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Securities Law Alert

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– The Legal 500

Supreme Court: Duty to Monitor ERISA Plan Investments and Remove Imprudent Ones Not Satisfied by Offering Low-Cost Investments as Plan Options

On January 24, 2022, the Supreme Court unanimously vacated the Seventh Circuit's judgment that was in favor of defendant plan fiduciaries in a lawsuit where ERISA plan participants alleged that defendants violated their duty of prudence by failing to remove imprudent investments from the plans' offerings. *Hughes v. Northwestern*, 142 S.Ct. 737 (2022) (Sotomayor, J.). The Court disagreed with the Seventh Circuit's conclusion that defendants offering plaintiffs' preferred type of low-cost investments as plan options eliminated any concern that other plan options were imprudent. The Court held that "[s]uch a categorical rule is inconsistent with the context-specific inquiry that ERISA requires and fails to take into account respondents' duty to monitor all plan investments and remove any imprudent ones."

Background

Petitioners, participants in two employee retirement plans, commenced this litigation alleging that respondents, their plan administrators, violated their fiduciary duty of prudence under ERISA by: (i) offering too many investment options, which caused participant confusion and poor investment decisions; (ii) offering retail share classes of mutual funds and annuities rather than institutional share classes, which resulted in higher fees; and (iii) failing to monitor and control recordkeeping fees. The district court granted respondents' motion to dismiss and denied leave to amend. The Seventh Circuit affirmed.

The Court Examines the Duty of Prudence Under *Tibble v. Edison International*

The Court began its analysis by discussing *Tibble v. Edison International*, 575 U. S. 523 (2015), where the Court interpreted a plan fiduciary's duty of prudence under ERISA. In *Tibble*, plaintiffs similarly alleged that the plan fiduciaries had offered higher priced retail-class mutual funds as plan investments when lower priced institutional-class mutual funds were available. The Court in *Tibble* concluded that plaintiffs had identified a potential violation because "a fiduciary is required to conduct a regular review of its investment." The Court further determined that this duty is a "continuing" one and that "a plaintiff may allege that a fiduciary breached the duty of prudence by failing to properly monitor investments and remove imprudent ones."

Failing to Remove an Imprudent Investment From a Plan Within a Reasonable Time Could Breach the Duty of Prudence

Applying *Tibble*'s discussion of the duty to monitor plan investments, the Court determined that petitioners' allegation—that respondents failed to remove imprudent investments from the plans' offerings—"must be considered in light of the principles set forth in *Tibble* to determine whether petitioners have stated a plausible claim for relief." The Court noted that the Seventh Circuit did not apply *Tibble*'s guidance and instead focused on "a fiduciary's obligation to assemble a diverse menu of options." The Seventh Circuit determined that the fiduciary's provision of "an adequate array of choices," including choices that petitioners wanted, precluded petitioners' claims.

However, the Court found that "[t]he Seventh Circuit erred in relying on the participants' ultimate choice over their investments to excuse allegedly imprudent decisions by respondents." The Court observed that the Seventh Circuit's exclusive focus on investor choice elided the duty to properly monitor investments and remove imprudent options. The Court held that fiduciaries could breach their duty if they "fail to remove an imprudent investment from the plan within a reasonable time[.]" The Court stated that on remand, "the Seventh Circuit should consider whether petitioners have plausibly alleged a violation of the duty of prudence as articulated in *Tibble*[.]"

Central District of California: Denies Class Certification Because Unsponsored ADRs Were Purchased in a Foreign Transaction

On January 25, 2022, the Central District of California denied class certification in a putative securities fraud class action alleging violations of the Exchange Act against a corporation headquartered in Japan. [*Stoyas v. Toshiba*, 2022 WL 220920 (C.D. Cal. 2022) (Pregerson, J.)]. The court determined that the plaintiff pension funds could not establish that the unsponsored American Depositary Receipts ("ADRs")[1] of defendant were purchased in a "domestic transaction" as required under *Morrison v. National Australia Bank*, 561 U.S. 247 (2010). The court further determined that the investment manager of one of the funds (and

1. Unsponsored ADRs are implemented by a depositary bank without the cooperation of the issuing foreign company.

by extension, that fund) incurred irrevocable liability in Japan when the investment manager's broker acquired the shares of defendant's common stock on the Tokyo Stock Exchange.

Background

Plaintiffs alleged that one of the pension funds purchased shares of unsponsored ADRs of defendant on the over-the-counter ("OTC") market[2] in the United States. The fund accessed the OTC market through its investment manager, which placed a buy order for the unsponsored ADRs through its broker. The broker then purchased the ADRs for the fund on the OTC market. Notably for the outcome of the case, before the ADRs were available to purchase on the OTC market, the broker had to purchase the defendant's common stock on the Tokyo Stock Exchange to be converted into ADRs.

After commencing this litigation, plaintiffs moved to certify a class of securities purchasers[3] under Federal Rule of Civil Procedure 23. Defendant argued that plaintiffs could not satisfy the typicality requirement under Rule 23(a) with respect to the Exchange Act claims, because, unlike the members of the proposed class, the fund did not acquire defendant's securities in the United States.

Class Certification Depends on Whether a "Domestic Transaction" Occurred Under the Second Prong of *Morrison*

Beginning its analysis, the court explained that under *Morrison*, "to state a fraud claim under the Exchange Act, fraudulent statements or omissions must be made in connection with the purchase or sale of (i) a security listed on an American stock exchange or (ii) the purchase or sale of any other security in the United States." Because unsponsored ADRs only trade on the OTC market, which is not a domestic stock exchange, the court stated that the typicality issue depends on whether a "domestic transaction" occurred. Defendant argued that the fund acquired its shares as common stock in Japan, and therefore the relevant purchase was a foreign transaction.

Whether a Domestic Transaction Occurred Depends on Where Irrevocable Liability to Take and Pay for the ADRs Occurred

The court pointed out that in 2018 the Ninth Circuit addressed the domesticity issue in this case, on appeal from the first motion to dismiss, by adopting the Second Circuit's "irrevocability test" from *Absolute Activist Value Master Fund v. Ficeto*. *Stoyas v. Toshiba*, 896 F.3d 933 (2d Cir. 2018). Applying the test, the Ninth Circuit examined whether plaintiffs alleged sufficient facts to support an inference that the fund purchased the unsponsored ADRs in a domestic transaction. Interpreting the Ninth Circuit's decision, the court observed that the "test focuses squarely on '*where* the purchaser incurred irrevocable liability to take and pay for the securities[,]" which can "determine the locus of a securities purchase or sale."

The court held that the fund incurred irrevocable liability to take and pay for the ADRs in Japan, not in the United States. The court took issue with plaintiffs' approach, stating that it "ascribes little importance to the first step in the ADR conversion process: the purchase of [defendant's] common stock. Plaintiffs' argument glosses over the fact that [the fund's] ability to acquire ADRs was contingent upon the purchase of underlying shares of common stock that could be converted into ADRs." The court found that the evidence indicated that the broker executed the purchase of defendant's common stock for conversion, on behalf of

2. The OTC market is where securities are traded via a broker-dealer network, as opposed to on a centralized exchange.

3. The class of securities purchasers was defined as: "All persons who purchased securities listed under the [corporation's] ticker symbols . . . between May 8, 2012 and November 12, 2015 using the facilities of the OTC Market ('American Securities Purchasers')[.]"

the investment manager for the fund. The court determined that once the broker fully executed the purchase of the common stock on the Tokyo Stock Exchange, the fund was "logically and legally" bound to take and pay for the ADRs, once converted. Accordingly, the transaction was not domestic.

Northern District of California: Dismissal Denied as Reasonable Minds Could Differ on Whether "Technical and Narrow" Disclosures Were Sufficient to Reduce the Risk of Misleading Investors

On January 14, 2022, the Northern District of California largely denied the dismissal of a putative securities class action alleging that a solid-state battery manufacturer and certain of its executives misrepresented that the testing conditions of the company's batteries were not compromised and that the testing condition disclosures were insufficient to reduce the risk of misleading investors to "nil." *In re Quantumscape Sec. Class Action Litig.*, 2022 WL 137729 (N.D. Cal. 2022) (Orrick, J.). The court found that the testing data disclosures "were certainly extensive and may well weaken or even defeat the plaintiffs' case at a later stage when a factfinder can weigh them contextually." However, at the motion to dismiss stage, the court held that it "cannot conclude that the adequacy of the disclosure is so obvious that reasonable minds could not differ about whether the statements were misleading."

Background

Plaintiffs alleged that defendants repeatedly falsely represented that their solid-state batteries had overcome certain well-known technical challenges, which prevented their successful commercialization, and that they were comparable to or outperformed conventional batteries. Plaintiffs also alleged that defendants' tests were "compromised" to make their batteries' performance look more promising than it was, and that their batteries performed meaningfully worse than conventional batteries. After plaintiffs' lawsuits were consolidated, defendants moved to dismiss.

"Technical and Narrow" Disclosures May Not Render "Categorical" Statements Non-Misleading

Defendants claimed that their statements[4] were not actionable because the testing methodologies and conditions were accurately disclosed. Defendants further argued that the testing statements amounted to interpretations of the data. Citing the standard used by the Supreme Court in *Virginia Bankshares v. Sandberg*, 501 U.S. 1083 (1991), plaintiffs argued that because defendants affirmatively represented that the conditions were not compromised when the conditions were in fact compromised, "the disclosure of test conditions were insufficient to reduce the risk of misleading investors to 'nil' especially where it would take an expert to know that the test conditions were compromised."

The court stated that it could not conclude that the adequacy of the disclosures was so obvious that reasonable minds could not differ about whether the overall statements were misleading. The court noted that the disclosures revealed particular information (such as discrete testing conditions), but the allegedly misleading statements also included "broader, more categorical statements." The court stated that it could not "definitively say that these more categorical statements would be rendered entirely non-misleading by the far more technical and narrow disclosures

4. Specifically, that the solid-state batteries were tested with uncompromised conditions/in real-world conditions; that, based on those test results, the technical challenges had been solved; and that, consequently, the batteries were ready for broader commercialization if production could be ramped up and the batteries could be layered.

that [defendants] rel[y] on." The court stated that it was reasonable to think that investors were entitled to rely on the unequivocal representation that the testing results were not compromised. Citing *Virginia Bankshares*, the court determined that, given the overall "mixture" of information, it could not say that defendants' disclosure of hyper-technical testing details would "discredit" the allegedly misleading statement (that others used compromised conditions but defendants did not) "so obviously that the risk of real deception *drops to nil*." The court similarly determined that the overall mix of information concerning the representation that the technical challenges had been solved did not lead it to conclude that the risk of deception was "nil."

New York Supreme Court: Rejects Proposed $300 Million Settlement in Derivative Lawsuit on Fairness Grounds

On December 10, 2021, the New York Supreme Court denied a proposed $300 million settlement in a closely watched shareholder derivative lawsuit alleging that the controlling shareholder defendants[5] defrauded the minority shareholders of a NYSE-listed Chinese company incorporated in the Cayman Islands. [*In re Renren Derivative Litig.*, 2021 WL 5873150 (N.Y. Sup. Ct. 2021) (Borrok, J.)]. Citing fairness concerns, the court held that the proposed settlement "cannot be approved as a settlement to a derivative action structured with direct payments to certain minority shareholders but excluding relevant injured minority shareholders." Specifically, the court took issue with plaintiffs' counsel's argument that only his clients should be paid and not all of the minority shareholders who were harmed, pointing out that plaintiffs were certain of the minority shareholders that are entitled to payment.

The parties entered into the stipulation of settlement in October 2021. It was notable due to both its record-breaking size and for creating a rare direct cash payment to the minority shareholders totaling *at least* $300 million. The proposed settlement was subject to a "true up" process that could have increased the ultimate payment amount depending on the final determination of the number of shares and American Depositary Shares held by non-defendants.

In rejecting the proposed settlement, the court explained that having undertaken to make a claim on behalf of all minority shareholders, plaintiffs may not limit the rewards reaped by this action to themselves. The court observed that this would be "antithetical" to the concept of the derivative action. Citing *Benedict v. Whitman Breed Abbott & Morgan*, 910 N.Y.S.2d 474 (N.Y. App. Div. 2010), the court concluded that "the settlement as structured is not fair and reasonable to the effected shareholders and when taken as a whole is 'so unfair on its face to preclude judicial approval[.]'"

By way of background, the defendant company became a major social media company in China after a prominent U.S. social media company was banned there. This development led to interest from Western investors and the company's U.S. IPO, which raised over $777 million. The lawsuit arose when plaintiffs claimed that defendants misrepresented, in soliciting its IPO, how the company planned to use the IPO proceeds and by seeking personal financial benefits. Plaintiffs alleged that the company had invested its 2011 NYSE IPO proceeds towards a number of ventures and became a *de facto* venture capital fund. Plaintiffs further alleged that defendants defrauded the company and its minority shareholders out of over $500 million in company investment

5. The company's CEO/board Chair, certain directors, controlling shareholders and the financial advisor for a special committee of the board. The complaint alleged that together defendants controlled a majority of the company's stock.

assets by spinning off the company's assets into a private company in exchange for an undervalued cash dividend. Plaintiffs asserted derivative claims under Cayman law and New York law in connection with the spin-off.

In May 2020, the New York Supreme Court denied defendants' motions to dismiss and held that plaintiffs had standing to bring derivative claims under Cayman law under the "fraud on the minority" exception established in the seminal English case, *Foss v. Harbottle* (2 Hare 461 [1843]).[6] *In re Renren Derivative Litig.*, 127 N.Y.S.3d 702 (N.Y. Sup. Ct. 2020). The court also held that it had personal jurisdiction over defendants based on their significant New York activities. In March 2021, the Appellate Division unanimously affirmed that there was proper personal jurisdiction and standing to pursue Cayman law derivative claims in New York against the company and its directors. *In re Renren*, 140 N.Y.S.3d 701 (N.Y. App. Div. 1st Dept. 2021). The parties reached the proposed settlement, now rejected, following the Appellate Division's decision.

6. Shareholders do not have standing to pursue derivative litigation under Cayman law unless they can meet one of the four exceptions first articulated in *Foss*. To proceed, a shareholder must show that the conduct: (1) infringed on the shareholder's personal rights; (2) would require a special majority to ratify; (3) qualifies as a fraud on the minority; or (4) consists of an *ultra vires* act.

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