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Pressed by Investors, Foreign Litigation Continues to Evolve

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The Wirecard saga evokes epic frauds of the past, notably the turn-of-the-century house of cards built by another financial middleman, U.S. energy trader Enron Corporation. There, too, an obscure startup rode a flashy sounding, opaque business model to blue-chip status. Fictitious accounts inflated sales and assets, driving stock prices ever upward. A "Big Four" accounting firm approved years of clean audits and itself became subject to civil and criminal liability. And when the scandal was revealed, the company's disgraced CEO faced prison.

To be sure, Wirecard features its own plot twists. Faced with persistent reports of suspicious accounting at Wirecard, for example, Germany's financial regulator, BaFin, chose to investigate short sellers who stood to benefit from the allegations instead of the company.

There is another major difference for investors harmed by apparent fraud, one familiar by now to readers of this publication. While Enron shareholders could sue under U.S. securities laws, investors in Wirecard stock—nearly all of which trades on European exchanges—must look to other jurisdictions for compensation.

Here are some recent developments impacting investors' ability to seek collective redress for securities fraud in non-U.S. jurisdictions.

Germany: Ruling in Consumer Case Finds Volkswagen Liable

In Germany, plaintiffs can file civil lawsuits under the Capital Market Investors' Model Proceedings Act (KapMuG) to seek damages resulting from false, misleading, and/or omitted information in the capital markets. Under KapMuG, courts select a "model case" to establish culpability and damages for lawsuits with common legal and factual questions. All other cases are stayed until the model case is decided.

In the Wirecard matter mentioned above, in fact, the first lawsuit seeking model case status was filed by the TILP law firm on May 12 in the Regional Court of Munich. The TILP firm represents plaintiffs in other KapMuG model proceedings, most notably in a shareholder suit against Volkswagen AG damaged by stock drops stemming from U.S. regulators' 2015 discovery that VW had cheated on emissions tests by installing "defeat devices" in 11 million diesel vehicles.

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ON MAY 25, VW INVESTORS REGISTERED FOR LAWSUITS ASSOCIATED WITH THE KAPMUG PROCEEDING RECEIVED A BOOST WHEN A GERMAN COURT FOUND THE COMPANY LIABLE IN ANOTHER BELLWETHER CASE, THIS ONE A CONSUMER LAWSUIT BROUGHT BY A MINIVAN OWNER.

On May 25, VW investors registered for lawsuits associated with the KapMuG proceeding received a boost when a German court found the company liable in another bellwether case, this one a consumer lawsuit brought by a minivan owner. In that case, the Federal Court of Justice in Karlsruhe ruled that VW used "deliberately immoral" methods to rig the tests. The illegal devices alerted diesel engines when tested to produce results with drastically fewer toxic emissions than the vehicles produced on the road.

The federal court ordered VW to pay the plaintiff in the model case €28,000 for the minivan he bought in 2014, clearing the way for VW to compensate up to 60,000 vehicle owners who did not accept or join a settlement with the German consumer federation. That earlier suit, which settled for a total of €830 million, is expected to pay between €1,350 and €6,300 each to approximately 235,000 car owners.

Volkswagen said the federal court's decision "provide[d] clarity" for most of the 60,000 cases still open in Germany. It planned to offer eligible car owners "adequate settlement proposals" in line with the model case ruling. The so-called Dieselgate scandal has already cost Volkswagen more than €30 billion in fines, legally mandated fixes, and settlements, most notably in the United States. Until now, however, the company has largely escaped paying large sums to consumers in Germany–though in May the company reached a deal with German prosecutors to pay €9 million to end legal proceedings against VW's chief executive and board chair, who had faced on market manipulation charges. It also faces a class action brought by 91,000 VW owners in the United Kingdom.

Back in Germany, investors from around the world awaiting results of the KapMuG model proceeding should take heart from the Karlsruhe federal court's decision to find wrongdoing and award damages.

European Parliament Poised to Approve EU-Wide Rules for Collective Redress

Although implementation is still up to two years off, the European Union is poised to approve rules for investors and other consumers to pursue collective actions after negotiators for the European Parliament and the European Commission reached a deal that includes a loser-pays provision.

ALTHOUGH IMPLEMENTATION IS STILL UP TO TWO YEARS OFF, THE EUROPEAN UNION IS POISED TO APPROVE RULES FOR INVESTORS AND OTHER CONSUMERS TO PURSUE COLLECTIVE ACTIONS AFTER NEGOTIATORS FOR THE EUROPEAN PARLIAMENT AND THE EUROPEAN COMMISSION REACHED A DEAL THAT INCLUDES A LOSER-PAYS PROVISION.

The Representative Action Directive, announced June 22, affects consumers harmed by domestic and cross-border violations of data protection, financial services, travel and tourism, energy, telecommunications, environment and health, air and train passenger rights, and general consumer law. The draft Directive has been the subject of negotiations since it was announced as part of a "New Deal for Consumers" in April 2018 to strengthen consumer protection in the European Union.

According to a news release issued by the European Parliament, the draft Directive requires each EU country to offer consumers "at least one representative action procedure for injunction and redress" both domestically and on an "EU level." Consumers launching a cross-border action must be represented by "qualified" non-profit consumer organizations or public entities. Member states that already have working collective redress procedures can follow their own laws for domestic matters if they are "consistent" with the objectives of the EU directive.

While the text of the measure has not been released, the news release made clear that European legislators wary of U.S.-style class actions included rules designed to protect businesses. It said the Parliament had introduced the loser-pays principle to "strike a balance between access to justice and protecting businesses from abusive lawsuits." Another rule will give courts or administrative authorities the power to "dismiss manifestly unfounded cases at the earliest possible stage of the proceedings in accordance with national law."

IT HAS BEEN A TUMULTUOUS SEVEN MONTHS FOR CLASS ACTIONS IN AUSTRALIA, WHERE A FLURRY OF COURT RULINGS, GOVERNMENT REGULATIONS, AND LEGISLATION HAVE AFFECTED THE WAY SHAREHOLDER LAWSUITS AND OTHER REPRESENTATIVE PROCEEDINGS ARE FUNDED.

Even so, some commentators said they expected the new measure would lead to more mass actions in the European Union, while others noted that the U.K., Italy, and the Netherlands have already codified opt-out lawsuits for certain consumer claims.

Once approved by the full Parliament and Commission and published, the Representative Action Directive will give EU member nations 24 months to enact laws that comply with its provisions and another six months to apply them.

Australian Class Actions: In Flux and Under Attack

It has been a tumultuous seven months for class actions in Australia, where a flurry of court rulings, government regulations, and legislation have affected the way shareholder lawsuits and other representative proceedings are funded.

In the first news, the High Court of Australia in December appeared to strike an important blow against so-called "open" class actions, in which settlements cover all damaged parties, including those who hadn't previously registered their legal claims with a law firm.

While class actions have a long tradition in Australia, they are typically limited to registered plaintiffs who agree to pay fees to litigation organizers in exchange for protection from loser-pays rules. Though plaintiffs may opt out of settlements, these “closed” class actions effectively act like opt-in cases, since damaged investors are only included in the class if they register.

Closed classes also have encouraged the predominance of third-party litigation funders, who compete to sign up large groups of investors at the outset of the case so that potential class damages will yield a large enough fee to make underwriting the litigation worthwhile—a process known as “book building.” Plaintiffs agree to pay funders a percentage of future recoveries while the funders pay the costs of litigation, including legal fees, on a no-win, no-fee basis. (Lawyers in Australia have historically been prohibited from charging contingency fees, though that has changed in one state, as explained below).

Since 2016, however, some Australian federal and state courts have begun using “common fund orders” (CFOs) to “open” class actions beyond plaintiffs who have already agreed to pay funders. CFOs require all group members—including those who haven’t signed a funding agreement—to pay a share of the fee. Without a common fund order, funders are incentivized to seek closed classes.

In separate decisions reached after common hearings in *BMW Australia Ltd v. Brewster* and *Westpac Banking Corporation v Lenthall*, the High Court ruled December 4 that neither the Federal Court nor the New South Wales Supreme Court had the power to make common fund orders at the early stages of litigation.

From the early reaction to *Brewster*, you would have thought the High Court had sounded the death knell for CFOs and open group proceedings. But while *Brewster* required judges to find that each CFO is “appropriate or necessary to ensure that justice is done in the proceeding,” it focused on two cases where the CFO had been issued early in the case. And since *Brewster*, at least two Federal Court judges have confirmed their power to make CFOs during the settlement approval process. Still, without the ability to secure a CFO early in a case, many funders are likely to rely on building a book of registered plaintiffs with large damages to ensure that their potential upside makes it financially viable.

On the positive side for investors, lawmakers in Victoria, the second most populous state, passed a law June 18 that allows plaintiffs’ lawyers to apply for contingency fees if they provide “security” that they can cover defendants’ court costs in the event of an adverse ruling.

Prior to the change, law firms, as elsewhere in Australia, were limited to charging an “uplift fee” capped at a 25% premium over their hourly fees, though they could pledge to waive their fee if they didn’t win the case. As a practical matter, that meant law firms teamed with third-party litigation funders. Proponents of the law claimed that the previous arrangement resulted in plaintiffs paying up to half of smaller settlements in fees and

THE CONSERVATIVE FEDERAL GOVERNMENT OF AUSTRALIA HEADED BY PRIME MINISTER SCOTT MORRISON, CITING WHAT IT SAYS IS A THREE-FOLD INCREASE IN CLASS ACTIONS OVER THE PAST DECADE, HAS TAKEN AIM AGAINST FUNDERS AND THE RULES THAT GOVERN THE LAWSUITS THEMSELVES.

costs, since both attorneys' uplift fees and funders contingency fees were subtracted from the total. While there is no cap on the percentage fee, the law grants Victoria's state courts wide discretion in approving costs in group proceedings that are "appropriate or necessary to ensure justice is done." The new law took effect July 1.

Finally, the conservative federal government headed by Prime Minister Scott Morrison, citing what it says is a three-fold increase in class actions over the past decade, has taken aim against funders and the rules that govern the lawsuits themselves.

On June 22, the Morrison government announced regulations to require that litigation funders be licensed as financial service providers by the Australian Securities and Investments Commission, the country's top financial regulatory agency. The regulations, set to take effect in August, will impose auditing and reporting requirements on funders and oblige them to maintain "adequate" financial resources. Funders were exempted from the licensing requirement in 2013. Treasurer Josh Frydenberg said the rules were necessary to control a 325% increase in Federal class actions since 2010.

Funders and lawyers initially split over the change. Omni Bridgeway (formerly IMF Bentham), the country's largest litigation funder, supported the requirements and urged that they be extended to law firms that fund their own class actions. Plaintiffs' lawyer Damian Scattini of the Quinn Emanuel law firm said they unnecessarily increased "governmental red tape."

The Morrison government is also pursuing a wide-ranging parliamentary investigation of the class action industry, a move backed by business groups (at least one of them aided by the U.S. Chamber of Commerce). The inquiry by the Parliamentary Joint Committee on Corporations and Financial Service was first announced in March. In May, its purview was expanded to include "the potential impact of Australia's current class action industry on vulnerable Australian business already suffering the impacts of the COVID-19 pandemic. Hearings were set for July, with a report due in December 2020. ■

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SUPREME COURT UPHOLDS SEC'S POWER TO DISGORGE FRAUDULENT PROFITS

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THE 8-TO-1 OPINION WAS LARGELY A VICTORY FOR REGULATORS AND INVESTORS, SINCE DISGORGEMENT IS A LONGSTANDING, CRITICAL TOOL IN THE SEC'S ENFORCEMENT ARSENAL.

Editor's Note: Ms. Posner and Cohen Milstein Sellers & Toll PLLC represented the North American Securities Administrators Association in connection with an amicus curie brief to the US Supreme Court on behalf of the SEC in Liu v. SEC.

On June 22, 2020, the U.S. Supreme Court ruled in *Liu v. SEC*, No. 18-1501, that the Securities Exchange Commission ("SEC") may disgorge profits obtained through fraudulent practices, provided that such award does not exceed the defendant's net profits. The 8-to-1 opinion was largely a victory for regulators and investors, since disgorgement is a longstanding, critical tool in the SEC's enforcement arsenal.

In *Liu*, petitioners Charles Liu and Xi Wang contested a civil action brought against them by the SEC in federal court. The petitioners had raised $27 million from foreign nationals which, according to a private offering memorandum, was earmarked for the construction of a cancer treatment center. An investigation by the SEC, however, revealed that the petitioners had violated the terms of the offering documents, had never intended to build a cancer treatment center, and had misappropriated millions of dollars of investor money. The Ninth Circuit Court of Appeals held in favor of the SEC, affirming the district court's order of disgorgement equal to the full amount petitioners had raised from investors, less the funds that remained in corporate accounts for the project.

In a 2017 decision, *Kokesh v. SEC*, 137 S. Ct. 1635 (2017), the Supreme Court had held that disgorgement in an SEC enforcement action constitutes a "penalty" for the purposes of the applicable statute of limitations. It did not, however, decide whether disgorgement can also qualify as "equitable relief" under the Securities Exchange Act of 1934, as amended ("Exchange Act"). Certain *dicta* in *Kokesh*, however, raised the distinct possibility that if brought before it, the Supreme Court would find that disgorgement could not qualify as "equitable relief" under the Exchange Act, depriving the SEC of this important remedy. Nonetheless, in *Liu*, the Supreme Court held, in an opinion authored by Justice Sonia Sotomayor, that a disgorgement award in an SEC civil enforcement action can qualify as equitable relief under the Exchange Act. As the Supreme Court explained, its decision to permit disgorgement stems from the long history of equity courts depriving wrongdoers of their net profits from unlawful activity, a foundational principle since it is "inequitable that [a wrongdoer] should make a profit out of his own wrong."

In the opinion, the Supreme Court discussed certain traditional limits placed on disgorgement to avoid transforming it into a penalty outside of a court's equitable powers. First, the disgorged profits should be returned to the victims of the fraudulent scheme, if possible. Second, courts traditionally ordered disgorgement awards against individuals or partners engaged in "concerted

AS THE SUPREME COURT EXPLAINED, ITS DECISION TO PERMIT DISGORGEMENT STEMS FROM THE LONG HISTORY OF EQUITY COURTS DEPRIVING WRONGDOERS OF THEIR NET PROFITS FROM UNLAWFUL ACTIVITY, A FOUNDATIONAL PRINCIPLE SINCE IT IS "INEQUITABLE THAT [A WRONGDOER] SHOULD MAKE A PROFIT OUT OF HIS OWN WRONG."

wrongdoing" and not against multiple wrongdoers under a joint-and-several liability theory. Finally, except in cases where the entire profits of a business or undertaking results from the wrongful activity, the remedy is limited to "net profits"—that is, the court must deduct legitimate expenses before ordering disgorgement under the Exchange Act. The Court noted that the SEC's disgorgement remedy is occasionally in tension with these traditional limits in cases where courts (i) order the proceeds of fraud to be deposited in U.S. Department of Treasury funds instead of disbursing them to victims, (ii) impose joint-and-several disgorgement liability, or (iii) decline to deduct legitimate expenses from the receipts of fraud.

The Supreme Court remanded the case for the lower courts to ensure that the award in *Liu* was in accordance with these traditional limits. While it did not decide the narrower questions raised by the petitioners of whether the award granted by the district court crossed these "bounds of traditional equity practices," the Court did discuss principles that "may guide the lower courts' assessment of these arguments on remand."

IN THE OPINION, THE SUPREME COURT DISCUSSED CERTAIN TRADITIONAL LIMITS PLACED ON DISGORGEMENT TO AVOID TRANSFORMING IT INTO A PENALTY OUTSIDE OF A COURT'S EQUITABLE POWERS.

First, the Court said the "equitable nature of the profits remedy generally requires the SEC to return a defendant's gains to wronged investors for their benefit." However, the Court did not foreclose the possibility that disgorged funds could be used to fund the SEC's other investor protection activities, such as whistleblower or investor education programs, in the event that returning disgorged funds to investors was either impossible or not cost effective. Notably, the SEC returns disgorged funds to victims in the overwhelming majority of its cases. The money goes to the U.S. Treasury only when the nature of the fraud does not result in easily identifiable victims (such as in insider trading cases), victims are difficult to identify or reach (as can be the case with foreign nationals like the victims in *Liu*), or the amount each victim is entitled to is too small to justify the expense of identifying the victims and returning the money to them. Even then, the SEC typically uses the disgorged funds for activities related to investor protection.

Second, the *Liu* opinion said the SEC's practice of seeking to impose joint-and-several liability in disgorgement cases may be "at odds with the common-law rule requiring individual liability for wrongful profits." At the same time, however, the Court acknowledged that joint-and-several liability may be appropriate in *Liu* because the petitioners were married and thus could be sufficiently "commingled" to a point where joint-and-several liability would be appropriate. The same may be true with other co-defendants in future cases due to the nature of the fraud and the comingling of assets.

Finally, the Court held that courts must deduct legitimate expenses before ordering a disgorgement order. Whether any of the expenses spent in *Liu* can properly be qualified as "legitimate" in light of Liu's fraud seems unlikely, particularly given that the record reflects that Liu never intended to build a cancer treatment center and the items the defendants purchased were made to entice more victims to invest, not for legitimate business purposes.

In sum, while the *Liu* decision places certain minor limitations on the SEC's ability to seek and obtain disgorgement, it upheld the SEC's critical ability to protect investors and deter fraud through the equitable remedy of disgorgement and its limitations are generally consistent with existing SEC practice. ■

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DELAWARE SUPREME COURT ALLOWS COMPANIES TO RESTRICT 1933 ACT CLAIMS TO FEDERAL COURT

RULING IN *SALZBERG V. SCIABACUCCHI* COULD PRESAGE FUTURE REDUCTIONS IN SHAREHOLDER RIGHTS

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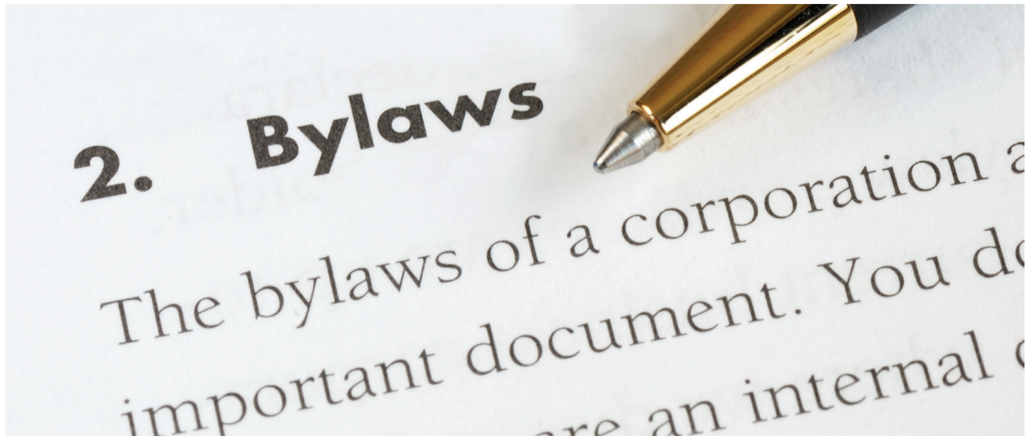
INSTEAD OF PROVIDING CLARITY, THE DELAWARE SUPREME COURT INTRODUCED MORE UNCERTAINTY WHEN, IN *SALZBERG V. SCIABACUCCHI,* 227 A.3D 102 (2020), IT REVERSED THE CHANCERY COURT'S RULING INVALIDATING THE PROVISIONS AND FOUND THEM A PERMISSIBLE EXERCISE OF CORPORATE POWER.



It has been quite a year on the forum selection front as many on both sides of the "v" waited for the Delaware Supreme Court to rule on a stockholder's challenge to the validity of corporate provisions restricting claims under the Securities Act of 1933 to federal court, even though the 1933 Act also allows investors to bring those claims in state court. Instead of providing clarity, however, the Delaware Supreme Court introduced more uncertainty when, in *Salzberg v. Sciabacucchi*, 227 A.3d 102 (2020), it reversed the Chancery Court's ruling invalidating the provisions and found them a permissible exercise of corporate power. While the decision on its face deals with a narrow issue, it may open the door to further efforts to eviscerate the rights of stockholders.

At issue in *Salzberg* were federal forum provisions that three companies, Stitch Fix, Roku and Blue Apron, had included in their articles of incorporation, sometimes referred to as a corporate charter, before they went public. While the language differed slightly in the forum provisions, all required that any claims under the 1933 Act be litigated in federal court, despite concurrent state and federal jurisdiction.[1] Matthew Sciabacucchi, who purchased shares in all three companies through the IPOs, or shortly thereafter, filed a class action in Delaware Chancery Court seeking to have the provisions declared invalid under Delaware law. The Chancery Court agreed, invalidating the provisions on a facial basis. Drawing a line between internal claims, which it said can be regulated by a company's charter or bylaws, and external claims involving a company, which cannot, the Chancery Court concluded that the 1933 Act claims were external to the company. The Chancery Court reasoned that "[f]ederal law creates the claim, defines the elements of the claims, and specifies who can be a plaintiff or defendant." Accordingly, the Chancery Court held that the provisions were invalid because the "constitutive documents of a Delaware corporation cannot bind a plaintiff to a particular forum when the claim does not involve rights or relationships that were established by or under Delaware's corporate law." Then, the Delaware Supreme Court reversed.

The Delaware Supreme Court held that the federal forum provisions did not violate Delaware law and were in fact facially valid under Section 102(b)(1) of the Delaware General Corporation Law. Section 102(b)(1) provides that articles of incorporation may contain "[a]ny provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and

1 Importantly, under the 1933 Act, Congress provided for both federal and state court jurisdiction over investors' claims and a statutory right of non-removal from state to federal court. *See* 15 U.S.C. §77v(a); *see also Cyan, Inc v. Beaver Cnty. Emps. Ret. Fund*, 138 S. Ct. 1061, 1078 (2018) (holding that SLUSA did not strip state courts of jurisdiction to adjudicate class actions alleging 1933 Act claims, nor could such cases be removed to federal court.)

regulating the powers of the corporation, the directors, and the stockholders ..., if such provisions are not contrary to the laws of this State." The Court explained that, in making a facial challenge, the plaintiff had to demonstrate that the "charter provisions 'do not address proper subject matters' as defined by statute, 'and can never operate consistently with the law.'" The Court reasoned that federal forum provisions fall within the categories of Section 102(b)(1) since the preparation and filing of a registration statement is an aspect of a "corporation's management of its business and affairs and of its relationship with its stockholders," and that "a bylaw that seeks to regulate the forum in which 'such intra-corporate' litigation can occur is a provision that addresses the 'management of the business' and 'conduct of the affairs of the corporation.'"

THE DELAWARE SUPREME COURT HELD THAT THE FEDERAL FORUM PROVISIONS DID NOT VIOLATE DELAWARE LAW AND WERE IN FACT FACIALLY VALID UNDER SECTION 102(b)(1) OF THE DELAWARE GENERAL CORPORATION LAW.

The Delaware Supreme Court rejected the Chancery Court's binary approach of internal versus external claims as well as its characterization of 1933 Act claims as external claims. Instead, the Court interjected a third category of claims into this analysis, "intra-corporate litigation," which falls somewhere on the continuum between internal (affairs) claims and external claims. Building on this framework, the Court concluded that federal forum provisions are "intra-corporate" and, like internal claims, are within the statutory scope of Section 102(b)(1)—and, as such, are facially valid under Section 102(b)(1).

Importantly, the Delaware Supreme Court also pointed out that federal forum provisions serve as a procedural mechanism and are not substantive, noting they "'regulate *where* stockholders may file suit, not *whether* the stockholder may file suit or the kind of remedy that the stockholder may obtain on behalf of herself or the corporation.'"

Putting aside that the forum provisions at issue appeared in a charter and not a bylaw, *Salzberg* leaves open several questions about just how far such provisions can go. As commentators have noted, the decision has opened the door to uncertainties, including issues relating to federalism, mandatory arbitration, and the interests of other states in seeing their law apply to companies that are headquartered in their state but incorporated in Delaware.[2] Regarding the latter, in *In re Dropbox Securities Litigation*, the plaintiffs in a California state class action asserting Section 11 claims against a California company incorporated in Delaware are currently litigating a motion to dismiss based on a federal forum provision similar to those at issue in *Salzberg*.

PUTTING ASIDE THAT THE FORUM PROVISIONS AT ISSUE APPEARED IN A CHARTER AND NOT A BYLAW, *SALZBERG* LEAVES OPEN SEVERAL QUESTIONS ABOUT JUST HOW FAR SUCH PROVISIONS CAN GO.

Further, the use of forum provisions to preclude litigation of federal derivative claims is also in play. Cohen Milstein is currently challenging The Boeing Company Board of Directors' use of a forum selection bylaw to strip stockholders of their substantive right to bring derivative claims under the Securities Exchange Act of 1934. Boeing's bylaw requires all derivative cases to be litigated in Delaware Chancery Court, which lacks jurisdiction over 1934 Act claims. In addition to appealing the federal district court's dismissal of the derivative case based on the forum selection bylaw, Cohen Milstein has filed a declaratory class action in Delaware Chancery Court challenging the validity and enforceability of the bylaw because it eliminates stockholders' rights to assert exclusively federal claims in a derivative action.

This may be just the start. Other attempts to push the boundaries of corporate charters and bylaws may follow as the battle over forum selection provisions designed to curtail the rights of stockholders continues. ■

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2 *See Del. Federal Forum Ruling Could Open Door To Mischief*, Law 360 (March 19, 2020); *So the Salzberg v. Sciabacucchi Decision is In!*, Ann Lipton, https://lawprofessors.typepad.com/business_law/2020/03/so-the-salzberg-v-sciabacucchi-decision-is-in.html (March 21, 2020). *See also Shareholder Advocate*, Winter 2019, quoting James D. Cox, a Duke Law School professor "... the Constitution's Supremacy Clause does not permit state law to eviscerate protections provided investors by the federal securities laws."

COURT CERTIFIES CLASS OF MILLER ENERGY SHAREHOLDERS IN FRAUD SUIT AGAINST KPMG

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THE EXTREMELY HIGH LEGAL STANDARD FOR FINDING AUDITORS LIABLE FOR SECURITIES FRAUD MAKES IT RARE FOR AUDITOR CASES TO WITHSTAND MOTIONS TO DISMISS, LET ALONE ACHIEVE CLASS CERTIFICATION.

Shareholders suing global auditing firm KPMG, LLC for its role in a massive fraud by Miller Energy, LLC cleared an important hurdle on June 29, 2020, when a federal magistrate judge granted their motion for class certification and appointment of lead plaintiffs and Cohen Milstein as co-lead counsel and denied defendant's attempt to disqualify the shareholders' expert. This ruling is a significant victory for investors. The extremely high legal standard for finding auditors liable for securities fraud makes it rare for auditor cases to withstand motions to dismiss, let alone achieve class certification.

The lawsuit accuses KPMG of violating the Securities Exchange Act of 1934 and the Securities Act of 1933 by allowing Miller Energy to enormously inflate the value of oil and gas reserves in Alaska it had purchased out of bankruptcy for less than $4 million. After Miller Energy claimed the assets it had purchased were worth over $480 million, its stock price soared by 982%.

A little over a year later, Miller Energy replaced its small auditing firm with national powerhouse KPMG. But KPMG failed to perform the required due diligence or force Miller Energy to come clean about its misstated valuations. Instead, KPMG committed a series of profound auditing failures, turning a blind eye to red flags about the asset valuation—including concerns raised by KPMG's own internal valuation specialists.

The fraud began unraveling in December 2013, as it became clear that the assets' valuation was significantly overvalued, eventually resulting in Miller Energy taking impairment charges exceeding $300 million. By the end of 2015, Miller Energy's securities had been de-listed from the New York Stock Exchange and the SEC had assessed a $5 million civil penalty against the company and $125,000 civil money penalties against each of two senior executives and officers. The company went into bankruptcy and all its stock was ultimately voided.

Subsequently, KPMG and the lead auditor partner on the engagement also settled with the SEC. In that settlement, KPMG admitted that it failed to comply with its obligations as an independent auditor and violated the federal securities laws and agreed to disgorge nearly $5 million of the fees it had earned on its audits of Miller Energy, to pay a multiple-million dollar penalty, and to substantially modify its policies and procedures.

THE LAWSUIT ACCUSES KPMG OF VIOLATING THE SECURITIES EXCHANGE ACT OF 1934 AND THE SECURITIES ACT OF 1933 BY ALLOWING MILLER ENERGY TO ENORMOUSLY INFLATE THE VALUE OF OIL AND GAS RESERVES IN ALASKA IT HAD PURCHASED OUT OF BANKRUPTCY FOR LESS THAN $4 MILLION.

IN GRANTING CLASS CERTIFICATION, MAGISTRATE JUDGE DEBRA C. POPLIN FOUND THAT THE PROPOSED CLASS SATISFIED ALL REQUIREMENTS OF FEDERAL RULE OF CIVIL PROCEDURE 23, INCLUDING THE VIGOROUSLY DISPUTED ISSUE OF WHETHER THE MARKET FOR MILLER ENERGY'S STOCK WAS EFFICIENT.

On August 2, 2018, shareholders in this case overcame defendants' motion to dismiss. Then, after extensive expert discovery, lengthy briefing, and a five-and-half-hour oral argument, on June 29, 2020 the federal magistrate judge issued a report and recommendation that shareholders' motion to certify two classes of shareholders of common stock and two series of preferred stock be granted. In granting class certification, Magistrate Judge Debra C. Poplin found that the proposed class satisfied all requirements of Federal Rule of Civil Procedure 23, including the vigorously disputed issue of whether the market for Miller Energy's stock was efficient.

Notably, while Magistrate Judge Poplin concluded that the number of days demonstrating a cause-and-effect relationship between earnings announcements and market reaction was not high, the court found that the evidence of a relationship, along with other evidence, weighed in favor of finding market efficiency. Magistrate Judge Poplin also denied defendant's motion to exclude the testimony of plaintiffs' expert witness, finding his opinion credible.

Magistrate Judge Poplin's decision also reinforces that market efficiency may be demonstrated through multiple methods and that the cause-and-effect analysis is one factor to be considered but is not dispositive—something particularly noteworthy in this case since there are two separate series of preferred stock at issue in addition to common stock.

In the coming weeks, defendants may appeal the magistrate judge's ruling to the district court. Cohen Milstein looks forward to defending the federal magistrate judge's correct ruling and continuing to pursue a meaningful recovery for the class of injured investors. ■

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EVERYTHING OLD IS NEW ONCE AGAIN: THE DOL'S PROPOSED REGULATIONS ON ESG

Fiduciaries and their advisors have long debated how much they can or should consider what are commonly called Environmental, Social and Governance (ESG) factors when making investment decisions. And since 1994, the U.S. Department of Labor (DOL) has offered shifting guidance on this important topic. On June 23, 2020, the DOL released proposed amendments to Employee Retirement Income Security Act (ERISA) regulations relating to ESG that some commentators say will chill sustainable investing practices. Are their concerns justified, and what are the takeaways for public pension plans?

ON JUNE 23, 2020, THE DOL RELEASED PROPOSED AMENDMENTS TO EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA) REGULATIONS RELATING TO ESG THAT SOME COMMENTATORS SAY WILL CHILL SUSTAINABLE INVESTING PRACTICES.

Previous DOL Guidance

Some context is necessary to understand the DOL's proposed regulations. In 1994, 2008 and again in 2015, the DOL issued Interpretive Bulletins that applied the fiduciary standards of ERISA to what were then called economically targeted investments (ETIs). Interpretive Bulletins are not legally binding on governmental plans, which are not covered by ERISA, but they nonetheless provide the most discrete and useful guidance for public plan fiduciaries considering ESG investing.

Interpretive Bulletin 94-1: The "All Things Being Equal Test"

Interpretive Bulletin 94-1 (IB 94-1), was published to "correct a popular misconception" that ETIs were wholly incompatible with ERISA's fiduciary requirements. In IB 94-1, the DOL used baseline fiduciary principles under ERISA and common law—that plan investments must be prudently managed for the exclusive benefit of plan participants—to establish what came to be known as the "all things being equal test" for ETIs. This test expressly permitted the consideration of collateral benefits while reaffirming that the interests of plan participants remained paramount. Only where there was a "tie" between the economic aspects of two potential investments could the consideration of collateral benefits function as the "tie-breaker" and permit a plan fiduciary to select the ESG investment.

Interpretive Bulletin 08-1: All Things Are Rarely Equal

In 2008, the DOL issued Interpretive Bulletin 2008-01 (IB 08-01), which superseded IB 94-1 and expressed the Department's perspective at that time that the situations in which collateral benefits may be used as a "tie-breaker" would be "very limited." The bulletin's language was overtly skeptical of ETIs and viewed the consideration of collateral benefits to be entirely distinguishable from a fund's more traditional financial analysis of potential investments. IB 08-01 applied the "tie-breaker" rule from IB 94-1 limited by a belief that alternative investment options would rarely be economically equivalent. IB 08-

01 directed plan fiduciaries to undertake “a quantitative and qualitative analysis of the economic impact on the plan” of competing investment alternatives before concluding that such alternatives were equal.

Interpretive Bulletin 15-1: Not Merely Collateral Considerations

The DOL tacked again in 2015, issuing Interpretative Bulletin 2015-01 (IB 15-01) out of a stated concern that IB 08-01 had “unduly discouraged” the consideration of ETIs and ESG factors. The DOL believed that the 2008 guidance could be dissuading fiduciaries from pursuing investment strategies that considered ESG factors where they were used solely to evaluate the economic benefits of investments, and investing in ESGs where economically equivalent. Accordingly, it withdrew IB 08-01 and reinstated the language from IB 94-1. The language and tone of this bulletin differed markedly from the two previous ones and used the term “ESG” for the first time. Notably, the DOL did not restrict its characterization of historically “non-economic” factors to “collateral benefits,” but spoke in terms of ESG issues affecting the “economic merits” of investment analysis. The DOL acknowledged that ESG factors were not always collateral to economic analyses but might instead directly affect the economic value of the plan’s investments. In such instances, the DOL said, ESG factors were not mere tie-breakers but rather proper components of a fiduciary’s primary analysis of the economic merits of competing investment choices.

IN 1994, 2008 AND AGAIN IN 2015, THE DOL ISSUED INTERPRETIVE BULLETINS THAT APPLIED THE FIDUCIARY STANDARDS OF ERISA TO WHAT WERE THEN CALLED ECONOMICALLY TARGETED INVESTMENTS (ETIS).

Back to the Future

The pendulum swung again in 2018 when the DOL issued a Field Assistance Bulletin (providing guidance to DOL staff to address questions arising under Interpretive Bulletins) that cautioned fiduciaries about too readily treating ESG factors as economically relevant. This, it turned out, was a precursor to the proposed regulations that the DOL issued for public comment in June.

2020 Proposed Regulations: All Things Are Almost Never Equal

Reflecting a return to the skepticism it articulated in 2008, the DOL states that “ESG investing raises heightened concerns under ERISA.” According to the DOL, the growing emphasis on ESG investing may be prompting fiduciaries to make investment decisions for purposes other than the only permissible reasons—providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan.

The proposed regulations are intended to confirm that ERISA requires plan fiduciaries to select investments based solely on financial considerations relevant to the risk-adjusted economic value of a particular investment. They also make clear that fiduciaries may not invest in ESG vehicles when they understand an underlying investment strategy of the vehicle is to subordinate return or increase risk for the purpose of what the DOL refers to as non-pecuniary objectives.

While the DOL acknowledges that ESG factors may qualify as economic considerations, they caution that this is true "only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories."

As to tie breakers under the "all things being equal" test, the DOL "expects that true ties rarely, if ever, occur."

Key Takeaways

COMMENTATORS SAY THE PROPOSED REGULATIONS WILL CHILL ESG INVESTING. THEY CLEARLY REFLECT A RETURN TO SKEPTICISM, AS SHOWN BY THE DOL'S STATEMENT THAT ESG INVESTING RAISES HEIGHTENED CONCERNS.

Commentators say the proposed regulations will chill ESG investing. They clearly reflect a return to skepticism, as shown by the DOL's statement that ESG investing raises heightened concerns. It is also noteworthy that the DOL chose to issue the latest ESG guidance by regulation, rather than sub-regulatory guidance in the form of an Interpretive Bulletin or Field Assistance Bulletin; if adopted, such regulations would have the force and effect of law. Still, it is possible that these regulations, even if ultimately adopted as drafted, might not necessarily reflect a sea change for prudent fiduciaries.

- **The underlying fiduciary principles remain unchanged:** Fiduciaries have always been bound by the exclusive benefit rule and the duties of loyalty and prudence, which remain unchanged. For example, under the Internal Revenue Code, no part of the corpus or income of a pension trust (including a public pension trust) may be used for purposes other than the exclusive benefit of participants and beneficiaries.
- **Prudent fiduciaries focus on the plan's financial risks and returns, and keep the interests of plan participants and beneficiaries paramount:** Prudent fiduciaries do not sacrifice investment returns, take on additional risk, or pay higher fees to promote non-pecuniary benefits or goals.
- **ESG investing can fit within the framework under the proposed regulations:** The DOL specifically recognizes that there may be instances where factors that are considered without regard to their pecuniary import, such as environmental considerations, will present an economic business risk or opportunity that would be appropriately treated as material economic considerations under generally accepted investment theories. The DOL gives examples, such as improper disposal of hazardous waste or dysfunctional corporate governance, that likely implicate business risks and opportunities, litigation exposure, and regulatory obligations.
- **Document, document, document:** As always, the key is documentation. Fiduciaries will demonstrate prudence through their documentation of the weight given to ESG factors in light of the assessment of their impact on risk and return; the economic

risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories; the examination of the level of diversification, degree of liquidity, and potential risk-return in comparison with other available investments that could play a similar role in their plan's portfolios. Finally, if using the "all things being equal" test, they will document specifically why the investments were determined to be indistinguishable and why the elected investment was chosen based on the purposes of the plan, diversifications of investments, and interest of the plan participants and beneficiaries in receiving benefits form the plan.

In the regulatory impact analysis, the DOL states that it believes most fiduciaries are operating in compliance with their guidance. The DOL's concern instead seems to lie with the lack of consensus about what constitutes an ESG investment, certain investment products being marketed to ERISA fiduciaries, and vague and inconsistent ESG rating systems.

THE DOL'S CONCERN INSTEAD SEEMS TO LIE WITH THE LACK OF CONSENSUS ABOUT WHAT CONSTITUTES AN ESG INVESTMENT, CERTAIN INVESTMENT PRODUCTS BEING MARKETED TO ERISA FIDUCIARIES, AND VAGUE AND INCONSISTENT ESG RATING SYSTEMS.

The proposed regulations may not necessarily represent the death knell for public pension plans that wish to incorporate consideration of ESG factors in their investing practices, provided they do so in a manner that reflects proper attention to their fiduciary duties. ■

Suzanne Dugan heads Cohen Milstein's Ethics & Fiduciary Counseling practice, which assists pension systems in creating and updating policies and procedures designed to address these and other fiduciary issues.

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As our country continues to respond to the pandemic, Cohen Milstein recognizes the efforts made by so many to keep our communities safe, healthy, and nourished. In particular, Cohen Milstein's longtime e-discovery partner, Casepoint, has demonstrated its commitment by donating $100 for every Casepoint employee—a total of $55,000. Casepoint made its first donation of $25,000 to Feeding America, a network of more than 200 food banks that feed more than 46 million people through food pantries, soup kitchens, shelters, and other community-based agencies. In the photo, Casepoint Co-Founder and Chief Technology Officer Vishal Rajpara loads up boxed meal kids during a company event.

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> "Joining Cohen Milstein and gaining access to the firm's depth, experience, and expertise allowed us to persevere through years of litigation [against issuers of mortgage-backed securities), secure favorable rulings, and ultimately recover over $2 billion for investors."

Christopher Lometti is Of Counsel in Cohen Milstein's Securities & Investor Protection practice group and based in the firm's New York office. For over 30 years, Chris has worked closely with Taft-Hartley plans and other institutional investors to protect their interests through securities litigation. Chris was one of the first attorneys to bring class action lawsuits on behalf of investors in mortgage-backed securities that imploded in the 2008 financial crisis. He has been recognized over the years as a "Plaintiffs' Lawyers Trailblazer" and "Super Lawyer" and was named to the 2016 Lawdragon 500 Leading Lawyers in America, which recognizes the "best of the best" among the 1.2 million members of the U.S. legal profession. For this issue of the **Shareholder Advocate,** ***Chris talked with Editor Christina Saler.***

I grew up in … Crestwood, New York which is a one of those leafy, close-knit suburbs where the houses rarely go up for public sale but rather pass from one family member to another or sell from one friend to another. My dad lived in our family home until he was 98. In Crestwood, I learned to love the outdoors at a young age. I was a Boy Scout and developed a passion for fishing I've had ever since and have passed on to my twin 23-year old sons.

I decided to become a lawyer … when I was studying at Fordham College, my dad's alma mater. I was a political science major and saw law school as a natural progression. I stayed in New York and went to Fordham Law School.

I joined Cohen Milstein … in 2009 because my law partner and I wanted to work with the firm on the cases we developed against the investment banks who had packaged and sold toxic mortgage-backed securities to investors through fraudulent registration statements. These cases were incredibly complex, with novel issues that required a bench deeper than my six-lawyer firm. Joining Cohen Milstein and gaining access to the firm's depth, experience, and expertise allowed us to persevere through years of litigation, secure favorable rulings, and ultimately recover over $2 billion for investors.

These past few months at home … I've gone back to reading collections of short stories. Houghton Mifflin publishes *The Best American Series* which includes yearly anthologies of *The Best American Short Stories*. These anthologies contain what are deemed the best short stories published in a given year by acclaimed contemporary American writers. I've ordered *The Best American Short Stories* for the 1990s and 2000s and am making my way through them. I'm currently reading *The Best American Short Stories 2005*. Each story can be read in an hour or less, so you never feel like you're slogging through a book. Instead, you get to enjoy an extensive sampling of quick, entertaining pieces of quality literature. ■

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