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Skadden

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Appraisal

Delaware Supreme Court Reverses Court of Chancery's Reliance on Unaffected Market Price as Best Indicator of Appraisal Value

Verition Partners Master Fund Ltd. v. Aruba Networks, Inc., Case No. 368, 2018 (Del. Apr. 16, 2019)
Click here to view the opinion.

The Delaware Supreme Court issued a *per curiam* decision reversing the Court of Chancery's determination that the fair value of Aruba Networks, Inc. was $17.13 — reflecting the company's 30-day average unaffected market price prior to announcement of its acquisition by Hewlett-Packard Company — and directing that the Court of Chancery enter a final judgment for petitioners in the amount of $19.10 per share, which represented the merger price minus synergies as estimated by Aruba.

In August 2014, HP approached Aruba about a potential combination. After several months of negotiations, the Aruba board accepted HP's offer of $24.67 per share. News of the deal leaked, causing Aruba's stock price to jump from $18.37 to $22.24. The next day, Aruba released quarterly results, beating analyst expectations and causing its stock price to rise by 9.7%.

Relying heavily on the Delaware Supreme Court's decisions in *DFC Global Corporation 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), Vice Chancellor J. Travis Laster determined that the fair value of Aruba was $17.13 per share on the theory that "once Delaware law has embraced a traditional formulation of the efficient capital markets hypothesis, the unaffected market price provides a direct route" to fair value for a company (1) that has many stockholders; (2) that lacks a controlling stockholder; (3) that has highly active trading; and (4) about which information is "widely available and easily disseminated to the market." The court found that "the market for Aruba's shares exhibited attributes associated with the premises underlying the efficient capital markets hypothesis" and further found that the "deal-price-less-synergies" was an unreliable measure of fair value because it was "likely tainted by human error" and would "incorporate ... the value the acquirer creates by reducing agency costs[, which t]he petitioners are not entitled to share in [because it] 'arise[s] from the accomplishment or expectation of the merger.'"

The Supreme Court reversed, holding that the Court of Chancery abused its discretion and rejecting the vice chancellor's "inapt theory that it needed to make an additional deduction from the deal price for unspecified 'reduced agency costs'" as unsupported by the record or corporate finance literature. The Supreme Court further explained that "the Court of Chancery's belief that it had to deduct for agency costs ignores the reality that HP's synergies case likely already priced any agency cost reductions it may have expected."

The Supreme Court clarified that "the trial judge's sense that [*DFC* and *Dell*] somehow compelled him to make the decision he did was not supported by any reasonable reading of those decisions or grounded in any direct citation to them," explaining that "*DFC* and *Dell* merely recognized that a buyer in possession of material nonpublic information about the seller is in a strong position (and is uniquely incentivized) to properly value the seller when agreeing to buy the company at a particular deal price, and that view of value should be given considerable weight by the Court of Chancery absent deficiencies in the deal process."

To avoid "burden[ing] the parties with further proceedings," the Supreme Court simply "order[ed] that a final judgment be entered for the petitioners in the amount of $19.10," Aruba's estimation of deal price less synergies, "plus any interest to which the petitioners are entitled."

Definition of a Security

Southern District of New York Holds That Cryptocurrency Is a Security

Balestra v. ATBCOIN LLC, 17-CV-10001 (VSB) (S.D.N.Y. Mar. 31, 2019)
Click here to view the opinion.

Judge Vernon S. Broderick denied the dismissal of claims brought by a putative class of purchasers of cryptocurrency against a coin issuer and certain of its officers alleging that they violated Section 12(a) of the Securities Act by offering and selling unregistered securities in an initial coin offering. The plaintiffs alleged that the profits from the unregistered securities — the company's coins — would be used to develop the company's blockchain technology and would lead to the coins increasing in value.

The court held that the company's coins were securities under the U.S. Supreme Court's decision in *SEC v. W.J. Howey Co*., 328 U.S. 293 (1946). Under *Howey*, an investment contract is a security "where there is '(i) an investment of money; (ii) in a common enterprise; (iii) with the expectation of profits to be derived solely from the efforts of others.'" The court determined that the plaintiffs adequately alleged a "horizontal commonality" in which the funds raised through purchases of the company's coins were pooled together to develop the company's blockchain technology, and the success of that technology would raise the value of the purchasers' coins. The court also determined that the plaintiffs adequately alleged that purchasers depended entirely on the company to increase the value of its coins through their work on the blockchain technology, and thus only the company could develop the blockchain technology, not the purchasers.

The court also held that the plaintiffs sufficiently alleged liability under Section 12(a). The plaintiffs sufficiently alleged that the company engaged in the steps necessary to distribute the coins by being the co-founders of the company and by publicizing the coins through interviews and attending conferences. The court reasoned that the plaintiffs sufficiently alleged that the officer defendants were motivated by their own financial interests as the sole officers of the company.

Fiduciary Duties

Delaware Supreme Court Reverses Dismissal Under *MFW*

Olenik v. Lodzinski, No. 392, 2018 (Del. Apr. 5, 2019)
Click here to view the opinion.

The Delaware Supreme Court reversed a dismissal of stockholder litigation under the framework set forth in *Kahn v. M & F Worldwide Corp*. (*MFW*), finding that the challenged merger transaction was not *ab initio* conditioned on *MFW*'s dual protections.

The *MFW* decision sets forth a framework that, if followed, reduces the standard of review under which the court will evaluate a challenge to an acquisition by a controlling stockholder from the onerous "entire fairness" standard of review to the highly deferential business judgment rule. In order to obtain business judgment review under *MFW*, the controller must condition the transaction *ab initio* on approval by both an empowered, independent special committee and a fully informed vote of disinterested stockholders. In another recent case, *Flood v. Synutra International, Inc.*, No. 101, 2018 (Del. Oct. 9, 2018), the Delaware Supreme Court clarified that under *MFW*'s *ab initio* requirement, "the key dual procedural protections must be in place before economic negotiations so the protections are not used as a bargaining tool in substitution for economic concessions by the controller."

In the case below, the Court of Chancery dismissed a stockholder challenge to an "Up-C" transaction, whereby two companies (Earthstone and Bold) under the same controller (EnCap) entered into an all-stock merger. Beginning in April 2016, before *MFW*'s dual protections were in place, EnCap, Earthstone and Bold engaged in discussions regarding valuations of Bold, the structure of the proposed transaction and the post-transaction equity split between Earthstone and Bold. Earthstone did not formally establish a special committee until late July 2016, and the controller did not condition the transaction on *MFW*'s dual protections until August 2016. Earthstone and Bold reached an agreement in November 2016, which provided that Earthstone stockholders would own 39% of the combined company. The Court of Chancery held that the *ab initio* requirement was satisfied because the acquirer's first offer letter — the starting point of "negotiations" — expressly conditioned the deal on approval of both a special committee of independent directors and a majority vote of the acquirer's stockholders unaffiliated with the controller. It therefore applied the business judgment rule to dismiss the claims.

On appeal, the Supreme Court reversed the dismissal, finding that the plaintiff had pleaded facts supporting a reasonable inference that the parties had "engaged in substantive economic negotiations before the Earthstone special committee put in place the *MFW* conditions." The Supreme Court explained that although the "Court of Chancery held correctly that preliminary discussions between a controller's representatives and representatives of the controlled company do not pass the point of no return for invoking *MFW*'s protections," when viewed along "the negotiating continuum, the well pled facts show[ed] that substantial economic negotiations took place well before the August 19 Letter with the *MFW* conditions."

The Supreme Court also refused to affirm the Court of Chancery's decision on the alternative basis that EnCap was not a controlling stockholder, finding that the plaintiff had adequately pleaded that EnCap acted as Earthstone's controlling stockholder while key economic negotiations took place and, further, Earthstone had described itself as a "company with a controlling shareholder." The court also rejected the plaintiff's additional argument that the majority of the minority vote was not fully informed and affirmed the Court of Chancery's ruling on that issue.

Court of Chancery Dismisses Claims Under *Corwin*

English v. Narang, C.A. No. 2018-0221-AGB (Del. Ch. Mar. 20, 2019)
Click here to view the opinion.

Chancellor Andre G. Bouchard applied the *Corwin* doctrine to dismiss a fiduciary challenge to a merger following a fully informed stockholder vote.

The plaintiff stockholders sued NCI, Inc.'s board of directors, challenging a transaction whereby the company would be acquired for cash through a tender offer followed by a merger. NCI's founder and retired CEO held 34% of the company's stock but (through a dual class structure) controlled 83.5% of the company's voting power. All stockholders, including the founder, received the same per-share consideration. Excluding the founder's shares, which were pledged in favor of the deal as a part of a tender and support agreement, approximately 73.6% of NCI's disinterested stockholders tendered their shares, and the merger closed. The defendants moved to dismiss the action under *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), which requires dismissal of post-closing challenges to mergers approved by a fully informed, uncoerced stockholder vote (absent a conflicted controller).

The plaintiffs did not dispute that the deal was approved by a majority of disinterested stockholders, or that the vote was uncoerced. Rather, the plaintiffs opposed the application of the *Corwin* doctrine on the basis that (1) NCI's controlling stockholder was conflicted with respect to the transaction because he faced a liquidity need as part of his estate planning and wealth management strategy, since most of his net worth was tied up in the company, and (2) the "stockholders who tendered their shares were not fully informed ... because the recommendation statement for the transaction was misleading and omitted material information."

The court rejected the argument that NCI's controlling stockholder was conflicted, finding the liquidity theory insufficiently pleaded. Outlining the "very narrow circumstances in which a controlling stockholder's immediate need for liquidity could constitute a disabling conflict of interest irrespective of pro rata treatment," such as a "crisis, fire sale" to satisfy an exigent personal need, the court held there were no allegations supporting such an inference. The court also relied on the lack of "concrete" alleged facts from which it could be inferred the controller faced "an exigent or immediate need for liquidity."

The court also rejected three disclosure challenges raised regarding alleged misrepresentations or omissions involving NCI's financial projections as well as potential conflicts of interest arising out of post-closing employment opportunities for NCI's management and fees earned by NCI's financial advisors.

Court of Chancery Enjoins Mergers Pending Additional Disclosures

FrontFour Capital Grp. LLC v. Taube, C.A. No. 2019-0100-KSJM (Del. Ch. Mar. 11, 2019)
Click here to view the opinion.

After an expedited trial, Vice Chancellor Kathaleen S. McCormick enjoined two cross-conditioned mergers pending the issuance of corrective disclosures but denied the plaintiffs' request for a "curative shopping process."

Medley Management, Inc. is the parent entity of several investment advisers that manage a number of funds, including Medley Capital Corporation and Sierra Income Corporation. Each of Medley Capital's "inside directors" also served on the boards of Medley Management and Sierra. In June 2018, the founders of Medley Management, the Taube brothers, proposed a three-way combination between Medley Management, Medley Capital and Sierra. Since the proposed transaction posed "significant conflicts," each of the three entities formed a special committee in an effort to simulate arm's length dealings. Ultimately, a deal was reached whereby Sierra would first acquire Medley Capital and then Medley Management in two cross-conditioned mergers, with Sierra as the surviving combined entity. After Medley Capital issued the proxy statement relating to the proposed mergers, multiple third parties expressed interest in an alternative deal with Medley Capital. The special committee considered these expressions of interest and ultimately determined not to engage or pursue them.

The plaintiffs, stockholders of Medley Capital, sought to enjoin the merger. The court held that the entire fairness standard of review applied because, although the Taube brothers owned less than 15% of Medley Capital's common stock, at least half of the special committee was beholden to them, and the special committee "sat supine in negotiations concerning the Proposed Transactions, allowing the Taube brothers to dominate the process." The court further held that the defendants failed to prove that the mergers were entirely fair, concluding that "a deeply flawed process obscure[d] the fair value of [the company]."

The court held that certain deal protections — including a no-shop, adverse-recommendation-change requirement and termination fee — also failed under enhanced scrutiny. The court clarified that although companies can use no-shops "to entice acquirers to make a strong offer by contractually eliminating the risk that the acquirer is a stalking horse," that justification did not apply because the parties knew that there was no pre-signing auction, "no risk that Sierra was being used as a stalking horse" and "no risk that Medley Capital would lose the 'bird in hand' if the transaction was shopped." Incrementally, the other two deal protections were "problematic" because the adverse-recommendation-change provision "unduly cabin[ed] the Board," and the termination fee (representing 2.79% of the deal value), in combination with the other deal protections, fell outside the range of reasonableness.

The court also held that Medley Capital's directors violated the duty of disclosure because the proxy statement (1) created "the misleading impression that the Special Committee process at Medley Capital was effective" and "replicated arm's-length negotiations amid the conflicts tainting the Proposed Transactions," and (2) failed to disclose other third-party indications of interest.

As a result, the court enjoined the defendants from holding "any stockholder vote" or from consummating the proposed transactions until corrective disclosures were made, but stopped short of ordering a "curative shopping process" because the plaintiffs failed to prove that Sierra aided and abetted the breach of fiduciary duty. The court noted that an "injunction may not issue if it would 'strip an innocent third party of its contractual rights' under a merger agreement, unless the party seeking the injunction proves that the third party aided and abetted a breach of fiduciary duty by the target directors."

Interpreting *Omnicare*

SDNY Dismisses in Part Claims That Mining Company Misled Investors About Profitability of Acquisition

SEC v. Rio Tinto plc, No. 1:17-cv-7994 (AT) (DCF) (S.D.N.Y. Mar. 18, 2019)
Click here to view the opinion.

Judge Analisa Torres granted in part and denied in part a motion to dismiss a Securities and Exchange Commission (SEC) enforcement action brought against a mining company and certain current and former officers alleging that the company violated Section 10(b) of the Securities Exchange Act by misleading investors concerning the value of a certain business the mining company had acquired for the purpose of expanding its production of coal and coal transportation activity. The SEC alleged that despite difficulties with the planned coal business projects, the company overvalued the assets of the acquisition in financial reports, and that even after knowing the project was almost certain to fail, the company continued to tout the project as being "prospective" and a "long-term opportunity with the potential to grow beyond 25 million tons of coal per year."

The court determined that the company's statements about the valuations of the acquisition were not adequately alleged to be false because they constituted statements of opinion rather than of fact. Citing the U.S. Supreme Court's decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015), the court held that the company's statement about the valuation of the coal business acquisition made in the financial report was explicitly described as "provisional" and "based on fair values at the acquisition date." The SEC failed to allege that the company fully appreciated the difficulties the project posed, and thus the valuation was not false or misleading. With respect to statements that the project was "prospective" and a "long term opportunity" at a time when the company was allegedly "aware that the best information indicated that [the coal project] had no value and no realistic options for transportation of coal," the court determined that the company misrepresented material facts to investors.

Investment Advisers Act

Fifth Circuit Holds That Life Settlements Are Securities Within Scope of Investment Advisers Act

In the Matter of Living Benefits Asset Mgmt., L.L.C. v. Kestrel Aircraft Co., No. 18-10510 (5th Cir. Feb. 22, 2019)
Click here to view the opinion.

The Fifth Circuit held that life settlements are securities, and thus an investment adviser advising about them must register under the Investment Advisers Act (IAA).

After filing for Chapter 11 bankruptcy, Living Benefits Asset Management, LLC filed a breach of contract action against Kestrel Aircraft Co. in the Bankruptcy Court for the Northern District of Texas. Kestrel had retained Living Benefits to help develop and execute a plan for raising capital by purchasing life

settlements in which investors could purchase security interests. Living Benefits and Kestrel documented their agreement in an engagement letter under which Living Benefits agreed to provide "consulting and advisory services" to help Kestrel structure the capital-raising plan. Although Living Benefits provided the agreed planning services, Kestrel ultimately did not purchase any life settlements and did not pay Living Benefits. The Bankruptcy Court held the engagement letter was unenforceable. Living Benefits appealed to the Fifth Circuit.

The dispute centered around whether Living Benefits was an "investment adviser" as defined in the IAA. If it was, the engagement letter would be void, because the IAA prohibits unregistered investment advisers from using the instrumentalities of interstate commerce to provide investment advice, and Living Benefits had not registered. The IAA defines "investment adviser" as one who engages in the business of advising others as to the value of securities, or as to the advisability of investing in, purchasing or selling securities. Living Benefits argued: (1) it was not in the business of advising others about the value of life settlements; and (2) life settlements are not securities.

The Fifth Circuit held that although Living Benefits did not provide advice about specific life settlements and Kestrel did not act on its advice, Living Benefits was still an adviser within the meaning of the IAA because it gave advice that was attuned to Kestrel's particular needs. The court rejected Living Benefits' argument that Kestrel's failure to act on its advice took it outside the purview of the IAA, explaining that the plain language of the IAA encompasses both positive and negative advice, and to read it otherwise would exclude those who advise against trading in securities, which "would make little policy sense."

The court then turned to the question of whether life settlements are securities. The court noted that the parties agreed that the test set forth by the U.S. Supreme Court in *Howey* governed whether the life settlements are investment contracts and therefore securities under the IAA. According to the Fifth Circuit, *Howey* laid out its three-prong test to determine if an instrument is an investment contract.

The court observed that there is a split between the D.C. and Eleventh circuits in their analyses of life settlements under the *Howey* test. In *SEC v. Life Partners, Inc.*, 102 F.3d 587 (D.C. Cir. 1996), the D.C. Circuit held that the third *Howey* prong was not met because some of the profits of life settlements stem from prepurchase managerial efforts. In contrast, the Eleventh Circuit came to the opposite conclusion in *SEC v. Mutual Benefits Corp.*, 408 F.3d 737 (11th Cir. 2005), by focusing on the investors' reliance on the defendant's prepurchase activities, holding that life settlements were "classic investment contract[s]" because investors were promised profits that were dependent on the efforts of the promoters. The Fifth Circuit agreed with and followed the Eleventh Circuit's approach, explaining that *Life Partners* took an overly rigid approach to defining securities. The Fifth Circuit ultimately held that the life settlements were investment contracts, thereby requiring Living Benefits to register as an investment adviser. Because it did not do so, the engagement letter was unenforceable.

Materiality

Second Circuit Affirms Dismissal of Fraud Claims Against Global Health Insurer

Singh v. Cigna Corp., No. 17-3484-cv (2d Cir. Mar. 5, 2019)
Click here to view the opinion.

The Second Circuit affirmed the dismissal of claims brought by a putative class of investors against a multinational health services company alleging that it violated Sections 10(b) and 20(a) of the Securities Exchange Act by making false or misleading statements about its efforts to comply with Medicare regulations issued by the Centers for Medicare & Medicaid Services (CMS). The plaintiffs alleged that statements that the company had established policies and procedures to comply with applicable requirements and that it would continue to allocate significant resources to its compliance efforts were false or misleading because the company had been found by CMS to be in noncompliance with certain regulations when those statements were made.

The Second Circuit found that the plaintiffs' complaint was a "creative attempt to recast corporate mismanagement as securities fraud." In particular, the court explained: "The attempt relies on a simple equation: first, point to banal and vague corporate statements affirming the importance of regulatory compliance; next, point to significant regulatory violations; and voila you have alleged a *prima facie* case of securities fraud! The problem with this equation, however, is that such generic statements do not invite reasonable reliance. They are not, therefore, materially misleading, and so cannot form the basis of a fraud case." Statements that contained only "generic" descriptions of the company's compliance efforts were not materially misleading because general statements about reputation, integrity and compliance with ethical norms are textbook examples of nonactionable puffery. In addition, the company's statements about continuing to allocate resources to its compliance efforts in the face of numerous, complex regulations were "tentative" in nature and thus not material to a reasonable investor.

Eighth Circuit Reverses Dismissal of Securities Claim for False and Materially Misleading Proxy Statement

Campbell v. Transgenomic, Inc., No. 18-2198 (8th Cir. Mar. 1, 2019)
Click here to view the opinion.

The Eighth Circuit reversed the district court's dismissal of a shareholder's claims under Sections 14(a) and 20(a) of the Securities Exchange Act and SEC Rule 14a-9. Following a merger between Transgenomic and Precipio, the plaintiff brought a class action on behalf of former Transgenomic shareholders alleging the company and its former president and CEO made materially misleading statements and omissions in the proxy statement.

The plaintiff alleged two bases on which the proxy statement was materially misleading. First, the statement omitted Precipio's projected net income/loss, which the Transgenomic board had reviewed prior to the merger. Transgenomic denied that the omission was materially misleading because it disclosed other important financial metrics in the proxy statement. The district court agreed, stating the appropriate inquiry as: "[T]he crux of the analysis is this: where the proxy statement chooses to disclose a financial valuation, does it do so honestly?"

The Eighth Circuit rejected this test, instead stating the test for materiality as whether "there is a substantial likelihood that a reasonable shareholder would consider [an omitted fact] important in deciding how to vote." Because a reasonable investor may have viewed disclosure of Precipio's net income/loss figures as significantly altering the "total mix" of information made available, the court held that the materiality of the omission should have been left to the trier of fact.

Second, the proxy statement mislabeled a revenue distribution table, according to the plaintiff. The table showed projections for post-merger Precipio, and accordingly, should have been labeled "New Precipio" instead of "Precipio." The plaintiff argued that this caused shareholders to believe the premerger company was more valuable than it actually was. The defendants disputed that the label was not materially misleading because surrounding clues in the proxy statement indicated that the table refers to the post-merger Precipio. The Eighth Circuit held that whether a reasonable investor could decipher those clues was a question for the trier of fact.

Additionally, the court also found sufficient the plaintiff's allegations against Transgenomic's former president and CEO, Paul Kinnon, for control person liability under Section 20(a). The court held that the plaintiff sufficiently pleaded that: (1) a "primary violator" violated securities laws; (2) Kinnon exercised control over the operations of the primary violator; and (3) Kinnon possessed the power to identify predicate acts underlying the violation.

Mergers and Acquisitions Litigation

Court of Chancery Denies Request to Force Merger Closing

Vintage Rodeo Parent, LLC v. Rent-A-Center, Inc.,
C.A. No. 2018-0927-SG (Del. Ch. Mar. 14, 2019)
Click here to view the opinion.

Following an expedited trial, Vice Chancellor Sam Glasscock III denied a request to close a merger transaction pursuant to which Vintage Capital, an affiliate of plaintiff Vintage Rodeo Parent, LLC, would acquire Rent-A-Center (RAC) for $15 per share.

Vintage Rodeo filed litigation seeking to force RAC to close the merger transaction after RAC exercised a unilateral termination right following the end date identified in the merger agreement. Under that agreement, both parties were permitted to unilaterally extend the end date by sending the required notice, but Vintage Rodeo failed to do so. The court rejected arguments that certain actions by Vintage Rodeo and RAC served as the required notice, or that merely satisfying the purported "purpose" of the notice requirement was enough. The court also held that RAC did not violate the "commercially reasonable efforts" provisions in the merger agreement and that, under the circumstances, such clause did not imbue RAC with a "duty to warn" Vintage Rodeo that it was planning to terminate the merger agreement if given an opportunity. The court also found that the implied covenant of good faith and fair dealing did not apply because there was no gap in the merger agreement to fill.

However, RAC also sought to recover an "enormous" 15.75% reverse termination fee even though it had terminated the merger agreement. The court stated that it was possible that the implied covenant could be used to preclude such recovery but ultimately reserved decision on the parties' requests for relief pertaining to the termination fee pending supplemental briefing. The case was resolved prior to a ruling on this issue.

Misrepresentations and Omissions

Second Circuit Affirms Dismissal of Fraud Claims Against Pharmacy Benefits Management Services Company

In re Express Scripts Co. Sec. Litig., No. 18-1850-cv (2d Cir. May 7, 2019)
Click here to view the opinion.

The Second Circuit affirmed the dismissal of claims brought by a putative class of investors against a pharmacy benefits management services company and certain of its officers, alleging that the defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act by making false and misleading statements concerning the company's relationship with its "most important customer" while the relationship deteriorated. Specifically, the plaintiff alleged that during several conference calls and in SEC filings the defendants made certain positive statements about its relationship with the customer while failing to disclose their contractual dispute. The plaintiff further alleged that in public filings the company improperly accounted for its contract with the customer, giving the false impression that the contract would be extended for five years beyond its current term.

The Second Circuit rejected the plaintiff's argument that the statements were materially misleading, finding that "no reasonable investor could have found the statements, in light of the overall context, to be false, misleading, or incomplete." In particular, the Second Circuit found that the statements about the company's positive relationship with its customer were unactionable "expressions of puffery" and noted that the company "made a number of statements acknowledging the possibility that negotiations could fail." The Second Circuit also rejected the plaintiff's argument that the company had a duty to publicly disclose the contract dispute, finding that "where the discussions [are] ongoing, Defendants [do] not have a duty to disclose more about the uncertain state of negotiations." The plaintiff failed to sufficiently allege scienter because the defendants' "statements were consistent with the facts and information available at the time." The plaintiff's claims amounted to "allegations of fraud by hindsight." Similarly, the company did not have a duty to amortize the contract over a 10-year period, instead of a 15-year period, in speculative anticipation of the failure of contract negotiations. The Second Circuit found that the company "need not present an overly gloomy or cautious picture of current performance and future prospects."

Second Circuit Affirms Denial of Leave to Amend Fraud Claims Against Pharmaceutical Company

Steamfitters' Indus. Pension Fund v. Endo Int'l PLC, No. 18-1669-cv (2d Cir. Apr. 29, 2019)
Click here to view the opinion.

The Second Circuit affirmed the denial of leave to amend claims brought by a putative class of investors against a pharmaceutical company alleging that the company violated Sections 10(b) and 20(a) of the Securities Exchange Act by allegedly misleading investors to believe that the company would not be making any significant changes to its generic pharmaceutical business in connection with its recent acquisition of a large generic pharmaceutical company. The plaintiffs alleged that the company had executed a secret plan to drastically change its generics business by using the high-margin business model of the acquired company and abandoning its current low-margin business model.

The Second Circuit held that the plaintiffs' motion to leave to amend was properly denied because their proposed fourth amended complaint was futile, as it failed to adequately allege any material misrepresentation or omission. The court determined that the company properly disclosed to investors, in press releases and SEC filings, that it had planned significant changes to its current generics business, including that it would be renaming its current business after the acquisition and that it would be "restructuring" and "transforming" its generic business. The court also reasoned that after the company announced the acquisition, it told investors during conference calls and in a press release that it would no longer retain its previous low-margin business model and instead would focus on higher-margin, higher-barrier-to-entry products.

The Second Circuit also held that the company had no duty to disclose its business strategy decision in connection with the acquisition because SEC regulations (*i.e.*, Item 303) did not require any such affirmative disclosure, and the SEC has "never gone so far as to require a company to announce its internal business strategies."

Inside the Courts
An Update From Skadden Securities Litigators

EDNY Dismisses Claims Against Organic Food Company Accused of Improper 'Channel Stuffing'

In re Hain Celestial Grp. Inc. Sec. Litig., 2:16-cv-04581 (ADS)(SIL) (E.D.N.Y. Mar. 29, 2019)
Click here to view the opinion.

Judge Arthur D. Spatt dismissed claims brought by a putative class of stockholders against an organic food company and certain of its officers and directors alleging that they violated Sections 10(b) and 20(a) of the Securities Exchange Act by making false and misleading statements concerning their inventory and revenues by engaging in the practice of "channel stuffing," *i.e.*, "intentionally oversupplying distributors with products in order to artificially inflate sales and revenue." The plaintiffs alleged that the company engaged in illegal channel stuffing by (1) shipping extra inventory to distributors with financial incentives, (2) offering discounts to distributors for accepting extra products beyond their needs, and (3) offering distributors an absolute right to return the products. The plaintiffs further alleged that the company failed to disclose that they were classifying inventory forced onto distributors as revenue, even though the distributors were not paying for the products and had an absolute right of return the products the next quarter. In support of their allegations, the plaintiffs adduced statements from six confidential witnesses (CWs) who worked at the company throughout the relevant time period.

The court determined that the CWs' allegations regarding the distributors' rights of return were neither sufficiently specific nor supported with specific reports or evidence, and thus the plaintiffs did not allege sufficient facts in support of their contention that the company engaged in a fraudulent channel stuffing scheme. The court noted that the U.S. Supreme Court, in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 321 (2007), established that there are forms of legitimate channel stuffing (*e.g.*, offering customers discounts) and illegitimate channel stuffing (*e.g.*, writing orders for unrequested products). The court determined that the plaintiffs "have not alleged sufficient facts in support" of their claim that the defendants "engaged in illegitimate channel stuffing."

Middle District of Tennessee Denies Motion to Dismiss Shareholder Suit for Materially Misleading Forward-Looking Statements

Weiner v. Tivity Health, Inc., Case No. 3:17-cv-01469 (M.D. Tenn. Mar. 18, 2019)
Click here to view the opinion.

The Middle District of Tennessee denied defendant Tivity Health, Inc.'s motion to dismiss a putative class action brought pursuant to Sections 10(b) and 20(a) of the Securities Exchange Act. The plaintiffs, a group of Tivity shareholders, brought suit alleging that Tivity made materially false or misleading statements or omissions in its public filings.

The plaintiffs alleged that Tivity intentionally misled shareholders regarding the risk of competition entering the market. Tivity's public statements indicated only the possibility that a competitor would enter the market, when Tivity allegedly knew that the competitor would enter. The plaintiffs alleged that the statements violated Section 10(b) and were not protected under the safe harbor provision of the Private Securities Litigation Reform Act (PSLRA) to shield Tivity from liability.

The court agreed. In looking at the cautionary remarks that accompanied Tivity's public statements, the court analyzed whether they were "meaningful" such that the safe harbor provision of the PSLRA would apply and render Tivity's state of mind irrelevant. The court found that "[n]otwithstanding Tivity's arguments to the contrary, the forward-looking statements at issue were provided in the context of cautionary statements that were boilerplate, not meaningful, and inconsistent with the historical facts." This finding removed Tivity from the safe harbor.

The court's final consideration was whether the plaintiffs sufficiently alleged the requisite level of scienter. The court found that the plaintiffs' allegations, when considered holistically, give rise to a strong inference that Tivity acted with at least reckless disregard for, if not knowledge of, the misleading nature of its statements. Accordingly, the court denied Tivity's motion to dismiss the putative class action under Section 10(b).

New Jersey District Court Dismisses Putative Class Action Against Technology Company Based on Statements About Its International Distributor Agreement

Padgett v. RiT Techs. Ltd., Civ. No. 16-cv-4579 (KM) (JBC) (D.N.J. Feb. 22, 2019)
Click here to view the opinion.

Judge Kevin McNulty granted a motion to dismiss a putative class action against an Israeli technology company and its senior officers asserting violations of Sections 10(b) and 20(a) of the Securities Exchange Act, concluding that the plaintiffs failed to plead any actionable misrepresentations or omissions.

The plaintiffs contended that the defendants materially misled investors by failing to disclose the extent of the company's reliance on an agreement with a distributor of its products and services in several former Soviet republics. The company's share price fell significantly when it disclosed difficulties in collecting overdue debts from the distributor. According to the plaintiffs, the company deceived investors when it described the distributor as "an additional non-exclusive distributor" rather than a "major distributor," thereby downplaying the risks the company faced if it encountered repayment difficulties from the distributor.

The court dismissed the amended complaint without prejudice, holding that the plaintiffs failed to adequately describe how the defendants' public statements were misleading to investors. Specifically, the court stated that the defendants' failure to use a particular adjective to characterize its distributor did not "equate to an actionable misrepresentation." Additionally, the court concluded that the plaintiffs failed to allege "the nature or size of [the company's] other distributors," "the amount of business" the distribution agreement totaled "in relation to other distributors," that the distributor was "*de facto* an exclusive one" or how the size of the distributor would be important to investors. Thus, the court found the amended complaint impermissibly "vague as to the misimpression that was created, and how it would have affected an investment decision."

Pleading Standards

District of Colorado Dismisses Class Claims Against Fast Food Retailer

Nardy v. Chipotle Mexican Grill, Inc., No. 17-cv-01760-WYD-STV (D. Colo. Mar. 29, 2019)
Click here to view the opinion.

Judge Wiley Y. Daniel dismissed claims brought by a putative class of investors in a fast food retail company and certain of its executives alleging that they violated Sections 10(b) and 20(a) of the Securities Exchange Act by making certain material misstatements and omissions about the company's commitment to implementing new food safety procedures and remedial food safety training measures. The plaintiffs alleged that, in the wake of certain bacterial and viral outbreaks, the company failed to disclose that, among other things: (1) the restaurants were inadequately staffed to implement those measures; (2) the company's restaurants failed safety audits; (3) employees falsified food handling temperatures; and (4) the company's employees were failing food safety certifications. The plaintiffs further alleged that the company failed to disclose in its public filings that if further outbreaks occurred, they would have a damaging effect on the company's financial performance.

The court found that the company's statements concerning the implementation of the new food safety procedures were not adequately alleged to be misleading because "even assuming a percentage of [the company's] restaurants were failing" food safety audits, "other aspects of the new food safety protocols had indisputably been implemented." The court also found that the plaintiff had not adequately pleaded a strong inference of scienter concerning the alleged omissions regarding falsified food handling temperatures because although books containing the falsified temperatures were mailed to the company's corporate offices, "these general allegations do not establish that Defendants themselves knew about the practice or could have identified evidence ... merely by looking at the books recording food temperatures." Concerning loss causation, the court

found that the alleged corrective disclosures were not corrective because they did not indicate that the outbreak was caused by the company's "failure to properly train its employees or compliance with applicable safety regulations or industry standards."

Finally, regarding alleged violations of Item 303 and Item 503, the court noted that there is a split among courts as to whether "a violation of Item 303 or Item 503 can serve to state a Rule 10b-5 securities fraud claim." Noting that the Tenth Circuit has not addressed this issue, the court concluded that violations of "Item 303 and Item 503 do not create an independent duty to disclose that may give rise to liability under Rule 10b-5." Instead, the court determined that a failure to meet those disclosure requirements would merely be "probative of what a company is otherwise obliged to disclose." Because the plaintiffs failed to adequately allege a strong inference of scienter, Items 303 and 503 did not support a claim for a violation of Rule 10b-5.

SDNY Denies Motion to Dismiss Allegations That Company Misled Investors About Use of High-Frequency Trading

In re Global Brokerage, Inc. Sec. Litig.,
Master File No. 1:17-cv-00916-RA (S.D.N.Y. Mar. 28, 2019)
Click here to view the opinion.

Judge Ronnie Abrams granted in part and denied in part a motion to dismiss claims brought by shareholders against a retail brokerage company that trades on the foreign exchange market and certain of its former directors alleging that they violated Sections 10(b) and 20(a) of the Securities Exchange Act by making false statements concerning their trading platform. The plaintiffs alleged that the company misled investors by stating that its agency-trading model would eliminate any conflicts of interest with its customers. The plaintiffs alleged that the company knowingly took positions against its customers using its relationship with another company that was secretly funded and controlled by the retail brokerage company, and that the retail brokerage company worked with the other company to implement a high-frequency trading algorithm to trade against the retail brokerage company's customers and then share the profits.

The court determined that the plaintiffs adequately pleaded that the retail brokerage company materially misstated and failed to fully disclose the nature of its relationship with the other company, and that it was heavily involved with the creation and funding of the other company as well as the plan to take positions against its own customers. The court, however, granted the motion to dismiss with respect to a certain former officer of the company, finding that the complaint failed to allege scienter because it included only boilerplate allegations about how he knew or should have known about the alleged misconduct based solely on his position as chief financial officer.

The court also found that the plaintiffs failed to adequately plead that the company had a duty to disclose that it was under regulatory investigation. The court stated that "there is no independent duty for a company to disclose that it is being investigated by a regulatory agency," and that any requirement to speak truthfully about an investigation by a regulatory agency "is only triggered by an 'express prior disclosure.'" Because the company had made no prior disclosure concerning any such investigations, it was not required to disclose that it was under investigation.

Seventh Circuit Affirms Dismissal for Failure to State a Claim Where Plaintiffs Failed to Plead Fraud With Particularity

Cornielsen v. Infinium Capital Mgmt., LLC, No. 17-2583
(7th Cir. Feb. 13, 2019)
Click here to view the opinion.

The Seventh Circuit affirmed the dismissal of a complaint for failure to state a claim. In the complaint, the plaintiffs alleged claims for federal securities fraud under Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder, along with common law claims for fraud and breach of fiduciary duty. The plaintiffs are 39 former employees of Infinium Capital Management, LLC, all of whom converted loans they had made to their employer into equity in the company. A year and a half after they made the conversion, the plaintiffs learned their investments were worthless and filed suit against Infinium. They alleged that during three town hall meetings, the defendants made various misrepresentations and omissions regarding the equity conversion proposal and Infinium's financial condition that had a material effect on the plaintiffs' decisions to convert their loans into equity. The Northern District of Illinois dismissed, with prejudice, the plaintiffs' fifth amended complaint for failure to state a claim.

The Seventh Circuit affirmed. It held that the existence of a nonreliance clause in the subscription agreement precluded any possibility of damages under federal securities laws for prior oral statements and could alone provide a reason for affirming the district court's decision. The court went on to address whether the plaintiffs had stated a claim, holding that the plaintiffs did not plead fraud with the particularity required by Rule 9(b) of the Federal Rules of Civil Procedure and the PSLRA. The plaintiffs conceded they did not know which individual defendants made which misrepresentations and omissions. Instead, the plaintiffs made general and identical allegations for each defendant, relying on the group pleading doctrine, which would allow the plaintiffs to link certain defendants to alleged misrepresentations simply by pleading that individual defendants were part of the group that likely made the relevant statements at town hall meetings. The court rejected this doctrine, noting that the PSLRA precludes the group pleading doctrine for both written documents and oral statements. In order to meet the PSLRA's pleading requirements, the plaintiffs would need to identify which individual defendant made which statement. Additionally, the plaintiffs could not satisfy PSLRA particularity requirements by making conclusory allegations of scienter derived from the defendant corporate officers' mere access to information.

The Seventh Circuit also agreed with the district court that the plaintiffs' allegations that the individual defendants assumed a duty to speak and owed the plaintiffs fiduciary duties are mere legal conclusions that the court need not accept as true.

Finally, the court held that dismissal with prejudice of the fifth amended complaint was appropriate where the plaintiffs never sought leave to again amend the complaint and did not propose how they might be able to amend the pleading to cure its deficiencies.

Sarbanes-Oxley Act

Ninth Circuit Holds That Acts of Congress Do Not Constitute Rules or Regulations of the SEC for Purposes of Sarbanes-Oxley Whistleblower Claims

Wadler v. Bio-Rad Labs., Inc., No. 17-16193 (9th Cir. Feb. 26, 2019)
Click here to view the opinion.

The Ninth Circuit partially vacated a jury verdict against a medical research company in a whistleblower retaliation suit, holding that acts of Congress do not constitute "rule[s] or regulation[s] of the Securities and Exchange Commission" for purposes of determining whether an employee engaged in "protected activity" under the whistleblower protection provision of the Sarbanes-Oxley Act (SOX).

Section 806 of SOX provides that covered corporations may not retaliate against an employee who reports violations of various specified statutes as well as "any rule or regulation of the [SEC]." In this case, the jury found that Bio-Rad Laboratories, Inc. and its CEO violated SOX, the Dodd-Frank Act and California public policy by terminating the employment of the company's former general counsel in retaliation for his internal report stating that he believed the company had violated the Foreign Corrupt Practices Act (FCPA) in China. On appeal, the defendants argued that the district court erred by instructing the jury that, for purposes of Section 806, rules or regulations of the SEC include the FCPA's books-and-records and anti-bribery provisions.

The Ninth Circuit agreed. Interpreting the plain language of the statute, the court held that the text of Section 806 "is clear: an FCPA provision is not a 'rule or regulation of the [SEC].'" The court explained that the "more natural" reading of the words "rule" and "regulation," together and in context, is that they "refer only to administrative rules or regulations," not statutes like the FCPA. The Ninth Circuit further held that the district court's instructional error was not harmless and therefore remanded for the district court to determine whether a new trial was warranted.

Scienter

New Jersey District Court Dismisses Putative Class Action for Failure to Plead Scienter

In re Elecs. for Imaging, Inc. Sec. Litig., Civil Action No. 17-5992 (D.N.J. Jan. 31, 2019)
Click here to view the opinion.

Judge Madeline Cox Arleo granted a motion to dismiss a putative securities fraud class action against a digital printing company and two of its officers, finding that the plaintiffs' amended complaint failed to adequately plead that the defendants acted with scienter.

The plaintiffs alleged that the defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder by intentionally or recklessly misrepresenting the adequacy of the company's internal controls in the company's annual and quarterly financial reports. Specifically,

the plaintiffs contended that statements in the company's 2016 10-K and its first quarter 2017 10-Q "falsely assured investors" that its "internal controls and procedures were functional and effective." The company later issued a press release announcing a delay of its second quarter financial results "due to an internal investigation into the effectiveness of its internal controls," and that the company "expected to report a material weakness in its internal controls." The following day, the company's stock declined over 45%. The company subsequently filed amendments to the SEC filings that enumerated deficiencies in the company's internal controls.

In support of their scienter allegations, the plaintiffs argued that "by certifying to the effectiveness of the internal controls, Defendants 'conceded that they actually assessed the effectiveness of those controls thoroughly.'" Based on those representations, the plaintiffs set forth two potential theories of liability: (1) if the defendants lied about the thoroughness of their assessment, they were at least "reckless in certifying those controls as effective"; and (2) if the defendants thoroughly assessed the effectiveness of their internal controls, then it "defie[d] credulity that they did not uncover what were pervasive deficiencies."

The court rejected both contentions. First, the court found that the complaint alleged "absolutely no corroborative facts — let alone 'strong circumstantial evidence' — to support the inference that Defendants lied about the performance or the depth of their review." Second, the court explained that the Third Circuit has repeatedly noted "the difficulty of establishing a 'they-must-have-known' type of inference." Thus, the court found both of the plaintiffs' theories to be "too speculative to support a strong inference of scienter."

The plaintiffs have appealed the court's ruling to the Third Circuit.

Securities Exchange Act

Southern District of New York Dismisses Section 16(b) Short-Swing Profit Claims

Rubenstein v. Berkowitz, 17-CV-821 (JPO) (S.D.N.Y. Mar. 27, 2019)
Click here to view the opinion.

Judge J. Paul Oetken dismissed claims under Section 16(b) of the Securities Exchange Act brought by a shareholder of a nationwide retailer against a group of investors who were alleged to be corporate insiders for purposes of the short-swing profit rule. The plaintiff alleged that certain investors in the retailer's stock formed a group with certain investment advisers for purposes of gaining control of the retailer's stock. In particular, the plaintiff alleged that within a six-month period, the investment advisers purchased and sold portions of the retailer's stock, including on behalf of the investors, and that the investment advisers had authority to conduct these purchases and sales because they entered into investment management agreements with the investors. The plaintiff further alleged that by delegating authority of the investors' accounts to the investment advisers, the investors formed a group of corporate insiders for Section 16(b) purposes.

The court held that the clients did not form a corporate insider group for the purpose of acquiring, holding or disposing of securities of a specific issuer, as required to be subject to the short-swing profit rule under Section 16(b). The court determined that because the investment management agreements did not instruct the investment advisers to invest in any particular stock, no group was formed. The court further determined that because the investors did not form a group, the investors were not a "beneficial owner" and thus not subject to Section 16(b) liability.

Suspicious Activity Reports

First Circuit Affirms Dismissal of Claims on Basis of Immunity Provision in Bank Secrecy Act

AER Advisors, Inc. v. Fidelity Brokerage Servs., LLC, No. 18-1884 (1st Cir. Apr. 17, 2019)
Click here to view the opinion.

The First Circuit affirmed the dismissal of various state law claims brought by an investment adviser and certain of its clients against a brokerage company that arose from an allegedly fraudulent suspicious activity report (SAR) that the company allegedly filed concerning transactions by the investment adviser. The court held that the immunity provision of the Bank Secrecy Act (BSA) barred the claims.

The plaintiffs alleged that, in connection with a series of transactions concerning a certain security that resulted in a short squeeze on that security, the company filed a SAR fraudulently claiming that the plaintiffs caused the short squeeze. The plaintiffs alleged that the SAR was fraudulent because the company knew that the plaintiffs could not have caused the short squeeze. The plaintiffs

further claimed that defending themselves in a subsequent SEC investigation allegedly arising from the SAR caused actionable damages under a variety of state law theories, including, for example, tortious interference with business opportunities.

The company moved to dismiss on the basis that the safe harbor provision of the BSA provides immunity to financial institutions that disclose "any possible violation of law or regulation to a government agency ... for such disclosure." The First Circuit rejected the plaintiffs' contention that to qualify for immunity, the company must file the report in good faith and report a violation of law that is "objectively" possible. The First Circuit held that the statutory and public policy considerations that the First Circuit had previously considered in its decision in *Stoutt v. Banco Popular de Puerto Rico*, 320 F.3d 26 (1st Cir. 2003), that led it against "splicing an 'objective reasonableness' requirement into the statute," still applied. The First Circuit also reasoned that while the immunity provision took "private actions ... off the table," financial institutions could, under the statutory framework, be held accountable by the government for filing "malicious or intentionally false SARs.

Inside the Courts
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