement redresses a public wrong—a violation against the United States, not a particular individual. The Court also concluded that disgorgement is imposed

1. Congress has authorized disgorgement in the SEC's own administrative proceedings, 15 U.S.C. § 78u–2(e), and monetary penalties in civil suits, 15 U.S.C. § 77t(d). However, it has never specifically authorized disgorgement as a remedy in enforcement actions by the SEC. Disgorgement remains an implied equitable remedy to be defined and applied by the courts.

primarily as a deterrent. The Court observed that there is no statutory requirement that courts distribute disgorged funds to a defendant's victims and courts infrequently do so. Accordingly, the Court held that disgorgement "bears all the hallmarks of a penalty" and "[t]he 5-year statute of limitations in § 2462 therefore applies when the SEC seeks disgorgement."

Finally, the Court responded directly to the U.S. Government's argument that disgorgement is "remedial" rather than "punitive" because it merely restores the defendant to his or her position before the violation occurred. The Court noted that disgorgement sometimes leaves a defendant worse off than if he or she had not violated the securities laws and is therefore punitive.

Ninth Circuit: *American Pipe* Tolls the Class Claims of Unnamed Plaintiffs Even If Class Certification Was Denied in the Prior Timely-Filed Action on Substantive Grounds

On May 24, 2017, the Ninth Circuit held that the *American Pipe* tolling doctrine permits plaintiffs to bring a new class action after the expiration of the statute of limitations if they were unnamed plaintiffs in a timely-filed putative class action, even if class certification was denied in the prior action on substantive grounds and the new action asserts similar class claims. *Resh v. China Agritech*, 2017 WL 2261024 (9th Cir. 2017) (Fletcher, J.).[2] In *Korwek v. Hunt*, 827 F.2d 874 (2d Cir. 1987), the Second Circuit considered this same question and held that *American Pipe* "does not apply to permit a plaintiff to file a subsequent class action following a definitive determination of the inappropriateness of class certification."[3]

Pursuant to the *American Pipe* tolling doctrine, "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 & Construction Co. v. Utah*, 414 U.S. 538 (1974). The *American Pipe* Court held that "unnamed members of an uncertified class could intervene as individual plaintiffs in the individual suit that remained even if the statutory limitations period had passed." *Resh*, 2017 WL 2261024. In *Crown, Cork & Seal Co. v. Parker*, 462 U.S. 345 (1983), "the Supreme Court extended *American Pipe* to permit tolling not only for individual intervention in the named plaintiffs' original suit, but also for individual filing of entirely new suits." *Resh*, 2017 WL 2261024. The Ninth Circuit found that *American Pipe* and *Crown, Cork & Seal* left "open the question [of] whether such plaintiffs may bring a new suit as a class action."

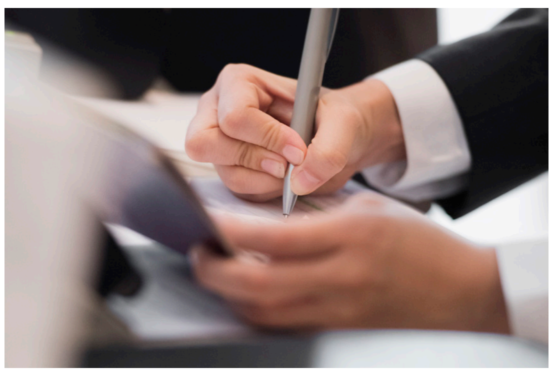
Relying on its prior decision in *Catholic Social Services v. INS*, 232 F.3d 1139 (9th Cir. 2000), the Ninth Circuit found that "the availability of a subsequent class action … depend[s] on the operation of preclusion and preclusion-related principles" and not general tolling principles. In *Catholic Social Services*, the Ninth Circuit held that unnamed members of a timely-filed putative class action could bring a class action after the expiration of the statute of limitations where certification was vacated in the prior class action based on an intervening change in the law. The *Catholic Social Services* court explained that the case before it did not involve "a statute of limitations question" but "rather, a question of whether plaintiffs whose individual actions are not barred may be permitted to use a class action to litigate those actions." 232 F.3d 1139. The Ninth Circuit in *Resh* found the *Catholic Social Services*

2. In *Resh*, the named plaintiffs had been unnamed members of two previously uncertified classes. Class certification was denied in the first action for failure to demonstrate market efficiency for purposes of the fraud-on-the-market presumption of reliance. Certification was denied in the second action based on the named plaintiffs' failure to meet Rule 23(a)(3)'s typicality requirement and class counsel's failure to meet the requirement of Rule 23(a)(4). The named plaintiffs in the *Resh* action contended that the denial of certification in the first action "was based upon the particular lead plaintiffs' experts' deficiencies rather than any suitability of the claims for class treatment." *Resh v. China Agritech*, 2014 WL 12599849 (C.D. Cal. Dec. 1, 2014). The district court found the *Resh* plaintiffs were essentially "argu[ing] that class certification was denied not because the claims were not suitable for class certification, but rather, because the plaintiffs *failed to establish* that the claims were not suitable for class certification."

3. Many courts have agreed with the Second Circuit's approach in *Korwek*. *See, e.g.*, *Yang v. Odom*, 392 F.3d 97 (3d Cir. 2004) ("[T]his Court agrees with the *Korwek* line of cases insofar as they refuse to toll limitations periods for substantively identical class actions in which the earlier putative class was denied certification because the substantive claims were inappropriate for class treatment. Our review of the case law of the Circuits which have addressed the issue reveals them to be unanimous on this point.").

holding was not limited only to "certain categories of class action denials," such as those based on the deficiencies of a class representative. 2017 WL 2261024. Rather, the *Resh* court determined that *Catholic Social Services* applies equally to cases in which class certification was previously denied based on a substantive deficiency in the class itself.

The *Resh* court found the Supreme Court's decision in *Shady Grove Orthopedic Assocs., P.A. v. Allstate Ins. Co.*, 559 U.S. 393 (2010) "confirmed" this interpretation. The *Shady Grove* Court held that "for purposes of class certification," courts must "look only to the criteria of Rule 23 and not to 'some other law.'" *Resh*, 2017 WL 2261024 (quoting *Shady Grove*, 559 U.S. 393). The *Resh* court reasoned that "[t]here is nothing in the certification criteria of Rule 23 that tells us to look to whether the statute of limitation has, or has not, been tolled."



The *Resh* court concluded that "permitting future class action named plaintiffs, who were unnamed class members in previously uncertified classes, to avail themselves of *American Pipe* tolling would advance the policy objectives that led the Supreme Court to permit tolling in the first place." The *Resh* court reasoned that this "rule creates no unfair surprise to defendants because the pendency of a prior class suit has already alerted them 'not only [to] the substantive claims being brought against them, but also [to] the number and generic identities of the potential plaintiffs who may participate in the judgment.'" *Id.* (quoting *American Pipe*, 414 U.S. 538). The *Resh* court explained that this "[t]he rule also promotes economy of litigation by reducing incentives for filing duplicative, protective class actions."

To the extent this rule might "lead to abusive filing of repetitive class actions," the *Resh* court stated that "the current legal system is adequate to respond to such a concern." The court explained that "if it is clear that a proposed class is not viable under Rule 23, as evidenced by an earlier federal court decision, potential future plaintiffs (or, more precisely, their attorneys) will have little to gain from repeatedly filing new suits." The court reasoned that "[a]ttorneys who are going to be paid on a contingency fee basis, or in some cases based on a fee-shifting statute, at some point will be unwilling to assume the financial risk in bringing successive suits."

Moreover, the *Resh* court found that "ordinary principles of preclusion and comity will further reduce incentives to re-litigate frivolous or already dismissed class claims, and will provide a ready basis for successor federal district courts to deny class action certification."[4]

Tenth Circuit: Plaintiffs Asserting ERISA Breach of Fiduciary Duty Claims Bear the Burden of Proving Loss Causation

On June 5, 2017, the Tenth Circuit held that the burden to prove loss causation in an ERISA breach of fiduciary duty action "falls squarely on the plaintiff." *The Pioneer Ctrs. Holding Co. Emp. Stock Ownership Plan and Tr. v. Alerus Fin.*, 2017 WL 2415949 (10th Cir. 2017) (McHugh, J.). The Tenth Circuit's decision deepened a circuit split on this issue.

Pursuant to 29 U.S.C. § 1109(a), "a fiduciary who breaches its duties under ERISA shall be personally liable for 'any losses to the plan resulting from each such breach.'" *Id.* (quoting 29 U.S.C. § 1109(a)). The Tenth Circuit noted that "[t]he plain language

4. The *Resh* court found the Supreme Court's decision in *Smith v. Bayer Corp.*, 564 U.S. 299 (2011) instructive on this point. In *Smith*, the Supreme Court held that class certification in a federal suit did not bar class certification in a parallel state court suit because the named plaintiffs in the state court suit were only unnamed members of the class in the federal court suit. In response to defendants' concern regarding the "serial relitigation of class certification," the Court suggested that "traditional principles of *stare decisis* and comity, combined with the possibility of removal under the Class Action Fairness Act or consolidation by the Panel on Multidistrict Litigation, were adequate to the task of protecting defendants." *Resh*, 2017 WL 2261024 (discussing *Smith*, 564 U.S. 299).

of § 1109(a) establishes liability for losses 'resulting from' the breach, which … indicates that there must be a showing of some causal link between the alleged breach and the loss plaintiff seeks to recover." The court underscored that "the statute is silent as to *who* bears the burden of proving a resulting loss."

The Tenth Circuit explained that "[w]here a statute is silent on burden allocation, 'the ordinary default rule [is] that plaintiffs bear the risk of failing to prove their claims.'" *Id.* (quoting *Schaffer ex rel. Schaffer v. Weast*, 546 U.S. 49 (2005)). The court recognized that "[t]here are exceptions to the default rule, such as when 'certain elements of a plaintiff's claim … can fairly be characterized as affirmative defenses or exemptions.'" *Id.* (quoting *Schaffer*, 546 U.S. 49). The court noted that "[a]nother exception to the default rule unique to the fiduciary duty question arises under the common law of trusts." The court stated that "[t]rust law advocates a burden-shifting paradigm whereby once a beneficiary has succeeded in proving that the trustee has committed a breach of trust and that a related loss has occurred, the burden shifts to the trustee to prove that the loss would have occurred in the absence of the breach."

The Tenth Circuit determined that none of these exceptions to the default rule apply to ERISA breach of fiduciary duty claims. The court stated that "nothing in the language of § 1109(a) or in its legislative history … indicates a Congressional intent to shift the burden to the fiduciary to disprove causation." Moreover, the court found no evidence "that suggests Congress intended to make the lack of causation an affirmative defense or an exemption to liability." The Tenth Circuit concluded that "causation is an element of the [ERISA breach of fiduciary duty] claim and that the plaintiff bears the burden of proving it."

The Tenth Circuit noted that "[t]he majority of federal circuits that have considered the issue … have refused to incorporate any burden shifting into ERISA breach of fiduciary duty claims."[5] However, the court observed that "some circuits have incorporated the common law of trust's burden shifting into ERISA breach of fiduciary duty claims."[6] The Tenth Circuit declined to "follow these decisions" and refused to "shift the burden to the fiduciary once the plaintiff establishes a prima facie showing of loss related to the breach."

The Tenth Circuit reasoned that "[w]here the plain language of the statute limits the fiduciary's liability to losses *resulting from* a breach of fiduciary duty, there seems little reason to read the statute as requiring the plaintiff to show only that the loss is *related* to the breach." Moreover, the court found that adopting "the burden-shifting framework could result in removing an important check on the otherwise sweeping liability of fiduciaries under ERISA."

Delaware Chancery Court: Merger Price Negotiated in a Robust Sales Process Is the Best Evidence of Fair Value Where the Company Did Not Prepare Management Projections in the Ordinary Course of Business

On May 26, 2017, the Delaware Chancery Court held that the deal price was the best evidence of the fair value of a company's shares where the merger was the result of a "robust pre-signing auction among informed, motivated bidders." *In re Appraisal of PetSmart*, 2017 WL 2303599 (Del. Ch. 2017) (Slights, V.C.). The court declined to rely on aggressive management projections that were not prepared in the ordinary course of business to calculate fair value using a discounted cash flow (DCF) analysis.

The court observed at the outset that the parties presented "two vastly different valuations … based on two binary views of the most reliable means by which to determine fair value—deal price versus a discounted cash flow analysis." The court noted that the $4.5 billion difference in the parties' proposed valuations left "much room for compromise." However, the court found no "path in the

5. *Id.* (citing *Wright v. Or. Metallurgical Corp.*, 360 F.3d 1090 (9th Cir. 2004); *Silverman v. Mut. Benefit Life Ins. Co.* 138 F.3d 98 (2d Cir. 1998); *Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995), *abrogated on other grounds by Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014); *Willett v. Blue Cross & Blue Shield of Ala.*, 953 F.2d 1335 (11th Cir. 1992)).

6. *Id.* (citing *Tatum v. RJR Pension Inv. Comm.*, 761 F.3d 346 (4th Cir. 2014); *McDonald v. Provident Indem. Life Ins. Co.*, 60 F.3d 234 (5th Cir. 1995); *Martin v. Feilen*, 965 F.2d 660 (8th Cir. 1992)).

evidence to reach a fair value somewhere between the values proffered by the parties." The court explained that accepting petitioners' proposed valuation "would be tantamount to declaring that a massive market failure occurred … that caused [the company] to leave nearly $4.5 billion on the table." The court found the evidence instead demonstrated that the company ran a "well-constructed and fairly-implemented auction process" in which none of the entities involved "colluded with or otherwise favored any bidder during the entirety of the process."

Although the court was "confident that the deal price in this case [was] a reliable indicator of fair value," the court nevertheless "approached the DCF valuations … with an open mind." The court explained that "[t]he first key to a reliable DCF analysis is the availability of reliable projections of future expected cash flows, preferably derived from contemporaneous management projections prepared in the ordinary course of business." The court emphasized that "if the data inputs used in the [DCF] model are not reliable, then the results of the analysis likewise will lack reliability."

In the case before it, the court found that the management projections were "not reliable statements of [the company's] expected cash flows" for several reasons. First, the company "had not historically created five-year projections prior to the creation of the auction-related projections." Second, the company's management "did have a history of preparing short-term forecasts that did not accurately predict [c]ompany performance." Third, the court found that "management did not believe that the projections they were preparing actually offered reliable projections of future performance." Lastly, the court noted that "the projections were created to be aggressive and extra-optimistic about the future of the [c]ompany" in order to "aid [the company] in its pursuit of strategic alternatives, including a sale of the [c]ompany." The court concluded that "[a]ny DCF analysis that relie[d] upon the [m]anagement [p]rojections … would produce 'meaningless' results."

The Securities Law Alert is edited by Paul C. Gluckow pgluckow@stblaw.com / +1-212-455-2653, Peter E. Kazanoff pkazanoff@stblaw.com /+1-212-455-3525 and Jonathan K. Youngwood jyoungwood@stblaw.com / +1-212-455-3539.

Simpson Thacher

New York

Paul C. Curnin
+1-212-455-2519
pcurnin@stblaw.com

Michael J. Garvey
+1-212-455-7358
mgarvey@stblaw.com

Susannah S. Geltman
+1-212-455-2762
sgeltman@stblaw.com

Paul C. Gluckow
+1-212-455-2653
pgluckow@stblaw.com

Nicholas S. Goldin
+1-212-455-3685
ngoldin@stblaw.com

Peter E. Kazanoff
+1-212-455-3525
pkazanoff@stblaw.com

Joshua A. Levine
+1-212-455-7694
jlevine@stblaw.com

Linton Mann III
+1-212-455-2654
lmann@stblaw.com

Joseph M. McLaughlin
+1-212-455-3242
jmclaughlin@stblaw.com

Lynn K. Neuner
+1-212-455-2696
lneuner@stblaw.com

Michael J. Osnato, Jr.
+1-212-455-3252
michael.osnato@stblaw.com

Thomas C. Rice
+1-212-455-3040
trice@stblaw.com

Mark J. Stein
+1-212-455-2310
mstein@stblaw.com

Alan C. Turner
+1-212-455-2472
aturner@stblaw.com

Craig S. Waldman
+1-212-455-2881
cwaldman@stblaw.com

George S. Wang
+1-212-455-2228
gwang@stblaw.com

David J. Woll
+1-212-455-3136
dwoll@stblaw.com

Jonathan K. Youngwood
+1-212-455-3539
jyoungwood@stblaw.com

Los Angeles

Michael D. Kibler
+1-310-407-7515
mkibler@stblaw.com

Chet A. Kronenberg
+1-310-407-7557
ckronenberg@stblaw.com

Palo Alto

Alexis S. Coll-Very
+1-650-251-5201
acoll-very@stblaw.com

James G. Kreissman
+1-650-251-5080
jkreissman@stblaw.com

Washington, D.C.

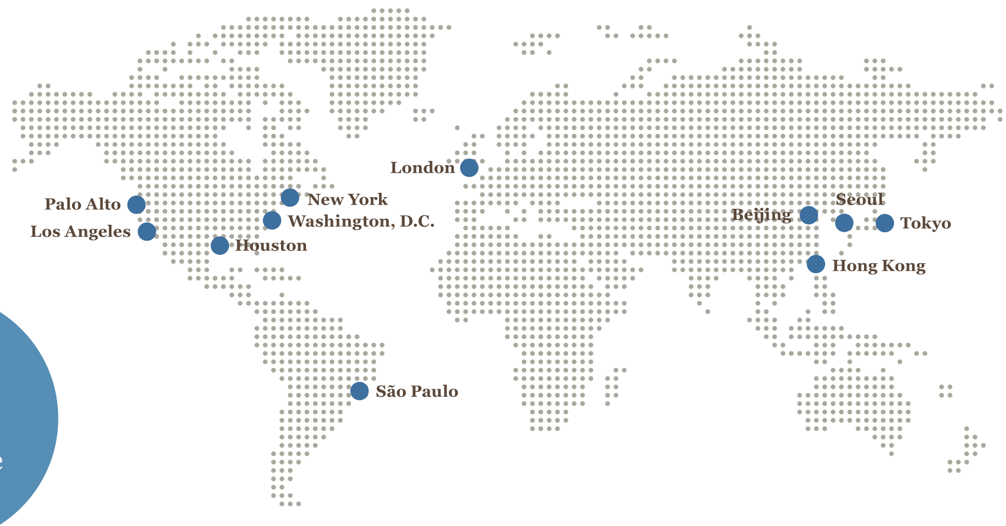
Jeffrey H. Knox
+1-202-636-5532
jeffrey.knox@stblaw.com

Cheryl J. Scarboro
+1-202-636-5529
cscarboro@stblaw.com

Peter C. Thomas
+1-202-636-5535
pthomas@stblaw.com

Simpson
Thacher

Simpson
Thacher
Worldwide



UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
25th Floor, West Tower
Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000