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Appraisal

Delaware Supreme Court Reverses and Remands Appraisal of Dell Inc.

Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd, No. 565, 2016 (Del. Dec. 14, 2017)
Click here to view the opinion.

The Delaware Supreme Court reversed in part and remanded to the Court of Chancery for further proceedings the appraisal of Dell Inc. arising from a 2013 management-led buyout by a private equity firm.

The Court of Chancery relied exclusively on a discounted cash flow (DCF) valuation and determined the fair value of Dell shares was $17.62, approximately 28 percent above the merger price of $13.75, which itself represented a 37 percent premium over Dell's 90-day-average unaffected trading price. The Court of Chancery rejected arguments that the well-run and robust deal process that led to the merger price was the most reliable indicator of fair value, concluding, among other things, that the market for Dell stock was inefficient and that, because the transaction was a management-led buyout, the deal price could not be relied upon.

The Supreme Court reversed, holding that the Court of Chancery's decision to rely "exclusively" on its own DCF analysis was based on several assumptions that were not grounded in relevant, accepted financial principles. Specifically, the Supreme Court held that the trial court erred because its reasons for failing to give the deal price weight did not follow from the court's key factual findings, which supported a finding that the "deal price deserved heavy, if not dispositive, weight." In addition, the Supreme Court expressed doubt regarding the Court of Chancery's DCF calculation, noting that the facts suggested that a "strong reliance upon the deal price" was warranted with "far less weight, if any, on the DCF analyses" upon remand.

The Supreme Court concluded that, on remand, the Court of Chancery could enter an order deferring to the deal price without further proceedings, or, if it decides to weigh factors other than the deal price, the weight assigned to each factor must be reconciled with the factual record and accepted financial principles.

Class Certification

Second Circuit Clarifies Application of Presumption of Reliance

In re Petrobras Sec., No. 16-1914-cv (2d Cir. July 7, 2017), *Waggoner v. Barclays PLC*, No. 16-1912-cv (2d Cir. Nov. 6, 2017) and *Ark. Teachers Ret. Sys. v. Goldman Sachs Grp., Inc.*, No. 16-250 (2d Cir. Jan. 12, 2018)
Click here to view the opinions.

The Second Circuit, in opinions by three different panels, has clarified the method by which plaintiffs may invoke, and defendants may rebut, the "fraud on the market" theory of reliance at the class certification stage.

In *In re Petrobras Securities*, decided last summer, the Second Circuit upheld the district court's finding that Petrobras securities traded in an efficient market — a prerequisite for plaintiffs to rely on the fraud-on-the-market theory and thus obtain the benefit of the presumption of classwide reliance established by *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). While declining to adopt a particular test for market efficiency, the Second Circuit held that the plaintiffs were not required to establish that the price of Petrobras securities increased in response to good news and decreased in response to bad news. Rather, it was sufficient to show that the price changed in response to significant events, regardless of the direction of the changes, and to offer "indirect" evidence of market efficiency, such as high trading volume, extensive analyst coverage and large market capitalization.

In *Waggoner*, the Second Circuit in November 2017 affirmed the district court's certification of a class of investors in a bank's American depositary shares (ADS) alleging claims in connection with the bank's operation of an alternative trading system, or "dark pool." The district court granted certification, finding that the plaintiffs were entitled to the *Basic* presumption of reliance based on indirect evidence that the ADS traded in an efficient market. On appeal, the Second Circuit affirmed, finding that the defendants had not met their burden to rebut, by a preponderance of evidence, the presumption of reliance. First, although there was an absence of direct evidence of price movement on the dates of the alleged misrepresentations, the plaintiffs proceeded

on a price maintenance theory (*i.e.*, the statements affected stock prices by maintaining already existent price inflation), and thus a lack of price movement alone did not rebut the presumption of reliance. Although defendants asserted that other market concerns impacted the stock price, they did not establish that the alleged misrepresentations did not also impact the price. Second, the court concluded that the ADS were traded in an efficient market. The court reasoned that evidence of price impact is not always necessary to establish an efficient market and was not necessary here in light of other factors, particularly the bank's status as "one of the largest financial institutions in the world." Separately, the court also found that the plaintiffs' damages model complied with U.S. Supreme Court guidance in *Comcast Corp. v. Behrend*, 569 U.S. 27 (2013), even though some of the price decline may have been attributable to other market factors, and even though the model failed to account for variations in inflation over time. The defendant has filed a petition for writ of *certiorari* with the Supreme Court.

In *Arkansas Teachers Retirement System*, the Second Circuit in January 2018 vacated an order certifying a class of investors. The district court found that the plaintiffs were entitled to the *Basic* presumption of reliance because the defendant had failed to prove "conclusively" the "complete absence" of an impact on stock price by the alleged misrepresentations. The defendant had presented evidence of 34 dates on which news media reported the alleged misrepresentations without an attendant decline in the stock's price. The Second Circuit held that the district court's finding did not comply with the holding in *Waggoner* that defendants need only rebut the presumption by a preponderance of the evidence, and it stated that the district court had erroneously construed the defendant's evidence of price impact (and lack thereof) as either a truth-on-the-market defense or evidence of a lack of materiality, neither of which would be appropriately considered at the class certification stage. To the contrary, the Second Circuit held that the defendant's evidence that the price had not reacted to news media reports regarding the alleged misrepresentations was competent evidence that the allegedly misleading statements "did not actually affect the stock's market price," as needed to rebut the presumption of reliance.

* * *

In *Petrobras*, *Waggoner* and *Arkansas Teachers Retirement System*, the Second Circuit addressed the practical application of the presumption of reliance first established by *Basic* and the standard for defendants to rebut it at the class certification stage. These cases remind litigants that plaintiffs are likely entitled to invoke the *Basic* presumption where the hallmarks of an efficient market are present, but defendants are afforded a meaningful opportunity to rebut any and all prerequisites of the presumption with competent evidence. In doing so, defendants need only meet a preponderance of the evidence standard to successfully rebut the presumption. The long-term impact of these opinions will be observed as the district courts apply them in coming years.

Northern District of California Denies Class Certification, Finds Defendants Successfully Rebutted Fraud-on-the-Market Presumption

In re Finisar Corp. Sec. Litig., No. 5:11-cv-01252-EJD
(N.D. Cal. Dec. 5, 2017)
Click here to view the opinion.

The district court denied a motion for class certification, holding that the plaintiffs failed to satisfy the predominance requirement under Rule 23(b)(3) of the Federal Rules of Civil Procedure using the fraud-on-the-market theory of reliance.

The theory is "a rebuttable presumption of classwide reliance on public, material misrepresentations when shares are traded in an efficient market." *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, 568 U.S. 455, 463 (2013). A defendant may rebut this presumption by showing with direct evidence that the alleged misrepresentation did not actually affect the stock's market price.

Here, the defense expert used an event study to show that the defendant corporation's stock price did not experience a statistically significant price increase following the alleged misrepresentations. Rather, the increase occurred before the alleged misstatements, as a result of the defendant's press release and earnings call the previous day, neither of which contained statements that the plaintiffs challenge.

While the court recognized that other courts have inferred price impact from the alleged corrective disclosure even where the alleged misstatement has no price impact, such an inference was unwarranted in this case because several analyst reports were issued between the alleged misrepresentation and the alleged corrective disclosure. Those reports served to "sever the link" between the alleged misstatement and any increase in the price of the corporation's stock.

Therefore, because the defendant met its burden to show by a preponderance of the evidence that the alleged misrepresentation did not impact the stock price, it successfully rebutted the presumption of reliance, and the plaintiffs could not satisfy the predominance requirement of Rule 23(b)(3).

SDNY Denies Plaintiffs' Motion for Leave to Amend Claims Because Proposed Amended Claims Would Not Prevail at Class Certification

Youngers v. Virtus Inv. Partners Inc., No. 15cv8262
(S.D.N.Y. Dec. 4, 2017)
Click here to view the opinion.

Judge William H. Pauley III denied a motion for leave to file a third amended complaint claiming that an investment management company and certain of its officers violated Section 10(b) of the Securities Exchange Act. Although the plaintiffs moved to amend after the close of fact discovery and after the court had denied class certification, the plaintiffs argued that amendment was warranted because of certain new facts that had arisen during discovery. Specifically, the company had produced transcripts of deposition testimony given by its officers in the context of an enforcement action brought by the Securities and Exchange Commission. The plaintiffs claimed that the testimony revealed that the company had been aware of certain calculation errors in the records of mutual fund indices at issue in the case and therefore had a duty to correct the records that they knew were false. Although the court had previously denied class certification on the grounds that individual issues predominated over issues common to the class, the plaintiffs argued that their new claim, based on the company's duty to correct, satisfied the predominance requirement because plaintiffs would be entitled to the presumption of reliance pursuant to *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

The defendants argued, *inter alia*, that the court should deny leave on futility grounds because such amendment would not enable plaintiffs to prevail on a renewed motion for class certification. The court agreed. Relying on a recent decision, *Waggoner v. Barclays PLC*, 875 F.3d 79 (2d Cir. 2017), the court noted that the "*Affiliated Ute* presumption of reliance should be applied sparingly in cases involving primarily a failure to disclose." The court found that this case primarily involved a failure to disclose, "namely, that the Defendants misrepresented the back-tested nature of the track records and the calculations underlying them." The court declined to extend the *Affiliated Ute* presumption to the plaintiffs and denied leave to amend.

Southern District of California Grants Class Certification, Finding Defendant Failed to Rebut Fraud-on-the-Market Presumption of Reliance

Baker v. SeaWorld Entm't, Inc., 14cv2129-MMA (AGS)
(S.D. Cal. Nov. 29, 2017)
Click here to view the opinion.

Blackfish was a 2013 documentary about killer whales in captivity. It purported to reveal the dangers that trainers of killer whales face at places like SeaWorld, and the physical and mental strain that captivity and capture methods place on the whales. The documentary received widespread media attention, and led companies and performers to end relationships with SeaWorld. The 11 SeaWorld parks saw a 13 percent decline in attendance following the film's release. SeaWorld, however, initially attributed the drop in attendance to weather, school and holiday schedules, and a new pricing strategy — even though other theme parks in the same locations did not suffer similar attendance drops. SeaWorld officers stated that the documentary "has had no attendance impact" and that SeaWorld could "attribute no attendance impact at all to the movie."

On August 13, 2014, SeaWorld charted a new course, issuing a statement that "the Company believes attendance in the quarter was impacted by demand pressures related to recent media attention surrounding proposed legislation in the state of California" — legislation prompted by *Blackfish* — that would ban killer whale breeding and captivity programs. SeaWorld's stock price dropped 33 percent following the statement.

Shareholders brought claims under Sections 10(b) and 20 of the Securities Exchange Act and later moved for class certification. In opposing the plaintiffs' motion, the defendants attempted to rebut the fraud-on-the-market theory of reliance, a rebuttable presumption that class members relied on public, material misrepresentations if the shares are traded on an efficient market. They relied on an event study by their expert that concluded there was no statistically significant evidence of price inflation on the six dates the defendants made the alleged misrepresentations. The plaintiffs countered by asserting the price maintenance theory, which posits that price impact in a securities fraud case can be quantified either by the price increase on the dates of the misrepresentation or by the drop in price when the truth is revealed.

While district courts within the Ninth Circuit have disagreed as to the viability of the price maintenance theory, the court noted several decisions in the Second, Seventh and Eleventh circuits that have accepted it. Agreeing with those decisions, the court concluded that a stock price change upon either the misrepresentation or the alleged corrective disclosure was sufficient to maintain the fraud-on-the-market presumption of reliance. Thus, even if the alleged misrepresentation did not cause the stock price to rise, the subsequent drop in stock price in connection with the alleged corrective disclosure prevents defendants from rebutting the presumption of reliance.

District of Massachusetts Rejects Disclosure as Curative

In re AVEO Pharm., Inc. Sec. Litig., No. 13-11157
(D. Mass. Nov. 14, 2017)
Click here to view the opinion.

The district court allowed the plaintiffs' motion for class certification in an action alleging that AVEO Pharmaceuticals, Inc. and certain of its officers violated Section 10(b) of the Securities Exchange Act by failing to disclose certain of the Food and Drug Administration's (FDA) concerns about AVEO's new drug application. The plaintiffs' proposed class period extended to when an advisory committee to the FDA met to hear the FDA's concerns, and the defendants argued that the class period should end a few days earlier, when the FDA released public materials for that meeting. The defendants asserted that the earlier-released materials contained the FDA's concerns about AVEO's new drug application and, as a result, the FDA's disclosure made public any previously concealed information, which led to a decline in the company's share price.

The court disagreed, explaining that "[if] disclosures 'fail[] to convey the extent' of a piece of information, they cannot be considered curative for class certification purposes." The court found that the FDA's public materials did not convey the full extent of the FDA's concerns because they only served as a starting point for discussion and the materials stated that they did not contain all the information on the new drug application. The court concluded that the FDA's concerns about the new drug application were not fully revealed to the market until the FDA's meeting with its advisory committee.

Core Operations Theory

Southern District of California Holds That Scienter Was Adequately Alleged Based on the Core Operations Theory

3226701 Canada, Inc. v. Qualcomm, Inc., No. 15cv2678-MMA (WVG) (S.D. Cal. Oct. 20, 2017)
Click here to view the opinion.

Judge Michael M. Anello denied in part a motion to dismiss a putative securities fraud class action, holding that the plaintiffs adequately alleged scienter under the core operations theory.

Qualcomm is a technology company that makes microprocessors often used in smartphones. The Snapdragon 810 is a microprocessor that was slated to be used in Samsung's Galaxy S6 model. Following its release in other smartphones, Qualcomm's CEO made statements that the microprocessor was "performing well" or "as expected." Ultimately, Samsung decided not to use the Snapdragon 810 because of alleged overheating and performance issues.

The plaintiffs sought to establish scienter on the part of the CEO under the core operations theory. Under that theory, "scienter may be inferred where the facts critical to a business' 'core operations' or important transactions are known to key company officers." Here, the plaintiffs alleged that the CEO had direct knowledge of the overheating issues through "contemporaneous reports or data and through attendance of meetings," allegations that were supported by confidential witness statements. The complaint identified five types of reports that were regularly generated and all of which related to the Snapdragon 810 and its performance issues. The plaintiffs also alleged that one of the CEO's direct reports was aware of the overheating problems, received daily reports on it and therefore must have conveyed that information to the CEO.

The plaintiffs further alleged that the Snapdragon 810's overheating issue was such a prominent fact for Qualcomm that it would be absurd for the CEO to be unaware of it. Samsung accounted for 10 percent of Qualcomm's revenues, and the Snapdragon 810 was the subject of extensive media coverage as Qualcomm's premier microprocessor.

The court accordingly found that the plaintiffs had adequately pleaded a strong inference of scienter as to the CEO under the core operations theory, which the court then imputed to Qualcomm.

Fiduciary Duties

Books and Records

Delaware Court of Chancery Rejects *Corwin* Defense in Books-and-Records Action

Lavin v. West Corp., C.A. No. 2017-0547-JRS
(Del. Ch. Dec. 29, 2017)
Click here to view the opinion.

Vice Chancellor Joseph R. Slights III granted a books-and-records request brought by a stockholder of West Corporation, holding that the Delaware Supreme Court's decision in *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015) — which insulates mergers approved by a fully informed, uncoerced stockholder vote (absent a conflicted controller) from post-closing challenges other than on grounds of waste — could not be raised as a defense in a books-and-records action.

The case arose from a merger between West Corporation and affiliates of Apollo Global Management that was approved by approximately 86 percent of the company's shares. Prior to the stockholder vote, the books-and-records plaintiff sought documents to investigate potential wrongdoing and mismanagement in connection with the merger, as well as the independence and disinterestedness of the members of West Corporation's board of directors. In the ensuing books-and-records litigation, the company's primary defense was that the merger had been approved by a disinterested, fully informed stockholder vote, and the *Corwin* doctrine therefore would limit any post-closing challenge to waste claims, which were not a stated basis for the Section 220 inspection.

The Court of Chancery rejected this argument, ruling that a *Corwin* defense was premature in a books-and-records action and would "invite defendants improperly to draw the court into adjudicating merits defenses to potential underlying claims."

After finding that it could not consider the *Corwin* defense, the Court of Chancery found that the plaintiff had satisfied the "low Section 220 evidentiary threshold" to demonstrate that the directors may have breached their fiduciary duties such that the plaintiff had stated a proper purpose for the inspection. The court reduced the categories of documents for production from the 13 demanded to five but ordered production of board minutes, banker presentations, offer letters and deal documents exchanged with bidders, communications (including emails) about a sale of one or more of West Corporation's business segments, and director independence questionnaires.

Delaware Court of Chancery Denies Books-and-Records Request Where Purpose Belongs to Counsel Rather Than Plaintiff

Wilkinson v. A. Schulman, Inc., C.A. No. 2017-0138-VCL
(Del. Ch. Nov. 13, 2017)
Click here to view the opinion.

Vice Chancellor J. Travis Laster denied a request for books and records pursuant to Section 220 of the Delaware General Corporation Law, finding that the purpose for the inspection belonged to the plaintiffs' counsel and not to the stockholder plaintiff himself, and thus the plaintiff lacked a proper purpose for the demand.

After trial, the court found, among other things, that the stockholder plaintiff had admitted the articulated purpose in the demand was not his purpose and that his counsel had identified each of the categories of documents sought in the demand; had never reviewed the company's response to the demand or any additional response letters after signing his initial demand letter; had verified the complaint without taking steps to confirm the accuracy of the allegations; did not participate in drafting responses to interrogatories; and had served as a nominal plaintiff for his counsel in at least seven other lawsuits, most of which settled for supplemental disclosures.

In finding that the plaintiff lacked a proper purpose, the court explained that while a stockholder may use counsel to seek books and records, doing so "is fundamentally different than having an entrepreneurial law firm initiate the process, draft a demand to investigate different issues than what motivated the stockholder to respond to the law firm's solicitation, and then pursue the inspection and litigate with only minor and non-substantive involvement from the ostensible stockholder principal."

Controlling Stockholder Litigation

Court of Chancery Expands *MFW* Business Judgment Protections to Transactions Outside the Merger Context

IRA Trust FBO Bobbie Ahmed v. Crane, C.A. No. 12742-CB (Del. Ch. Dec. 11, 2017)
Click here to view the opinion.

Chancellor Andre G. Bouchard dismissed breach of fiduciary duty claims asserted against board members and a controlling stockholder challenging approval of a stock reclassification because the defendants had followed the framework of *Kahn v. M&F Worldwide* (*MFW*), 88 A.3d 635 (Del. 2014).

The plaintiff, a stockholder of NRG Yield, Inc. (Yield), alleged that NRG Energy, Inc. (NRG), the controlling stockholder of Yield, caused Yield to approve a reclassification to prevent the company from diluting its position.

Chancellor Bouchard held that the reclassification was subject to the entire fairness standard of review. Distinguishing cases holding that pro rata treatment of stockholders warrants business judgment review, the chancellor held that the ability to maintain its control position by preventing further dilution of its ownership interest through the use of the reclassification was a benefit of the reclassification that was enjoyed by NRG but not shared by the other stockholders. Therefore, entire fairness review was the appropriate standard of review.

Chancellor Bouchard then held that the framework adopted by the Delaware Supreme Court in *MFW* — which lessens the standard of review for evaluating mergers involving a controlling stockholder from entire fairness to business judgment review when certain procedural protections are used — also applied to the reclassification. The court highlighted prior cases in which the Court of Chancery has endorsed using the *MFW* framework outside of the context of a merger, including the sale of a controlled company to a third party and other corporate transactions, and concluded that no rationale exists for treating mergers and other corporate transactions differently under *MFW*.

Finally, Chancellor Bouchard determined that the plaintiff had failed to plead facts sufficient to call into question the satisfaction of any of the six elements of the *MFW* framework: (1) the transaction is conditioned *ab initio* on the approval of both a special committee and a majority of the minority; (2) the special committee is independent; (3) the special committee is empowered to select advisers and to say no definitively; (4) the special committee meets its duty of care in negotiating a fair price; (5) the vote of the minority is informed; and (6) there is no coercion of the minority. The plaintiff had made no effort to overcome the business judgment rule, and therefore the court dismissed the fiduciary duty claims against both the Yield directors and NRG.

Derivative Litigation

Delaware Supreme Court Affirms Dismissal of Wal-Mart Derivative Litigation on Issue Preclusion Grounds

Cal. State Teachers' Ret. Sys. v. Alvarez, No. 295, 2016 (Del. Jan. 25, 2018)
Click here to view the opinion.

The Delaware Supreme Court affirmed the Court of Chancery's ruling holding that a federal court's prior dismissal of derivative litigation on demand futility grounds precluded the plaintiffs in the Delaware action from attempting to re-plead demand futility.

The case arose from the discovery of an alleged bribery scheme and cover-up by Wal-Mart's Mexican subsidiary, Walmex. Widespread multiforum litigation followed. Numerous actions were filed in Arkansas federal court and in the Delaware Court of Chancery. The Arkansas ligation proceeded ahead of the Delaware litigation, which was slowed by protracted books-and-records litigation. Ultimately, the Arkansas action was dismissed pursuant to Federal Rule of Civil Procedure 23.1 for failure to establish that a demand on the board to initiate litigation was futile.

Chancellor Andre G. Bouchard's initial opinion dismissed the Delaware action, finding that the Arkansas decision on demand futility carried preclusive effect. However, the original opinion did not expressly focus on federal due process concerns as a "separate issue." The Delaware Supreme Court remanded the original opinion, requesting the chancellor to supplement his opinion by focusing on due process considerations. On remand, he concluded that under the current state of the case law, there was no due process violation. Chancellor Bouchard nevertheless advocated for a different approach, based on *dicta* in a prior Court of Chancery opinion, that would have required a prior judgment to have survived a motion to dismiss under Rule 23.1 before it would carry preclusive effect in a subsequent derivative action.

The Supreme Court affirmed the original opinion and declined to adopt the new approach embraced by the Court of Chancery. The Supreme Court emphasized that three federal circuit courts concluded that there is no due process violation to giving preclusive effect to a Rule 23.1 dismissal so long as the plaintiffs' interests were aligned with, and were adequately represented by, the

prior plaintiffs. The Supreme Court explained that each element of the applicable issue preclusion standard (here, Arkansas law) was met and that the plaintiffs' interests were aligned.

In finding the Arkansas representation adequate, the Supreme Court rejected the argument that failure to pursue a Section 220 action for company books and records *per se* rendered the Arkansas representation inadequate. The Supreme Court characterized not pursuing a Section 220 action as a "tactical error" that did not render the representation inadequate "*in this instance*" because the Arkansas plaintiffs had access to various internal company documents from a news report.

Director Compensation

Delaware Supreme Court Addresses Stockholder Ratification of Director Compensation

In re Investors Bancorp, Inc. Stockholder Litig., No. 169, 2017 (Del. Dec. 13, 2017)
Click here to view the opinion.

The Delaware Supreme Court reversed and remanded to the Court of Chancery the dismissal of a complaint challenging director compensation awards as excessive and unfair to the corporation.

The Court of Chancery dismissed the complaint based on prior case law holding that the directors' decision to grant themselves compensation was subject to business judgment review if the incentive plan under which the compensation was granted had been approved by the stockholders and contained "director-specific" limits on the amount of compensation the directors could award themselves. The Supreme Court reversed, holding that stockholder ratification could not be used to lower the standard of review of discretionary awards from entire fairness to the business judgment rule. Because the plan at issue had received stockholder approval only over the broad parameters and limits of the equity incentive plan but allowed for director discretion in making compensation decisions, stockholder ratification was unavailable and the grant of stock awards remained subject to entire fairness review.

The Supreme Court also concluded that demand was excused as to all directors because it was "implausible" that the 10 nonemployee directors who approved the grant of stock awards to both themselves and the two executive directors could have independently considered a demand when doing so would have required them to call into question the grants of stock they had made to themselves.

Mergers and Acquisitions

Court of Chancery Rejects *Corwin* Defense but Dismisses Claims Against Directors for Failure to Plead a Nonexculpated Breach of Fiduciary Duty

van der Fluit v. Yates, C.A. No. 12553-VCMR (Del. Ch. Nov. 30, 2017)
Click here to view the opinion.

Vice Chancellor Tamika Montgomery-Reeves rejected a *Corwin* defense based on a disclosure violation in the proxy statement issued in connection with a merger transaction, but she ultimately dismissed claims asserted against directors based on the plaintiff's failure to plead a nonexculpated breach of fiduciary duty.

The plaintiff, a former stockholder of Opower, Inc., alleged that Opower directors breached their fiduciary duties by permitting a purported controlling stockholder to orchestrate an unfair tender offer and subsequent merger with subsidiaries of Oracle Corporation. The defendants moved to dismiss on multiple grounds.

As an initial matter, the Court of Chancery rejected the defendants' attempt to rely on the Delaware Supreme Court's decision in *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), which requires dismissal of challenges to mergers that are approved by a fully informed, uncoerced stockholder vote. The court rejected the plaintiff's arguments that a controller extracted personal benefits in the transaction (a fact that would bar *Corwin* from applying) because the complaint failed to adequately allege the existence of a control group. However, the court found that disclosures in advance of the stockholder decision to tender their shares were materially deficient, and thus the stockholder vote was not "fully informed." Specifically, the court held that the tender offer solicitation failed to disclose the role the two alleged controllers and company co-founders (who were also the CEO and president, respectively) played in the transaction negotiations. Importantly, each individual received post-closing employment and the conversion of unvested Opower options into unvested Oracle options following the transaction. The court found that the "vague language" in the disclosures about who led the negotiations prohibited Opower stockholders from determining whether the fiduciaries who negotiated the deal had interests that deviated from stockholders.

Although dismissal was inappropriate under *Corwin*, the court dismissed the action for failure to plead a nonexculpated breach of fiduciary duty. Because the complaint sought only monetary damages, and because the company's charter contained an exculpation provision, the plaintiff was required to plead a breach of

the duty of loyalty. The court explained that to meet this burden in the context of a sale, the plaintiff must plead nonconclusory facts that support an inference that the majority of the board was either interested in the sales process or acted in bad faith. The plaintiff asserted five separate arguments as a basis for finding a duty of loyalty violation. Each was analyzed and rejected for lack of sufficient factual allegations to draw an inference of disloyalty.

High-Speed Trading

Second Circuit Revives Claims That Certain Securities Exchanges Participated in Manipulative Scheme With High-Frequency Trading Firms

City of Providence v. BATS Global Mkts., Inc.,
No. 15-3057-cv (2d Cir. Dec. 19, 2017)
Click here to view the opinion.

The Second Circuit reversed and vacated the dismissal of claims that multiple national securities exchanges violated Section 10(b) of the Securities Exchange Act by misleading investors about the products and services sold to high-frequency trading (HFT) firms. The plaintiffs alleged that the defendants favored HFT firms by selling them products (access to proprietary data feeds, co-location services and certain complex-order types) that provided them with market information more quickly and with more detail than what they provided to ordinary investors, which permitted HFT firms to front-run the market. The plaintiffs claimed that the proprietary data feeds allowed market data to reach HFT firms before other investors. The plaintiffs claimed that the co-location services allowed HFT firms to place their computer servers in close proximity to the exchanges' systems, reducing the lag time in communication between the servers. The plaintiffs also claimed that certain complex-order types enabled HFT firms to "place orders that remain hidden from the ordinary bid-and-offer listings on an individual exchange until a stock reaches a particular price, at which point the hidden orders emerge and jump the queue ahead of other investors' orders." The plaintiffs alleged that the defendants failed to fully disclose the services it was providing to HFT firms, harming ordinary investors.

The lower court had dismissed those claims on the grounds that (1) the exchanges are registered with the SEC as self-regulatory organizations (SROs) and are entitled to absolute immunity as quasi-governmental entities, and (2) even if the exchanges were not absolutely immune, the plaintiffs failed to state a claim under the Securities Exchange Act. On appeal, the defendants argued that they were entitled to immunity, as the Second Circuit had previously held that SROs were immune to suits because they were delegated regulatory authority pursuant to the Securities Exchange Act and effectively "st[ood] in the shoes of the SEC." The defendants also argued that the plaintiffs failed to plead that the SROs engaged in a manipulative scheme under Section 10(b) because the "plaintiffs do not allege that the exchanges themselves engaged in any manipulative 'trading activity'" and because Section 10(b) does not provide for liability for aiding and abetting. The plaintiffs argued that the exchanges were not entitled to immunity because they were acting not in their capacity as regulators in providing premium products and services to HFT firms but as ordinary market participants. The plaintiffs argued that the exchanges had engaged in a manipulative scheme by permitting HFT firms to obtain nonpublic information unavailable to normal investors and had failed to disclose the impact of those services, "creat[ing] a false appearance of market liquidity that, unbeknownst to [the] plaintiffs, resulted in their bids and orders not being filled at the best available prices."

The Second Circuit agreed with the plaintiffs. The court declined to extend immunity to the SROs because the SROs' alleged conduct was not regulatory. The court noted that the plaintiffs "do not allege that the exchanges inadequately responded to, monitored, or policed their members' actions," and that "plaintiffs challenge exchange actions that are wholly divorced from the exchanges' role as regulators." Regarding the manipulative scheme claim under Section 10(b), the court found that the plaintiffs need not allege that the exchanges themselves engaged in manipulative trading activity. The court noted that "the exchanges do not cite, and we are not aware of, any authority explicitly stating that such a claim must concern a defendant's trading activity." Although the court agreed with the defendants that Section 10(b) does not provide for aiding-and-abetting liability, the court noted that "the plaintiffs do not assert that the exchanges simply facilitated manipulative conduct by the HFT firms. ... [T]he plaintiffs contend that the exchanges were co-participants ... and profited by that scheme."

Loss Causation

Ninth Circuit Holds That General Proximate Cause Test Governs Loss Causation Inquiry; Market Need Not Learn Defendant Engaged in Fraud to Satisfy Standard

Mineworkers' Pension Scheme v. First Solar Inc.,
No. 15-17282 (9th Cir. Jan. 31, 2018)
Click here to view the opinion.

Shareholders claimed that First Solar Inc. fraudulently inflated stock prices by concealing defects in its solar panels. The plaintiffs argued that First Solar's misrepresentations caused their loss when the stock price fell from $300 in 2008 to less than $50

in 2012. The defendants countered that loss causation requires that the market learn of alleged fraud and react to it, leading to a stock drop. Both parties pointed to conflicting lines of cases to back their arguments.

The Ninth Circuit answered the following question that the district court certified for interlocutory appeal: "[W]hat is the correct test for loss causation in the Ninth Circuit? Can a plaintiff prove loss causation by showing that the very facts misrepresented or omitted by the defendant were a substantial factor in causing the plaintiff's economic loss, even if the fraud itself was not revealed to the market (*Nuveen*, 730 F.3d at 1120), or must the market actually learn that the defendant engaged in fraud and react to the fraud itself (*Oracle*, 627 F.3d at 392)?"

The panel concluded that "a general proximate cause test ... is the proper test" for loss causation. Under that standard, the "ultimate issue" is simply "whether the defendant's misstatement, as opposed to some other fact, foreseeably caused the plaintiff's loss." The market need not actually learn that the defendant engaged in fraud and react to the fraud itself. The panel stated, "Disclosure of the fraud is not a *sine qua non* of loss causation, which may be shown even where the alleged fraud is not necessarily revealed prior to the economic loss." While acknowledging prior Ninth Circuit precedent that appeared to require a revelation of fraud, the panel stated that "[r]evelation of fraud in the marketplace is simply one of the 'infinite variety' of causation theories a plaintiff might allege to satisfy proximate cause."

Securities Exchange Act

Fourth Circuit Declines to Find a 'Strong Inference' of Scienter Based on Inference That Defendant Knew He Had Made a Material Misrepresentation

Maguire Fin., LP v. PowerSecure Int'l, Inc., No. 16-2163 (4th Cir. Nov. 15, 2017)
Click here to view the opinion.

A three-judge panel affirmed the judgment of the Eastern District of North Carolina dismissing plaintiff-appellant Maguire Financial, LP's amended complaint because it failed to adequately allege scienter under Section 10(b) of the Securities Exchange Act and Rule 10b-5. The court held that a statement by the CEO of PowerSecure International, Inc. to analysts regarding a multimillion dollar contract renewal was insufficient to support an allegation of scienter. The court rejected Maguire Financial's theory that an inference that the CEO knew his statement was false was sufficient to demonstrate the CEO acted intentionally or recklessly to deceive, manipulate or defraud.

PowerSecure provides utility and energy technologies to electric utilities and their customers. Its CEO, Sidney Hinton, referring to PowerSecure's three-year contract with Florida Power & Light (FP&L) for the West Palm Beach area that would soon expire, stated during an August 7, 2013, conference call and live webcast that PowerSecure was "blessed to announce securing a $49 million three-year contract renewal, both the renewal and expansion with one of the largest investor [owned] utilities in the country."

On May 7, 2014, PowerSecure reported a first quarter loss due to increased costs and expenses resulting from the changed geographies it was serving pursuant to its new contract with FP&L. Three class action lawsuits were then filed against PowerSecure, Hinton and PowerSecure's chief financial officer.

The district court consolidated the lawsuits and appointed Maguire Financial lead plaintiff. Maguire Financial filed a consolidated complaint, alleging that "PowerSecure's share price was artificially inflated after Hinton's August 7, 2013, statement that PowerSecure had obtained a 'contract renewal,' because PowerSecure knew then that its West Palm Beach contract had not been extended, and it had instead been awarded a less profitable contract in Ft. Meyers." The district court held that Maguire Financial had adequately alleged the August 7, 2013, statement was materially misleading but that the complaint failed to plead scienter.

On appeal, Maguire Financial argued that Hinton, as CEO of PowerSecure with decades of experience, must have known that the contract was not a renewal but rather a new contract for a different location, which would require PowerSecure to hire and train new workers at a significant expense. Maguire Financial also argued that Hinton, along with other company executives, had various motives to inflate the stock price and that these motives, combined with Hinton's knowledge that the contract was not a renewal, satisfy the scienter requirement.

The Fourth Circuit held that Maguire Financial failed to adequately plead scienter as required by Section 10(b), Rule 10b-5 and the Private Securities Litigation Reform Act (PSLRA). The court drew a distinction between the material misrepresentation and scienter elements of a Rule 10b-5 claim, explaining that "[t]he material misrepresentation inquiry focuses on the reasonable investor's view of a factual statement, while the scienter inquiry focuses on the defendant's mental state."

The court rejected Maguire Financial's argument that the inference that Hinton knew his statement was false was sufficient to show he acted with scienter. The court explained that Maguire Financial's "argument fuses an inference that Hinton knew enough to realize that his characterization was technically incorrect with an inference that he intended it to deceive." The court instructed that "scienter and knowledge with respect to misrepresentation are distinct components of the requisite analytical framework," and that "[t]o conflate the two, as [Maguire Financial] would have us do, would read the scienter element out of the analysis in contravention of the PSLRA's exacting pleading standard."

The court also analyzed the complaint's allegations in totality and held that the alleged facts did not support the inference that defendants intentionally or recklessly misled investors. In explaining where Maguire Financial's allegations fell short, the court noted that "the amended complaint's failure to identify a single fact that shows that Hinton knew ... the new contract would be less profitable" at the time he made the allegedly material misrepresentation was a "serious deficiency." The court was not swayed by the fact that the new contract eventually did reduce PowerSecure's profitability, partly because the complaint neither alleged that PowerSecure had previously incurred additional costs in serving an existing client in a new location nor that this was common knowledge in the industry. Moreover, Maguire Financial's allegation that PowerSecure sold 2.3 million shares a week after Hinton's statement, absent anything more, was "scarcely sufficient" to suggest impropriety in the court's view.

Securities Fraud Pleading Standards

Ninth Circuit Holds Disclosure of FTC Consumer Complaints Insufficient to Establish Loss Causation

Curry v. Yelp, Inc., No. 16-15104 (9th Cir. Nov. 21, 2017)
Click here to view the opinion.

The Ninth Circuit affirmed the dismissal of a putative securities fraud class action against Yelp, Inc. for failure to adequately allege loss causation and scienter.

Yelp, Inc. hosts a website that provides reviews of businesses. In response to a Freedom of Information Act request, the Federal Trade Commission (FTC) disclosed more than 2,000 complaints from businesses claiming that Yelp had manipulated reviews of their services. The plaintiffs alleged that this disclosure revealed that Yelp's prior statements about the independence and authenticity of its reviews were false, and that Yelp's stock dropped as a result.

The district court dismissed the complaint, and the Ninth Circuit affirmed. The court explained that the announcement of an investigation is insufficient to establish loss causation under Ninth Circuit law. Given that standard, the lesser revelation of mere consumer complaints — which were not followed by an investigation — certainly cannot meet the heightened pleading standards of the PSLRA and Federal Rule of Civil Procedure 9(b). In short, the court concluded, the plaintiffs cannot simply assert that "where there is smoke, there must be fire."

As an additional basis for dismissal, the court also held that the plaintiffs failed to adequately plead scienter. In rejecting the plaintiffs' attempt to invoke the core operations theory, the court reasoned that management's general awareness of the daily business did not satisfy the pleading standard. The court noted that 2,000 complaints represented a small fraction of Yelp's business — just one in 26,500 reviews — and, therefore, the FTC complaints were not so central to the company's operations as to support a strong inference of scienter.

The court also held that the plaintiffs' allegations of stock sales were insufficient to plead scienter. In particular, the plaintiffs failed to allege specifics of the individual defendants' prior trading history, despite the district court's directives to do so. Absent such allegations, the plaintiffs could not allege that the sales were dramatically different from prior trading practices.

Inside the Courts
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