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Skadden

Inside the Courts
An Update From Skadden Securities Litigators

US Supreme Court

Supreme Court Holds That SEC Administrative Law Judges Are Unconstitutionally Appointed

Lucia v. SEC, No. 17-130 (U.S. June 21, 2018)
Click here to view the opinion.

In a 7-2 decision, the U.S. Supreme Court held that the Securities and Exchange Commission's (SEC) administrative law judges (ALJs) are "Officers of the United States" and thus subject to the Appointments Clause of the U.S. Constitution. The clause requires that all "Officers of the United States" be appointed by the president, "Courts of Law" or "Heads of Department." The Supreme Court thus held that the appointment of the SEC's ALJs by SEC staff, and not the commission itself, violated the Appointments Clause.

Writing for the majority, Justice Elena Kagan determined that the case was controlled by the Court's precedent in *Freytag v. Commissioner*, 501 U.S. 868, 880-81 (1991), which found that "special trial judges" (STJs) of the U.S. Tax Court — adjudicative officials who exercise very similar functions as the ALJs — fell under the category of "Officers of the United States." Critically, both the STJs in *Freytag* and the ALJs here exercised "significant authority pursuant to the laws of the United States," based on an inquiry into "the extent of power an individual wields in carrying out his assigned functions." Even though neither STJs nor ALJs could issue final decisions that would bind the agency, they could, among other things, preside over adversarial hearings, take testimony, and prepare proposed findings and opinions — in the course of which both exercised significant discretion. The Court also reasoned that the ALJs had more autonomy because their decision could automatically become binding under SEC rules if the commission denied review. Additionally, both held "continuing office[s] established by law."

Thus, as in *Freytag*, the Court held that ALJs are "Officers of the United States" whose appointment must comply with the requirements of the Appointments Clause. The Court further determined that the appropriate remedy for the petitioner in this case — who had previously been found by an ALJ to have violated the Investment Advisers Act — was a new hearing before a properly appointed ALJ.

Supreme Court to Consider Whether a False or Misleading Statement by Someone Who Is Not Its 'Maker' May Nonetheless Be the Basis of a Fraudulent Scheme Claim

Lorenzo v. SEC, 872 F.3d 578 (D.C. Cir. 2017),
cert. granted 138 S. Ct. 2650 (2018)
Click here to view the opinion.

The U.S. Supreme Court granted a petition for a writ of *certiorari* urging it to decide whether the scheme liability provisions of Securities Exchange Act Rule 10b-5(a) and (c) may be used to impose liability in connection with false or misleading statements by a person who is not a "maker" of those statements within the meaning of *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 135 (2011), and who is thus not liable under the false-and-misleading statements provision of Rule 10b-5(b).

On October 14, 2009, at the behest of his boss, petitioner Francis Lorenzo — who was director of investment banking at a registered brokerage firm — emailed two potential investors several "key" points about Waste2Energy Holdings, Inc.'s (W2E) pending debenture offering. In his emails, Lorenzo forwarded information provided to him by his boss touting the highly attractive nature of the offering but omitting any mention of the devaluation of W2E's intangible assets.

On September 29, 2017, a 2-1 majority of the D.C. Circuit upheld the SEC's determination that Lorenzo had violated Section 17(a)(1) of the Securities Act, Section 10(b) of the Securities Exchange Act and Securities Exchange Act Rules 10b-5(a) and (c) by copying, pasting and sending statements prepared by Lorenzo's boss to investors. The D.C. Circuit held that substantial evidence supported the SEC's determination that Lorenzo acted extremely recklessly in sending his boss' statements to investors because he knew they were false at the time, used them to deceive investors and was therefore liable for engaging in a fraudulent scheme.

The D.C. Circuit held, however, that Lorenzo was not liable under Rule 10b-5(b) for "making" the statements because he did not have "ultimate control" over their content and dissemination, as required to impose liability under the Supreme Court's decision in *Janus*. In explaining its rationale for imposing liability for false statements under the fraudulent scheme provisions of Rules 10b-5(a) and (c) while declining to impose liability for those same statements under Rule 10b-5(b), the court noted that claims involving false statements are not exclusively within the purview of Rule

10b-5(b); Rules 10b-5(a) and (c) may encompass conduct involving the dissemination of false statements even if that conduct is beyond the reach of Rule 10b-5(b). Judge Brett Kavanaugh dissented, expressing his view that scheme liability must be based on conduct that goes beyond a defendant's role in preparing misstatements or omissions made by others.

With its decision, the D.C. Circuit joined the Eleventh Circuit in holding that a person who is not the "maker" of a false statement could still be liable for fraudulent scheme claims. *See SEC v. Big Apple Consulting USA, Inc.*, 783 F.3d 786, 795-96 (11th Cir. 2015).

In his petition to the Supreme Court, Lorenzo contended that the false statements that form the basis of the misstatement claim cannot be the sole basis for the fraudulent scheme claim. Lorenzo asserted that a majority of circuits that have ruled on this issue, including the Second, Eighth and Ninth circuits, have held that misstatements alone cannot form the basis of a fraudulent scheme claim under Rule 10b-5(a) or (c) and that additional deceptive conduct is required to impose liability. *See Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2005), *WPP Lux. Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057-58 (9th Cir. 2011) and *Pub. Pension Fund Grp. v. KV Pharm. Co.*, 679 F.3d 972, 986-87 (8th Cir. 2012). Lorenzo further asserted that the D.C. Circuit's holding allows the SEC to relabel inadequate fraudulent statement claims as fraudulent scheme claims to sidestep the standards set forth in *Janus*, thereby rendering it meaningless. Lorenzo also contended that the D.C. Circuit's decision erases the distinction between primary and secondary violators of the securities laws, thereby exposing large numbers of defendants who are secondary actors to aiding-and-abetting claims that would otherwise be barred in private litigation.

In its opposition to Lorenzo's petition, the SEC argued that the imposition of liability under Rule 10b-5(b) for "*making* a false statement" did not preclude the imposition of liability under Rules 10b-5(a) and (c) for "*disseminating* a false statement." The SEC similarly rejected Lorenzo's concern regarding meritless private actions, noting the additional reliance requirement that must be established by private plaintiffs and the heightened pleading standards imposed by the Private Securities Litigation Reform Act (PSLRA).

The ultimate outcome in *Lorenzo* may very well depend on whether Judge Kavanaugh is confirmed to the Court, and if so, whether he participates in the decision.

Appraisal

Court of Chancery Grants Appraisal Award of Deal Price Minus Synergies

In re Appraisal of Solera Holdings, Inc., C.A. No. 12080-CB (Del. Ch. July 30, 2018)
Click here to view the opinion.

Chancellor Andre G. Bouchard issued a post-trial appraisal decision, finding that the fair value of Solera Holdings, Inc. was the deal price minus synergies.

Solera was acquired by private equity firm Vista Equity Partners for $55.85 per share. The appraisal petitioners contended that, based on a discounted cash flow analysis, the fair value of their shares was $84.65, a figure 51.6 percent higher than the deal price. On the other hand, for most of the litigation, Solera argued that the best evidence of fair value was the price Solera stockholders received in the transaction, minus synergies. After the Court of Chancery's decision in *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*, C.A. No. 11448-VCL (Del. Ch. May 21, 2018), was issued, Solera also argued in supplemental briefing that the best evidence of fair value was the unaffected market price of $36.39 per share.

In awarding deal price minus synergies, the court explained that the Delaware Supreme Court's recent decisions in *DFC Global Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346 (Del. 2017), and *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, 177 A.3d 1 (Del. 2017), "teach that deal price is 'the best evidence of fair value' when there was an 'open process,' meaning that the process is characterized by 'objective indicia of reliability,'" and that "[i]f the process was open, then 'the deal price deserve[s] heavy, if not dispositive, weight.'" The court determined that the Solera merger "was the product of an open process" with "the requisite objective indicia of reliability emphasized in *DFC* and *Dell*." The court also found the record supported the conclusion that the market for Solera's stock was efficient and well-functioning.

The court rejected the petitioners' argument that merger fees (such as buyer fees, seller fees, debt fees and an "early participation premium" to retire debt in connection with the transaction) should be added to the deal price "because the court's 'focus should be on what Vista was actually willing to spend to buy the Company.'" The court explained that this argument was (i) inconsistent with the definition of fair value, which is "what [stockholders] deserve to receive based on what would fairly be given to them in an arm's-length transaction," and (ii) undesirable as a matter of appraisal policy because "[i]f stockholders received payment for transaction fees in appraisal proceedings, then it would compel rational stockholders in even the most pristine deal processes to seek appraisal to capture their share of the transaction costs (plus interest) that otherwise would be unavailable to them in any non-litigated arm's-length merger."

Finally, the court rejected Solera's supplemental argument, based on the recent *Aruba* decision, that unaffected market price was the most reliable indicator of fair value. The chancellor explained that while the court in *Aruba* declined to adopt "deal price less synergies" because, among other things, that figure "continues to incorporate an element of value derived from the merger itself: the value that the acquirer creates by reducing agency costs," the chancellor did not read *DFC* and *Dell* "to suggest that agency costs represent an element of value attributable to a merger separate from synergies that must be excluded under Section 262(h)."

Court of Chancery Grants Appraisal Award Above the Deal Price

Blueblade Capital Opportunities LLC v. Norcraft Cos., C.A. No. 11184-VCS, (Del. Ch. July 27, 2018)
Click here to view the opinion.

In a post-trial appraisal decision, Vice Chancellor Joseph R. Slights III rejected the contention that the $25.50 per share price that stockholders of Norcraft Companies, Inc. received when the company was acquired by Fortune Brands Home & Security, Inc. was the best indicia of Norcraft's fair value and instead relied on a discounted cash flow analysis to arrive at a fair value of $26.16, approximately 2.5 percent above the deal price.

The appraisal action arose from Fortune's 2015 acquisition of Norcraft. The court found that "significant flaws in the process leading" to the merger undermined the reliability of the deal price as the best indicia of fair value. Among other things, the court emphasized that there was no pre-signing market check, and the company "fixated" on Fortune while never "broaden[ing] their view to other potential merger partners." The court also found that Norcraft's "lead negotiator was at least as focused on securing benefits for himself as he was on securing the best price." Additionally, the court criticized the "go-shop" process as ineffective, in part because Fortune's financial advisor attempted to "contact and dissuade possible bidders" in a "fit of bad judgment." The court ultimately concluded that, given the flaws in the sales process, the evidence in the case did "not allow for principled reliance upon the efficient capital markets hypothesis" and instead required the court to perform an independent calculation of fair value using a "traditional valuation methodology."

The court therefore performed a discounted cash flow analysis, which resulted in a fair value of $26.16 a share. The court then considered the deal price as a "reality check" on its discounted cash flow calculation, nothing that the $0.66 delta between the court's discounted cash flow (DCF) analysis and the merger price was not so large "as to cause [the court] to question whether the DCF is grounded in reality."

Disclosure

Court of Chancery Clarifies Stockholder's Entitlement to Appraisal

City of N. Miami Beach v. Dr Pepper Snapple Grp., Inc.,
C.A. No. 2018-0227-AGB (Del. Ch. June 1, 2018)
Click here to view the opinion.

Chancellor Bouchard granted defendants' motions for summary judgment in a pre-closing breach of fiduciary duty action, holding that in a transaction where stockholders were to receive cash via a special dividend in connection with a merger involving the company's subsidiary, the stockholders were not entitled to appraisal.

The underlying business combination between Dr Pepper Snapple Group, Inc. and Keurig Green Mountain, Inc. was structured as a reverse triangular merger whereby a merger subsidiary of Dr Pepper would merge into Keurig's indirect parent, Maple Parent Holdings Corp. Following the merger, Maple would become a wholly owned subsidiary of Dr Pepper, and each share of Maple would be converted into a right to receive newly issued shares of Dr Pepper stock. In addition, Dr Pepper stockholders were to receive a special cash dividend of $103.75 per share. After the transaction, Dr Pepper stockholders would own 13 percent of the combined company.

The preliminary proxy issued in connection with the transaction advised Dr Pepper stockholders, who were asked to vote to authorize the issuance of stock as merger consideration, that they were not entitled to appraisal in the transaction. The plaintiff filed suit pre-closing, asserting that Dr Pepper stockholders had appraisal rights in this structure because they were receiving cash in connection with a merger, and the Dr Pepper board therefore breached its fiduciary duties by not disclosing the existence of appraisal rights. The parties cross-moved for summary judgment on an expedited basis, requesting a decision before the impending stockholder vote.

The court granted summary judgment in favor of the defendants. The court explained that Delaware's appraisal statute expressly provides that appraisal rights are available only for the shares of stock of a "constituent corporation" in a merger — in other words, an entity "*actually being merged or combined* and not the parent of such an entity." Because the merger involved Dr Pepper's subsidiary and not Dr Pepper itself, stockholders of Dr Pepper were not entitled to appraisal. The court further concluded that "if the Legislature is concerned about the lack of availability of appraisal rights for this type of transaction, the appropriate recourse is to amend the statute."

Class Certification

Southern District of New York Grants Motion for Class Certification

In re Goldman Sachs Grp., Inc. Sec. Litig., No. 10 Civ. 3461 (S.D.N.Y. Aug. 14, 2018)
Click here to view the opinion.

Judge Paul A. Crotty granted the plaintiffs' motion for class certification in an action brought against an investment bank under Section 10(b) of the Securities Exchange Act, alleging that the bank misled investors regarding the company's conflicts of interest policies and business practices.

The court first granted the plaintiffs' motion for class certification on September 24, 2015. The defendants took an interlocutory appeal. The Second Circuit agreed with Judge Crotty that the plaintiffs had satisfied the four requirements of Rule 23(a) and that the plaintiffs could invoke the rebuttable presumption of reliance set forth in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). The Second Circuit, however, vacated the class certification and ordered the court to reconsider if the defendants had rebutted the *Basic* presumption by a preponderance of the evidence.

On remand, citing the U.S. Supreme Court's holding in *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014), that *Basic*'s presumption of reliance may be rebutted with evidence that the alleged misstatements had no price impact, the court concluded that the defendants failed to show that there was no statistically significant price impact following the corrective disclosures. The defendants argued that between the alleged misrepresentation and the corrective disclosures, 36 news reports disclosed Goldman's alleged conflicts of interests, and that after these news reports, the stock price did not decline. The defendants argued that (i) this lack of price movement meant that the alleged misstatements did not support any price inflation, and (ii) the price decline following the alleged corrective disclosures were not caused by the news of Goldman's conflicts of interest. The court held that the absence of price movement alone was insufficient to "sever the link between the first corrective disclosure and the subsequent stock price drop" and that the first corrective disclosure contained new evidence about the conflicts of interest. The court also held that the defendants' experts failed to reliably demonstrate that the price drop following the corrective disclosures was in no way caused by revealing the alleged misrepresentations.

Fiduciary Duties

Controlling Stockholder Litigation

Court of Chancery Denies Request for Temporary Restraining Order in Controlling Stockholder Dispute

CBS Corp. v. Nat'l Amusements, Inc., C.A. No. 2018-0342-AGB (Del. Ch. May 17, 2018)
Click here to view the opinion.

Chancellor Bouchard denied a request for a temporary restraining order brought by CBS Corp. and five members of the CBS board of directors who sought to preclude CBS' controlling stockholder, National Amusements, Inc. (NAI), from interfering with a special board meeting called to issue a stock dividend intended to dilute NAI's voting power.

Sumner Redstone, who is 95, holds a controlling interest in both CBS and Viacom Inc. through his indirect ownership in NAI. According to the CBS plaintiffs, beginning in 2016, Sumner Redstone's daughter, Shari Redstone, who serves as the president of NAI, began to pursue a merger of CBS and Viacom, which was rejected by an independent special committee of the CBS board on two occasions. The CBS plaintiffs, concerned that Shari Redstone would "replace members of the Board and use the new directors to force through the merger," scheduled a special board meeting at which the board planned to approve a stock dividend to dilute NAI's voting power from 80 percent to 17 percent. They then sought a temporary restraining order in the Court of Chancery prohibiting the Redstones from interfering with the composition of the CBS board, the stock dividend or any other decisions taken by the CBS board at the special meeting.

The court denied the request for a temporary restraining order. In its decision, the court found that the CBS plaintiffs had stated colorable claims for breach of fiduciary duty, given "CBS's proclaimed commitment to independent board governance" and Shari Redstone's alleged interference with CBS' board processes, undermining of CBS management and refusal to agree to public company governance in connection with a potential merger, among other things. However, the court declined to issue a temporary restraining order because the CBS plaintiffs could not demonstrate that irreparable harm would result in the absence of an injunction, noting that "the court has extensive power to provide redress if Ms. Redstone takes action(s) inconsistent with the fiduciary obligations owed by a controlling stockholder."

In addition, the court found that the equities weighed in favor of denying the request, observing "an apparent tension in our law between a controlling stockholder's right to protect its control position and the right of independent directors ... to respond to a threat posed by a controller, including possible dilution of the controller." The court noted that "no precedent has been identified ... in which the court has ever entertained, much less sanctioned, the type of request for relief" sought by the CBS plaintiffs, and that a "truly extraordinary set of circumstances would be necessary to grant" such relief. Although "[t]he exigency of plaintiffs' application preclude[d] further consideration of this point of tension," the court concluded that the "clearest precedent" — namely, *Adlerstein v. Wertheimer*, No. CIV.A. 19101, 2002 WL 205684 (Del. Ch. Jan. 25, 2002), which expressly endorsed a controller's right to make the first move pre-emptively to protect its control interest — "is the clearest precedent and weighs heavily in defendants' favor."

Disclosure

Court of Chancery Validates Written Consents and Dismisses Claim for Breach of Fiduciary Duty

Cirillo Family Trust v. Moezinia, C.A. No. 10116-CB (Del. Ch. July 11, 2018)
Click here to view the opinion.

Chancellor Bouchard granted a motion for summary judgment, validating written consents under Section 205 of the Delaware General Corporation Law (DGCL) and dismissing a claim for breach of fiduciary duty based on inadequate disclosures in a notice to stockholders regarding their appraisal rights.

In August 2014, DAVA Pharmaceuticals, Inc., a private held company, merged with an affiliate of Endo Pharmaceuticals, Inc. DAVA sought stockholder approval of the merger by written consent under Section 228 of the DGCL. DAVA succeeded in obtaining written consents from all of its stockholders except the plaintiff, The Cirillo Family Trust (the Trust). When it became apparent that the Trust would not provide its written consent, DAVA sent the Trust a notice that the merger had been approved by a majority of DAVA's stockholders and provided information about how to seek appraisal. The Trust never provided its written consent, nor did it seek appraisal of its shares.

The Trust filed a complaint asserting two claims: (i) a claim seeking rescissory damages against DAVA and its directors based on purported defects in the dating of certain written consents, and (ii) a claim for breach of fiduciary duty against DAVA's directors because the notice provided to the Trust allegedly failed to include information material to its determination of whether to accept the merger consideration or to seek appraisal of its shares. DAVA asserted a counterclaim seeking an order validating and declaring effective certain written consents under Section 205 of the DGCL.

First, the court validated the written consents under Section 205 despite the fact that, at the time of the merger, Section 228(c) of the DGCL required that written consents bear the date of signature of each stockholder signing the consent. The defendants admitted that most of the written consents had not been dated by the signatories on the dates they were signed. However, the court recognized that, since its enactment in 2014, Section 205 has provided a mechanism for the court to validate defective corporate acts that would otherwise be incurable due to a technical defect. The court concluded that validating the otherwise defective written consents was appropriate based on the factors set forth in the statute.

Second, with respect to the claim for breach of fiduciary duty against DAVA's directors, the court concluded that while the notice was "totally bereft of information required under Delaware law to permit a stockholder to decide whether to seek appraisal in lieu of accepting the Merger consideration," the directors were entitled to summary judgment because the record demonstrated that they reasonably relied on their longtime outside corporate counsel to prepare the notice. The court determined that nothing in the record suggested that the directors knew or should have known that their counsel was not competent to prepare the notice or that the legal advice concerning the contents of the notice was so erroneous. The court also concluded that Section 141(e) of the DGCL, which creates a safe harbor for directors to rely on the advice of experts, provided a separate statutory ground for judgment in favor of the directors.

Inside the Courts
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Mergers and Acquisitions

New York Supreme Court Enjoins Xerox Merger as Likely Breach of Fiduciary Duty

In re Xerox Corp. Consol. S'holder Litig., 76 N.Y.S. 3d 759
(Sup. Ct. New York County 2018)
Click here to view the opinion.

The New York Supreme Court temporarily enjoined a merger pursuant to which Fujifilm Holdings Corp. would acquire a 50.1 percent controlling interest in Xerox Corp.

For decades, Fuji and Xerox had explored various potential transactions. In early 2017, Xerox and Fuji were in discussions regarding Fuji outright purchasing all of Xerox's shares. The negotiations were being conducted primarily by Xerox's CEO, Jeff Jacobson. Xerox indicated that it would only be willing to entertain discussions about an all-cash, premium transaction. In early summer 2017, when Jacobson was speaking with Fuji's senior executives about a potential transaction, the Xerox board decided that Jacobson was not the right person to continue as CEO. Moreover, large Xerox stockholder Carl Icahn had indicated that he intended to launch a proxy contest to replace Jacobson at the 2018 annual stockholder meeting. Jacobson was told that the express and unanimous direction of the board was that he should stop further discussions with Fuji about a possible combination. Nevertheless, Jacobson continued negotiations for a deal with Fuji.

Ultimately, in 2018, Xerox and Fuji entered into a merger that provided Xerox stockholders with no cash payment and in which Fuji obtained a 50.1 percent stake in Xerox. The proposed merger provided that, post-transaction, Jacobsen would be CEO of the combined company, and that five existing Xerox directors would be members of the combined board.

In evaluating whether to enjoin the deal, the court applied New York fiduciary duty law. The court found that the plaintiffs had demonstrated a likelihood of success on the merits of the claim that the Xerox board breached its fiduciary duties in approving the merger and that Fuji aided and abetted the breach. The "lynchpin" of the court's decision turned on the conduct of Jacobsen "in the time frame preceding the Board's approval of a transaction that granted control of an iconic American company to Fuji without any cash payment by Fuji to Xerox shareholders, and the Board's acquiescence in Jacobson's conduct." The court stated that "[t]he facts ... clearly show that Jacobson, having been told on November 10 that the Board was actively seeking a new CEO to replace him, was hopelessly conflicted during his negotiation of a strategic acquisition transaction that would result in a combined entity of which he would be CEO." Moreover, "Jacobson was consistently acting without the knowledge of the entire Xerox Board even after the Board decided ... that he immediately cease any further communications and negotiations with Fuji about a possible transaction. Despite the Board's decision, Jacobson doubled down on his efforts and worked directly with Fuji to ensure a deal that is disproportionately favorable to Fuji, not Xerox."

The court found that the business judgment rule did not apply, and entire fairness was instead the relevant standard of review, because Jacobson was conflicted, and it was likely that "the director defendants, a majority of whom would have future directorship positions on the board of the combined entity, acted in bad faith in structuring and negotiating the proposed transaction." Indeed, according to Xerox's own financial advisor, the transaction undervalued Xerox and provided an inadequate control premium. With respect to the aiding-and-abetting claim, the court stated that "plaintiffs have demonstrated that throughout negotiations, Fuji's representatives ... believed that the proposed transaction disproportionately favored Fuji at the expense of Xerox shareholders," and "knowing full well that Jacobson was under enormous pressure from Icahn and the Board and that Jacobson could soon be replaced as CEO, presented Jacobson with the opportunity to stay on as CEO of the combined entity that would emerge from a change of control transaction that deprived Xerox shareholders of an adequate control premium."

Thus, the court enjoined the transaction until a final hearing on the merits could be had. The court also enjoined Xerox's enforcement of its advance notice bylaw deadline at the upcoming annual meeting, to allow dissident shareholders to nominate a competing slate. The court required plaintiffs to provide a $150 million undertaking as security for the injunction.

Following the injunction, Xerox and activist stockholders seeking to replace the Xerox board reached a settlement with Xerox, under the terms of which Xerox terminated the Fuji merger, and the CEO of Icahn Enterprises became chairman of Xerox, and Jacobson was also replaced as CEO of Xerox. Subsequently, Fuji sued Xerox in federal court, seeking over $1 billion in damages in connection with the failed merger, arguing that Xerox caved to activist pressure and made the "unilateral decision to terminate [the merger] without legitimate cause."

Privilege

Court of Chancery Provides Guidance on Limiting Directors' Access to Information

In re CBS Corp. Litig., Consol. C.A. No. 2018-0342-AGB (Del. Ch. July 13, 2018)
Click here to view the opinion.

Two months after denying the CBS plaintiffs' request for a temporary restraining order in *In re CBS Corp. Litigation*, Chancellor Bouchard granted in part and denied in part a motion to compel filed by NAI, providing guidance on when limitations can be placed on a director's ability to access privileged information.

Through the motion to compel, NAI sought (i) communications between any officer or director of CBS, on the one hand, and CBS' in-house and outside counsel, on the other; and (ii) communications between members of the special committees formed to consider the Viacom-CBS merger, on the one hand, and CBS' in-house and outside counsel, on the other.

The court summarized "three recognized limitations on a director's ability to access privileged information": (i) a "director's right can be diminished by an *ex ante* agreement among the contracting parties"; (ii) a board can act "openly with the knowledge of the excluded director to appoint a special committee"; and (iii) a "board or a committee can withhold privileged information once sufficient adversity exists between the director and the corporation such that the director could no longer have a reasonable expectation that he was a client of the board's counsel."

Applying these principles, Chancellor Bouchard held that NAI was not entitled to communications between members of the special committees and their counsel, on the one hand, and CBS' in-house and outside counsel, on the other, that were "undertaken in aid of the process of" the special committees. The court found that because NAI "placed [itself] across the negotiating table from CBS," sufficient adversity existed such that the NAI directors could not have reasonably expected that they were clients of either the board or the special committees' counsel with respect to matters delegated to the special committees. The court further explained that "it is logical to expect that a special committee charged with evaluating a proposed transaction ... may wish or may need to confer with the corporation's in-house lawyers and outside counsel to discharge their duties in an informed and responsible manner."

However, the court granted the motion to compel with respect to "any matter *other than the matters falling within the purview of the Special Committees for which CBS Counsel provided assistance*." Chancellor Bouchard noted that the NAI directors were not made aware (nor should they reasonably have been aware) that CBS' in-house counsel and outside counsel were not representing them jointly with other CBS directors with respect to such matters.

Foreign Corporations

Second Circuit Holds That Transaction Involving Foreign Corporation Constitutes 'Domestic Transaction'

Giunta v. Dingman, No. 17-1375-cv (2d Cir. June 19, 2018)
Click here to view the opinion.

The Second Circuit vacated the dismissal of claims brought against a foreign hospitality corporation under Section 10(b) of the Securities Exchange Act alleging the company made various misrepresentations in the United States that induced the plaintiff to invest in the foreign company.

The court held that the plaintiff plausibly alleged a "domestic transaction" under the Securities Exchange Act. The court reasoned that although the company's shares were not listed on a domestic exchange, the plaintiff had sufficiently alleged that the company incurred irrevocable liability within the United States. The investment offer to purchase a 50 percent interest in the company and the subsequent wire transfer of $100,000 was a "sufficiently definite" agreement that was entered into in New York and imposed an obligation on the company to take, pay for and delivery a securities in the United States. Although the agreement was subject to a condition subsequent — approval from the Bahamian exchange of the issuance of shares — irrevocable liability was incurred when the parties entered into the agreement. The court also held that the agreement was not "so predominately foreign" to render the application of Section 10(b) "impermissibly extraterritorial": The agreement was entered into in New York, the misrepresentations occurred in New York and both parties were U.S. citizens.

Inside the Courts
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Insider Trading

Second Circuit Clarifies State of Insider Trading Law

United States v. Martoma, No. 14-3599 (2d Cir. June 25, 2018)
Click here to view the opinion.

Ten months after issuing its original decision in *United States v. Martoma,* 869 F.3d 58 (2d Cir. 2017), the Second Circuit issued an amended opinion clarifying the state of insider trading law in the Second Circuit following the U.S. Supreme Court's decision in *Salman v. United States*, 137 S. Ct. 420 (2016).

In *Dirks v. SEC*, 463 U.S. 646 (1983), the Supreme Court established that a recipient of confidential information (a "tippee") can be liable for insider trading when the tipper has breached a fiduciary duty by disclosing the information; whether the tipper has breached a fiduciary duty depends on whether he will personally benefit from the disclosure. *Dirks* provided several examples of personal benefits that could prove a tipper's breach, including a relationship between the tipper and the tippee "that suggests a *quid pro quo* from the latter" and the tipper's "intention to benefit" the tippee.

In *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), the Second Circuit held that proof of a personal benefit requires evidence of "a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." However, the Supreme Court subsequently held in *Salman v. United States*, 137 S. Ct. 420 (2016), that *Newman*'s requirement that the tipper receive something of a "pecuniary of similarly valuable nature" was inconsistent with *Dirks*.

The Second Circuit nevertheless determined that *Newman*'s "meaningfully close personal relationship" requirement could be satisfied by evidence of a *quid pro quo* relationship between the tipper and tippee, or the tipper's intent to benefit the tippee — consistent with *Dirks* and not inconsistent with *Salman*. Accordingly, even though the district court misstated the law in its instructions to the jury, the error did not affect the defendant's substantial rights because evidence that the defendant traded on the basis of confidential information disclosed to him by a consulting expert who had been paid $70,000 in fees was sufficient evidence of a *quid pro quo* relationship supporting the defendant's insider trading conviction.

Pleading Standards

Ninth Circuit Reverses Dismissal, Warns of 'Concerning' Overuse of Judicial Notice and Incorporation-by-Reference

Khoja v. Orexigen Therapeutics, Inc., No. 16-56069 (9th Cir. Aug. 13, 2018)
Click here to view the opinion.

The Ninth Circuit reversed the dismissal of a putative securities class action against Orexigen Therapeutics, taking issue with what the court called a "concerning pattern in securities cases" in which the "overuse" of the judicial notice and incorporation by reference doctrines have resulted in the improper dismissal of securities suits at the pleading stage.

The complaint alleged that the defendant pharmaceutical company made material misrepresentations and omissions regarding clinical trials involving its developmental-stage obesity drug. When later results revealed that there were no cardiovascular benefits associated with the drug, the company's stock price plunged.

The district court dismissed the complaint after it judicially noticed and incorporated by reference 21 of the 22 documents requested by the defendant. The Ninth Circuit reversed, holding that the district court abused its discretion by incorporating at least seven of the 21 documents into the complaint and judicially noticing certain facts. The panel stated that the defendants were "exploiting these procedures improperly to defeat what would otherwise constitute adequately stated claims," and that "[i]f defendants are permitted to present their own version of the facts at the pleading stage — and district courts accept those facts as uncontroverted and true — it becomes near impossible for even the most aggrieved plaintiff to demonstrate a sufficiently 'plausible' claim for relief." The court stated that this problem was "especially significant" in securities fraud cases, where there is a heightened pleading standard and the defendants possess materials to which the plaintiffs do not yet have access.

Inside the Courts
An Update From Skadden Securities Litigators

Scienter

District of New Jersey Dismisses Suit for Failure to Adequately Plead Individual or Corporate Scienter

Christian v. BT Grp. Plc., No. 2:17-cv-497-KM-JBC
(D.N.J. Aug. 1, 2018)
Click here to view the opinion.

Judge Kevin McNulty dismissed a putative securities class action brought on behalf of purchasers of BT Group American depositary receipts (ADRs), who alleged that the defendants made a series of misstatements relating to control problems at a BT Group subsidiary in Italy.

In October 2016, BT Group announced a £145 million write-down due to "certain historical accounting errors" at BT Italy that were identified through an internal investigation by its audit committee. In January 2017, BT Group announced that the write-down was being increased to £530 million, explaining that the "extent and complexity of inappropriate behaviour" was greater than previously identified.

In the follow-on securities suit, the plaintiffs attempted to establish scienter with respect to the individual defendants by arguing that the defendants knew, or were reckless in ignoring, significant concerns that were raised in the audit committee's annual reports. The district court rejected that argument, finding that the annual reports did not put executives on notice of fraud at BT Italy, and that the audit committee's monitoring didn't amount to a "red flag[]." The court concluded it was more reasonable to infer that the executives were unware of the fraud.

The court also rejected the plaintiffs' efforts to plead "corporate scienter." While noting that the Third Circuit has neither accepted nor rejected the corporate scienter doctrine, Judge McNulty observed that courts that have permitted plaintiffs to plead corporate scienter still required the plaintiff to plead facts giving rise to a strong inference that someone in the corporation — whether or not that person was a named defendant — acted with scienter. Given that standard, the court found that, "taken collectively," the allegations were not "so fundamental and pervasive as to support an inference of corporate scienter," and in fact an opposing inference was "at least as likely."

Securities Fraud Pleading Standards

Seventh Circuit Affirms Dismissal of Securities Fraud Case for Insufficient Scienter Pleading

Pension Tr. Fund for Operating Eng'rs v. Kohl's Corp., No. 17-2697
(7th Cir. July 12, 2018)
Click here to view the opinion.

In an opinion by Chief Judge Diane P. Wood, the Seventh Circuit affirmed the dismissal of securities fraud claims under Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder. The plaintiffs, a pension fund, alleged in a putative class action that a major retailer and two of its executives defrauded investors by publishing false and misleading information in the lead-up to correcting several years of lease accounting statements in its financial filings. The plaintiffs alleged that repeated corrections in 2005, 2010 and 2011 showed that the defendants knew or at least recklessly disregarded that the information in their financial filings was false. Judge J.P. Stadtmueller of the Eastern District of Wisconsin dismissed, with prejudice, the securities fraud claims because the plaintiffs failed to meet the heightened pleading requirements for scienter under the PSLRA.

The Seventh Circuit agreed. The court noted that it must consider the probability of whether, taken as a whole, the false statements alleged by the plaintiffs indicated "an intent to deceive or a reckless indifference to whether the statements were misleading," as opposed to being "the result of merely careless mistakes at the management level based on false information fed it from below." The plaintiffs' complaint alleged a litany of facts but did not connect those facts in a manner that pointed toward scienter. This included the plaintiffs' allegations that executives continued selling stocks around the time of the accounting corrections; the complaint did not allege anything actually suspicious about the stock sales that would support an inference of scienter. The Seventh Circuit further held that the plaintiffs had not established that an amended complaint would cure insufficiencies in the original, so the district court's finding that an amendment would be futile was warranted. Accordingly, the Seventh Circuit did not find error in the district court's dismissal with prejudice.

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Southern District of New York Dismisses Securities Fraud Claims Against Currency Brokerage Firm

Ret. Bd. of the Policemen's Annuity & Benefit Fund of Chi. v. FXCM Inc., 15-CV-3599 (KMW) (S.D.N.Y. Aug. 10, 2018)
Click here to view the opinion.

Judge Kimba M. Wood dismissed claims brought against a currency brokerage firm and under Section 10(b) of the Securities Exchange Act alleging that the company misled investors regarding the brokerage firm's business risks. The plaintiffs alleged that the brokerage firm allowed its customers to trade currency and bet on changes in prices for certain currency pairs, and that the firm operated under an "agency model" in which it earned money through commissions on trades, as opposed to a "principal model" under which it earned money when its customers lost on trades. The plaintiffs alleged that the company made materially false and misleading statements about the business risks associated with this compensation structure.

The court held that the alleged misrepresentations were nonactionable statements. The statement "that the agency model reduced [the Company's] risks" was puffery. Statements that the brokerage firm was "a riskless principal," "was not exposed to [ ] market risk" and "had a no debit policy" were not materially misleading when taken in context, and the statements that the company "had a fairly conservative margin policy, maintained a substantial pool of liquidity, [ ] maintained excess regulatory capital ... had no material changes in its risk factors" were too general for investors to rely upon. The court also held that the plaintiffs failed to sufficiently allege scienter and show that the founder believed that the company's business risks were greater at the time the statements were made.

Eastern District of Michigan Denies Defendants' Motion to Dismiss Federal Securities Law Claims Brought by Plaintiff Seeking to Recover Funds From Ponzi Scheme Within Ponzi Scheme

Gordon v. Royal Palm Real Estate Inv. Fund I, LLLP, No. 09-11770 (E.D. Mich. May 25, 2018)
Click here to view the opinion.

Judge Arthur J. Tarnow granted in part and denied in part a motion to dismiss claims under Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder, as well as numerous state securities statutes. The claims were brought by a court-appointed receiver to recover funds illegally derived from one Ponzi scheme that were later invested into the defendants' real estate investment Ponzi scheme.

In their motion, the defendants asserted the *in pari delicto* defense — the plaintiff was engaged in the same wrongdoing as the defendants, which should bar recovery. Applying the U.S. Supreme Court's test set forth in *Bateman Eichler v. Berner*, 472 U.S. 299 (1985), the court rejected the defendants' *in pari delicto* defense for the federal securities law claims, stating that precluding the suit would interfere with the effective enforcement of federal securities laws and would not serve to protect the investing public.

Nonetheless, the court rejected the plaintiff's "maker" liability theory because an individual no longer party to the action was in fact the "maker" of the relevant misrepresentations. Rather, the court allowed the plaintiff's federal securities law claim to proceed under a theory of "scheme" liability, finding the plaintiff sufficiently pleaded that the defendants participated in a scheme designed to defraud. Accordingly, the court granted the defendants' motion to dismiss with respect to the plaintiff's "maker" allegations but denied it with respect to the plaintiff's "scheme" allegations.

SLUSA Preclusion

Second Circuit Affirms Dismissal of State Law Best Execution Claims

*Rayner v. E*Trade Fin. Corp.*, No. 17-1487 (2d Cir. July 31, 2018)
Click here to view the opinion.

The Second Circuit affirmed the dismissal of state law best execution claims brought against an online brokerage platform, finding that the claims were precluded by the Securities Litigation Uniform Standards Act (SLUSA). The plaintiff alleged that the company routed standing limit orders to trading venues (*e.g.*, stock exchanges, hedge funds and third-party market makers) that were "willing to pay the largest 'kickbacks,'" or commissions, to the company in exchange for order flow. The plaintiff brought claims for breach of fiduciary duty, unjust enrichment and declaratory relief, alleging that the company "violate[d] its duty of best execution by seeking to maximize its own revenue from 'kickbacks'" instead of executing the transactions "at optimal price and volume." The company argued that these claims were precluded by SLUSA, which bars class actions based on state law claims that allege a misrepresentation or omission in connection with the purchase or sale of covered securities.

The court determined that the complaint "plainly alleges fraudulent conduct," as, for example, the plaintiff alleged that the company falsely announced on its website that it would "do everything possible to seek best execution." The court also found that the alleged fraud was made in connection with securities transactions because the company's alleged fraudulent failure to provide best execution was material to the securities transactions. The court determined the plaintiff's claims "amount[ed] to an allegation that [the company's] routing practice fraudulently induced the plaintiffs ... to purchase and sell securities at less favorable prices and at lower volumes than expected."

Eleventh Circuit Holds That SLUSA Does Not Bar State Law Claims Based on Misrepresentations Regarding Broker Fees

Brink v. Raymond James & Assocs., Inc., No. 16-14144
(11th Cir. June 8, 2018)
Click here to view the opinion.

The Eleventh Circuit reversed the dismissal of a putative class action, holding that the plaintiff's state law claims for negligence and breach of contract based on alleged misrepresentations by a brokerage house regarding its brokerage fees were not precluded by SLUSA.

The complaint alleged that the defendant brokerage house advertised a particular type of brokerage account through which customers would pay as a transaction fee only the actual "expenses incurred in facilitating the execution and clearing" of their trades. According to the complaint, however, the defendant actually charged a fee higher than the expenses it incurred. The district court dismissed the complaint for lack of subject matter jurisdiction, concluding that the claims were precluded by SLUSA because the alleged misrepresentations constituted "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security."

The Eleventh Circuit reversed, holding that the alleged failure to disclose the hidden profit built into the transaction fee was not a misrepresentation of a material fact for purposes of SLUSA. The court reasoned that a misrepresentation, for purposes of SLUSA, must make a "significant difference to someone's decision to purchase or to sell a covered security." Here, a reasonable investor would not have made a different investment decision had he or she known that some of the transaction fee included profit for the brokerage house. The court explained that the choice of a type of investment account is not intrinsic to the investment decision itself. Thus, although the alleged misrepresentation might have influenced a reasonable investor's decision to pick one brokerage account over another type of account, it would not have influenced the underlying investment decision.

Two Appellate Courts Reach Opposite Conclusions Regarding Application of SLUSA to Nearly Identical Complaints

O'Donnell v. AXA Equitable Life Ins. Co., No. 17-1085-cv
(2d. Cir. Apr. 10, 2018)
Click here to view the opinion.

Shuster v. AXA Equitable Life Ins. Co., No. A-3160-15T1
(N.J. Super. Ct. App. Div. Apr. 17, 2018)
Click here to view the opinion.

The Second Circuit and the New Jersey Appellate Division of the Superior Court reached opposite conclusions in two putative class actions against the same defendant, each involving the application of SLUSA, which precludes class actions based on state law claims that allege misrepresentations or omissions in connection with the purchase or sale of covered securities.

Two plaintiffs brought claims against a life insurance company on behalf of a nationwide putative class of policyholders — one in Connecticut state court and one in New Jersey state court — alleging that the insurer implemented an investment strategy in variable insurance contracts, in alleged breach of those contracts. Both complaints were based on a regulatory consent order entered into by the insurer and its regulator, the New York State Department of Financial Services (DFS), in which DFS found that the insurer made omissions in filings with DFS concerning the implementation of the investment strategy. Each plaintiff alleged that the insurer's filings with DFS violated a New York insurance law and breached a provision in the insurance contract requiring compliance with those laws. Each plaintiff claimed to have been harmed on the grounds that their investment returns would have been higher without the implementation of the investment strategy.

The insurer removed both actions to federal court under SLUSA. (The Connecticut action was thereafter transferred to the Southern District of New York.) In the action that originated in Connecticut, the court determined that SLUSA precluded that plaintiff's putative class action. The court reasoned that the plaintiff's breach-of-contract claim depended entirely on an allegation that the insurer had made omissions to him and to DFS about the new investment strategy and that his decision to hold his investment after the new strategy was introduced was made "in connection with" those alleged omissions. In the New Jersey action, the federal court remanded the case to New

Jersey state court, finding that SLUSA did not preclude the action because the consent order did not address that plaintiff's policy. On remand, however, that plaintiff conceded that her claim depended on the consent order. The New Jersey state court thus performed its own analysis of SLUSA and determined that SLUSA precluded that plaintiff's putative class action. Both cases were appealed.

The Second Circuit reversed the dismissal of the Connecticut action, holding that SLUSA did not preclude the action because the insurer's alleged misrepresentations or omissions were made to DFS and not to the plaintiff, and there could be "no link between the misrepresentation (to a regulator) and the inaction of a securities holder following misrepresentations of which the holder was unaware." The Second Circuit further held that the "in connection with" requirement was not met because the insurer's alleged misrepresentation "could not have been 'material to a decision by one or more individuals ... to buy or sell a covered security' for the simple reason that it was unknown to them." The Second Circuit directed that the action be remanded to Connecticut state court.

One week after the Second Circuit rendered its decision, the New Jersey Appellate Division reached precisely the opposite conclusion and affirmed the dismissal of the New Jersey action. The New Jersey Appellate Division rejected the plaintiff's contention that her claims did not satisfy SLUSA's "in connection with" requirement on the theory that the insurer's nonpublic filings with DFS did not induce her to make any investment decision. It reasoned that the U.S. Supreme Court in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006), rejected such a "cramped construction." The New Jersey Appellate Division concluded that the "in connection with" requirement was met because the plaintiff was alleged to have held the investments in which the new strategy was implemented as a consequence of the insurer's alleged omissions to DFS.

The plaintiff moved the New Jersey Appellate Division to reconsider its decision based on the Second Circuit's holding in the Connecticut action, but the Appellate Division denied the motion, explaining that it had considered the Second Circuit's decision and did not find its reasoning persuasive.

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