Leaving Liability on the "Shelf"—A Discussion of the Time Limitations for Bringing Claims against Officers and Directors for Alleged Fraudulent Statements in Shelf Registrations

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Introduction

Over the past several years, there has been an onslaught of litigation arising out of the bursting of the real estate bubble and subsequent financial crisis. As a result of the complexity of the financial instruments at issue and the number of parties involved, the subject matter involved requires clients to retain lawyers with sufficient background in economics to understand how to apply legal principles to these factual predicates. Securities litigators are thus provided the opportunity to search for new applications of existing law that may otherwise seem routine. One such opportunity for cutting-edge lawyering arose in the context of claims against a former CFO of Countrywide Financial Corporation (Countrywide) in the federal securities law class action brought against Countrywide and certain of its subsidiaries and former officers and directors.[1]

In that case, a former CFO of Countrywide, who resigned in April 2005, was included as a defendant in the case because Countrywide had used a process called "shelf registration" to sell certain securities pursuant to registration statements and prospectus supplements. Prior to *Countrywide*, no court had considered the effect of amendments adopted by the Securities and Exchange Commission (SEC) in late 2007 on the three year "statute of repose"[2] for claims under Section 11 of the Securities Act of 1933 (Securities Act) alleging false statements in connection with shelf-offerings.[3] In this matter of first impression, the Court granted in part the motion to dismiss brought by the former CFO based on the statute of repose, and dismissed the claims brought against him under Section 11 with prejudice.[4] The legal arguments and factual analysis illustrate how the law evolves along with the financial world it regulates.

Background of Financial Crisis

The U.S. housing market's staggering growth in the recent past was unprecedented. In 1990, mortgage originations in the United States stood at less than $500 billion.[5]

By 2005, the mortgage market had grown 600 percent to over $3 trillion.[6] This explosive rise resulted in a surge in securitization activity, a structured finance process whereby companies pooled and packaged mortgage loans and sold securities backed by those packages—known as "mortgage-backed securities" (MBS)—to investors who received pro rata payments of principal and interest. Between 2001 and 2007, the MBS market enjoyed phenomenal growth, peaking at over $2.7 trillion in 2003.[7]

Use of Shelf Registrations

The rapid growth in the MBS market was fueled in part by the rise of companies using the shelf registration process to sell securities. In creating the shelf registration process under Rule 415 of the Securities Act, the SEC recognized that large companies desired faster access to the capital markets to take advantage of favorable market conditions. Shelf registrations permit a company to file a single registration statement covering a certain amount of securities (placing securities "on the shelf"), and then issue securities under that registration statement on a continuous or delayed basis. Pursuant to amendments adopted by the SEC at the end of 2007, companies with less than $75 million in public float must meet certain qualifications to file shelf registrations, including having a class of common equity securities listed and registered on a national securities exchange and avoiding selling in a 12-month period more than the equivalent of one-third of their public float. In addition, certain large public companies may qualify as "well known seasoned issuers" (WKSIs), as defined in Securities Act Rule 405. Generally, companies may qualify as WKSIs if they either have a public float of at least $700 million or have issued, for cash, within the last three years at least $1 billion in aggregate principal amount of nonconvertible securities. An automatic shelf registration becomes effective immediately and allows WKSIs to offer securities immediately after filing the shelf registration statement.

As mortgage loan originations and securitizations grew dramatically, the secondary market for MBS grew even more robust. However, with the unprecedented seizing of the global credit market and the precipitous decline of the housing boom, the MBS market came to a dramatic halt, and companies increasingly found themselves in court facing a litany of claims that the disclosures contained in offering documents underlying the sale of MBS were false and misleading.

Companies are far from solitary targets—officers and directors, in particular, have also been swept up in the growing wave of litigation based on purported material misstatements or omissions contained in offering documents. Whether an officer or a director signed a registration statement years ago, or left a company before the filing of a lawsuit, Section 11 of the Securities Act, a strict liability statute, is broadly written, and plaintiffs attempt to cast a wide net to include a variety of actors, sometimes stretching back for years before the crisis occurred.

Securities Offering Reform of 2005

In 2005, the SEC adopted a set of rules that modified and advanced the registration, communications, and offering processes under the Securities Act, known as the Securities Offering Reform.[8] The reforms, which became effective December 1, 2005, had several aims: to eliminate unnecessary and outmoded restrictions on securities offerings, to provide more timely investment information to investors while balancing the needs of issuers, and to integrate disclosure and capital formation processes under the Securities Act and the Securities Exchange Act of 1934.[9] As part of the package of reforms, the Securities Offering Reform sought to address certain timing issues concerning the liability of various participants in the offering process. In particular, the reforms modified the application of the statute of repose as to certain actors, setting forth specific rules that distinguish between issuers and underwriters, on the one hand, and officers and directors, on the other. Specifically, Securities Act Rule 430B, part of the Securities Offering Reform, governs Section 11 liability periods under certain circumstances by determining the first bona fide offering date for different actors. Under the reforms, certain types of supplements or amendments will re-start the three-year repose clock for issuers and underwriters, but not for officers and directors. The Securities Offering Reform did not alter the timing of liability as applied to officers and directors; the timing of their liability remained mostly the same pre and post-reforms.

Countrywide

Countrywide is one of the first and only cases to consider the Securities Offering Reform's effect on the statute of repose. The federal class action included over 40 defendants and alleged a variety of federal securities law violations. Plaintiffs' primary allegation was that Countrywide, in issuing billions of dollars of securities to the public over the course of several years, filed shelf registration statements that contained material misstatements or omissions, thereby deceiving investors into purchasing securities offered therein. Plaintiffs targeted nearly every individual who signed many of these registration statements, regardless of whether or not the individual had left Countrywide soon after signing a registration statement.

In its Order, on a motion to dismiss, the Court dismissed with prejudice the Section 11 claim against a former CFO of Countrywide because of the expiration of the statute of repose. In doing so, the Court provided a comprehensive analysis of the statute of repose under both pre-Rule 430B law and Rule 430B. The Court recognized that it was the first to consider the Securities Offering Reform's effect on repose timing and, as a consequence, proceeded carefully with its detailed analysis.

As discussed in the Court's analysis, Rule 430B governs all securities traceable to registration statements effective on or after December 1, 2005—the Securities Offering Reform's effective date. The Court concluded that Rule 430B does not apply retroactively, and that pre-Rule 430B law controlled plaintiffs' claims against the CFO because the registration statement at issue became effective prior to December 1, 2005. Nevertheless, the Court analyzed repose timing under pre-Rule 430B law and Rule 430B, and reached the same conclusion under both. In the case, the complaint alleged that the former CFO signed a registration statement that first offered securities to the public on February 7, 2005. However, the former CFO was not named as a defendant until plaintiffs filed an amended complaint on April 11, 2008—more than three years after the securities were first "bona fide offered to the public," in violation of the absolute three-year cut-off established under Section 13 of the Securities Act. Accordingly, the Court found that the statute of repose had expired under both pre-Rule 430B law and Rule 430B.

Can the Three-Year Repose Clock Re-start?

Though the former officer in *Countrywide* faced an absolute three-year repose period, in some cases, under both pre-Rule 430B law and Rule 430B, certain events can re-start the three-year repose clock, thereby potentially extending a defendant's liability beyond three years. As alleged in *Countrywide*, the company filed prospectus supplements each time it took the registration statement off the "shelf" to sell the securities at issue. The Court ruled that each supplement did not re-start the three-year repose clock. There are a few limited exceptions that may re-start the repose clock for officers and directors under pre-Rule 430B law and Rule 430B, which the Court also carefully discussed, but none were applicable in the case.

The facts in *Countrywide* underscore the policy behind the differential treatment of certain defendants found in the Securities Offering Reform. The former CFO had resigned from Countrywide in April 2005, just a few months after the securities at issue were bona fide offered to the public. Nearly all of the securities were offered *after* his departure, and he had no input on any decisions related to any offerings after he had resigned. Once he left, he was in no position to alter the mix of information provided to potential investors regarding particular securities. Thus, any measure to re-start the repose clock and extend his legal exposure would not have been in accord with the ultimate intent of the Securities Act, which is to prohibit fraud and deceit in the sale of securities and to insure that companies are providing accurate information to potential investors.

Conclusion

The three-year statute of repose under Section 13 was designed to provide an absolute outside date to impose liability against a defendant. For large, sophisticated companies, under the 2005 SEC reforms, Section 11 liability can be extended beyond three years under certain circumstances and companies should be aware of the potential extent of their liability. But for officers and directors, the statute of repose can extinguish their Section 11 liability and, ultimately, the specter of liability. Though not as common as other more standard Section 11 defenses, the statute of repose may prove just as useful to officers and directors swept up in the broad reach of Section 11 litigation.

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1 *In re Countrywide Fin. Corp. Sec. Litig.*, No. 07-CV-05295 (C.D. Cal. Apr. 6, 2009).

2 *See* Section 13 of the Securities Act of 1933 ("In no event shall any action be brought to enforce a liability created under [Section 11] . . . more than three years after the security was bona fide offered to the public . . . .").

3 The statute of repose is the maximum time period within which an action may be brought, regardless of injury. While a statute of limitations limits the remedy of going to court, a statute of repose limits the underlying cause of action.

[4] While the former CFO had already been dismissed from the case, on August 2, 2010, the Court granted preliminary approval of a settlement of the case for $624 million.

[5] Jennifer E. Bethel, Allen Ferrell & Gang Hu, Legal and Economic Issues in Litigation Arising from the 2007-2008 Credit Crisis, at 6-7 (Harvard Law & Econ. Discussion Paper No. 212; Harvard Law Sch. Program on Risk Regulation Research Paper No. 08-5, 2008).

[6] *Id*.

[7] *Id*. at 9.

[8] *See* SEC Release Nos. 33-8591, 34-52056, IC-26993, FR-75, and International Series Release No. 1294, File No. S7-38-04 (July 19, 2005); 70 Fed. Reg. 44,722, 44,774 (Aug. 3, 2005).

[9] *Id*.