

# Morgan Lewis

**GLOBAL PUBLIC COMPANY ACADEMY**

## **SECURITIES LITIGATION AND ENFORCEMENT UPDATE**

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# THE RISE OF SECURITIES ACT CASES IN STATE COURT

# A Brief History of Federal Securities Law

- The Securities Act of 1933 (the “**Securities Act**” or “’33 Act”) imposes disclosure requirements on companies offering securities to the public and allows private plaintiffs to sue in either state or federal court. Unlike most federal statutes, the Securities Act bars removal of a case from state to federal court.
- The Securities Exchange Act of 1934 (the “**Exchange Act**” or “’34 Act”) regulates not the original issuance of securities but their subsequent trading. The Exchange Act also provides for enforcement through private actions, but federal courts have exclusive jurisdiction over those suits.
- In response to perceived abuses by plaintiffs in bringing cases under these statutes, Congress passed the Private Securities Litigation Reform Act (“**PSLRA**”) in 1995 which imposed new substantive and procedural hurdles. As a result, plaintiffs began bringing securities class actions in state court in an effort to escape the strictures under the PSLRA.
- To stem the shift from federal to state courts, Congress enacted the Securities Litigation Uniform Standards Act of 1998 (“**SLUSA**”) to further amend both Acts. SLUSA amended the Securities Act to eliminate jurisdiction in state court for certain securities class actions and to prohibit certain securities class actions arising under state law, and it empowered defendants to remove those suits to federal court, where they would then be dismissed.
- A **split** arose in federal and state courts as to whether these provisions of SLUSA apply to lawsuits brought *exclusively* under the Securities Act.

# The Supreme Court's Decision in *Cyan*

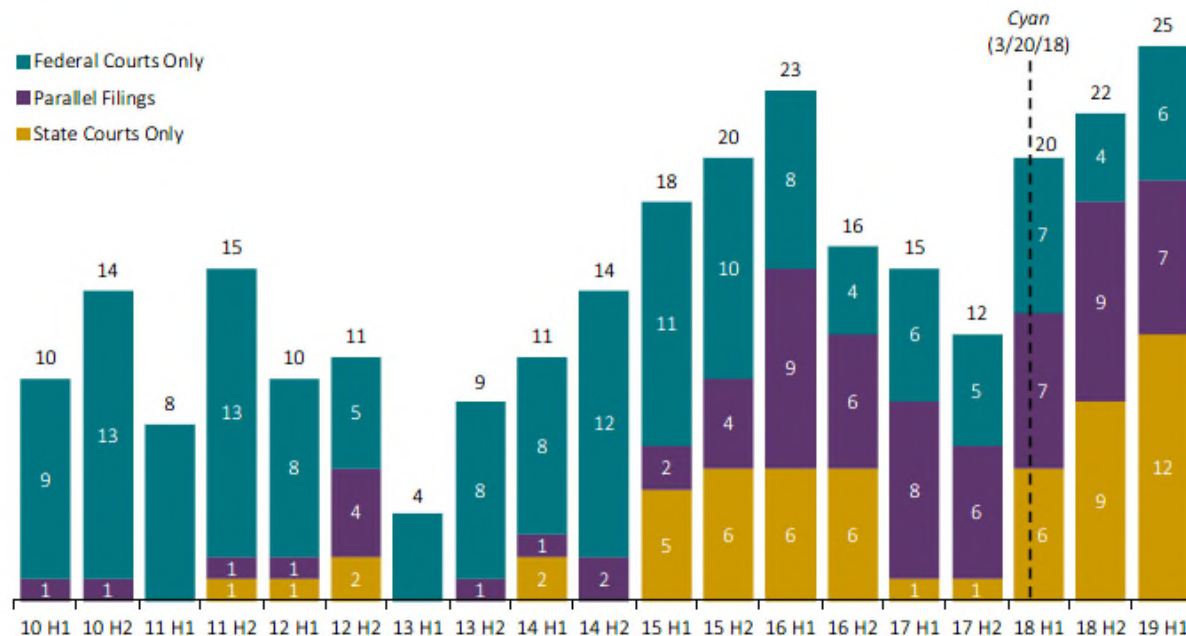
- In 2014, the Beaver County Employees Retirement Fund, a pension fund that purchased Cyan stock in the IPO, filed a class action in California Superior Court alleging only violations of the Securities Act. Cyan moved to dismiss, arguing that the Securities Act, as amended by SLUSA, deprived the court of jurisdiction over the action. The Superior Court rejected Cyan's argument and denied the motion, and the state appellate court denied review. The United States Supreme Court granted certiorari.
- On March 20, 2018, in *Cyan, Inc. v. Beaver County Employees Retirement Fund, et al.*, 138 S. Ct. 1061 (2018), the Supreme Court unanimously ruled that investors in securities offerings who assert class action claims under the Securities Act can bring those claims in state court if the action asserts only claims under the Securities Act, and defendants cannot remove the actions to federal court.
- The Court found that the petitioner's argument about the legislative history and purpose behind the various amendments to the Securities Act failed to overcome the statutory language (which Justice Alito commented was poorly drafted "gibberish" at argument). The Court acknowledged that SLUSA was a confusing statute and that it did not know why Congress declined to treat Securities Act class actions like Exchange Act class actions which must be brought in federal court, noting that "[i]f further steps are needed, they are up to Congress." *Cyan*, 138 S.Ct. at 1078.

# The Rise of Securities Act Cases in State Courts – Why Does It Matter?

- *“I’m sorry, I thought the whole purpose, the main purpose, of SLUSA was just that, to ensure that claims of this particular type were not covered under state law but covered under federal law. If I accept that that was the main purpose of Congress’s position, what difference does it make who adjudicates the claim if both courts are going to be bound by federal law?”*
  - Justice Sotomayor at oral argument in *Cyan*
- The theory is that plaintiffs are filing in state court to take advantage of lower pleading standards.
- This could lead to defendants facing increasingly complex and expensive litigation, and increase the risk of inconsistent rulings by state court judges unfamiliar with the Securities Act.

# The Rise of Securities Act Cases in State Courts: By The Numbers

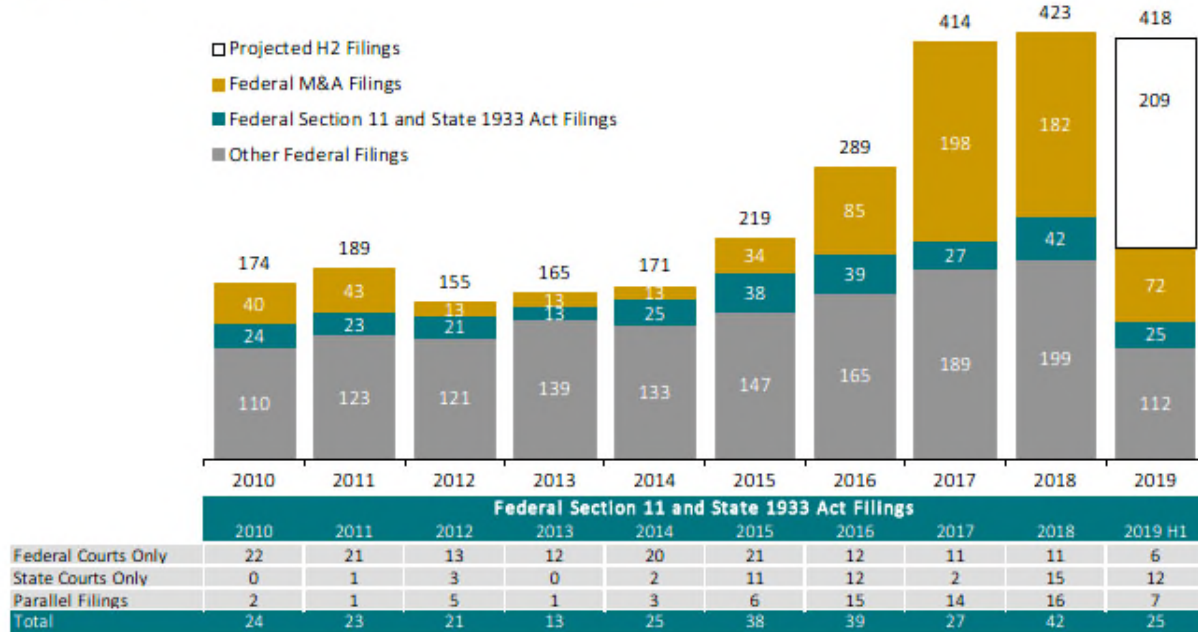
Figure 12: Pre- and Post-Cyan Semiannual Federal Section 11 and State 1933 Act Filings  
2010 H1–2019 H1



Source: Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse

# The Rise of Securities Act Cases in State Courts: By The Numbers

Figure 13: Federal Section 11 and State 1933 Act Class Action Filings by Venue  
2010–2019 H1



Source: Cornerstone Research and the Stanford Law School Securities Class Action Clearinghouse

# The Rise of Securities Act Cases in State Courts: By The Numbers

Appendix 3: 1933 Act Filings in State Courts

Year	1933 Act Filings in State Courts						
	California	New York	Texas	Massachusetts	Pennsylvania	Others	All
2010	1	0	0	0	0	0	1
2011	3	0	0	0	0	0	3
2012	5	0	0	0	0	2	7
2013	1	0	0	0	0	0	1
2014	5	0	0	0	1	0	6
2015	15	0	0	2	0	0	17
2016	19	0	1	1	0	6	27
2017	7	0	1	0	1	4	13
2018	16	13	0	0	0	5	34
2019 H1	5	7	2	1	1	3	19
Average (2010–2018)	8	1	0	0	0	2	12



# Cases Pending in Pennsylvania State Courts

- *Fir Tree Value Master Fund, LP, et al., v. Teva Pharmaceutical Industries Ltd., et al.*, No. 2018-19713-0, Montgomery County Court of Common Pleas (2018) – Petition to Dismiss on *Forum Non Conveniens* filed on October 16, 2018 (pending).
- *Aaron Taylor v. the Vanguard Group, Inc., et al.*, No. 01015, Court of Common Pleas of Philadelphia County (2018) – Preliminary Objections filed on July 1, 2019 (pending).
- *Plymouth County Retirement Association v. Livent Corporation, et al.*, No. 190501229, Court of Common Pleas of Philadelphia County (2019) – Motion to Dismiss and Preliminary Objections were filed on October 11, 2019 (pending), and Motion to Stay Discovery Pending Preliminary Objections was granted on October 21, 2019.
- *In re BrightView Holdings, Inc. Securities Litigation*, No. 2019-07222, Court of Common Pleas of Montgomery County (2019) - Petition to Dismiss or Stay on *Forum Non Conveniens* and Preliminary Objections were filed on August 12, 2019 (denied). Preliminary objections were overruled on November 6, 2019. Motion to Certify Class was filed on November 4, 2019 (pending). Motion for Protective Order to Enforce Automatic Discovery Stay was filed on October 16, 2019 (withdrawn).
- *City of Warren Police & Fire Retirement System v. USA Technologies, Inc., et al.*, No. 2019-04821-MJ, Chester County Court of Common Pleas (2019) – Petition to Stay was granted on September 20, 2019, staying proceedings pending final disposition of first-filed New Jersey Action.

## Recent State Court Stays In Favor Of Parallel Federal Action

- *OPKO Health, Inc. v. Lipsius*, Nos. 3D19-840 and 3D19-841, 2019 WL 4291682 (Fla. 3d DCA Sept. 11, 2019) – Reversing a denial of defendants’ motion to stay a subsequently-filed state court action in favor of a previously-filed federal action.
- *In re Sogou Inc. Securities Litigation*, No. 18CIV06699 (Cal. Super Ct. San Mateo Cty. Oct. 7, 2019) – Granting motion to stay on *forum non conveniens* grounds based on subsequently-filed federal action in New York.
- *Qudian Securities Litigation*, No. 651804/2018, 2018 WL 6067209 (N.Y. Cty. Super Ct. Nov. 14, 2018) – Granting motion to stay where five identical actions had also been filed in federal court, including one filed prior to the state court action.
- *In re Rewalk Robotics Ltd. Stockholder Litigation*, No. SUCV20163336BLS2, 2017 WL 7362342 (Mass. Super Ct. May 8, 2017) – After originally denying a motion to stay, the court granted renewed motion to stay after a second federal case that raised the same issues against the same parties was filed.

# Recent State Court Dismissals

- *Netshoes Sec. Litig. v. XXX*, No. 157435/2018, 2019 WL 3227251 (N.Y. Sup. Ct. July 16, 2019)
  - On July 16, 2019, Judge Andrew Borrock of the New York Supreme Court dismissed this post-*Cyan* securities suit, holding that plaintiffs failed to allege that the statement on which plaintiffs sought to rely relating to Netshoes' customer loyalty and past performance of the vitamin and supplements business were not false or misleading when made, and thus do not give rise to a securities claim.
- *City of Livonia Retiree Health and Disability Benefits Plan v. Pitney Bowes Inc., et al.*, No. X08-FST-CV-18-6038160-S (Conn. Super. Ct. May 17, 2019)
  - On October 24, 2019, the Court granted defendants' motion to strike plaintiff's allegation that defendants had an affirmative duty to disclose that lower equipment sales and margins in Pitney Bowes' Small and Medium Business Solutions would reduce Pitney Bowes' income in the third quarter of 2017 because "'trends,' as the term is used in the disclosure context, take place over a longer period of time than merely one quarter."
- *Yogina Rezco, et al., v. Xbiotech Inc., et al.*, No. D-1-GN-17-003063 (Travis Cty. Dist. Ct. Nov. 13, 2018)
  - The Court dismissed the case, agreeing with Xbiotech that statements in the prospectus adequately warned investors about uncertainties regarding the clinical trials at issue.
- These decisions represent a reality check for plaintiffs seeking an advantage at the motion to dismiss stage by filing in state court. By resorting to state court, plaintiffs will not necessarily avoid the kind of scrutiny to which securities suits are subject in federal court.

# Does the PSLRA Discovery Stay Apply?

- A key question in the aftermath of *Cyan* is whether the PSLRA's discovery stay applies to actions filed in state court. The *Cyan* Court did not address the applicability of the discovery stay provision found in the PSLRA on state courts. However, at least two other state courts have declined to stay discovery under the PSLRA since the Supreme Court decided *Cyan*.
- *City of Livonia Retiree Health and Disability Benefits Plan v. Pitney Bowes Inc., et al.*, No. X08-FST-CV-18-6038160-S (Conn. Super. Ct. May 17, 2019)
  - The Court applied the "plain meaning rule" and granted defendants' motion for a discovery stay pending defendants' motion to strike. The Court examined 15 USC 77z-1(a)(1), the subsection of the PSLRA preceding the discovery stay subsection, which applies to private class actions and states that "[t]he provisions of this subsection shall apply to each private action arising under this subchapter that is brought as a plaintiff class action *pursuant to the Federal Rules of Civil Procedure*," contrasting it against the language of 15 USC 77z-1(b)(1), the discovery stay subsection, which applies to "[a]ny private action arising under this subchapter." The court held that, because the discovery stay subsection does not have the same language as the private class actions subsection, it is not limited to actions commenced in federal court.
  - The Court also noted that 15 USC 77z-2(c)(1), the provision following the discovery stay subsection, provides a "safe harbor" for forward-looking statements "in any action arising under this subchapter," and uses identical language as the discovery stay subsection. The Supreme Court in *Cyan* found that this safe harbor provision applied even when a Securities Act case is brought in state court. The Court held that because the language in the discovery stay and safe harbor subsections are identical, the discovery stay subsection applies to actions pending in state court as well as in federal court.
- *In Re Everquote, Inc. Securities Litigation*, No. 651177/2019 (N.Y. Sup. Ct. Aug. 7, 2019)
  - Judge Borrock granted defendants' motion to stay discovery pending decision on their motion to dismiss. Judge Borrock held that *Cyan* "d[id] not control" the question before him, as *Cyan* "only addressed" the issue of state courts' jurisdiction to adjudicate Securities Act claims and whether removal of such claims is permitted. Judge Borrock interpreted the plain meaning of the PSLRA's discovery stay section, which states that discovery is stayed during a pending motion to dismiss "[i]n any private action arising under this subchapter," finding that the discovery stay applies to securities actions in state court. Judge Borrock noted that nowhere in this section does the statute indicate that it only applies to actions brought in federal court.

# Prohibition on Securities Act Cases in State Court Via Bylaws?

- Another question that remains open in the aftermath of *Cyan* is whether a company can write into its bylaws that Securities Act cases must be brought in federal court.
- In recent years, the number of companies that have adopted forum-selection clauses in their charters has skyrocketed.
- The Delaware Court of Chancery wrestled with this issue for the first time in *Sciabacucchi v. Salzberg*, No. 2017-0931-JTL, 2018 WL 6719718 (Del. Ch. Dec. 19, 2018). On December 19, 2018, the Court issued an order invalidating provisions that three companies adopted in their certificates of incorporation before their initial public offerings, that would have required shareholders to file securities class actions in federal court.
- Relying on Delaware General Corporation Law, the Court held that bylaws can regulate internal affairs brought by stockholders qua stockholders, but does not authorize a Delaware corporation to regulate external relationships. The Court held that a Securities Act claim is external to the corporation in that federal law creates the claim, defines the elements of the claim, and specifies who can be a plaintiff or defendant. Because a Securities Act claim exists outside of the corporate contract, the Court held that bylaws dictating the forum for tort or contract claims against a company are invalid.
- This issue is currently up on appeal before the Delaware Supreme Court. Argument is scheduled for January 8, 2020.

## Additional Considerations

- The premiums that corporations incur to protect their directors and officers against alleged violations of the Securities Act of 1933 have increased as much as 200% in the last three years. Securities Act claims that are litigated in a state forum inhibit transparency in the securities class action arena.
- Issues/complications may arise in measuring damages and in the settlement of parallel state and federal proceedings, or multiple state proceedings.

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# SEC ENFORCEMENT UPDATE

# SEC DIVISION OF ENFORCEMENT

The Division of Enforcement is responsible for investigations of securities law violations and bringing civil actions in federal court or as administrative proceedings on behalf of the Commission.

Enforcement Division's efforts are guided by five core principles:

- (1) focus on the Main Street investor,
- (2) focus on individual accountability,
- (3) keep pace with technological change,
- (4) impose remedies that most effectively further enforcement goals, and
- (5) constantly assess the allocation of resources.



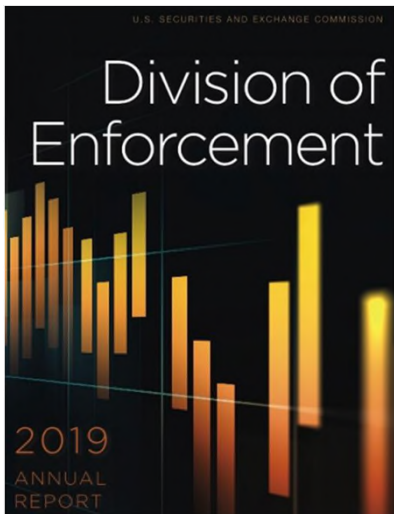
Stephanie Avakian, Co-Director, Division of Enforcement



Steven Peikin, Co-Director, Division of Enforcement



# FY 2019 Annual Report



- SEC Enforcement Division's November 6, 2019 Annual Report
  - 862 enforcement actions in FY 2019
    - 526 standalone actions (vs. 490 in FY 2018, a 7.3% increase)
    - 210 “follow on” proceedings
    - 126 were proceedings to de-register public companies that were delinquent in their periodic reporting to the agency
  - 5% increase in the overall number of enforcement actions compared to FY 2018; highest annual number of enforcement actions since FY 2016.

## FY 2019 Annual Report Cont'd



# FY 2019 Annual Report Cont'd

- Monetary recoveries: Disgorgement and Penalties Ordered
  - \$4.349 billion recovered (10.2% increase over FY 2018)
    - \$1.101 billion of penalties
    - \$3.248 billion represented disgorgements
  - 70% of the total recoveries came from 5% of cases while the remaining 95% of cases accounted for 30% of the recoveries
  - The report notes that it obtained the elevated levels in disgorgement recoveries during 2019 despite the Supreme Court's June 2017 decision in *Kokesh v. SEC*, which held that SEC disgorgement claims are a penalty under 28 U. S. C. §2462 and subject to a five-year statute of limitations.

Total Money Ordered (in millions)					
	FY 2019	FY 2018	FY 2017	FY 2016	FY 2015
Penalties	\$1,101	\$1,439	\$832	\$1,273	\$1,175
Disgorgement	\$3,248	\$2,506	\$2,957	\$2,809	\$3,019
Total	\$4,349	\$3,945	\$3,789	\$4,083	\$4,194

# Protecting Retail Investors

- “The Division of Enforcement is acutely focused on protecting the interests of retail investors.”
- Retail Strategy Task Force (RSTF) was initiated to “develop targeted initiatives to identify misconduct impacting retail investors.”
  - working with the SEC’s Office of Investor Education and Advocacy on two new Commission-wide initiatives: the Teachers’ Initiative and the Military Service Members’ Initiative.
- In FY 2019, the elevated number of standalone actions was due in part to the number of actions arising from the Share Class Initiative
  - In March, SEC announced the settlement of charges against 79 investment advisers who will return more than \$125 million to clients, with a substantial majority of the funds going to retail investors.

# Holding Individuals Accountable

- 69% of standalone enforcement actions (excluding Share Class Initiative, which applied only to entities) involved charges against one or more individuals.
- The following case excerpts were included in the “Message from the Co-Directors” about individual accountability:
  - In an action filed in parallel with criminal authorities, the Commission alleged that the CEO, CFO, CAO, and Senior VP of Accounting at a publicly traded real estate investment trust fraudulently manipulated a key non-GAAP metric relied on by analysts and investors to evaluate the company's financial performance. The Commission achieved partial settlements against two of the four individual defendants.
  - In a litigated action, the Commission alleged that a company, two subsidiaries, and the company's former CEO defrauded investors when it raised billions of dollars through corporate bond and fixed income offerings while making a series of deceptive claims about the environmental impact of the company's products.
- FY 2019 included actions against 42 individuals who misappropriated or traded unlawfully on material, nonpublic information.

# **“Illustrative” Enforcement Actions Against Public Companies**

- The following actions against public companies excerpts were cited in the “Message from the Co-Directors”:
  - Misleading risk factor disclosures: In a settled action the Commission alleged that a company’s risk factor presented the misuse of user data as hypothetical when the company knew that user data had in fact been misused.
  - Misleading presentation of non-GAAP metrics: In a settled action, the Commission found that a company inflated monthly sales results by paying automobile dealers to report fake vehicle sales and maintaining a “cookie jar” of actual but unreported sales. In months when the company would have fallen short of certain targets, it dipped into the “cookie jar” and reported the old sales as if they had just occurred.

## Continuing Areas of Focus

- Coordination with law enforcement
- Accelerating the pace of investigations
- Credit for cooperation
- Whistleblowers

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# DEVELOPMENTS IN DELAWARE LAW



## Recent Developments Under *Caremark*

*Marchand v. Barnhill*, 212 A.3d 805, 821 (Del. Supr., 2019)

- A *Caremark* claim attacking “board-level compliance efforts at Blue Bell regarding what has to be one of the most central issues at the company: whether it is ensuring that the only product it makes—ice cream—is safe to eat.”
- “In defending this case, the directors largely point out that by law Blue Bell had to meet FDA and state regulatory requirements for food safety, and that the company had in place certain manuals for employees regarding safety practices and commissioned audits from time to time.”
- “But the fact that Blue Bell nominally complied with FDA regulations does not imply that the board implemented a system to monitor food safety at the board level.”
- “*Caremark* does have a bottom-line requirement that is important: the board must make a good faith effort—i.e., try—to put in place a reasonable board-level system of monitoring and reporting.”

# Circumstances That Increase A Finding Of Liability Under *Caremark*

## **1. Oversight of compliance with “positive law” requirements is more likely to result in liability**

“The legal academy [and now the courts] has observed that Delaware courts are more inclined to find *Caremark* oversight liability at the board level when the company operates in the midst of obligations imposed upon it by positive law yet fails to implement compliance systems, or fails to monitor existing compliance systems, such that a violation of law and resulting liability occurs.” *In re Facebook, Inc. Section 220 Litigation*, 2019 WL 2320842, at \*14 (Del.Ch., 2019)

## **2. Oversight of “mission critical” risks is more likely to result in liability**

*Marchand*; see also *In re Clovis Oncology, Inc. Derivative Litigation*, 2019 WL 4850188 (Del. Ch., 2019)

## But *Caremark* is still not concerned with the “effectiveness” of controls

“[O]ur focus here is on the key issue of whether the plaintiff has pled facts from which we can infer that Blue Bell's board made no effort to put in place a board-level compliance system. That is, ***we are not examining the effectiveness of a board-level compliance and reporting system after the fact.*** Rather, we are focusing on whether the complaint pleads facts supporting a reasonable inference that the board did not undertake good faith efforts to put a board-level system of monitoring and reporting in place.”

*Marchand v. Barnhill*, 212 A.3d 805, 821 (Del. Supr., 2019)

# Recent Developments in Section 220 Books and Records Litigation

- When are emails required to be produced in a Section 220 case?  
*KT4 Partners LLC v. Palantir Technologies Inc.*, 203 A.3d 738, 741 (Del. Supr., 2019)
- Can disagreements with business decisions give rise to entitlement to inspect books and records?  
*Hoeller v. Tempur Sealy International, Inc.*, 2019 WL 551318 (Del. Ch., 2019)  
*High River Limited Partnership v. Occidental Petroleum Corp.*, C.A. No. 2019-0403 (Del. Ch. Nov. 14, 2019)  
*Feuer v. Merck & Co.*, (NJ 2019), affirming 455 NJ Super. 69 (App. Div. 2018).

# Recent Developments: Executive Compensation Decisions Involving Controlled Companies

- The Old Regime: *Friedman v. Dolan*, 2015 WL 4040806 (Del. Ch. June 30, 2015)
  - Allegedly excessive executive compensation decisions for a controlling stockholder made by independent directors acting in good faith is subject to the business judgment rule
  - “It is hard to look at the facts of this case without going away troubled. A compensation committee with various ties to the controlling shareholder family awarded considerable executive compensation and benefits to the patriarch of that family and his son. Additionally, a board dominated by members of the controlling family approved non-executive director compensation, which accrued to three family-member directors with qualifications and attendance records that have been called into question. Nonetheless, compensation decisions are not the expertise of trial judges, and the Court should not second-guess an independent compensation committee's business decisions that are not irrational.”

# Recent Developments: Executive Compensation Decisions Involving Controlled Companies

The New Regime: *Torretta v. Musk*, 2019 WL 4566943 (Del. Ch., 2019)

- Allegedly excessive executive compensation decisions for a controlling stockholder made by independent directors acting in good faith is subject to entire fairness review
- To avoid entire fairness, the board must employ *MFW* protections:
  1. Fully functioning, independent compensation committee
  2. Fully informed, uncoerced stockholder approval

(Why? And will the *MFW* doctrine expand further in controlled company situations? *See In re Ezc Corp Inc. Consulting Agreement Derivative Litigation*, 2016 WL 301245 (Del. Ch., 2016))

## Recent Developments in Appraisal Law

- *Verition Partners Master Fund LTD v. Aruba Networks, Inc.*, 210 A.3d 128 (Del. 2019)
- In appraisal dispute following HP's acquisition of Aruba for \$24.67/share, the petitioners sought \$32.57/share. The Chancery Court below found the fair value of Aruba was \$17.13 per share, relying principally on company's thirty-day average unaffected market price.
- Delaware Supreme Court found that fair value was the "deal price minus synergies" metric of \$19.10.
- While the Supreme Court took issue with the Chancery Court's use of the unaffected market price, it supported the use of that metric in some circumstances and in awarding "deal price less synergies," supported a valuation which was far less than the fair value sought by Petitioners and the merger price.

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**QUESTIONS?**



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