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Inside the Courts

An Update From Skadden Securities Litigators

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U.S. SUPREME COURT

Lawson v. FMR LLC,
No. 12-3 (U.S. March 4, 2014)

Click here to view the opinion.

Supreme Court Clarifies Scope of Sarbanes-Oxley Whistleblower Protections to Include Employees at Private Firms That Contract With Publicly Traded Companies

In a 6-3 decision (Justice Ginsburg), the U.S. Supreme Court held that the Sarbanes-Oxley Act's whistleblower protections apply to employees of a public company's private contractors and subcontractors. The question presented was whether Section 1514A of Sarbanes-Oxley, which protects employees of public companies from retaliation for reporting potential misconduct, extends to employees of a private company that works as a contractor for a public company. Two employees of a private investment advisor sought protection under Section 1514A. The employees alleged retaliation after they raised concerns related to the cost-accounting methodologies and SEC disclosures of a family of public mutual funds.

The court held that the plain language of the Act "shelters employees of private contractors and subcontractors, just as it shelters employees of the public company served by the contractors and subcontractors." In addition, the statute's language and enforcement mechanisms indicated that Congress expected the retaliator to be the purported whistle-blower's employer, rather than a contractor hired specifically to avoid the statute's provisions as the investment advisor argued. The court reasoned that its textual interpretation aligned with Congress's objectives of avoiding "another Enron debacle." Congress recognized that certain of Enron's contractors had retaliated against employees that objected to Enron's practices. Without the provision's protections, contractor's employees "would be vulnerable to retaliation by their employers for blowing the whistle on a scheme to defraud the public company's investors, even a scheme engineered entirely by the contractor."

Chadbourne & Parke LLP v. Troice,
No. 12-79 (U.S. Feb. 26, 2014)

Click here to view the opinion.

Supreme Court Decides Scope of SLUSA 'In Connection With' Requirement

In a 7-2 decision, the U.S. Supreme Court held that the Securities Litigation Uniform Standards Act (SLUSA) — which bars state law class action lawsuits based on misrepresentations "in connection with the purchase or sale" of nationally traded securities (covered securities) — did not prevent a class of purchasers of certificates of deposits in a Ponzi scheme from asserting claims under state law, even though the CDs were supposedly backed by nationally traded stocks and bonds. The Court explained that SLUSA's "basic focus" is on the regulation of securities traded on a national exchange, and both parties agreed that the CDs were not covered securities. Although investors were induced to purchase the CDs by misrepresentations about securities that would have been covered by SLUSA had they existed, for purposes of the "in connection with" requirement, the Court held that the "connection matters where the misrepresentation makes a significant difference to someone's decision to purchase or to sell a covered security, not to purchase or to sell an uncovered security, something about which the Act expresses no concern." In addition, the Court held that the person purchasing the covered securities cannot be the fraudster himself. The Court's opinion balanced the federal interest in standardized litigation concerning nationally traded securities against the preservation of state law remedies for fraud traditionally regulated by the states.

CLASS CERTIFICATION

In re BP p.l.c. Sec. Litig., MDL Nos. 10-md-2185, 4:10-md-2185 (S.D. Tex. Dec. 6, 2013)

Click here to view the opinion.

Texas District Court Denies Class Certification Because Proposed Methodology for Calculating Class-Wide Damages Did Not Track Plaintiffs' Theories of Liability

Judge Keith P. Ellison of the U.S. District Court for the Southern District of Texas denied the plaintiffs' motion for class certification in a case alleging that British Petroleum misled investors through a series of misstatements made before and after the Deepwater Horizon spill. The alleged misstatements concerned BP's progress in implementing safety procedures, ability to respond to and contain a catastrophic deepwater oil spill, and the magnitude of the spill. The defendants opposed class certification arguing, among other things, that the plaintiffs could not make the required showing of predominance under FRCP 23(b)(3) because they could not show class-wide damages consistent with their theory of the case. In support of their class certification motion, the plaintiffs indicated that they would use an event study to calculate class-wide damages, but did not explain in detail how the study would be conducted.

In response, the defendants argued that the plaintiffs' proposed event study methodology would violate the Supreme Court's requirement in *Comcast Corp. v. Behrend*, 133 S. Ct. 1426 (2013), that class-wide damages must conform to plaintiffs' theories of liability. The defendants submitted their own event study, similar to the type used by the plaintiffs' expert in other securities fraud cases, to illustrate potential disconnects between an event study and the frauds alleged by plaintiffs. The defendants' study revealed multiple ways in which the plaintiffs' proposed methodology for calculating damages was inconsistent with the plaintiffs' theories of liability. In denying class certification, the court, applying *Comcast*, held that it was the plaintiffs' burden to show that damages could be measured on a class-wide basis consistent with their theories of liability and that the plaintiffs failed to meet that burden. Noting that the *Comcast* decision "signals a significant shift in the scrutiny required for class certification," the court explained that "[w]ithout a more complete explication of how Plaintiffs propose to use an event study to calculate class members' damages, and how that event study will incorporate—and, if necessary, respond to—the various theories of liability, the Court cannot certify this litigation for class action treatment."

IBEW Local 90 Pension Fund v. Deutsche Bank AG, No. 11 Civ. 4209 (KBF) (S.D.N.Y. Oct. 29, 2013)

Click here to view the opinion.

S.D.N.Y. Denies Class Certification in RMBS and CDO Exposure Dispute

Judge Katherine B. Forrest of the U.S. District Court for the Southern District of New York denied class certification on claims that a bank violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting its exposure to residential mortgage-backed securities and collateralized debt obligations. The plaintiffs' expert on market efficiency was rejected as unqualified because he lacked relevant academic and career experience other than that gained while serving as an expert in prior litigation. In addition, the expert failed to sustain the plaintiffs' burden of establishing that the market for the bank's global registered shares was efficient. The plaintiffs' expert failed to consider the efficiency of the German market for the bank's shares, which the bank's experts demonstrated was an influential determinant of the pricing of those shares in U.S. markets. Further, the expert failed to take into account unique circumstances affecting the financial industry generally at the time of the alleged conduct, such as the U.S. and German bans on short-selling. The expert also chose, inappropriately, to test market efficiency only on certain days on which the bank released earnings numbers. Because plaintiffs must demonstrate an efficient market (rather than defendants establishing inefficiency), they were not entitled to the fraud-on-the-market presumption of reliance, and individual issues of reliance predominated. Moreover, the lead plaintiff was not typical of the class because its "in-and-out" trading strategy likely subjected it to unique defenses related to causation and reliance.

DEMAND FUTILITY

Leyte-Vidal v. Semel, No. H037762 (Cal. Ct. App. Oct. 23, 2013)

Click here to view the opinion.

California Appeals Court Affirms Dismissal of Shareholder Derivative Action Against Yahoo! Officers and Directors for Failure to Adequately Allege Demand Futility

The Court of Appeal of California affirmed the dismissal of the third amended complaint in a shareholder derivative action brought against Yahoo! officers and directors on the grounds that the plaintiff did not adequately plead demand futility. The court agreed that the complaint failed to allege that at least half of Yahoo!'s 12 directors were not disinterested and independent, which would have excused demand.

The original complaint, naming 15 defendants, brought numerous allegations, including insider trading, improper financial reporting, abuse of control, gross mismanagement and waste. Following demurrer, however, the plaintiff abandoned all causes of action except those involving insider trading.

At the time the action commenced, only five of the "Insider Selling Defendants" held seats on the 12-director board. The trial court agreed with the plaintiff that those five directors were not disinterested and independent. However, because the plaintiff needed to plead that at least half of the directors could not consider a demand, the plaintiff still had to identify an additional director that was not disinterested and independent for demand to be excused.

The plaintiff focused on two directors, who had been the subject of the now-abandoned allegations of mismanagement and improper financial reporting. The trial court concluded, and the court of appeals agreed, that the reference to those allegations was insufficient to call into question those directors' disinterest and independence. As an initial matter, those allegations were "insufficient to ascribe bad faith to the directors." Moreover, the plaintiff had abandoned those allegations after the initial complaint, and the court refused to allow the plaintiff to subsequently reintroduce them. The plaintiff further argued that demand was excused because the other directors were dominated and controlled by Yahoo!'s co-founder, and therefore could not exercise their judgment in an independent and disinterested manner. To the court of appeal, that allegation was "circular and conclusory." The complaint lacked any "particularized facts that permit an inference that because of [the co-founder's] *relationship* with each director, each acted under [his] influence in making the challenged decisions." The allegations demonstrated merely that the plaintiff disagreed with the decisions made by the co-founder and the other directors.

EXCHANGE ACT

Reese v. Malone, No. 12-35260 (9th Cir. Feb. 13, 2014)

Click here to view the opinion.

Ninth Circuit Reverses Dismissal of Section 10(b) Claims in British Petroleum Alaska Oil Spill Case, Holding Plaintiffs Adequately Pled Scienter Against BP and One Executive

The U.S. Court of Appeals for the Ninth Circuit reversed in part the dismissal of a federal securities claim brought against British Petroleum (BP) and certain executives of the company.

In March 2006 an oil leak in one of BP's Alaskan pipelines spilled 200,000 gallons of oil onto the Alaskan tundra in Prudhoe Bay. A second leak occurred five months later in a different BP oil line in Prudhoe Bay. In this purported class action, BP shareholders alleged the company made false and misleading statements prior to and in the wake of the first spill regarding the condition of the pipelines and BP's pipeline maintenance and leak detection practices. The district court granted the defendants' motion to dismiss with prejudice. Although the district court found some of the statements false or misleading, it dismissed the claims because the plaintiffs did not sufficiently plead scienter.

On appeal, the Ninth Circuit reviewed four allegedly false and misleading statements. First, the panel considered a statement made two weeks after the first spill by a BP-Alaska executive in charge of operations in the region. The executive stated that, a year earlier, the pipe was

(continued on next page)

corroding at a "low manageable" rate. The panel agreed with the district court that, based on the allegations and the facts that later came to light, the statement was demonstrably false. However, the panel reversed the district court as to scienter. The court stated that, given the executive's position, she "had every reason to review the results of BP-Alaska's corrosion monitoring to understand what happened … . Evidence of high levels of corrosion would be central to this inquiry." Furthermore, the executive "had a clear motive for omitting information about the detection of high corrosion levels." Finally, because the executive specifically addressed corrosion rate data in her statement, it was unlikely she was unaware of the true corrosion rate.

Second, the court considered statements by the same executive in the wake of the first spill that "'[s]imilar problems have not been found in other lines downstream and elsewhere in Prudhoe Bay.'" These statements were false, the panel explained, because other pipelines, including the line that produced the second leak, did exhibit similar problems. The court also concluded that the plaintiffs adequately alleged scienter. The court analyzed scienter from two perspectives: (i) evidence of contemporaneous knowledge and (ii) the "core operations inference." As to evidence of contemporaneous knowledge, the executive had received a report from a federal agency that drew comparisons between the construction, operation and maintenance of the two pipes. In addition, later disclosures contradicting the executive's statement "can be circumstantial evidence of scienter." Under the "core operations" analysis, the court considered two factors. First, the court asked whether it would be "absurd" to suggest that management was without knowledge of the matter. The court answered this inquiry in the affirmative, concluding that it was "absurd" to think the head of Prudhoe Bay operations did not know the comparable conditions of the two pipes. Second, the court asked whether the allegations "'suggest that the defendants had actual access to the disputed information.'" Again, the court answered in the affirmative, determining that the executive's specific statements indicated that she likely had access to the disputed information. Because the allegations were sufficient under the "absurdity" and "actual access" analyses applied by the court, the panel held that the plaintiffs adequately alleged scienter under the "core operations inference."

Third, the court considered a statement by BP's CEO that the first spill occurred "'in spite of the fact that we have both world class corrosion monitoring and leak detection systems.'" While that statement appeared to be false, the plaintiffs did not allege facts showing, directly or circumstantially, that the CEO knew of the problems when he made the statement. Therefore, there was no strong inference of scienter.

Finally, the panel considered a statement in BP's annual report, issued nearly four months after the first oil spill, that "Management believes that the Group's activities are in compliance in all material respects with applicable environmental laws and regulations." As to this statement, the panel said it could find "no reasonable basis for management's 'belief' that BP was in material compliance" with applicable laws and regulations. In addition, "we find it most unlikely that top management was unaware of facts undermining its belief in compliance." BP argued that its statement was not false because it prefaced the statement with management "believes," and used the qualifier "material" to describe its level of compliance. The court disagreed. The court acknowledged that BP's ongoing discussions with regulators suggested some "effort" to achieve compliance, but stated that those efforts did not negate the "pre-existing, significant violations" alleged in the complaint. As to scienter, the panel once again inquired whether it would be "absurd" to suggest that management was without knowledge of the matter. The court noted the "significant federal and state government intervention into BP's operations" after the March oil spill. Further, the annual report itself discussed the spill. Moreover, the former CEO requested updates on BP's response to the spill, which the court viewed as "direct evidence of its prominence in the eyes of BP's top management." Given that, the panel said, "we find it 'absurd' that management would not be aware of BP's significant, existing compliance issues that rendered the statement misleading." Put in context, the panel said, the statement appeared to be made with the intent to downplay BP's noncompliance with regulations, which further raises the inference of scienter.

The panel remanded the case to the district court for further proceedings.

Bartelt v. Affymax, Inc.,
No. 13-01025
(N.D. Cal. Jan. 21, 2014)

Click here to view the opinion.

Northern District of California Denies in Part Motion to Dismiss, Holding That Defendants' Failure to Disclose Certain Adverse Reactions Rendered Statements About Drug's Safety False and Misleading

Judge William H. Orrick of the U.S. District Court for the Northern District of California granted in part and denied in part the defendants' motion to dismiss claims brought under Rule 10b-5. The plaintiff alleged that Affymax, a pharmaceutical company, and four Affymax officers violated federal securities laws by making false and misleading statements about the company's primary drug, which eventually was recalled because of safety concerns. The company's stock dropped following the recall.

The allegations focused on three instances in which the defendants made statements about the drug's safety and efficacy despite knowing "that there were serious adverse reactions" to the drug, including patient death. The court held that the first two statements could not support a 10b-5 claim. The defendants made the first statement prior to the time they allegedly learned of the "adverse reactions," so they could not have knowingly misrepresented the seriousness or impact of the adverse reactions. The second statement was neither false nor misleading because the statement contained accurate and specific disclosures regarding the drug, negating any purported falsity.

The court held that the third statement could support a 10b-5 claim because the plaintiff adequately pleaded it was materially false and misleading. In that statement, the defendants said that the drug's "safety and efficacy were established," and, according to the plaintiff, implied that the issue with the drug was simply dose efficacy, rather than safety. According to the plaintiff, this statement was misleading because the defendants knew about the adverse reactions and failed to disclose them. The defendants argued that they did not have a duty to disclose information about the adverse reactions because the occurrence of adverse reactions is not a material fact. A fact is material when there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the "total mix" of information made available. The defendants cited *Matrixx Initiatives Inc. v. Siracusano*, 131 S. Ct. 1309 (2011) for the proposition that the "mere existence of reports of adverse events" does not alter the "total mix of information" available. In *Matrixx*, the Supreme Court explained that "[t]he fact that a user of a drug has suffered an adverse event, standing alone, does not mean that the drug caused the event." Rather, "something more is needed" to make the existence of reports of adverse events something a reasonable investor would view as altering the "total mix of information available." According to the defendants, the plaintiff failed to establish the "something more."

The court disagreed. In *Matrixx*, the Supreme Court held that it was substantially likely that a reasonable investor would have viewed adverse event reports "about more than 10 patients who had lost their sense of smell" after using a drug as having significantly altered the total mix of information because "in some case[s,] reasonable investors would have viewed reports of adverse events as material even though the reports did not provide statistically significant evidence of a casual link." Using the same rationale, the court here determined that it was "substantially likely that a reasonable investor would have viewed over two dozen fatal, life-threatening and other adverse reactions to" the drug as altering the total mix of information made available. Therefore, the plaintiff had adequately pleaded that the statement was materially false and misleading.

Finally, the court rejected the defendants' argument that the company made adequate public disclosures in other ways, such as on the drug's package insert, so as to negate the misleading nature of the statement at issue.

Integral Dev. Corp. v. Tolat,
No. 12-06575
(N.D. Cal. Oct. 25, 2013)

Click here to view the opinion.

Northern District of California Denies Motion to Dismiss Exchange Act Claim, Holding Plaintiff's Contractual Right of First Refusal Could Qualify as a Contract to Sell or Purchase Securities

Judge Jeffrey S. White of the U.S. District Court for the Northern District of California granted in part and denied in part a motion to dismiss claims brought by a software development company against its former employee. The court refused to dismiss the plaintiff's Rule 10b-5 claim, but dismissed the state securities claims brought under California law.

Tolat, the defendant employee, left plaintiff Integral after negotiating employment terms with one of Integral's competitors. Integral had a right of first refusal to purchase shares held by Tolat when he left the company. When discussing with Integral the right of first refusal to purchase his shares, Tolat allegedly failed to disclose to Integral that the price the competitor was offering for the shares in the competitor's stock purchase agreement was artificially inflated. As a result of the fraudulently inflated price presented to Integral, Integral allegedly was not able to exercise its right of first refusal. In his motion to dismiss, Tolat argued that because no actual contract to purchase securities was formed and no actual purchase of securities was ever consummated, Integral lacked standing to bring a claim under 10b-5. In addition, Tolat argued that Integral could not allege damages because it never actually purchased his shares. The court disagreed, holding first that Integral's contractual right of first refusal could qualify as an underlying contract to sell or purchase securities. Moreover, Integral sufficiently pleaded facts that it suffered economic loss as a result of Tolat's conduct to survive a motion to dismiss.

As to Integral's state securities claim, the court explained that the relevant California Code sections do not provide a private right of action unless there is a completed sale of a security. Because Integral could not allege a completed sale or securities purchase, Integral lacked standing to sue under California law.

FIDUCIARY DUTIES

Books and Records

Cook v. Hewlett-Packard Co.,
No. 8667-VCG
(Del. Ch. Jan. 30, 2014)

Click here to view the opinion.

Delaware Court of Chancery Denies Books and Records Review in Connection With HP's Acquisition of Autonomy

Vice Chancellor Sam Glasscock III of the Delaware Court of Chancery denied a Section 220 request by a Hewlett-Packard Co. (HP) shareholder seeking to review books and records related to government investigations into the company's acquisition of Autonomy Corp. (Autonomy). The government investigations stemmed from HP taking a goodwill impairment charge after the acquisition due to accounting improprieties that occurred at Autonomy prior to the acquisition.

The plaintiff's stated purposes for requesting the documents were to (i) investigate wrongdoing at HP, (ii) communicate with HP's board about possible wrongdoing and (iii) determine whether HP's board was disinterested and acted in accordance with their fiduciary duties when acquiring Autonomy. HP voluntarily produced some board-level documents, but the plaintiff demanded more. The court held that documents "necessary and essential to the Plaintiff's stated purpose of investigating wrongdoing on the part of HP's officers and directors are the documents that the Plaintiff ha[d] already received: board and committee minutes for meetings at which the board discussed the Autonomy acquisition, and documents reflecting presentations given at those meetings." The court denied the plaintiff's request for additional broader categories of documents, including "all documents produced by, or sought from, the Company by all government authorities investigating wrongdoing *by the acquired entity*," stating that the requests "amount[ed] to a fishing expedition."

Derivative Litigation

Cottrell v. Duke,
No. 12-3871
(8th Cir. Dec. 18, 2013)

Click here to view the opinion.

Eighth Circuit Holds Colorado River Abstention Inappropriate in Shareholder Derivative Suits Alleging Securities Exchange Act Violations

The U.S. Court of Appeals for the Eighth Circuit held that *Colorado River* abstention was not appropriate in a case in which shareholders alleged that Wal-Mart corporate officers violated Section 14(a) of the Securities Exchange Act because the federal courts have exclusive jurisdiction over such claims. The shareholders claimed that the defendants violated the Securities Exchange Act and breached their fiduciary duties by causing Wal-Mart to disseminate false and misleading statements regarding the effectiveness of oversight over compliance issues at Wal-Mart, permitting the company to violate foreign and federal laws and participate in a cover up, among other actions. Because shareholder derivative lawsuits were brought in both state and federal court, Wal-Mart moved to stay the federal court proceedings in deference to the ongoing state court case. The district court granted the motion, citing both *Colorado River* principles of abstention and the court's inherent power to control its docket.

Citing holdings in the U.S. Courts of Appeal for the Second, Seventh and Ninth Circuits, the Eighth Circuit held that *Colorado River* abstention is not appropriate when a plaintiff raises a claim over which federal courts have exclusive jurisdiction, such as a claim under the Securities Exchange Act. The Eighth Circuit noted it could not find a circuit court that has held otherwise, and also rejected the defendants' attempt to avoid precedent from other circuits by pointing to the derivative claims. The court reasoned that, although the pleading requirements for derivative actions incorporate a state-law demand requirement, it could not simply assume that state demand requirements would dispose of the controversy for the purpose of determining that the state and federal actions were sufficiently "parallel" for *Colorado River* abstention to apply. Further, the Eighth Circuit held that the district court abused its discretion by using its inherent power to control its docket as an alternative justification for the stay.

Mergers and Acquisitions

In re Answers Corp. S'holders Litig.,
No. 6170-VCN
(Del. Ch. Feb. 3, 2014)

Click here to view the opinion.

Delaware Court of Chancery Dismisses Claims That Answers Corp. Board Acted in Bad Faith to Sell the Company

Vice Chancellor John W. Noble of the Delaware Court of Chancery granted the defendants' motion for summary judgment and dismissed claims of breach of the duty of loyalty in connection with a merger. The plaintiffs claimed that the board of Answers Corp. breached its fiduciary duties by acting in bad faith to sell the company by (i) purposefully engaging in a limited shopping process; (ii) failing to act in the interests of the company's stockholders after circumstances changed to indicate the offer price was too low and (iii) exerting willful blindness to ignore alternatives to the transaction.

The court rejected all of these claims and granted the defendants' motion for summary judgment. The court stated that it "generally grants boards latitude to determine how to conduct an appropriate sale process. Thus, a board may reasonably prefer 'a discreet approach relying upon target marketing by an investment bank' to conducting a public auction. Prior decisions also support some leeway in determining which potential acquirers to target. Finally, a plaintiff's inability to explain a Board's motivation to act in bad faith may also be relevant in analyzing bad faith claims." With respect to the plaintiffs' claims that the market check was flawed, the court remarked that "*Lyondell* counsels that there is a vast difference between a flawed, inadequate effort to carry out fiduciary duties and a conscious disregard for them." Thus, even a limited market check that lasted only two weeks over the holidays and only focused on strategic buyers "does not constitute a complete abandonment of fiduciary duty and thus is insufficient to survive a bad faith abandonment of duty claim." Moreover, the court found that the board could take a variety of factors into account about the company's financial prospects when

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determining whether to accept a deal, remarking that "[s]uch considerations are within the purview of a disinterested Board in assessing whether to pursue the proverbial bird in hand over the one in the bush; particularly here, because no allegations have been made concerning the Board's motives for favoring [one] bidder or presenting some other motive for failing to maximize shareholder value." Ultimately, the court concluded that "[a]lthough Plaintiffs identify a variety of ways in which they believe the process could have been better conducted, they offer no evidence of that extreme set of facts required to show that the board utterly failed to attempt to comply with its duties." The court also dismissed claims that certain board members were interested or were dominated and controlled and lacked independence. The court also rejected claims for aiding and abetting against the buyer.

Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP,
80 A.3d 155
(Del. Ch. Nov. 15, 2013)

Click here to view the opinion.

Delaware Court of Chancery Rules That Premerger Communications Pass to Transaction's Surviving Corporation

Chancellor Leo E. Strine Jr. of the Delaware Court of Chancery held that, pursuant to Section 259 of the Delaware General Corporation Law (DGCL), the buyer of a Delaware corporation owned and controlled premerger privileged communications between the selling corporation's outside counsel and its stockholders and representatives regarding the negotiation of the transaction, which were contained in the corporation's computer systems. The opinion arose from an ongoing dispute wherein the buyer claimed that it was fraudulently induced to acquire the Delaware company.

Chancellor Strine noted that this case presented an issue of statutory interpretation in the first instance. Under Section 259 of the DGCL, following a merger, "all property, rights, privileges, powers and franchises, and all and every other interest shall be thereafter as effectually the property of the surviving or resulting corporation … ." Chancellor Strine reasoned that if the Delaware legislature had intended to exempt attorney-client privileged communications from the property and rights to be transferred under Section 259, it would have so provided. He also distinguished a decision of the New York Court of Appeals, *Tekni-Plex, Inc. v. Meyner & Landis*, 674 N.E.2d 663 (N.Y. 1996) relied on by the seller, which concluded (without citation to Section 259) that premerger attorney-client communications regarding the merger negotiations did not pass to the surviving corporation for policy reasons under New York attorney-client privilege law.

Chancellor Strine further explained that "the answer to any parties worried about facing this predicament in the future is to use their contractual freedom in the manner shown in prior deals to exclude from the transferred assets the attorney-client communications they wish to retain as their own. … Absent such an express carve out, the privilege over all pre-merger communications—including those relating to the negotiation of the merger itself—passed to the surviving corporation in the merger, by plain operation of clear Delaware statutory law under § 259 of the DGCL."

Offerings

Becker v. Inland Am. Real Estate Trust, Inc.,
No. 13-cv-3128
(N.D. Ill. Nov. 18, 2013)

Click here to view the opinion.

Northern District of Illinois Dismisses Suit Alleging Breach of Fiduciary Duty Against REIT Board

Judge Harry D. Leinenweber of the U.S. District Court for the Northern District of Illinois dismissed with prejudice a case against the Board of Inland American Real Estate Trust, Inc., a public, nontraded REIT incorporated in Maryland, alleging that the company's directors breached their fiduciary duties by selling shares through a dividend reinvestment program "at inflated prices that did not reflect the true value of Inland American." The shareholders also brought claims for a constructive trust and unjust enrichment. The court rejected these claims, concluding that the directors acted in their managerial capacity when they established the price charged for shares, and thus that Maryland law imposed on them only the

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duties of loyalty, good faith and reasonable care. The plaintiffs' allegations did not support a determination that the directors breached these fiduciary duties because the prospectus cautioned investors that the stock offering prices were "arbitrarily determined by [the] board of directors" and that the real value could be higher or lower than their estimate and because plaintiffs did not contend that any of the financial information disseminated by the board was false. The court also rejected the shareholders' claims for a constructive trust and unjust enrichment because these rested upon the claim for breach of fiduciary duty.

MATERIALITY

Tabak v. Canadian Solar Inc., No. 13-1681 (2d Cir. Dec. 20, 2013)

Click here to view the opinion.

Second Circuit Affirms Dismissal of Claims Alleging Canadian Solar Recognized Revenue From a Sham Transaction

The U.S. Court of Appeals for the Second Circuit affirmed by summary order the dismissal of claims that Canadian Solar Inc. violated Section 10(b) of the Securities Exchange Act by allegedly recognizing revenue from a sham transaction. Because the manufacturer's alleged inflation of earnings was *de minimis* — only 2.7 percent of the company's third quarter revenue and .9 percent of its total annual revenue — the alleged misstatements were immaterial as a matter of law. The plaintiffs also pointed to other alleged false statements concerning improper revenue recognitions from other sham transactions and the timing of a stock offering in relation to the alleged misrepresentations. The plaintiffs, however, failed to allege any facts to support their allegations that the additional transactions were shams, and thus failed to meet the fraud pleading requirements under the PSLRA. Further, the timing of the stock offering did not affect materiality. In addition, the plaintiffs failed to adequately plead scienter, because the alleged attempts to avoid stock dilution by company insiders were not sufficient to demonstrate motive to defraud investors.

MISREPRESENTATIONS

City of Brockton Ret. Sys. v. CVS Caremark Corp., No. 09-cv-554 (D.R.I. Dec. 31, 2013)

Click here to view the opinion.

District of Rhode Island Upholds Section 10(b) Claims Against CVS in Connection With Caremark Merger

Judge Joseph L. Laplante of the U.S. District Court for the District of New Hampshire (sitting by designation in the District of Rhode Island) upheld claims brought against CVS for alleged violations of Section 10(b) of the Securities Exchange Act for purportedly misrepresenting the success of the company's computer system integration following its merger with Caremark. The district court's prior determination that the plaintiffs failed to sufficiently alleged loss causation was reversed in part and remanded by the U.S. Court of Appeals for the First Circuit for consideration of whether the plaintiffs also properly pleaded an actionable misrepresentation or omission and scienter. On remand, the district court held that the plaintiffs had adequately alleged that CVS's statement that its re-pricing was unrelated to service issues was misleading, given CVS's alleged re-pricing of half of its contracts to retain customers dissatisfied with its post-merger service. In addition, even though several other alleged misstatements potentially were inactionable puffery, the court declined to make that determination on a motion to dismiss where the plaintiffs had alleged at least one misrepresentation. The court further determined that the plaintiffs adequately alleged sufficient facts to infer that CVS's CEO acted with the requisite state of mind when he denied that the unsuccessful system integration caused the re-pricing of certain accounts.

La. Mun. Police Emps. Ret. Sys., v. Green Mountain Coffee Roasters, Inc., No. 11-cv-289 (D. Vt. Dec. 20, 2013)

Click here to view the opinion.

District of Vermont Dismisses Section 10(b) Claims Against Green Mountain Coffee Roasters

Judge William K. Sessions of the U.S. District Court for the District of Vermont dismissed with prejudice claims that Green Mountain Coffee Roasters violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting the company's inventory levels and obsolescence reserves. The company's representations that it was increasing production capacity and inventory to meet higher product demand were not false because the plaintiffs failed to allege that the company's financial disclosures understated the inventory levels the company maintained when those statements were made. Even if the company's statements about inventory status were inconsistent with actual inventory levels, the court could not credit the plaintiffs' reliance on various confidential witnesses because the allegations based on confidential witnesses' accounts were not linked to specific statements made during the class period. Furthermore, the confidential witnesses' accounts were not sufficiently particularized because the plaintiffs failed to show that the witnesses had the requisite knowledge to demonstrate the falsity of the statements.

The court also dismissed claims that statements about the company's reported obsolescence reserves were false for the same reasons. In addition, the court determined that the plaintiffs failed to adequately allege a "cogent and compelling inference of scienter." Stock trades made by company insiders amounting to approximately $50 million were not unusual because in both absolute and percentage values the sales were relatively small, and the trades were made pursuant to 10b5-1 trading plans several months before the alleged misstatements occurred. Nor did the company's secondary stock offering support an inference of scienter because a stock offering to raise cash generally does not support a motive to commit fraud. Further, company executives were not reckless because reliance on the core operations doctrine was insufficient where plaintiffs failed to allege supplemental facts supporting the theory. While the Second Circuit has neither accepted nor rejected the core operations doctrine following the passage of the PSLRA, the court noted that pleading a core operations theory, without more, is insufficient to support scienter. This decision has been appealed to the Second Circuit.

PSLRA

Lead Plaintiff

In re Lightinthebox Holding Co., No. 13 Civ. 6016 (S.D.N.Y. Nov. 21, 2013)

Click here to view the opinion.

S.D.N.Y. Holds That Grouping Unrelated Plaintiffs Would Defeat Goals of PSLRA Appointment Process

Judge P. Kevin Castel of the U.S. District Court for the Southern District of New York denied motions to appoint a group of investors as lead plaintiffs in a securities fraud action against a Chinese online retailer. Two groups of individual investors (each referring to themselves as the LightInTheBox Investor Group) proposed to join together as a single group with the largest financial stake in the litigation for purposes of becoming lead plaintiffs. The group proposed to make decisions regarding the litigation by majority vote. Although the PSLRA does not expressly prohibit groupings of unrelated plaintiffs, the court held that appointing such a group as lead plaintiffs would defeat the goals of the PSLRA's appointment process. Doing so would encourage lawyers to direct the litigation by hand-selecting groups of smaller plaintiffs to compete with larger, more sophisticated investors for lead plaintiff appointment. Moreover, allowing decisions to be made by majority vote of the group would result in plaintiffs with smaller financial stakes voting together to control the litigation to the exclusion of the investors with the largest losses.

Pleading Standards

Takiguchi v. MRI Int'l, Inc.,
No. 13-01183
(D. Nev. Dec. 11, 2013)

Click here to view the opinion.

Magistrate Judge Says Preliminary Injunction Does Not Satisfy PSLRA's Heightened Pleading Standard

Magistrate Judge Cam Ferenbach of the U.S. District Court for the District of Nevada held that the prior issuance of a preliminary injunction does not satisfy the PSLRA's heightened standard for lifting the automatic stay of discovery that is triggered when a defendant files a motion to dismiss.

The plaintiffs accused defendants of running a Ponzi scheme for more than 15 years. When the alleged scheme purportedly came to light, the plaintiffs sued under the Securities Act, the Exchange Act and various Nevada state laws. The district court judge issued a preliminary injunction, freezing the defendants' assets and ordering expedited discovery for 90 days because there was reason to believe defendants might hide money or destroy documents.

The question before the magistrate judge was whether the plaintiffs could continue to conduct discovery after the 90-day period ended. Under the PSLRA, discovery is permitted "only after the court has sustained the legal sufficiency of the complaint." The plaintiffs argued that the district court's granting of the preliminary injunction satisfied that standard because that court decided that the plaintiffs were "likely to succeed on the merits" of their state and federal claims. The magistrate judge rejected that argument. First, the court dispatched with the plaintiffs' argument that "because its policy objectives have been satisfied, the PSLRA does not require any discovery stay." The court reasoned that policy concerns and pleading standards are different issues that trigger separate inquiries. Second, in this case, the preliminary injunction and the PSLRA pleading standard focused on different moments in time. To satisfy the heightened PSLRA pleading standard, the complaint must have alleged that the defendants actually knew a statement was false when made. The preliminary injunction, on the other hand, was predicated on the defendants' failure to comply with regulatory freezes on defendants' assets. Finally, the court noted that the preliminary injunction largely focused on the plaintiffs' state law claims without examining the securities claims in detail.

SCIENTER

Jones v. Perez,
No. 13-2195-cv
(2d Cir. Dec. 26, 2013)

Click here to view the opinion.

Second Circuit Affirms Eastman Kodak Officers Did Not Misrepresent Company's Liquidity Position

The U.S. Court of Appeals for the Second Circuit affirmed by summary order the dismissal of claims that officers of Eastman Kodak Company violated Section 10(b) of the Securities Exchange Act by misrepresenting the company's liquidity position. Although the company ultimately declared bankruptcy despite previous optimistic statements by company officers, the plaintiffs failed to adequately allege facts giving rise to a strong inference of scienter. Statements indicating that the company was comfortable with its liquidity were not intentionally misleading and did not require the company to disclose that a portion of its cash was committed overseas, that certain patents were proving difficult to sell or that the company missed certain internal revenue targets. In addition, a press release indicating that the company had "no intention to file for bankruptcy" was not analogous to a guarantee that the company never would do so, and allegations that the company actually intended otherwise were based on information from confidential witnesses without direct knowledge of the matter. Moreover, the statement was forward-looking and accompanied by sufficiently meaningful cautionary language; thus, it was protected by the PSLRA safe harbor. Further, the plaintiffs failed to sufficiently allege the defendants believed that certain statements of opinion were false when

(continued on next page)

made, even though the officers' predictions about the company's year-end cash position and ability to sell its patent portfolio and transition its business from film to digital photography products subsequently proved to be incorrect.

SECURITIES ACT CLAIMS

Freidus v. ING Groep, N.V., No. 12-4514 (2d Cir. Nov. 22, 2013)

Click here to view the opinion.

Second Circuit Affirms Dismissal of RMBS-Related Sections 11 and 12(a)(2) Claims Because of Statute of Limitations Expiration

The U.S. Court of Appeals for the Second Circuit affirmed the dismissal of claims that a financial services company violated Sections 11 and 12(a)(2) of the Securities Act for allegedly misrepresenting the quality of loans in the pools underlying certain residential mortgage-backed securities. The panel held that the claims were untimely under the applicable one-year statute of limitations. Information disclosed by the company in September 2007 was sufficient for a reasonably diligent plaintiff to discover the alleged misstatements related to a June 2007 offering. The plaintiff did not file suit, however, until February 2009. Additionally, the plaintiffs failed to plausibly allege that ING did not believe its opinion that the loans underlying its residential mortgage-backed securities were of "relatively high quality" when it made the statement, even though the statement may have subsequently proved to be inaccurate or incomplete.

SECURITIES FRAUD PLEADING STANDARDS

In re MF Global Holdings Ltd. Sec. Litig., No. 11 Civ. 7866 (S.D.N.Y. Nov. 12, 2013)

Click here to view the opinion.

S.D.N.Y. Upholds Claims That Former MF Global Directors, Executives and Advisors Violated Section (10(b)

Judge Victor Marrero of the U.S. District Court for the Southern District of New York upheld claims that former directors, executives and advisors of the now-bankrupt MF Global violated Section 10(b) of the Securities Exchange Act and Section 11(a) of the Securities Act by misrepresenting the company's exposure to certain European sovereign debt holdings and its liquidity and by the untimely reporting of a valuation allowance against deferred tax assets. The plaintiffs' complaint sufficiently identified the allegedly misleading statements and the reason each statement was false and misleading, including the date, publication and speaker of each. In addition, although the company's statements regarding its deferred tax assets were subject to a "very subjective standard" and thus were opinions, the plaintiffs sufficiently alleged that the statements were false and that executives actually knew that the company should have taken a valuation allowance but did not. Further, general risk disclosures were not sufficient to render the allegedly false opinions immaterial given the specific information allegedly known by executives but concealed from investors. Additionally, allegations regarding the risks related to the company's investments in European sovereign debt were not fraud-by-hindsight because market players affirmatively reacted when the risks were disclosed, and the complaint alleged particular knowledge of the risks that was concealed by executives. The plaintiffs also sufficiently alleged a strong inference of scienter by circumstantial evidence, including the executives' knowledge of GAAP standards (for claims arising from the company's treatment of deferred tax assets) and internal reports criticizing the company's internal controls and liquidity management (for claims arising from the company's exposure to European debt and the liquidity crisis). Finally, the underwriter defendants' affirmative defense, based on reasonable reliance on the company's public filings, was not a basis for dismissal at this stage because the plaintiffs sufficiently alleged "red flags" that the underwriter defendants could have discovered. However, the affirmative defense may be reconsidered at summary judgment.

STANDING

CILP Assocs., L.P. v. Lipper Convertibles, L.P., Nos. 11-4904-cv, 11-4905-cv, 11-5104-cv, 11-5106-cv (2d Cir. Nov. 8, 2013)

Click here to view the opinion.

Second Circuit Vacates Summary Judgment in Favor of Bankrupt Hedge Fund's Auditor in Connection With Alleged Section 10(b) Violation

The U.S. Court of Appeals for the Second Circuit vacated summary judgment in favor of a bankrupt hedge fund's auditor on claims that the auditor violated Section 10(b) of the Securities Exchange Act. The plaintiffs — limited partners in the fund — alleged that they had relied on the auditor's audit opinions stating that the fund's allegedly inflated financial statements complied with GAAP and GAAS when purchasing their interests in the fund. The district court granted summary judgment to the auditor on the sole ground that the plaintiffs had not suffered any injury distinct from the fund's injuries and so lacked standing to bring direct claims.

The Second Circuit vacated summary judgment, holding that the plaintiffs' evidence created a factual dispute as to whether they were directly injured when they purchased their interests in the fund. Although the fund's financial statements indicated that it used a particular fair value methodology for valuing its securities portfolios, the fund's principal trader — who was responsible for valuations — previously had admitted that he deliberately used his own unique methodology that valued the securities differently. In addition, an independent report of the fund's assets, which concluded that the fund was overvalued in each year between 1995 and 2001, was evidence of direct injury, even though the report failed to specifically value the fund at particular dates and times. A jury reasonably could find that the report's own methodology for valuing securities during the relevant period was reliable because it was relied upon by a New York state court during related bankruptcy proceedings. Further, at summary judgment, the plaintiffs were not required to demonstrate the precise valuation of the securities at each relevant date, and the report included month-to-month valuations that indicated significant inflation during the relevant period.

WHISTLEBLOWER PROTECTIONS

United States v. Quest Diagnostics, Inc., No. 11-1565-cv (2d Cir. Oct. 25, 2013)

Click here to view the opinion.

Second Circuit Holds That the False Claims Act Does Not Relieve Attorneys of Ethical Duty to Maintain Client Confidentiality

The U.S. Court of Appeals for the Second Circuit affirmed the dismissal of a *qui tam* action brought pursuant to the False Claims Act alleging that a medical laboratory violated the federal Anti-Kickback Statute by offering certain discounted services to induce referrals for services billable to Medicare and Medicaid. The district court had dismissed the action because one of the *qui tam* plaintiffs — the laboratory's former general counsel — violated his ethical duty of confidentiality by divulging information gained through his position. The Second Circuit affirmed, holding that the False Claims Act does not relieve an attorney of his ethical duty to maintain client confidences and that the attorney violated New York's ethical rule prohibiting an attorney from using confidential information to the disadvantage of a former client. Although an exception to the rule allows for the release of information an attorney reasonably believes is necessary to prevent a client from committing a crime, the court held that the information disclosed — including information dating back to far before the beginning of the alleged misconduct — exceeded what was necessary under the circumstances. Certain documents alone, if disclosed to the government, would have provided a sufficient basis for the government to prevent further criminal conduct. The attorney need not have participated in the *qui tam* action at all, much less made broad disclosures of confidential information throughout discovery and in his deposition. Further, the district court's decision to dismiss the entire action was justified because the prejudice to the defendant likely would continue through the remaining plaintiff and counsel who were privy to the wrongfully revealed confidential information, even though those parties did not violate any ethical duties.

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