Skadden

Inside the Courts

An Update From Skadden Securities Litigators

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AUCTION RATE SECURITIES

In re MRU Holdings Sec. Litig., No. 09 Civ. 3807 (RMB) (S.D.N.Y. Feb. 17, 2011)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims Relating to Alleged Misrepresentations Regarding Student Loan Pools Securitization

Judge Richard M. Berman of the U.S. District Court for the Southern District of New York dismissed claims that MRU's officers, its banker and its auditor violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting MRU's ability to securitize student loan pools into auction rate securities (ARS), which generally represented MRU's business model. As MRU had filed for Chapter 7 bankruptcy, it was not named as a defendant. The plaintiffs did not allege a misrepresentation because MRU had in fact disclosed in detail the assumptions and risks its use of ARS created, and MRU also had clearly disclosed its reliance on securitization of its student loan pools and the risks associated with ARS. Further, as to MRU's banker, the plaintiffs did not plead that the banker owed them any fiduciary duty, and therefore the banker could not be liable for alleged omissions; even if it had, the plaintiffs did not allege with particularity any specific alleged misrepresentations or omissions. As to scienter, the court concluded that the plaintiffs did not plead a specific motive as to MRU's officers (instead alleging only generalized motives such as preventing losses) and that the banker's alleged motive — to obtain repayment of a loan to MRU — also was insufficient, as it did not explain why the banker would continue to underwrite MRU's ARS after the loan was repaid. Finally, the complaint did not allege specific red flags that MRU's auditor purportedly ignored, and the plaintiffs could not allege simply that the auditor committed the alleged fraud to increase its fees.

Anschutz Corp. v. Merrill Lynch & Co., Inc., No. 09 MD 2030 (LAP) (S.D.N.Y. Feb. 9, 2011)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims Involving Auction Intervention Disclosure

Chief Judge Loretta A. Preska of the U.S. District Court for the Southern District of New York dismissed claims that Merrill Lynch violated Section 10(b) of the Securities Exchange Act in connection with ARS that Merrill Lynch had underwritten. The court determined that the plaintiffs failed to plead a material omission or misrepresentation by Merrill Lynch because the alleged omissions — that Merrill Lynch would intervene in auctions to prevent failure — were disclosed in a website disclosure on Merrill Lynch's website that it would routinely intervene in auctions (a disclosure that was made as a result of an SEC order that highlighted auction interventions). Further, the plaintiffs failed to plead scienter because Merrill Lynch's desire to maintain a profit was insufficient, and the plaintiffs did not plead that the conduct was highly unreasonable — Merrill Lynch sufficiently disclosed the challenged practices, and therefore cannot be found to have acted recklessly. In addition, the court concluded that sanctions were not warranted under the PSLRA, and that the ratings agencies did not commit common-law negligent misrepresentation by rating the ARS and not downgrading those ratings quickly enough.

CLAL Fin. Batucha Inv. Mgmt., Ltd. v. Perrigo Co., No. 09 Civ. 2255 (TPG) (S.D.N.Y. Sept. 30, 2010)

Click here to view the opinion.

S.D.N.Y. Upholds Claims Involving Write Down of Lehman-Issued ARS

Judge Thomas P. Griesa of the U.S. District Court for the Southern District of New York upheld claims that Perrigo, its CEO and its CFO violated Section 10(b) of the Securities Exchange Act by failing to write down Perrigo's ARS, which it had acquired from Lehman Brothers, in the immediate aftermath of Lehman's September 2008 bankruptcy. Instead, Perrigo continued listing its Lehman-issued ARS at the value it assigned those ARS at the end of the first quarter of 2008 (in which Lehman declared bankruptcy) and only wrote down the value of those ARS at the end of the following quarter. The complaint pled an alleged material misrepresentation because (i) the basis for maintaining the March 2008 value for the ARS was that the market for those ARS might be revived, which was no longer possible following Lehman's bankruptcy, and (ii) Perrigo's net income would have declined from the prior quarter, if it had written down the ARS in March 2008. Further, scienter was pled adequately because the defendants were

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aware of the "severe danger" to the ARS's value in November 2008 when they announced the results of the quarter ending in September 2008. Among other things, other companies that held Lehman-issued ARS had immediately written them down for the quarter that covered Lehman's bankruptcy. Finally, the complaint pled loss causation because the purported corrective disclosure — the write-down of Perrigo's ARS in the following quarter — was pled to be a substantial cause of the decline in Perrigo's stock price (which happened the same day as two indexes that Perrigo's stock was part of registered a gain). The court also upheld in part, and dismissed in part, the associated Section 20(a) control-person liability claim, reasoning that a Section 20(a) claim must allege particularized facts of the controlling person's culpable behavior; the complaint did so for Perrigo's CEO and CFO, but not for the other defendants.

AUDITOR LIABILITY CLAIMS

Amorosa v. Ernst & Young LLP, No. 09-5270-cv (L) (2d Cir. Feb. 2, 2011)

Click here to view the opinion.

Second Circuit Affirms Dismissal of Claims Involving Audit Opinion

Last month, the U.S. Court of Appeals for the Second Circuit affirmed the dismissal of claims that AOL's auditor, Ernst & Young, violated Section 11 of the Securities Act and Sections 10(b) and 14(a) of the Securities Exchange Act by making alleged misrepresentations in a "clean" audit opinion on AOL. The court, agreeing with the trial court, concluded that the plaintiff did not plead loss causation in connection with his Sections 10(b) and 14(a) claims and that the Section 11 claim was barred by the one-year limitations period. As to the Section 10(b) and 14(a) claims, the plaintiff did not identify any purported corrective disclosures that implicated Ernst & Young's challenged audit opinions and, further, did not connect AOL's alleged fraud to Ernst & Young itself. As to the Section 11 claim, the complaint alleged that the first disclosures relating to Ernst & Young's alleged misrepresentations, which started running the statute of limitations, were more than a year before the plaintiff filed suit. Further, although the plaintiff claimed that true corrective disclosure occurred less than one year before he filed suit, AOL's stock price had actually increased after that purported true corrective disclosure, making his Section 11 claim fail for lack of loss causation.

In re Interbank Funding Corp. Sec. Litig., No. 09-7167 (D.C. Cir. Dec. 28, 2010)

Click here to view the opinion.

D.C. Circuit Affirms Denial of Proposed Amended Complaint for Failure to Plead Reliance

The U.S. Court of Appeals for the D.C. Circuit affirmed the denial of a proposed amended complaint alleging that Interbank's auditor (Radin Glass & Co., LLP) violated Section 10(b) of the Securities Exchange Act, because the proposed amended complaint did not adequately plead reliance. The plaintiff alleged that Interbank was a Ponzi scheme, and that the auditor violated Section 10(b) by stating that Interbank's financial statements were prepared in accordance with GAAP. The proposed amended complaint did not directly plead reliance, and, because it alleged that the auditor made an affirmative misrepresentation (*i.e.*, that Interbank's financial statements were prepared in conformity with GAAP), the plaintiff was not entitled to a presumption of reliance under *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

Lewin v. Lipper Convertibles, L.P., No. 03 Civ. 1117 (RMB) (S.D.N.Y. Nov. 17, 2010)

Click here to view the opinion.

S.D.N.Y. Grants Summary Judgment in Case Involving Bankrupt Limited Partnership

Judge Richard M. Berman of the U.S. District Court for the Southern District of New York granted summary judgment on claims by investors in a bankrupt limited partnership that the limited partnership's auditor, PricewaterhouseCoopers, violated Section 10(b) of the Securities Exchange Act by issuing a purportedly false and misleading unqualified audit opinion. The trustee of the bankrupt limited partnership had settled claims against the auditor in New York state court. The court concluded that the plaintiffs lacked standing to assert direct claims

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against the auditor because they did not demonstrate that their injuries were distinct from the limited partnership's injuries. In fact, the auditor's expert opined that the plaintiffs' losses were the reduced value of their investments, which were shared in common with other limited partners. Those losses were not unique to the plaintiffs. The court explained that suffering only a diminution in the value of shares was insufficient to establish standing to assert direct claims, and the plaintiffs did not introduce evidence showing that they had suffered any other injury to rebut the expert opinion offered by the auditor. The court also explained that the plaintiffs had not provided *any* evidence of what their actual damages might be, further entitling the auditor to summary judgment. In so doing, the court rejected the plaintiffs' attempt to establish a rescissionary measure of damages.

In re Beacon Assocs. Litig., No. 09 Civ. 777 (LBS) (S.D.N.Y. Oct. 5, 2010)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims Relating to Madoff Feeder Fund

Judge Leonard B. Sand of the U.S. District Court for the Southern District of New York dismissed claims that Friedberg, the auditor of a Madoff feeder fund, violated Section 10(b) of the Securities Exchange Act because it purportedly failed to investigate red flags. Although the complaint alleged numerous red flags (*e.g.*, Madoff's intense secretiveness and investors' inability to replicate his results with his claimed strategy), it did not allege that Friedberg was aware of those red flags. Friedberg was not required to corroborate Madoff's account statements; the plaintiffs argued that Friedberg ignored the red flags because it did not investigate Madoff, rather than argue the more compelling reason — that it did not investigate Madoff because it relied on his reputation as an industry leader. The court, however, upheld claims against the investment adviser and the feeder fund's general partner because they allegedly knew Madoff's investment strategy was inconsistent with publicly available information, and chose not to disclose this knowledge to investors in order to maintain assets under management, a key metric for the sale of their business, while also not disclosing a decrease in assets under management.

CLASS CERTIFICATION

In re IMAX Sec. Litig., No. 06 Civ. 6128 (NRB) (S.D.N.Y. Dec. 20, 2010)

Click here to view the opinion.

S.D.N.Y. Denies Class Certification for Failure to Plead Loss Causation

Judge Naomi Reice Buchwald of the U.S. District Court for the Southern District of New York denied certification of a purported class alleging that IMAX violated Section 10(b) of the Securities Exchange Act because the proposed class representative, Snow Capital, did not adequately plead loss causation. IMAX allegedly violated Section 10(b) in connection with purported misrepresentations as to revenue recognition in two periods: fiscal years 2002 and 2004 (which were revealed through a 2007 disclosure) and fiscal years 2005 and 2006 (which were revealed through a 2006 disclosure). The court determined that the 2006 disclosure did not act as a corrective disclosure for the 2002/2004 alleged misrepresentations because (i) it did not reveal at the time that IMAX may have made misrepresentations in 2002/2004 and (ii) it did not reveal a sustained course of conduct, as the alleged revenue-recognition misrepresentations in 2002/2004 and in 2005/2006 were different. Because Snow Capital purchased all of its IMAX stock *before* the 2005/2006 alleged misrepresentations and sold it *before* the 2007 corrective disclosure for those alleged misrepresentations, the court determined that Snow Capital could not establish loss causation. In doing so, the court rejected Snow Capital's argument that the 2006 corrective disclosure (after which Snow Capital had sold its IMAX stock) was sufficient to establish loss causation because it led to an SEC investigation that resulted in the 2007 corrective disclosure. Consequently, Snow Capital's inability to establish loss causation raised typicality issues and might subject it to a unique defense (*i.e.*, lack of loss causation), and therefore the court could not certify a class with Snow Capital as the class

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representative. However, the court noted that numerosity, commonality and predominance requirements of Rule 23 of the Federal Rules of Civil Procedure were satisfied, and ordered other parties who wished to be appointed lead plaintiff to file applications with the court.

DIRECTORS AND DIRECTORS' DUTIES

BOOKS AND RECORDS

King v. Verifone Holdings, Inc., C.A. No. 330, 2010 (Del. Jan. 28, 2011)

Click here to view the opinion.

Delaware Supreme Court Reverses Holding on Commencement of Section 220 Proceedings After Derivative Actions

The Delaware Supreme Court, sitting en banc, reversed the Delaware Court of Chancery's holding that a stockholder-plaintiff who has brought a derivative action without first prosecuting an action to inspect books and records under 8 *Del. C.* § 220 is, for that reason alone, precluded from prosecuting a later-filed Section 220 proceeding. [See *Inside the Courts, Vol. 2, Issue 2*, for a discussion of the Court of Chancery's decision.]

The court explained that, while commencing a Section 220 proceeding in advance of a derivative action is advisable, the failure to do so did not preclude a Section 220 proceeding. The court discussed three prior Delaware cases in which Section 220 proceedings were permitted following the commencement of a derivative action. The court explained that, under Delaware law, commencing a Section 220 action in order to aid in pleading demand futility is a proper purpose.

MERGERS & ACQUISITIONS

Golden Telecom, Inc. v. Global GT LP, No. 392, 2010 (Del. Dec. 29, 2010)

Click here to view the opinion.

Delaware Supreme Court Affirms Decision in Appraisal Action

The Delaware Supreme Court affirmed the decision of the Delaware Court of Chancery's findings in this appraisal case. Following a tender offer, Golden Telecom merged into Lillian Acquisition, a wholly owned subsidiary of Vimpel-Communications. Golden shareholders received $105 per share in the transaction. A Golden special committee rejected several Vimpel-Communication bids before reaching a definitive merger agreement. The special committee did not, however, conduct a large pre-merger market check because a large stakeholder had committed to refuse support for any transaction with a partner other than Vimpel-Communications. Certain Golden shareholders thereafter sought appraisal. The Delaware Court of Chancery valued Golden at $125.49 per share, and Golden appealed.

In affirming the Court of Chancery's decision, the Delaware Supreme Court rejected the argument that the Court of Chancery erred by failing to defer to the merger price as indicative of Golden's fair value, and concluded that "[r]equiring the Court of Chancery to defer — conclusively or presumptively — to the merger price, even in the face of a pristine, unchallenged transactional process, would contravene the unambiguous language of the [appraisal] statute and the reasoned holdings of our precedent." Further, the court found that the company was not bound in an appraisal proceeding by the company-specific data it had previously sent to stockholders, noting that the appraisal statute does not "require the parties to adhere to previously prepared data," but rather "vests the court with significant discretion to consider 'all relevant factors'" when determining fair value. The Delaware Supreme Court also noted that "[r]equiring public companies to stick to transactional data in an appraisal proceeding would pay short shrift to the difference between valuation at the tender offer stage — seeking 'fair price' under the circumstances of the transaction — and valuation at the appraisal stage — seeking 'fair value' as a going concern." Therefore, the Delaware Supreme Court found that the Court of Chancery had a rational basis for accepting Golden's proposed tax rate in the

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appraisal proceeding, even though it was different than the tax rate in Golden Telecom's proxy statement. Finally, the Delaware Supreme Court concluded that the vice chancellor did not abuse his discretion in its valuation.

In re Del Monte Foods Co. S'holders Litig., C.A. No. 6027-VCL (Del. Ch. Feb. 14, 2011)

Click here to view the opinion.

Court of Chancery Grants Limited Preliminary Injunction Prohibiting Shareholder Vote on Transaction Involving Bank Misconduct

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery granted a limited preliminary injunction prohibiting a shareholder vote on the $5.3 billion leveraged buyout of Del Monte Foods Company for a period of 20 days. Del Monte entered into an agreement and plan of merger with Blue Acquisition Group, Inc. (comprised of three private equity firms) under which, if approved by stockholders, each share of Del Monte common stock will be converted into the right to receive $19 in cash. The consideration represented a premium of approximately 40 percent over the average closing price of Del Monte's common stock for the three-month period ending prior to the announcement of the merger. According to the court, the sale process was engineered in a manner permitting Del Monte's banker "to obtain lucrative buy-side financing fees." The court explained that information was withheld "from the Board that could have led Del Monte to retain a different bank, pursue a different alternative, or deny [the bank] a buy-side role." The court also stated that the bank failed to disclose to the board its "behind-the-scenes efforts" to put Del Monte "into play." These actions, according to the court, were designed to fulfill the bank's goal of providing buy-side financing to the acquirer. The court noted that having this particular bank serve a buy-side financing role "was not necessary to secure sufficient financing for the Merger, nor did it generate a higher price for the Company. It simply gave [the bank] the additional fees it wanted from the outset." The court pointed out that the bank stood to earn slightly more from providing buy-side financing than it will from serving as Del Monte's sell-side adviser.

The court found that the plaintiffs had established a reasonable probability of success on the merits of a claim for breach of fiduciary duty against the individual defendants for "failing to provide the serious oversight" that would have avoided this situation. The court noted, however, that, in light of the protections provided by an exculpatory clause authorized by 8 *Del. C.* § 102(b)(7), its decision did not mean that the directors will face a meaningful threat of monetary liability in the damages portion of the litigation, given that the board appeared to have sought in good faith to fulfill its fiduciary duties, but failed because of the court's findings regarding the bank. As an equitable remedy to the board's breach of fiduciary duty, the court enjoined the vote on the merger for the 20-day period. Pending the vote on the merger, the court enjoined the parties to the merger agreement from enforcing the no-solicitation and match-right provisions, as well as the termination fee provisions relating to topping bids and changes of the board's recommendation. The injunction was conditioned on the plaintiffs posting a bond in the amount of $1.2 million.

Steinhardt v. Howard-Anderson, C.A. No. 5878-VCL (Del. Ch. Jan. 24, 2011) (Transcript)

Click here to view the opinion.

Court of Chancery Grants Limited Disclosure-Based Injunction Against Closing of Merger Transaction

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery, in a transcript ruling, granted a limited disclosure-based injunction against the closing of a merger transaction offering $3.8337 per share in cash and 0.2925 shares of the acquirer's common stock for each share of the target's stock. The court first engaged in a brief discussion concerning whether *Revlon* duties are triggered in this mixed stock/cash deal, in which public shareholders of the target would own approximately 15 percent of the post-transaction entity if the deal were approved. The court opined that *Revlon*'s reasonableness standard should apply because "[t]his is a situation where the target stockholders are in the end stage in terms of their interest in [the target]. This is the only chance they have to have their fiduciaries bargain for a premium for their shares

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as the holders of equity interests in that entity." The court continued that "it's just not worth having the dance on the head of a pin as to whether it's 49 percent cash or 51 percent cash or where the line is. This is the only chance that [target] stockholders have to extract a premium, both in the sense of maximizing cash now, and in the sense of maximizing their relative share of the future entity's control premium." Ultimately, however, the court did not see enough in the record to warrant an injunction based on a *Revlon* analysis, concluding that "[g]iven where we are ... with no topping bidder, I think it's up to the stockholders to decide whether this is the price and the mix of consideration that they want for their shares. But they have to be able to do that on a fully informed basis."

The court did find that disclosure concerns warranted an injunction. First, the court found the proxy had a "partial disclosure issue" because, while it explained the events concerning the company's "road show" leading up to a merger agreement, it failed to explain the impact of the road show. That impact was, according to the court, a reduction of the cash value delivered to shareholders of approximately $25 million. Second, the court found the failure to disclose fully the accretion/dilution analysis preformed in connection with a banker's fairness opinion was a material omission. The court explained that the full analysis, and range derived therefrom, was contained in the final board book, and therefore should be included in the proxy. Third, the court found that an agreement in principle that a target board member would become a director on the surviving company board should be disclosed. Fourth, the court found the proxy's description of certain contacts the target's board made during the process of shopping the company were misleading. Finally, the court found certain disclosures concerning additional aspects of the banker's fairness opinion may be insufficient, and ordered the retaking of the banker's Court of Chancery Rule 30(b)(6) deposition in order to discover whether there is "a good explanation" for certain changes in the banker's analysis that occurred during the process leading to the transaction.

Reis v. Hazelett Strip-Casting Corp., C.A. No. 3552-VCL (Del. Ch. Jan. 21, 2011)

Click here to view the opinion.

Court of Chancery Holds That Reverse Stock Split Was Not Entirely Fair

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery, in a post-trial opinion, held that a reverse stock split used in a going-private transaction was not entirely fair, and awarded damages, as well as pre- and post-judgment interest. Hazelett Strip-Casting was formed as a family business in 1956. The company was closely held, with two brothers as the only shareholders. When the brother holding the minority interest died, the controlling shareholder brother offered to purchase the minority interest from the deceased's estate (the Estate) for $1,500 per share, with no valuation analysis. The Estate resisted the stock sale, and the Hazelett board approved, at the behest of the controlling shareholder brother, a reverse split in which every share would become a 1/400 fractional interest. After the split, the Estate would hold 350/400 of a share, and the board determined to issue the Estate cash instead of a fractional share. The Estate sued, arguing the reverse stock split was unfair, and a breach of the board and its controlling shareholder's fiduciary duties.

The court found that the reverse split was unfair, and held that, when a controlling stockholder uses a reverse split to freeze out minority stockholders without any procedural protections, it will review the transaction under the entire fairness standard of review — Delaware's "most onerous standard" — under which the defendants bear the burden of proof. The court determined that this standard of review was appropriate because a reverse split under these circumstances "is the 'functional equivalent' of a cash-out merger." The court noted that, if the controlling stockholder "permits the board to form a duly empowered and properly functioning special committee, or if the transaction is conditioned on a correctly formulated majority-of-the-minority vote, then the burden could shift to the plaintiff to prove that the transaction was unfair." The court also explained that, had the controlling stockholder permitted both a properly functioning special committee and conditioned the transaction on a correctly formulated majority-of-the-minority vote, application of the business judgment rule would result. However,

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in this case, the court found that the burden of proof remained with the defendants, and that they failed to prove that the reverse split was entirely fair. The court determined that "[t]here was no dealing in this case that could be called 'fair.' Procedural protections were not implemented, and no one bargained for the minority." Likewise, the defendants failed to show fair price, and they made no effort to determine the fair value of the fractional interests when those entitled to receive such fractions were determined.

The court went on to determine the fair value of Hazelett's shares, relying on two methods — capitalized earnings and book value. In doing so, the court rejected the plaintiffs' comparable companies and capitalized free cash flow methods. Ultimately, the court determined that the fair value of each fractional interest was $3,980, and ordered the defendants to pay the remainder that was not paid in connection with the stock split, as well as pre- and post-judgment interest.

In re John Q. Hammons Hotels Inc. S'holder Litig., No. 758-CC (Del. Ch. Jan. 14, 2011)

Click here to view the opinion.

Court of Chancery Concludes Merger Price Is Fair and Board Breached No Fiduciary Duty

Chancellor William B. Chandler III of the Delaware Court of Chancery, in this post-trial opinion, concluded that a $24-per-share cash merger between John Q. Hammons Hotels, Inc. (JQH) and Elian was entirely fair, the JQH board breached no fiduciary duty in connection with the merger, and the plaintiffs failed to state an aiding and abetting claim against the third-party acquirers.

First, the Court of Chancery found that the transaction, which it evaluated under the entire fairness standard, was entirely fair. The court determined that the JQH special committee in charge of negotiating and approving the merger satisfied the threshold requirements for independence, which the plaintiffs also conceded at trial. The court rejected the plaintiffs' contention that the special committee was coerced into accepting Elian's offer to avoid worse outcomes for the minority shareholders, finding "a claim of coercion cannot be premised on the threat of simply maintaining the status quo." Moreover, this alleged threat to the status quo was fully disclosed to potential investors. Further, the court found no credible evidence at trial that demonstrated improper self-dealing by John Q. Hammons, the company's founder and one of JQH's directors, or "strong-arm" conduct that would have coerced the special committee or shareholders into supporting the merger. As to fair price, the court found that the defendants' evidence of fair value was more convincing, persuasive and thorough than the plaintiffs' weak evidence. Moreover, that the unaffiliated stockholders "overwhelmingly supported the transaction" was an "undisputed fact" that further supported the fairness of the merger.

Second, the court rejected the plaintiffs' disclosure claims, finding that none of the alleged omissions were material to JQH shareholders' voting decision. The court found no evidence that the directors were required to disclose that an employee of Lehman, the special committee's adviser, had allegedly contacted Elian about the possibility of underwriting an Elian security offering. The court stated that "directors do not owe a duty to disclose facts that they are not aware of." The court also found that the defendants were not required to disclose that the special committee's legal adviser also represented the entity providing financing for Elian. Finally, the court found that the defendants did not have to disclose the substance of a presentation by Elian to the special committee because it was "premised on a hypothetical scenario."

Third, with respect to the claim against Hammons, the court found that he breached no duty to the minority stockholders. Hammons did not participate as a director in the approval of the merger, and was not involved in the special committee process. The court noted that Hammons was also not on both sides of the merger, as he made no offer as a controlling stockholder and did not engage in any conduct that adversely affected the minority's merger consideration.

Fourth, as for the aiding and abetting claim, there was no evidence that the third-party acquirers knowingly participated in a breach of fiduciary duty by Hammons.

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Thus, the court found in favor of all of the defendants, and concluded that the $24-per-share merger price was the fair value of JQH shares.

Narrowstep, Inc. v. Onstream Media Corp., No. 5114-VCP (Del. Ch. Dec. 22, 2010)

Click here to view the opinion.

Court of Chancery Refuses to Dismiss Claims Related to Expeditious Closing of Merger

Vice Chancellor Donald F. Parsons Jr. of the Delaware Court of Chancery dismissed breach of covenant of good faith and fair dealing claims, but allowed other claims to proceed, in a case arising out of the failed merger between Narrowstep and Onstream Media Corporation. In 2008, the parties entered into a merger agreement that required them to use their reasonable best efforts to close the merger expeditiously. The merger agreement contained terms that required Narrowstep to cede all operational control to Onstream well before closing in order to expedite the two companies' integration. The merger never closed, and Narrowstep sued Onstream, alleging that Onstream breached the merger agreement and the implied covenant of good faith and fair dealing, unjustly enriched itself and fraudulently induced Narrowstep to enter into the merger agreement. Onstream moved to dismiss the complaint for failure to state a claim.

First, with respect to the breach of the merger agreement claim, the court found that the complaint alleged sufficient facts that supported the inference that Onstream failed to take all steps necessary to consummate the merger expeditiously. For example, the court found that Onstream failed to use its best efforts to timely file the registration statement, and repeatedly stalled and failed to take actions necessary to consummate the merger — including that Onstream refused to close unless Narrowstep acquiesced to three separate amendments to the merger agreement that reduced the merger price. Second, the court found that Narrowstep failed to state a claim for breach of the implied covenant of good faith and fair dealing, noting that the court will not invoke the implied covenant to override the express provisions of the merger agreement, and Narrowstep's implied covenant claims were duplicative of claims alleging breaches of express provisions of the merger agreement. Third, the court found that Narrowstep adequately pleaded common law fraud. The complaint alleged that Onstream made several false representations with respect to closing the merger in an expeditious matter, and also alleged details of Onstream's plan to misappropriate Narrowstep's assets before closing. Fourth, the court found that the complaint stated a claim for equitable fraud because it alleged a special relationship between the parties similar to a fiduciary relationship. The court noted that "[w]hat began as arms-length commercial bargaining between the parties transitioned into Onstream controlling Narrowstep for all intents and purposes, pursuant to the express terms of the Agreement, even before the merger closed," and that the parties' relationship exhibited "many of the factual indicia usually associated with fiduciary dealings." Finally, the court allowed Narrowstep to proceed with its unjust enrichment claim as an alternative remedial theory.

In re Art Tech. Group, Inc. S'holders Litig., C.A. No. 5955-VCL (Del. Ch. Dec. 20, 2010) (Transcript)

Click here to view the opinion.

Court of Chancery Enjoins Stockholder Vote on Proposed Merger

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery, in a transcript ruling, enjoined a stockholder vote on a proposed merger until 10 days after the target provided supplemental disclosures to its stockholders describing the fees that its financial adviser, Morgan Stanley, had been paid by the acquirer, Oracle, over the preceding four years. The court also required a description of the nature of the services Morgan Stanley provided to Oracle during those years. The court found that such disclosures would likely be material to stockholders in deciding how much weight to give the Morgan Stanley fairness opinion issued in connection with the merger. According to the court's subsequent implementing order, the required disclosures were ordered to be made "in a manner reasonably designed to disseminate the information rapidly to ATG's stockholders, such as via a public filing with the Securities and Exchange Commission. A separate mailing is not required."

Caspian Alpha Long Credit Fund, L.P. v. Marsico Parent Superholdco, LLC, No. 5941-VCL (Del. Ch. Nov. 8, 2010) (Transcript)

Click here to view the opinion.

Court of Chancery Refuses to Enjoin Debt-for-Equity Exchange Offer

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery, in a transcript ruling, refused to enjoin a debt-for-equity exchange offer. The swap was being affected through a consent plus an exchange offer. In the transaction, if the debtholder exchanged, then the debtholder's vote was considered to be cast in favor of amending the existing indenture. The effect of that vote was to strip covenant protections of those who did not exchange. The plaintiffs who were non-exchanging debtholders claimed that the court should enjoin the exchange offer, as well as the company's restructuring as a whole, arguing that the amendments to the indenture affected by the exchange violated provisions of the indenture that required unanimous consent to strip the covenant protections. The vice chancellor refused to enjoin the transaction or the restructuring, finding the plaintiffs had no probability of success on the merits and that there was no irreparable harm. Significantly, the court found that the balance of hardships favored the company, in that the transaction was beneficial in terms of the company's debt burden, and was supported by a large number of noteholders. The court found that, in contrast, the balance of hardships did not favor the plaintiffs, given their relatively small stake and the totality of the circumstances. Thus, the court refused to enjoin the debt-for-equity exchange offer.

FOREIGN CORPORATIONS

Elliott Assocs. v. Porsche Automobil Holding SE, No. 10 Civ. 0532 (HB) (S.D.N.Y. Dec. 30, 2010), *appeal docketed*, No. 11-447 (2d Cir. Jan. 28, 2011)

Click here to view the opinion.

S.D.N.Y. Rules Claims Against German Automaker Precluded by *Morrison*

Judge Harold Baer, Jr. of the U.S. District Court for the Southern District of New York dismissed claims that Porsche, a German company, and two of its Germany-based senior executives violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting Porsche's intention to take over Volkswagen, another German company whose stock is traded only on a German bourse. Although the plaintiff hedge funds allegedly had entered into security-swap agreements in New York and Texas referencing Volkswagen's stock, the court determined that the plaintiffs' claims were precluded by the U.S. Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010). The court explained that the security-swap agreements were economically equivalent to the purchase of Volkswagen's shares — which would not be subject to Section 10(b) if that were the transaction — and therefore the security-swap agreements were not subject to Section 10(b).

Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co., No. 08 Civ. 1958 (JGK) (S.D.N.Y. Oct. 1, 2010)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims Involving Swiss Re's Exposure to Mortgage-Related Securities

In a suit over Swiss Re's exposure to mortgage-related securities, Judge John G. Koeltl of the U.S. District Court for the Southern District of New York dismissed claims that Swiss Re and two of its senior officers violated Section 10(b) of the Securities Exchange Act under the transactional test enunciated in *Morrison v. National Australia Bank, Ltd.* The court concluded that, because Swiss Re is a Swiss company whose stock trades only on a foreign bourse, plaintiffs could not bring claims against it for violations of the Securities Exchange Act, even if the plaintiffs are American investors who initiated their purchase orders for Swiss Re's stock from the United States (but the transactions were completed electronically on the foreign exchange platforms). In addition, even if Section 10(b) claims were not precluded by *Morrison*, the court explained that those claims would still fail because (i) Swiss Re's challenged statements about credit-default swap (CDS) risk were not purported to have been made by someone who did not believe the statements to be true and accurate and (ii) to the extent Swiss Re purportedly failed to mark the CDSs to market value, the plaintiffs did not specifically plead that the defendants believed the CDS values were inflated.

INSIDE TRADING CLAIMS

United States v. Corbin,
No. 09 Cr. 0463 (VM)
(S.D.N.Y. Oct. 21, 2010)

Click here to view the opinion.

S.D.N.Y. Denies Motion to Dismiss Charges Relating to Misappropriation of Confidential Information

Judge Victor Marrero of the U.S. District Court for the Southern District of New York denied the defendant's motion to dismiss criminal insider trading charges. The defendant was accused of misappropriating confidential information received from the wife of one of the defendant's associates, who worked with a communication firm that provided services to companies in connection with mergers, acquisitions and similar transactions. The court explained that the government sufficiently alleged a duty of confidentiality based upon the associate's express agreement with his wife (and course of conduct with his wife) not to misappropriate information she received in the course of her employment. Further, the court determined that SEC Rule 10b5-2 was not unconstitutionally adopted because that rule was derived from the U.S. Supreme Court's decision in *United States v. O'Hagan*, 521 U.S. 642 (1997). Finally, the court explained that the government was not obligated to allege that the defendant made an improper statement in connection with an insider trading charge.

LOSS CAUSATION

In re Oracle Corp. Sec. Litig.,
No. 09-16502
(9th Cir. Nov. 16, 2010)

Click here to view the opinion.

Ninth Circuit Holds That an Earnings Miss Is Insufficient to Establish Loss Causation

The U.S. Court of Appeals for the Ninth Circuit held that a mere earnings miss is, standing alone, insufficient to establish loss causation. Shareholders of Oracle Corporation brought an action against the software company, alleging that three of its top executive officers issued misleading forecasts about the company's financial condition, in violation of Section 10(b) of the Securities Exchange Act. The shareholders alleged that Oracle's December 2000 internal earnings forecast ignored slowing economic and business conditions, and that Oracle and its executive officers made misrepresentations regarding the quality of its recently released integrated business software. The district court granted summary judgment in favor of Oracle, holding that the plaintiffs failed to identify sufficient evidence as to loss causation for their non-forecasting claims by relying on an earnings miss rather than any actual disclosures about defects in the software.

The Ninth Circuit agreed. Applying the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), the court held that proving loss causation requires more than a mere earnings miss. In particular, the court rejected the shareholders' argument that loss causation can be proved merely by showing that the market reacted to the purported "impact" of the alleged fraud — the earnings miss — rather than to the alleged fraudulent acts themselves. The court found that the "overwhelming evidence produced during discovery indicates the market understood Oracle's earnings miss to be a result of several deals lost in the final weeks of the quarter," rather than customers' failure to buy the products as a result of the defects. Shareholders were thus unable to establish a triable issue that losses were caused by alleged misrepresentations regarding the quality of Oracle's software or alleged fraudulently overstated earnings.

Alaska Laborer Employers Ret. Fund v. Scholastic Corp.,
No. 07 Civ. 7402 (GBD)
(S.D.N.Y. Sept. 30, 2010)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims Involving Alleged Misrepresentations About Scholastic Divisions

Judge George B. Daniels of the U.S. District Court for the Southern District of New York dismissed claims that Scholastic, its CEO and its CFO violated Section 10(b) of the Securities Exchange Act by making alleged misrepresentations about two particular Scholastic divisions, which ultimately required Scholastic to restate its financial results. The court concluded that

(continued on next page)

loss causation was not pled because the complaint did not allege sufficient facts showing that the purported misconduct actually caused the plaintiffs' losses. To establish loss causation, plaintiffs must disaggregate their losses due to economic change from those caused by misrepresentations, requiring a connection between purported misstatements and the plaintiffs' alleged losses from the stock price decline. To do so, the plaintiffs pointed to two press releases as purported corrective disclosures; however, the problems disclosed in the first press release had been previously released, and the losses revealed in the second press release were attributed to different Scholastic divisions than at concern in the purported misrepresentations. Consequently, the court concluded that the complaint failed to allege loss causation.

MORTGAGE-BACKED SECURITIES

Footbridge Ltd. Trust v. Countrywide Home Loans, Inc., No. 09 Civ. 4050 (PKC) (S.D.N.Y Sept. 28, 2010)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims for Failure to Adequately Plead Misrepresentations

Judge P. Kevin Castel of the U.S. District Court for the Southern District of New York dismissed claims that Countrywide and its CEO and COO violated Section 10(b) of the Securities Exchange Act by making alleged misrepresentations in connection with the sale of securitized mortgages that Countrywide had originated. According to the complaint, Countrywide allegedly misrepresented what percentage of the securitized mortgages were on owner-occupied properties, the quality of Countrywide's underwriting guidelines and how Countrywide selected borrowers for mortgages based on reduced documentation (*e.g.*, stated income). Unlike many cases challenging mortgage-backed securities, the plaintiffs were not alleging that Countrywide misrepresented the loans as high quality; rather, the plaintiffs conceded that they understood the securitized mortgages were low quality and claimed that Countrywide misrepresented just how low quality. The court, however, determined that the complaint did not adequately plead misrepresentations because it did not tie Countrywide's purported misrepresentations about mortgages it had originated to the specific securitized mortgages at issue, or provide non-conclusory allegations about the details underlying Countrywide's purported misrepresentations. In addition, the court noted that the complaint did not plead scienter (rather, it only set forth conclusory allegations) or loss causation (as it did not plead how, when and to what extent the plaintiffs' losses were the alleged result of the purported misrepresentations).

PSLRA SANCTIONS

Libaire v. Kaplan, No. 09-2659-cv (2d Cir. Oct. 6, 2010)

Click here to view the opinion.

Second Circuit Affirms Imposition of Sanctions in Case Involving Purchase of Security 18 Years Ago

In a *per curiam* summary opinion, the U.S. Court of Appeals for the Second Circuit affirmed the imposition of sanctions following the dismissal of the plaintiff's claims that North Fork Preserve violated Section 10(b) of the Securities Exchange Act. The court determined that sanctions were appropriate because the plaintiff's sole purchase of a security occurred 18 years before the complaint was filed, which was not disclosed in the complaint, and as a consequence any Securities Exchange Act claims based upon that transaction were time-barred. Moreover, contrary to the plaintiff's unsupported argument, the plaintiff's payment of annual dues in 2005 to North Fork did not constitute a purchase of security (because that payment was not made "solely" for purposes of a return on investment). Finally, the district court properly considered that the plaintiff filed the federal action after the plaintiff's virtually identical state-court action had been dismissed.

SARBANES-OXLEY ACT

Cohen v. Viray, No. 08-3860-cv (2d Cir. Sept. 30, 2010)

Click here to view the opinion.

Second Circuit Vacates Class Settlement Agreement for Indemnifying Chief Officers From Liability Under Section 304

The U.S. Court of Appeals for the Second Circuit vacated a class settlement agreement in a class action against DHB Industries for securities fraud because, under the agreement, DHB improperly indemnified DHB's former CEO and CFO from liability under Section 304 of the Sarbanes-Oxley Act. The court's decision came after a shareholder and the U.S. Department of Justice challenged the validity of the settlement. If a company is forced to restate its financial results due to misconduct, Section 304 requires the individuals who served as CEO and/or CFO at the time of the original financial results to reimburse the company for their bonus and any profits from securities sales for the twelve months after the incorrect financial results were issued. As a threshold matter, the court determined (consistent with the U.S. Courts of Appeals for the Ninth and D.C. Circuits) that there is no private right of action under Section 304 because only the SEC has the express right to exempt an individual from complying with that section. The court then concluded, as a matter of first impression in the federal courts, that the agreement's indemnification provision was invalid because that provision would allow the former CEO and CFO to escape any personal financial liability under Section 304, frustrating the SEC's power to enforce the public's interest in ensuring the integrity of the financial markets.

SEC ENFORCEMENT

Sec. & Exch. Comm'n v. Cuban, No. 09-10996 (5th Cir. Sept. 21, 2010)

Click here to view the opinion.

Fifth Circuit Allows SEC's Insider Trading Case Against Marc Cuban to Go Forward

The U.S. Court of Appeals for the Fifth Circuit reversed the district court's dismissal of the SEC's insider trading complaint against Mark Cuban, holding that it was at least as plausible, based on the SEC's allegations, that Cuban violated a duty not to trade on material, nonpublic information in violation of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act. The complaint arose out of Cuban's sale of his 6.3 percent stake of Mamma.com Inc. in 2004. The complaint alleged that Mamma.com planned to raise capital through a private placement of its equity (PIPE). Mamma.com's CEO called Cuban, then Mamma.com's largest shareholder, and informed him of the PIPE offering. Cuban agreed to keep the information regarding the PIPE offering confidential. According to the opinion, because this offering would dilute his position, Cuban became upset and said, "Well, now I'm screwed. I can't sell." Nevertheless, he instructed his broker to sell his entire stake in Mamma.com prior to the company's public announcement of the PIPE offering, thereby saving himself over $750,000. The SEC alleged that Cuban was liable for insider trading under the misappropriation theory of liability, under which a person is liable when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. The SEC relied on Rule 10b5-2(b)(1), which states that a person has "a duty of trust and confidence" for purposes of misappropriation liability when that person "agrees to maintain information in confidence." The district court granted Cuban's motion to dismiss, finding that an agreement merely to keep information confidential was insufficient to create a duty to disclose or abstain from trading under the misappropriation theory. Rather, only an express agreement not to trade creates such a duty.

The Fifth Circuit reversed, holding that on the "factually sparse record" an equally plausible inference was that Cuban had in fact agreed not to trade — *i.e.*, that his conversation with the CEO was more than just a confidentiality agreement. The court pointed out that Cuban's position — that he could trade upon learning the information but not relay it to others — in effect gave him "an exclusive license to trade on the material nonpublic information." The court vacated the dismissal and remanded the case for further proceedings.

Sec. & Exch. Comm'n v. Pentagon Capital Mgmt. PLC, No. 08 Civ. 3324 (S.D.N.Y. Nov. 12, 2010)

Click here to view the opinion.

S.D.N.Y. Denies Motion to Compel SEC to Turn Over Exculpatory Evidence

Judge Robert W. Sweet of the U.S. District Court for the Southern District of New York denied a motion by the defendants in an SEC enforcement action to compel the SEC to turn over any exculpatory evidence pursuant to *Brady v. Maryland*, 373 U.S. 83 (1963), and *United States v. Giglio*, 405 U.S. 150 (1972). The court reasoned that there was no basis to extend *Brady* and *Giglio* to the SEC enforcement action because the defendants had a right to conduct extensive pretrial discovery, and, in fact, had done so. The court also raised, but did not resolve, the open question of whether *Brady* and *Giglio* are limited to only criminal proceedings.

Sec. & Exch. Comm'n v. Mozilo, No. CV 09-3994-JFW (C.D. Cal. Sept. 16, 2010)

Click here to view the opinion.

California Federal Court Refuses to Grant Summary Judgment on 'Truth-in-the-Market' Defense in Securities Fraud Action

Judge John F. Walter of the U.S. District Court for the Central District of California denied the motions for summary judgment of three senior executives of Countrywide Financial Corporation, finding that the SEC's complaint raised genuine issues of material fact regarding whether the executives made misleading statements and omissions about the quality of Countrywide's loan portfolio and underwriting practices. The SEC's complaint alleged, *inter alia*, that the CEO, the COO and the CFO committed securities fraud, in violation of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act, by misrepresenting the risks of Countrywide's loan portfolio and underwriting practices. In particular, the SEC alleged that the defendants made misleading statements in periodic SEC filings and during earnings calls, conferences and investor presentations that assured investors that Countrywide was an originator of quality mortgages, unlike competitors who primarily engaged in subprime loan origination. However, during the same time period, Countrywide allegedly "undertook an unprecedented loosening or expansion of its underwriting guidelines, to the point of virtually abandoning its guidelines by matching products offered by any competitor, writing riskier and riskier loans, and making exceptions to its already lax underwriting guidelines."

The defendants moved for summary judgment on the SEC's fraud claims primarily on the grounds that the alleged material misrepresentations and omissions were not misleading as a matter of law because accurate information could be found in the market, which factored such information into Countrywide's stock price — *i.e.*, the so-called "truth-in-the-market" defense. The court rejected the defendants' argument that they were entitled to the "truth-in-the-market" defense "in light of Countrywide's extensive disclosures about the risk characteristics of its loan" portfolio. The court concluded that the defendants were attempting to "replace the traditional analysis of materiality, *i.e.*, whether there is a substantial likelihood that a *reasonable investor* would view disclosure of the omitted fact as having significantly altered the total mix of information available, with a 'truth in the market' defense ... in this SEC enforcement action." The U.S. Court of Appeals for the Ninth Circuit has held that, "in an action that does not involve the fraud on the market presumption, that truthful information is available elsewhere does not relieve a defendant from liability for misrepresentations in a given filing or statement." *Miller v. Thane Int'l, Inc.*, 519 F.3d 879, 887 n.2 (9th Cir. 2008). According to the court, therefore, because the SEC in an enforcement action need not prove reliance, the fraud-on-the-market presumption "is not relevant," and, thus, the alleged misstatements and omissions by the Countrywide executives were not rendered immaterial as a matter of law simply because truthful information was available to the public elsewhere.

SECONDARY ACTORS

Affco Inv. 2001 LLC v. Proskauer Rose L.L.P., No. 09-20734 (5th Cir. Oct. 27, 2010)

Click here to view the opinion.

Fifth Circuit Adopts Second Circuit's Approach to Secondary Actor Liability

The U.S. Court of Appeals for the Fifth Circuit held that a law firm that purportedly assisted in developing alleged fraudulent tax strategies through the provision of certain tax opinions could not be primarily liable under Section 10(b) of the Securities Exchange Act because there

(continued on next page)

was no conduct or statements that could be directly attributable to the law firm. The plaintiffs alleged that the company that promoted the tax strategies informed investors that it would provide independent opinions from "several major national law firms" that had analyzed and approved the tax strategy. Based on these assurances, the plaintiffs allegedly agreed to invest in the purported scheme. After the transactions were complete, but before the plaintiffs filed their tax returns, the IRS issued notices addressing certain transactions it deemed prohibited. In response, the plaintiffs allegedly sought tax opinions from the law firm of Proskauer Rose L.L.P., which Proskauer provided; the opinions allegedly concluded that the "losses" plaintiffs generated through the alleged tax shelter likely were allowable. Based on this advice, the plaintiffs allegedly reported the "losses" from the investment. The IRS later audited the plaintiffs, and they were required to pay back taxes and penalties. The plaintiffs sued Proskauer under Section 10(b) for their involvement, but the district court granted Proskauer's motion to dismiss the plaintiffs' securities.

The Court of Appeals agreed with the district court that the plaintiffs had failed to plead sufficiently the element of reliance. Drawing on the U.S. Supreme Court's decisions in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), and *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the court held that a secondary actor cannot be held liable in a private Section 10(b) action for deceptive conduct not explicitly attributed to it before an investor decides to invest. Although the plaintiffs claimed to have relied on Proskauer's tax opinions, the court found that they failed to allege "that they ever saw or heard any Proskauer work product before making their decision, nor d[id] they explicitly allege that the promoters specifically identified Proskauer as one of the 'major national law firms.'" Accordingly, the plaintiffs "failed to show reliance on Proskauer" and the law firm could not be a primary violator.

In reaching this conclusion, the Fifth Circuit expressly adopted the standard articulated by the U.S. Court of Appeals for the Second Circuit in *Pacific Investment Management Co. LLC v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010) (*PIMCO*), which held that a secondary actor could only be liable under Section 10(b) for false statements attributed to it at the time of dissemination. Notably, the Supreme Court has granted certiorari in *In re Mutual Funds Investment Litigation*, 566 F.3d 111 (4th Cir. 2009), *cert. granted*, *Janus Capital Group, Inc. v. First Derivative Traders*, 130 S. Ct. 3499 (2010), and will be reviewing this issue.

SECURITIES ACT CLAIMS

NECA-IBEW Health & Welfare Fund v. Goldman, Sachs & Co., No. 08 Civ. 10783 (MGC) (S.D.N.Y. Oct. 14, 2010)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims Involving Mortgage-Backed Securities

Judge Miriam Goldman Cedarbaum of the U.S. District Court for the Southern District of New York dismissed claims that Goldman Sachs violated Section 11 of the Securities Act in connection with mortgage-backed securities issued by a Goldman Sachs subsidiary. The plaintiff is required to have suffered a loss to state a claim for violation of Section 11; because the plaintiff still received the "pass-through" cash flow payments it was entitled to as an owner of those securities, it had not suffered a loss in the traditional sense. Instead, the plaintiff claimed that the value of the securities had declined because it would take a loss if it sold the securities. However, not only did the prospectus disclose that the securities might be illiquid because no secondary market is guaranteed to exist or continue to exist, but the plaintiff did not adequately plead that any secondary market actually existed for those securities. As such, the plaintiff had not suffered an injury cognizable under Section 11. Finally, the court noted that the increased risk associated with future "pass-through" cash flow payments due to increased risks with the underlying mortgages was also insufficient injury to state a Section 11 claim.

In re Am. Int'l Group, Inc. 2008 Sec. Litig., No. 08 Civ. 4772 (LTS) (S.D.N.Y. Sept. 27, 2010)

Click here to view the opinion.

S.D.N.Y. Upholds Claims Against AIG Involving Credit-Default Swaps and Residential Mortgage-Backed Securities

Judge Laura Taylor Swain of the U.S. District Court for the Southern District of New York upheld claims that AIG and its senior officers, directors, underwriters and auditor violated Sections 11 and 12(a)(2) of the Securities Act, in connection with 101 AIG securities offerings, premised upon alleged misrepresentations with respect to AIG's credit-default swaps (CDS) portfolio and residential mortgage-backed securities (RMBS) exposure made in AIG's SEC filings. First, the plaintiffs had standing to assert claims relating to all 101 offerings because all of the offerings used the same shelf registration statement, and the plaintiffs — who purchased in some of those offerings — were challenging alleged misrepresentations and omissions in the shelf registration statement. Second, the Securities Act claims were timely because they were brought within three years of all of the plaintiffs' transactions and within one year of AIG's announcement of the government bailout — when plaintiffs were finally on notice of the claims (inquiry notice did not start earlier, because AIG continued to make misrepresentations throughout the purported class period). Third, the court explained that it would be "inappropriate" to dismiss the Securities Act claims against AIG's auditor on a motion to dismiss when the auditor was accused of blessing financial statements that allegedly violated specified GAAP principles and were "fundamentally misleading." (A discussion of the court's decision about related claims under Section 10(b) of the Securities Exchange Act may be found below under "Securities Fraud Pleading Standards" on Page 17.)

SECURITIES FRAUD PLEADING STANDARDS

Detroit Gen. Ret. Sys. v. Medtronic, Inc., No. 09-2518 (8th Cir. Sept. 16, 2010)

Click here to view the opinion.

Eighth Circuit Affirms Dismissal of Case Against Medtronic and Three of Its Directors

The U.S. Court of Appeals for the Eighth Circuit affirmed the dismissal of securities fraud against Medtronic, Inc. for failure to plead fraud with sufficient particularity. The complaint alleged that Medtronic engaged in securities fraud by misleading investors regarding the severity of a problem with defibrillator leads the company designed, manufactured, marketed and sold. The complaint further alleged that in March 2007, after being made aware of a potential problem with the device, Medtronic sent a letter to physicians informing them that some clinics had reported higher than normal fail rates and fracturing in the device, and that Medtronic was investigating the reports. In May 2007, according to the complaint, Medtronic filed an application with the Food and Drug Administration to modify the design of the device, and, in October 2007, Medtronic announced it was suspending sales of the device. As a result, the company's stock price dropped approximately 11 percent from its pre-recall price of $56.33 in the days following the recall, falling to a low of $45.54. The plaintiffs filed suit, alleging that the March 2007 letter to physicians "falsely reassured" investors that problems stemmed from doctor error and that the product's failure rate was in line with that of similar products.

The Eighth Circuit agreed with the district court that the letter was not materially misleading as it did not make an equivocal statement regarding the device's safety, nor did it cite doctor error as the sole problem. Rather, the letter presented its information as preliminary and referenced Medtronic's ongoing investigation. The Court of Appeals also agreed with the district court's rejection of the plaintiffs' contention that Medtronic's failure to disclose information about the product's fracture rate rendered the letter materially misleading. The court found that the plaintiffs failed to show that Medtronic possessed the information when the alleged inconsistent statements were made. The court also held the complaint failed to establish scienter because it did not contain facts sufficient to show falsity of the statements and, thus, could not show that Medtronic or its officers knew the statements were false.

Sec. & Exch. Comm'n v. Czarnik, No. 10 Civ. 745 (PKC) (S.D.N.Y. Nov. 29, 2010)

Click here to view the opinion.

S.D.N.Y. Upholds Claims Against Attorney for Alleged Misconduct in Offerings

Judge P. Kevin Castel of the U.S. District Court for the Southern District of New York upheld most of the claims asserted by the SEC, charging that an attorney violated Sections 10(b) of the Securities Exchange Act and Sections 5(a), 5(c) and 17(a) of the Securities Act by drafting legal documents, including opinion letters, for issuers to use in inducing transfer agents to issue unregistered shares of penny stock in three companies in connection with five offerings. The SEC further alleged that the issuers — with whom the attorney worked — sold the unregistered shares to the unsuspecting public in a pump-and-dump scheme. The court dismissed claims as to the attorney's alleged misconduct in the first three offerings and upheld claims as to the attorney's alleged misconduct in the later two offerings because the complaint alleged that the attorney (having become aware of the issuer's purported misrepresentations after the first three offerings were completed) only acted recklessly in connection with the later two offerings. Further, the complaint pled scienter about the later two offerings because the attorney knew that the promoters' representations that they would not sell the stock in the first three offerings was false. Finally, the attorney was a necessary participant and substantial factor in the unregistered offering, and therefore the complaint stated a claim for violations of Sections 5(a) and 5(c).

In re Celestica Inc. Sec. Litig., No. 07 CV 312 (GBD) (S.D.N.Y. Oct. 14, 2010)

Click here to view the opinion.

S.D.N.Y. Dismisses Claim Against Majority Owner Relating to Subsidiary's Statements

Judge George B. Daniels of the U.S. District Court for the Southern District of New York dismissed claims that Celestica, its former CEO and CFO, its majority shareholder and its majority shareholder's CEO violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting Celestica's earnings and corporate restructuring to purportedly inflate Celestica's stock price. The court determined that the complaint did not plead that the majority shareholder or its CEO made the alleged misrepresentations because neither was alleged to have actually made them or had any role in their preparation, issuance or dissemination. It was insufficient to premise the majority shareholder's (or its CEO's) liability solely on its holdings in Celestica or on conclusory allegations that the majority shareholder's CEO attended Celestica's executive committee meetings. Similarly, the complaint did not plead that Celestica's CEO or CFO acted with scienter because it did not provide a specific motive (other than the general motive that their employer should appear profitable and maintain a high stock price) or plead that either acted recklessly (because it did not plead what specific information was provided to the CEO or CFO that was contrary to their public statements).

In re Am. Int'l Group, Inc. 2008 Sec. Litig., No. 08 Civ. 4772 (LTS) (S.D.N.Y. Sept. 27, 2010)

Click here to view the opinion.

S.D.N.Y. Upholds Claims Against AIG Involving Credit-Default Swaps and Residential Mortgage-Backed Securities

Judge Laura Taylor Swain of the U.S. District Court for the Southern District of New York upheld claims that AIG and its directors, senior officers, underwriters and auditors violated the federal securities laws through alleged misrepresentations with respect to AIG's credit-default swaps (CDS) portfolio and residential mortgage-backed securities (RMBS) exposure made in AIG's SEC filings. The complaint adequately pled violations of Section 10(b) of the Securities Exchange Act by AIG and its senior officers because it pled that AIG made alleged misrepresentations about the extent of the CDS portfolio that AIG subsidiary AIGFP entered into in 2005 (including about AIGFP's risk controls, pre-purchase due diligence for CDS and CDS models) and the percentage of AIG's securities lending programs made in RMBS. The court explained that the challenged statements were not protected as forward-looking statements under the PSLRA safe-harbor because AIG's risk disclosures were inadequate in light of undisclosed "hard facts" indicating that AIG did not reasonably believe the forward-looking statements. Moreover, scienter was adequately pled because AIG and its senior officers knew about the extent of the CDS exposure and RMBS investments and chose not to disclose

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those facts, despite internal indicators (and warnings from AIG's auditor) of potential problems. Finally, loss causation was pled because the purported corrective disclosures of the principal undisclosed facts caused AIG's stock price to drop, to the plaintiffs' detriment. (A discussion of the court's decision about related claims under Sections 11 and 12(a)(2) of the Securities Act against AIG may be found above under "Securities Act Claims" on Page 15.)

In re SLM Corp. Sec. Litig., No. 08 Civ. 1029 (WHP) (S.D.N.Y. Sept. 24, 2010)

Click here to view the opinion.

S.D.N.Y. Upholds Claims Against Sallie Mae Relating to Loan Issuance Standards

Judge William H. Pauley III of the U.S. District Court for the Southern District of New York upheld claims that Sallie Mae and its CEO violated Section 10(b) of the Securities Exchange Act through alleged misrepresentations about Sallie Mae's practices with private educational loans. The complaint pled that Sallie Mae allegedly misrepresented its loan issuance standards, understated its loan loss reserves and improperly shifted defaulted loans into "forbearance" (allowing deferral of payments while interest continued to accrue) to hide defaults. The court determined that the complaint adequately pled that the CEO, and therefore Sallie Mae, acted with scienter because the complaint alleged a specific motive for the CEO to wish to keep Sallie Mae's stock price high. The CEO allegedly wished to keep Sallie Mae's stock price high because (i) Sallie Mae had entered into futures contracts that would subject Sallie Mae to significant liability if its stock price fell below a certain price, (ii) the CEO was attempting to engineer a merger with another company, which would pay him $225 million if completed, and needed to keep Sallie Mae's stock price above the trigger price in the futures contracts to keep the merger viable, and (iii) during the purported class period, the CEO sold approximately 97 percent of his Sallie Mae stock. However, the court dismissed Section 10(b) claims against Sallie Mae's former CFO for failure to adequately plead his scienter because he was not alleged to have engaged in unusual trading activity and was not specifically alleged to have acted recklessly, *e.g.*, making a statement while in possession of a specific report indicating the statement was false. Further, the complaint adequately pled misrepresentations by pleading facts showing that the challenged statements were false and were known to be false when made and were directed at Sallie Mae's present condition.

STATUTES OF LIMITATIONS

Riordan v. Sec. & Exch. Comm'n, No. 10-1034 (D.C. Cir. Dec. 28, 2010)

Click here to view the opinion.

D.C. Circuit Affirms SEC Administrative Sanctions and Disgorgement Order Against Individual

The U.S. Court of Appeals for the D.C. Circuit affirmed the SEC's administrative sanctions and disgorgement order against an individual, Guy P. Riordan, who was found to have violated Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act. Riordan had paid kickbacks to New Mexico's state treasurer in exchange for steering state securities transactions to Riordan's brokerage firms from 1996 to 2002. However, SEC enforcement actions seeking a "civil fine, penalty, or forfeiture" are subject to a five-year limitations period, and the SEC brought its enforcement action in late 2007. Both the civil fine and association bar that Riordan received were subject to that limitations period, but the SEC properly only considered Riordan's conduct in late 2002 in determining the amount of the fine and whether to impose an association bar. Further, the SEC could consider Riordan's pre-2002 conduct in determining how much he would be required to disgorge because, under *Zacharias v. Sec. & Exch. Comm'n*, 569 F.3d 458 (D.C. Cir. 2009), disgorgement is not a "civil penalty," and therefore is not subject to the five-year limitations period. Applying *Drath v. FTC*, 239 F.2d 452 (D.C. Cir. 1956), the court further determined that the SEC could consider Riordan's pre-2002 conduct in determining whether to impose a cease-and-desist order because those orders are "purely remedial and preventive" and not a "penalty or forfeiture," and so also was not subject to the five-year limitations period.

Teva Pharm. Indus. Ltd. v. Deutsche Bank Sec., Inc., No. 09 Civ. 6205 (AKH) (S.D.N.Y. Dec. 14, 2010)

Click here to view the opinion.

S.D.N.Y. Dismisses Claims Relating to Sale of ARS to Non-Qualified Buyer

Judge Alvin K. Hellerstein of the U.S. District Court for the Southern District of New York dismissed claims that the broker-dealer for auction rate securities (ARS) issued by special-purpose vehicles organized by the broker-dealer violated Sections 12(a)(1) and 12(a)(2) of the Securities Act. The ARS were issued as exempt from registration because they only were offered to qualified institutional buyers; however, some of the ARS were sold to an entity that was not a qualified institutional buyer, a fact that the entity disclosed in an SEC filing. The court concluded that both claims were barred by the one-year statute of limitations applicable to Securities Act claims. As to the Section 12(a)(1) claim, the court explained that the one-year statute of limitations was an absolute limitations period that was not subject to the discovery rule; because that claim was filed more than one year after the ARS were sold to the entity that was not a qualified institutional buyer, it was time-barred. As to the Section 12(a)(2) claim, although the limitations period was subject to the discovery rule, the court concluded that the plaintiff was on inquiry notice of its claim more than a year before filing suit because the sale to a non-qualified institutional buyer was disclosed in an SEC filing, and the plaintiff, as a sophisticated investor, would have reviewed SEC filings.

TOLLING

Simmonds v. Credit Suisse Securities (USA) LLC, No. 09-35262 (9th Cir. Dec. 2, 2010)

Click here to view the opinion.

Ninth Circuit Reaffirms Rule Regarding Section 16(b) Statute of Limitations

The U.S. Court of Appeals for the Ninth Circuit held that the statute of limitations for claims brought under Section 16(b) of the Securities Exchange Act — which requires corporate insiders to disgorge profits realized on securities sold within six months of the date of their purchase — is tolled until the insider discloses such "short-swing" transactions in a Section 16(a) filing, regardless of whether the plaintiff knew or should have known of the conduct at issue. Vanessa Simmonds brought 54 related complaints under Section 16(b), alleging that various investment banks violated the prohibition on short-swing transactions in connection with the initial public offerings of 54 companies between 1999 and 2000. Thirty underwriter defendants moved to dismiss based on Simmonds' failure to present an adequate demand letter to the companies' boards prior to filing her lawsuits. The remaining 24 underwriter defendants moved to dismiss on the grounds that Simmonds' claims were barred by Section 16(b)'s two-year statute of limitations. The district court granted the defendants' motions to dismiss all 54 complaints. On appeal, the Ninth Circuit affirmed the district court's conclusion that Simmonds failed to make adequate demand as to 30 complaints, but reversed the district court's conclusion that the remaining 24 cases were barred by Section 16(b)'s two-year statute of limitations.

Section 16(b) provides that "no ... suit shall be brought more than two years after the date such profit was realized" from the alleged short-swing transactions and, further, Section 16(a) imposes a reporting requirement on persons who beneficially own more than 10 percent of the issuer's securities, requiring them to file Form 4s with the SEC, disclosing their acquisitions and dispositions of the issuer's stock. In the 1981 decision of *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir. 1981), the Ninth Circuit adopted a "disclosure approach" to Section 16(b)'s statute of limitations provision, under which "an insider's failure to disclose covered transactions in the required Section 16(a) reports tolls the two year limitations period for suits under Section 16(b) to recover profits connected with such a non-disclosed transaction. The two-year period for Section 16(b) begins to run when the transactions are disclosed in the insider's Section 16(a) report." Here, the Ninth Circuit rejected the underwriter defendants' argument that *Whittaker*'s tolling rule should not apply to cases in which plaintiffs knew or should have known of the alleged wrongful conduct. Instead, the Ninth Circuit held that *Whittaker* established a "blanket rule that applies in *all* Section 16(b) actions," "regardless of whether the plaintiff knew or should have known of the conduct at issue."

(continued on next page)

Judge Milan Smith took the atypical step of writing a special concurrence to the majority opinion, which he authored, in order to criticize *Whittaker*'s blanket rule. He noted that a strict reading of Section 16(b) — under which no suit could be filed over two years after a short-swing profit is realized — is "eminently logical." Nevertheless, Judge Smith wrote that he was bound to apply *Whittaker* under *stare decisis* principles. On Dec. 16, 2010, the underwriter defendants petitioned the Ninth Circuit for rehearing en banc.

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