Simpson Thacher

Securities Law Alert

Year in Review:

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- Significant Delaware Supreme Court Decisions

2020

Simpson Thacher's securities litigation team has "a deep bench with top talent, and their young lawyers and associates provide a depth of experience."

–Chambers USA

Supreme Court Decisions and Developments

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

On June 22, 2020, in [*Liu v. SEC*, 140 S. Ct. 1936 (2020) (Sotomayor, J.)](), the Supreme Court resolved the question it raised but left open 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*, the petitioners argued that disgorgement was not an equitable remedy, and therefore, not within the statutory authorization. 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 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 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."

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

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."

"Actual Knowledge" Requirement for the Three-Year Statute of Limitations for ERISA Breach of Fiduciary Duty Claims Is Not Satisfied Merely by the Plaintiff's Receipt of the Relevant Disclosures

ERISA breach of fiduciary duty claims are subject to a six-year statute of limitations unless the plaintiff "had actual knowledge of the breach or violation," in which case a three-year statute of limitations applies. 29 U.S.C. § 1113(2). On February 26, 2020, the Supreme Court held that an ERISA plaintiff does not necessarily have "actual knowledge" of information contained in disclosures that he received but did not read or recall reading. *Intel Corp. Inv. Pol'y Comm. v. Sulyma*, 140 S. Ct. 768 (2020) (Alito, J.). The Court found that in order to satisfy Section 1113(2)'s "actual knowledge" requirement, "the plaintiff must in fact have become aware of that information."

In a unanimous decision authored by Justice Alito, the Court held that Section 1113(2)'s "actual knowledge" requirement demands "more than evidence of disclosure alone." The Court determined that "[Section] 1113(2) begins only when a plaintiff actually is aware of the relevant facts, not when he should be" based on the receipt of the relevant disclosures. The Court explained that "a given plaintiff will not necessarily be aware of all facts disclosed to him; even a reasonably diligent plaintiff would not know those facts immediately upon receiving the disclosure."

The Court rested its decision on the plain meaning of the phrase "actual knowledge." The Court found that the phrase "actual knowledge" refers to "[r]eal knowledge as distinguished from presumed knowledge or knowledge imputed to one." The Court explained that in order "to have 'actual knowledge' of a piece of information, one must in fact be aware of it." The Court found that "if a plaintiff is not aware of a fact, he does not have 'actual knowledge' of that fact however close at hand the fact might be."

Supreme Court Agrees to Hear Class Action Certification Challenge

On December 11, 2020, the Court announced that it would hear a bank's challenge to the certification of an investor class in a long-running securities fraud case. *Goldman Sachs Grp. v. Ark. Teacher Ret. Sys.*, (No. 20-222). The highly anticipated decision, expected before the end of the Court's current term in June, concerns the ability of defendants to rebut the presumption of shareholder reliance and the extent to which defendants in opposing class certification can rely on materiality.

On April 7, 2020, the Second Circuit affirmed the district court's certification of a class, which accused defendant of misrepresenting its ability to identify and address conflicts of interest. *Ark. Teacher Ret. Sys. v. Goldman Sachs Grp.*, 955 F.3d 254 (2d Cir. 2020) (Wesley, J.).[2] Plaintiffs alleged that certain "general statements" (for example, "[o]ur clients' interests always come first[]") were false because defendant "made them while knowing that it was riddled with undisclosed conflicts of interest." The Second Circuit held that the district court did not "abuse[] its discretion by certifying the shareholder class, either on legal grounds or in its application of the *Basic* presumption." This refers to the presumption of classwide reliance on the alleged misrepresentations that plaintiffs must invoke for a private securities lawsuit to proceed as a class action, which was first recognized in *Basic v. Levinson*, 485 U.S. 224 (1988). In their cert petition, defendants asked the Court to address two questions. First, whether a defendant may rebut the *Basic* presumption by pointing to the generic

2. Simpson Thacher filed an *amici curiae* brief with the Second Circuit on behalf of the Securities Industry and Financial Markets Association and the Bank Policy Institute in support of defendants-appellants.

nature of the alleged misrepresentations to show that the statements had no impact on the price of the security, even though that evidence is also relevant to the substantive element of materiality. Second, whether a defendant seeking to rebut the *Basic* presumption has only a burden of production or also the ultimate burden of persuasion. Commentators have noted that in practice the *Basic* presumption is rarely rebutted and that class certification often causes defendants to settle rather than risk further litigation.

Circuit Court Decisions Addressing Section 10(b) Claims

First Circuit: Disclosure of FDA Concerns Undercuts Any Inference of Scienter

On April 9, 2020, the First Circuit affirmed the dismissal of a securities fraud action alleging that a biopharmaceutical company failed to disclose "material facts about [the company's] manufacturing problems and the impact those problems were likely to have on the FDA's approval" of the company's ocular pain drug. *Mehta v. Ocular Therapeutix*, 955 F.3d 194 (1st Cir. 2020) (Stahl, J.). The First Circuit found it significant that defendants fully disclosed the FDA's concerns regarding certain manufacturing issues. The court held that these disclosures belied any inference of scienter.

The First Circuit held that plaintiffs' "allegations do not give rise to a strong inference of scienter." The court noted that the company's 2016 and 2017 Forms 10-K "disclosed receipt of the February 2016 Form 483, described its relevance to [the company's] manufacturing capabilities, and warned of its implications." The 2016 and 2017 Forms 10-K also specifically warned investors that resolution of the issues identified in the February 2016 Form 483 was a prerequisite for FDA approval. The First Circuit found "[t]hese informative disclosures about the nature and consequences of the February 2016 Form 483 undercut any inference that defendants intentionally or recklessly misled investors" concerning the company's compliance with "current Good Manufacturing Practices" regulations.

Eighth Circuit: Affirms the Dismissal of a Securities Fraud Action Against a Major Retailer for Failure to Allege Scienter

On April 10, 2020, the Eighth Circuit affirmed the dismissal of a securities fraud action alleging that a major retailer and several of its executives made misstatements concerning the company's ultimately unsuccessful foray into the Canadian market. *In re Target Corp. Sec. Litig.*, 955 F.3d 738 (8th Cir. 2020) (Kobes, J.). The Eighth Circuit determined that "[n]othing in the complaint makes a 'compelling' case for fraud." Rather, the court found "the more compelling inference" is that the company's executives "did not understand the magnitude of the problems they faced" with the Canadian stores.

The Eighth Circuit found that "none" of plaintiffs' allegations satisfied the scienter requirement. The Eighth Circuit found that "[t]he strongest, but still insufficient, allegation" concerned the company's May 2014 representation that the longer the

Canadian stores had been open, the better they were performing. Plaintiffs alleged that defendants must have known that this statement was false because in August 2014, the company "revealed that same-store sales had fallen more than 11% in Canada over the previous year." The Eighth Circuit stated that "financial deterioration alone is not enough to show fraud." The court explained that "the apparent incongruity" between the May 2014 statement and the August 2014 financial results was not sufficient to "show that the May 2014 statement was necessarily false, let alone that [company] executives knew it was false."

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*, 962 F.3d 405 (9th Cir. 2020) (Bress, 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."

Second Circuit: Reverses the Dismissal of a Securities Fraud Action Where the Allegations of a Material Omission Raised a Strong Inference of Recklessness

On August 3, 2020, the Second Circuit revived a putative securities fraud class action alleging that a real estate investment trust ("REIT") "misled investors by failing to disclose a $15 million working capital loan it made to one of its major tenants" in May 2017, which the tenant then used to make partial rent payments to the REIT. [*Setzer v. Omega Healthcare Invs.*, 968 F.3d 204 (2d Cir. 2020) (Wesley, J.)](). The Second Circuit found plaintiffs adequately alleged that the REIT's "decision not to disclose the [l]oan . . . in the context of its disclosures regarding [the tenant's] financial health" was "a sufficiently extreme departure from the standards of ordinary care to satisfy the [Private Securities Litigation Reform Act's] requirement for showing recklessness."

The Second Circuit held that the REIT "was duty-bound to disclose that its loan was the source of [the tenant's] rent payments." The court found that "by putting [the tenant's] rental payments in play, [d]efendants were required to speak accurately and completely." The court determined that "[t]he omission concealed the extent of [the tenant's] solvency problems: [the tenant] could not pay rent without borrowing from its landlord." The court concluded that "[t]he facts as alleged create a compelling inference that [d]efendants made a conscious decision to not disclose the [l]oan in order to understate the extent of [the tenant's] financial difficulties," particularly because "multiple analysts ho[n]ed in on [the tenant's] rental payments being key to [the REIT's] prospects."

Second Circuit: Revives a Securities Fraud Action Where Plaintiffs Adequately Pled Falsity and Loss Causation

On July 13, 2020, the Second Circuit reversed the dismissal of putative securities fraud class action claims based on its determination that plaintiffs adequately alleged falsity and loss causation as to certain challenged statements. [*Abramson v. NewLink Genetics Corp.*, 965 F.3d 165 (2d Cir. 2020) (Walker, J.)]. However, the Second Circuit affirmed the dismissal of claims challenging defendants' optimistic statements regarding the results of a clinical trial because the court found those statements were "unactionable puffery."

In September 2013, during a presentation for investors at a biotech conference, the company's President & Chief Medical Officer ("CMO") described the 24.1 month survival rate for participants in the company's Phase 2 trial as "remarkable." He stated that "all the major studies" show that "survival rates come between 15 to 19, 20 months. That's it." Then in March 2014, an analyst asked how the company's statistical assumptions would be impacted if it assumed that the control group lived for 24 or 25 months. The President & CMO responded that the company did not have "any reason to believe that median survival [rate] for these patients will be more than [the] low 20s." Plaintiffs alleged that the September 2013 and March 2014 statements were misleading because numerous significant studies "showed survival rates ranging from 25 months to 43 months."

With respect to the September 2013 statement, the court noted that the President & CMO did not "couch his representation of survival rates with prefatory language like 'I believe' or 'In my estimation.'" He instead presented a "categorical proposition," and "cited the results of all the major American studies" in support of his statement. The court found it significant that the statement was made "at an important conference for biotech investors." Given the context, the court determined that "[i]nvestors in attendance reasonably would not have interpreted his statement as a baseless, off-the-cuff judgment; instead, they would have credited his statement as researched and intentional, part of a well-prepared professional presentation." The Second Circuit held that the statement could lead "a reasonable investor" to believe that "no credible studies have shown resected pancreatic cancer patients to have survival rates higher than 20 months." The court found the March 2014 statement to be similarly misleading, "[b]oth because of its posture as a response to a specific question and its categorical nature."

Ninth Circuit: Whistleblower Complaint Filed by a Company Insider May Constitute a Corrective Disclosure

On October 8, 2020, the Ninth Circuit revived a securities fraud action that the district court had dismissed on loss causation grounds. [*In re BofI Holding Sec. Litig.*, 977 F.3d 781 (9th Cir. 2020) (Watford, J.)]. The Ninth Circuit held plaintiffs adequately alleged that a whistleblower complaint filed by a former employee constituted a corrective disclosure for loss causation purposes.

The Ninth Circuit held that "the relevant question for loss causation purposes is whether the market reasonably perceived [the whistleblower's] allegations as true and acted upon them accordingly." In the case before it, the court noted that the whistleblower's "descriptions of wrongdoing [were] highly detailed and specific, and they [were] based on firsthand knowledge that he could reasonably be expected to possess by virtue of his [former] position as a midlevel auditor" at the company. The court also found it significant that the stock price dropped more than 30% following the filing of the complaint. The court reasoned that "[a] price drop of that magnitude would not be expected in response to whistleblower allegations perceived as unworthy of belief." The court concluded that plaintiffs adequately alleged that the whistleblower complaint was a corrective disclosure.

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Significant Delaware Supreme Court Decisions

Federal Forum Selection Provisions for Securities Act Claims Are Facially Valid

On March 18, 2020, the Delaware Supreme Court held that forum selection provisions in certificates of incorporation requiring actions arising under the Securities Act of 1933 (the "Securities Act") to be filed in federal court are facially valid under Section 102(b)(1)[3] of the Delaware General Corporation Law. *Salzberg v. Sciabacucchi*, 227 A.3d 102 (Del. 2020) (Valihura, J.). The Court recognized that federal forum provisions "can provide a corporation with certain efficiencies in managing the procedural aspects of securities litigation following the United States Supreme Court's decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund*," 138 S. Ct. 1061 (2018), which held that state courts have concurrent jurisdiction over actions asserting Securities Act claims.

The Chancery Court based its decision on *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013), which held that companies may adopt forum selection bylaws requiring "internal affairs" litigation to be brought in Delaware Chancery Court. The Delaware Supreme Court found that "*Boilermakers* did not establish the outer limit of what is permissible under . . . Section 102(b)(1)." The Court explained that "[t]here is a category of matters that is situated on a continuum between the *Boilermakers* definition of 'internal affairs' and its description of purely 'external' claims," and held that that the federal forum provision in this case falls within "the universe of matters encompassed by Section 102(b)(1)." The Court found that claims under Section 11 of the Securities Act "are 'internal' in the sense that they arise from internal corporate conduct on the part of the Board and, therefore, fall within Section 102(b)(1)."

Approval of a "Flawed Transaction" After Consideration of Its Risks Does Not Give Rise to an Inference of Bad Faith

On January 13, 2020, the Delaware Supreme Court held that a board's approval of a "flawed transaction" that implicated the misappropriation of a competitor's confidential information did not give rise to an inference of bad faith, where "the directors considered the risks and nonetheless proceeded with the transaction." *McElrath v. Kalanick*, 224 A.3d 982 (Del. 2020) (Seitz, C.J.). The Court underscored that "there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties."

In the case, plaintiff stockholder filed suit against the company's directors claiming that they ignored an alleged theft of intellectual property and failed to investigate pre-closing diligence that would have revealed problems with a 2016 transaction. Defendant directors moved to dismiss under Court of Chancery Rule 23.1, asserting that plaintiff failed to make a demand on the board. The Court of Chancery dismissed the complaint, finding that a majority of the board could have fairly considered the demand. The Delaware Supreme Court affirmed, finding that a majority of the board was independent and disinterested "because it had no real threat of personal liability due to [the company's] exculpatory charter provision."

The Court explained that because of the exculpation clause in the company's Certificate of Incorporation, the directors could face personal liability only if "their conduct [was] motivated by an actual intent to do harm," or if there was "an intentional dereliction of duty." The Court emphasized that "[p]leading bad faith is a difficult task and requires that a director acted inconsistent[ly] with his fiduciary duties and,

3. Section 102(b)(1) provides that a company's certificate of incorporation may include: "Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders . . . if such provisions are not contrary to the laws of this State." 8 Del. C. § 102(b)(1).

most importantly, that the director knew he was so acting."

The Court concluded that "[t]he complaint's allegations do not lead to a reasonable inference that the board intentionally ignored the risks of the transaction." Here, the "board met to consider the [] acquisition," hired outside counsel and an investigative firm to conduct due diligence, listened to a presentation from the company's CEO, and "discussed the terms of the deal and its risks." The Court determined that "the board's failure to investigate further cannot be characterized fairly as an intentional dereliction of its responsibilities."

Chancery Court Did Not Err in Finding the Deal Price Was the Best Evidence of Fair Value Despite a Sales Process Described as "Not Perfect"

On October 12, 2020, the Delaware Supreme Court affirmed a Chancery Court decision holding that the deal price was the most reliable indicator of a metal mining company's fair value in an appraisal action, even though "[t]he sale process was not perfect." *Brigade Leveraged Cap. Structures Fund v. Stillwater Mining Co.*, 240 A.3d 3 (Del. 2020) (Montgomery-Reeves, J.). The Delaware Supreme Court further determined that the Chancery Court did not err in declining to adjust the deal price to account for an increase in the commodity price of the metal mined by the mining company. The Delaware Supreme Court explained that "fair value is just that, fair. It does not mean the highest possible price that a company might have sold for."

The Delaware Supreme Court observed that the Chancery Court "walked through each step of the sale process" and "found that there were objective indicia of reliability." While the Delaware Supreme Court acknowledged that there were "fewer indicia of fairness than [it] identified when reviewing the sales processes in *DFC*, *Dell* or *Aruba*, the [Chancery Court] did not abuse its discretion by determining that the objective indicia that were present provide a cogent foundation for relying on the deal price as a persuasive indicator of fair value."[4]

Because the Chancery Court "thoroughly analyzed the facts surrounding [the company's] sale in accordance with [Delaware Supreme Court] precedent," the Delaware Supreme Court declined to "second-guess" the Chancery Court's determination that "the deal price was a reliable indicator of [the company's] fair value."

4. Please click here to read our discussion of the Delaware Supreme Court's discussion in *Aruba*. (This discussion also addresses the Delaware Supreme Court's decisions in *DFC* and *Dell*.)

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