November 2019 / Volume 11 / Issue 4

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Inside the Courts
An Update From Skadden Securities Litigators

2 / Definition of a Security
SEC v. Feng (9th Cir. Aug. 23, 2019)
United States v. Shelton (6th Cir. Aug. 20, 2019)

3 / Fiduciary Duties
Derivative Litigation
In re Clovis Oncology, Inc. Derivative Litig. (Del. Ch. Oct. 1, 2019)
Morris v. Spectra Energy Partners (DE) GP, LP (Del. Ch. Sept. 30, 2019)
Tornetta v. Musk (Del. Ch. Sept. 20, 2019)

5 / Investment Company Act
Edwards v. Sequoia Fund, Inc. (2d Cir. Sept. 9, 2019)

6 / Loss Causation
Karth v. Keryx Biopharmaceuticals, Inc. (D. Mass. Sept. 23, 2019)

6 / Materiality
Carvelli v. Ocwen Fin. Corp. (11th Cir. Aug. 15, 2019)

7 / Misrepresentations and Omissions
Lea v. TAL Educ. Grp. (S.D.N.Y. Sept. 25, 2019)
Haw. Structural Ironworkers Pension Trust Fund v. AMC Entm't Holdings, Inc. (S.D.N.Y. Sept. 23, 2019)
Lefkowitz v. Synacor, Inc. (S.D.N.Y. Aug. 28, 2019)

8 / Securities Exchange Act
Batchelar v. Interactive Brokers, LLC (D. Conn. Sept. 30, 2019)
Walleye Trading LLC v. AbbVie, Inc. (N.D. Ill. Sept. 18, 2019)

9 / Securities Fraud Pleading Standards
Fiduciary Duties
Collins v. Mnuchin (5th Cir. Sept. 6, 2019)
Scienter
Heinert v. Bank of Am. (W.D.N.Y. Oct. 18, 2019)
Loreley Fin. (Jersey) No. 3, Ltd. v. Wells Fargo Sec., LLC (S.D.N.Y. Sept. 17, 2019)
Sgarlata v. PayPal Holdings, Inc. (N.D. Cal. Sept. 9, 2019)
Sjunde AP-Fonden v. Gen. Elec. Co. (S.D.N.Y. Aug. 29, 2019)

12 / SLUSA
North Sound Capital LLC v. Merck & Co., Inc. (3d Cir. Sept. 12, 2019)

Inside the Courts
An Update From Skadden Securities Litigators

Definition of a Security

Ninth Circuit Holds That Investments in EB-5 Immigrant Investor Program Qualify as 'Securities'

SEC v. Feng, No. 17-56522 (9th Cir. Aug. 23, 2019)
Click here to view the opinion.

The Ninth Circuit affirmed summary judgment in favor of the U.S. Securities and Exchange Commission (SEC), holding that pooled investments made pursuant to the EB-5 immigration program qualify as "securities" and therefore can give rise to liability under the federal securities laws.

The U.S. Immigrant Investor Program, known more commonly as the EB-5 program, provides legal permanent residency in the United States to foreign nationals who invest in U.S.-based projects. Under this program, qualified immigrants can gain U.S. visas if they make a direct investment of at least $1 million in a new commercial enterprise that creates at least 10 full-time jobs for U.S. workers. Multiple foreign investors are permitted to pool their money in the same enterprise, as long as each investment results in the creation of 10 jobs. Pooled investments are made through "regional centers," which offer specific projects to investors and manage the pooled investments.

Hui Feng, the defendant, is an immigration lawyer who led approximately 150 clients through the EB-5 process. On December 7, 2015, the SEC filed a civil complaint against Feng and his law firm, alleging that Feng committed fraud and failed to register as a broker-dealer, both in violation of the federal securities laws. The parties cross-moved for summary judgment in the district court, with Feng arguing that the EB-5 investments were not "securities" because the investors had no expectation of profit, and only expected to obtain a green card. The district court held that the EB-5 investments were "securities" and granted summary judgment to the SEC.

On appeal, the Ninth Circuit affirmed. The court explained that the Securities Act defines "security" broadly, enumerating a long list of financial instruments that qualify, including any "investment contract." An "investment contract," in turn, is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." The inquiry is an objective one, and courts are to consider the character of the instrument or transaction based on what the purchasers were led to expect, including what was contained in any promotional materials.

Here, the regional centers' promotional materials repeatedly referred to the investments as "securities" and specifically stated that the offerings were made pursuant to U.S. securities laws. In addition, the EB-5 transactions were structured as investments in limited partnerships, with the promise of a fixed annual return on the investment, ranging from 0.5% to 5%. Both attributes — investment in a limited partnership and the promise of a fixed rate of return — are classic features of an investment contract. The court also rejected Feng's argument that the investments should not be considered a "security" because the investors were motivated by the promise of a visa, not profits. While the court did not doubt that obtaining a visa was the investors' primary motive, their interest in a visa was necessarily tied to the financial success of the regional center's project. Indeed, only a successful investment that creates 10 full-time jobs can secure a visa for the investor. Moreover, the record showed that many of Feng's client-investors sought out EB-5 projects with higher rates of return. Thus, the investments were made with an expectation of profit, and qualify as "securities."

Sixth Circuit Affirms Securities Fraud Convictions Proving Fraudulent Intent

United States v. Shelton, No. 18-5434 (6th Cir. Aug. 20, 2019)
Click here to view the opinion.

The Sixth Circuit affirmed Clay Shelton's conviction of wire fraud, money laundering and securities fraud surrounding Shelton's solicitation of investments in his limited partnership, Escrow 2011. Shelton claimed the purpose of the company was to secure financing to purchase and operate the Monterey gas pipeline in Tennessee. To do so, Shelton represented to investors that Escrow 2011 would sell 30 units at $50,000 each. Once the account reached the maximum of $1.5 million, an unnamed bank would give Escrow 2011 $15 million in financing to acquire the pipeline. Shelton further claimed that once financing was complete the escrow would be released and returned to investors in full. Shelton memorialized this information in a one-page "quick summary" document, as well as a longer Private Placement Memorandum.

Between March 3, 2011, and September 24, 2012, Shelton received $1.37 million from investors in the pipeline project. None of the money ever went into escrow. Instead, Shelton deposited the money into two separate bank accounts. Shelton wired $1 million to a separate bank account to invest in collateralized mortgage obligations and used $124,000 to pay for his payroll, business expenses and salary.

Shelton was convicted of three counts of wire fraud, four counts of money laundering and 17 counts of securities fraud. He appealed the conviction on three grounds, claiming he had no fraudulent intent when receiving investments, investors did not rely on his misrepresentations and the investments did not meet the legal definition of the term security.

Shelton claimed that the government failed to show adequate evidence of his fraudulent intent. Here, the court noted that Shelton represented that the money he was given would remain in escrow, as the name of the company implies. However, none of the money was ever actually put in escrow. Furthermore, the court held that the jury could rely on a defendant's efforts to conceal his unlawful activities when making a finding of fraudulent intent. When investors asked Shelton about their money, he continually claimed that it was still in the escrow account, but never provided any proof. The court rejected Shelton's claim that the government failed to show adequate evidence of his fraudulent intent.

Shelton next claimed that some of his convictions should be overturned because the government failed to show which representations were material. According to Shelton, because investors involved in some counts did not testify, there was no proof of why they invested. The court disagreed. Although these investors did not testify personally, there was evidence that each of them received from Shelton the quick summary document that suggested the financing already was approved and the money would remain in escrow. The court held that a jury could properly determine that these misrepresentations were material and related to investors' decisions to invest.

Shelton also claimed that the investments were not securities, but rather, risky loans. In analyzing this claim, the court applied the *Howey-Forman* test under which a security is defined as an investment in a common venture based on the reasonable expectation of profits from the entrepreneurial efforts of others. The court further noted that the name assigned to the transaction by the parties is another relevant factor in determining whether something is a security. In the Private Placement Memorandum, Shelton repeatedly referred to the investments as securities. Thus, the court held that the jury could properly find that the investments were securities.

Accordingly, the court affirmed Shelton's convictions on all counts.

Fiduciary Duties

Derivative Litigation

Court of Chancery Sustains *Caremark* Claim

In re Clovis Oncology, Inc. Derivative Litig., Consol. C.A. No. 2017-0222-JRS (Del. Ch. Oct. 1, 2019)
Click here to view the opinion.

The Court of Chancery denied a motion to dismiss fiduciary duty claims based on alleged breaches of the duty of loyalty arising out of a failure to monitor (*Caremark* claims), but granted the motion to dismiss with respect to breach of fiduciary duty claims related to insider trading (*Brophy* claims) and related unjust enrichment claims.

The plaintiffs, stockholders of Clovis Oncology, Inc., a clinical stage biopharmaceutical company, alleged that the company's board of directors "ignored red flags" that the company was not adhering to clinical trial protocols in connection with the development of its "most promising" drug, Rociletinib (Roci). According to the complaint, the company publicly reported that Roci was keeping pace with competing drugs in clinical trials, while the board began receiving reports that the company's clinical trial protocol was not being followed, risking approval by the U.S. Food and Drug Administration (FDA), and that trial-compliant efficacy results were worse than what was being publicly reported. The plaintiffs alleged that the Clovis board "did nothing" in response to receiving these reports, relied upon the noncompliant publicly reported data to raise money and signed the company's annual report "[w]ith hands on their ears to muffle the alarms." The complaint further alleged that the company submitted false data to the FDA. When the lower trial-compliant numbers were disclosed, the stock price dropped 70%.

In addition, during the relevant time period, three directors and one executive "sold small percentages of their Clovis stock holdings," and a securities fraud case arising out of the same allegations was settled for $142 million in cash and Clovis stock, while an SEC case led to a "consent decree" requiring Clovis and two executives to pay monetary penalties and disgorge profits from stock sales.

The court held that the complaint alleged particularized facts that stated a *Caremark* claim, a breach of the duty of loyalty based on a lack of board oversight. Relying on the Delaware Supreme

Court's recent decision in *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019), the Court of Chancery explained that "to satisfy their duty of loyalty, directors must make a good faith effort to implement an oversight system and then monitor it," particularly "when a monoline company operates in a highly regulated industry." The court found that plaintiffs had adequately pleaded that Roci was "'intrinsically critical to the [C]ompany's business operation,' yet the Board ignored multiple warning signs that management was inaccurately reporting Roci's efficacy … violating both internal clinical trial protocols and associated FDA regulations." The court noted: "[a]s *Marchand* makes clear, when a company operates in an environment where externally imposed regulations govern its 'mission critical' operations, the board's oversight function must be more rigorously exercised." The court found that the plaintiffs had pleaded that demand was futile because the board member defendants faced a "substantial likelihood of personal liability" as a result of the non-exculpated *Caremark* claim.

However, the court granted the motion to dismiss breach of fiduciary duty claims based on allegations that certain defendants traded on inside information — so-called *Brophy* claims. The plaintiffs alleged that certain defendants sold shares when they knew that higher noncompliant numbers were being publicly reported, and that they profited unfairly as a result of these sales. The court noted that *Brophy* claims require plaintiffs to plead scienter, which can be inferred based on the timing and size of the trade. The court found that the sizes of the trades encompassed a range of 0.1% to 4% of the defendants' total holdings of shares, a figure too small to allow the court to infer scienter. The court also found that "[n]oticeably absent" from the complaint "[we]re any well-pled facts that the trades at issue represented a deviation from the sellers' past trading practices." The court dismissed unjust enrichment claims predicated on the *Brophy* claims.

Court of Chancery Dismisses *Primedia* Claim, Finding Value of Litigation Asset Was Not Material

Morris v. Spectra Energy Partners (DE) GP, LP, C.A. No. 2019-0097-SG (Del. Ch. Sept. 30, 2019)
Click here to view the opinion.

Vice Chancellor Sam Glasscock III dismissed claims brought by a public unitholder of a master limited partnership, Spectra Energy Partners, LP (SEP), against the partnership's general partner, Spectra Energy Partners (DE) GP, LP (SEP GP), arising out of SEP GP's alleged failure to obtain appropriate consideration for a derivative litigation asset in a roll-up transaction with SEP's corporate sponsor. The court held that the plaintiff did not have standing to bring a direct claim because the value of the litigation asset, a derivative claim challenging a 2015 reverse drop-down transaction, was not material when compared to the overall value of the roll-up.

In March 2016, a unitholder plaintiff filed a derivative suit challenging a reverse drop-down transaction. In that litigation, the plaintiff alleged that SEP had not received sufficient value for certain pipeline assets and that a special committee acting on behalf of SEP GP had breached its contractual duty of good faith in approving the transaction. One count survived a motion to dismiss. In May 2018, a transaction was announced between SEP and Enbridge Inc., through which Enbridge acquired all of the outstanding public units of SEP (the roll-up). Upon the roll-up's closing, the derivative claim was dismissed because the transaction extinguished the plaintiff's ownership in SEP and therefore his standing to pursue the claim on behalf of SEP.

On February 8, 2019, the same plaintiff filed a new complaint bringing direct claims challenging the roll-up. The plaintiff alleged that the special committee acting on behalf of SEP GP had breached its contractual duty of good faith and the implied covenant of good faith and fair dealing because the committee ascribed zero value (other than avoided defense costs) to the derivative claim in approving the roll-up. SEP GP moved to dismiss, arguing that the plaintiff lacked standing to bring his claims directly and that the plaintiff had failed to state a claim.

The court looked to the Court of Chancery's prior decision in *In re Primedia, Inc. Shareholders Litigation*, 67 A.3d 455 (Del. Ch. 2013), which "set[] out the standing requirements under Delaware law for a plaintiff who attacks the fairness of a merger based on a board's alleged failure to obtain value for an underlying derivative claim." Under *Primedia*, "the plaintiff must plead an underlying derivative claim that has survived a motion to dismiss or otherwise could state a claim for which relief could be granted"; "the value of the derivative claim must be material in the context of the merger"; and "the complaint challenging the merger must support a pleadings-stage inference that the acquirer would not assert the underlying derivative claim and did not provide value for it."

The court held that the first and third prongs of the *Primedia* test were met because the derivative claim had survived a motion to dismiss and there was no value received for the derivative claim in the roll-up. The court ultimately concluded that the second prong of the *Primedia* test was not satisfied, however, because the value of the derivative claim was not material in the overall context of the roll-up. In concluding that the value of the derivative claim was not material, the court assumed that the plaintiff's best estimate of the value of the derivative claim, $661 million, was true. The court noted, however, that this was not the value of the claim "for *Primedia* purposes," because it had to be discounted both to "reflect the minority stockholders' beneficial interest in the litigation recovery" and "the chance of success" of the derivative claim. Taking into account that the minority unitholders held only 17% of SEP, as well as the court's assessment that the chances of success of the derivative claim were "slim, and certainly less than one-in-four," the court concluded that the value of the derivative claim was, at most, less than 1% of the total value of the roll-up, which was not material in the context of the roll-up. Accordingly, the court found that the plaintiff lacked standing to pursue his claim and dismissed the complaint.

Court of Chancery Rejects Ratification Defense, Holding That Entire Fairness Applies to Board's Approval of Compensation Plan Awarded to Controller

Tornetta v. Musk, C.A. No. 2018-0408-JRS (Del. Ch. Sept. 20, 2019)
Click here to view the opinion.

The Court of Chancery declined to dismiss claims for breach of fiduciary duty and unjust enrichment against Elon Musk and Tesla's board of directors, finding that entire fairness applied to the board's decision to approve an incentive-based compensation plan for Musk that the plaintiff alleged had a maximum potential value of $55.8 billion.

In January 2018, the board approved the compensation plan, which consisted of a 10-year grant of stock options that would vest in 12 tranches, contingent on certain market capitalization and operational milestones. The board conditioned implementation of the plan on the approval of a majority of the disinterested shares voting at a special meeting of Tesla stockholders. At the meeting, 73% of disinterested shares voted in favor of the plan, which equated to approximately 47% of the total disinterested shares outstanding. For purposes of the motion to dismiss only, the defendants did not dispute that Musk was Tesla's controlling stockholder.

The court held that entire fairness was the appropriate standard of review, rejecting the defendants' argument that the business judgment rule should apply because stockholders ratified the board's decision to approve the compensation plan. The court explained that stockholder ratification did not justify business judgment deference because the award benefited a conflicted controller. The court observed that the defendants could have obtained business judgment review at the pleadings stage had they implemented the dual protections outlined in *In re MFW Shareholders Litigation*, 67 A.3d 496 (Del. Ch. 2013), by conditioning the consummation of the award upon the approval of an independent, fully functioning committee of the board and a statutorily compliant vote of a majority of the unaffiliated stockholders.

After finding that entire fairness applied, the court declined to dismiss the claims for breach of fiduciary duty and unjust enrichment, stating that the plaintiff adequately pled, "albeit just barely," that the award was not entirely fair, observing that "it is reasonably conceivable the present fair value of the Award is, as Plaintiff alleges, well in excess of that paid to Musk's peers." The court did, however, dismiss the waste claim, observing that a majority of disinterested stockholders voting at the special meeting approved the compensation plan and that "stockholders would be unlikely to approve a transaction that is wasteful."

Investment Company Act

Second Circuit Affirms Dismissal of Shareholder Breach of Contract Claims That Mutual Fund Violated the Investment Company Act

Edwards v. Sequoia Fund, Inc., Docket No. 18-3467-cv (2d Cir. Sept. 9, 2019)
Click here to view the opinion.

The Second Circuit affirmed the dismissal of claims brought by a putative class of shareholders against a mutual fund alleging that the fund breached a contractual obligation not to "concentrate" its investments in a single industry. The plaintiffs alleged that the mutual fund's registration statement constituted an enforceable contract with shareholders that required the fund to observe an investment policy, provided in the fund's statement of additional information, to not "concentrate" its investments in a single industry, as "concentrate" is defined in the Investment Company Act of 1940 (the 1940 Act). The plaintiffs claimed that, pursuant to the 1940 Act and related regulatory guidance, improper "concentration" is triggered when a fund's investment in an industry exceeds 25% of the fund's assets, and that the fund thus breached its concentration policy at least three times in 2015 when, due to increases in the value of the fund's health care assets, the value of those assets came to exceed 25% of the fund's overall assets.

The court assumed, without deciding, that the registration statement, including the statement of additional information, was a contract, but agreed with the fund that the alleged instances where its investments in a particular industry exceeded 25% did not violate the fund's policy. The court rejected the plaintiff's argument that SEC guidance adopted in 1998 that defined "concentration" as having "more than 25 percent of the value of [the fund's] assets in any one industry" (the 1998 Guidance) rescinded the SEC's 1983 guidance (the 1983 Guidance), which allowed concentration by "passive increase" that occurs "when securities of a given industry come to constitute more than 25 percent of the value of the registrants assets by reason of changes in value of either the concentrated securities or the other securities." The court noted that although the section of the 1998 Guidance addressing concentration does not expressly address passive increases, it still cites to and incorporates the 1983 Guidance, which expressly allows for such increases. The Second Circuit reasoned that the SEC would not adopt such a major change without "calling attention to it and without explanation."

Loss Causation

District of Massachusetts Denies Motion for Class Certification Filed by Investors in Biopharmaceutical Company and Dismisses Claims on the Pleadings

Karth v. Keryx Biopharmaceuticals, Inc., Civil Action No. 16-cv-11745 (D. Mass. Sept. 23, 2019)
Click here to view the opinion.

Judge Denise J. Casper declined to certify a class of investors in a pharmaceutical company and dismissed on the pleadings the plaintiff's claims against the company and certain of its officers and directors. In the operative complaint, the plaintiff alleged that the defendants violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder by making material misrepresentations concerning the company's manufacturing process of its drug for treating patients with chronic kidney disease. Specifically, the plaintiff alleged that in 2013 the company represented in an SEC filing that it was engaging multiple manufacturers or "third parties" to manufacture the drug, a representation the company repeated in several subsequent SEC filings. The plaintiff alleged that this representation was fraudulent because in August 2016 the company admitted in a press release that it needed to shut down production with the manufacturer producing the drug, and that this manufacturer was in fact the only third party with whom the company had contracted to manufacture the drug. After this announcement, the company's stock fell by 36%. The plaintiff moved for class certification, arguing that this created a class of harmed investors spanning from the 2013 SEC filing until the August 2016 press release.

The court denied the plaintiffs' motion for class certification, holding that the class representative did not meet the adequacy requirement of Federal Rule of Civil Procedure 23, governing class certification. Further, the court found that the defendants had cured the inaccurate disclosure in February 2016 — months before the alleged August 2016 corrective announcement — by disclosing in their 2015 10-K that the company was relying on a single manufacturer, a disclosure the company repeated with more specificity in its Form 10-Q filed in April 2016. The court held that because the class representative purchased his shares in July 2016, after the curative disclosures, his claims conflicted with the other purported class members. The court similarly determined that the predominance requirement could not be met because "the proposed class period … spans non-ambiguous public disclosures as to the single contract manufacturer for [the product at issue] in February and April 2016."

The court's ruling also allowed the defendants' Rule 12(c) motion for judgment on the pleadings, after earlier denying their Rule 12(b)(6) motion to dismiss. Judge Casper accepted the defendants' "truth on the market" theory. The "truth on the market" defense "posits that despite any alleged misrepresentation the market already knows the truth of the matter." The court reasoned that the availability of the February and April 2016 corrective disclosures indicating that the company relied on a single manufacturer broke the "causal link" between the announcement of the same information later in 2016, and the related decrease in the company's stock price. The court noted that the corrective disclosures "apparently were not briefed or addressed by either side in connection with Defendants' motion to dismiss and the Court did not address same in its earlier decision regarding that motion." However, the court determined that the statements were in the operative complaint, concerned "a legal basis not previously addressed or resolved by the Court" and thus were "properly before the Court" in connection with the motion for judgment on the pleadings. Therefore, in light of the earlier disclosures the court held that the plaintiff could not plead that the defendants' alleged material misrepresentation in 2013 caused the company's stock price to drop in August 2016.

Materiality

Eleventh Circuit Affirms Dismissal, Applies Puffery Defense for First Time in Reported Securities Fraud Case

Carvelli v. Ocwen Fin. Corp., No. 18-12250 (11th Cir. Aug. 15, 2019)
Click here to view the opinion.

The Eleventh Circuit affirmed the dismissal of a putative federal securities class action, holding for the first time in a securities fraud decision reported by that circuit that the alleged false and misleading statements were inactionable because they constitute immaterial "puffery."

The plaintiff, an alleged Ocwen shareholder, sued the company, claiming that Ocwen's statements regarding its efforts to achieve regulatory compliance were false or misleading, and that when the truth was revealed — by way of additional state regulatory actions — Ocwen's stock price declined and shareholders were injured.

In affirming the dismissal, the Eleventh Circuit held that certain of the challenged statements were inactionable because they were immaterial "puffery" as a matter of law. Puffery, the court explained, describes the "[e]xcessively vague, generalized, and optimistic comments" that a reasonable investor would not "view as moving the investment-decision needle—that is, they're not material." Here, the court held that Ocwen's statements that it continued "to devote substantial resources to … regulatory compliance and risk management efforts," that its investments in those areas were "now mature and delivering improved results," that it felt "good about the progress" it had made toward its "national mortgage settlement compliance" and that it had "taken a leading role in helping to stabilize communities most affected by the financial crisis" were not of the class of statements that a reasonable investor could possibly regard as significant.

The plaintiff objected, arguing that Ocwen's statements cannot qualify as nonactionable puffery because Ocwen did not genuinely or reasonably believe those statements when it made them. The court rejected that argument because it misses the point: "Whether a statement was made in bad faith or without a reasonable basis is irrelevant to the question whether the statement is nonetheless so airy as to be insignificant." While those considerations may be relevant to scienter, "what matters for *materiality* purposes is whether a statement is of a type that a reasonable investor would find relevant to investment decision-making."

Misrepresentations and Omissions

SDNY Dismisses Claims Against Educational Company in Their Entirety

Lea v. TAL Educ. Grp., No. 18 Civ. 5480 (LAP) (S.D.N.Y. Sept. 25, 2019)
Click here to view the opinion.

Judge Loretta A. Preska dismissed claims brought by a putative class of shareholders against a company that provides education services in China and certain of its executives alleging that they violated Sections 20(a) and 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder by making false or misleading statements in the company's accounting statements. Specifically, the plaintiffs alleged that the company fraudulently inflated the company's reported revenue and consequently its share price by making misleading statements related to the sale of the company's tutoring business and to the company's investment in a startup company. The plaintiffs claimed that these misstatements were later disclosed to the market and caused the share price to decrease.

The court held that the plaintiffs failed to sufficiently plead that the alleged misstatements were false or that the defendants acted with the required scienter. First, the court held that the plaintiffs' allegations for why the sale of the tutoring business was a sham — for example, that the company repurchased the business about a year after selling it — fell short. The court observed that there were many plausible reasons, other than fraud — for example, that the business was not a good fit with the purchaser — explaining the transactions. Second, on the investment in the startup, the court determined that the plaintiffs insufficiently pleaded that the defendants controlled the startup and were required to disclose their relationship sooner, finding that the plaintiffs selectively quoted certain statements by the startup's CEO concerning the startup's relationship with the company without putting those statements into context. Finally, Judge Preska rejected the plaintiffs' allegations related to scienter, concluding "there is no material misrepresentation here, so there can be no scienter."

SDNY Dismisses Certain Claims Against Theater Chain, Upholds Other Claims

Haw. Structural Ironworkers Pension Trust Fund v. AMC Entm't Holdings, Inc., No. 18-cv-00299 (AJN) (S.D.N.Y. Sept. 23, 2019)
Click here to view the opinion.

Judge Alison J. Nathan granted in part and denied in part a motion to dismiss claims brought by a putative class of investors against a multinational theater company, certain of its directors and officers, and several financial institutions that underwrote a secondary public offering (SPO). The plaintiffs alleged that, in connection with the SPO, the defendants violated Sections 11, 12 and 15 of the Securities Act by negligently failing to disclose facts about the company's acquisition of a theater chain. The plaintiffs further alleged that the defendants had made misleading statements during the class period, in violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, by failing to disclose certain material facts about the acquired theater chain, including that the chain's theaters were in disrepair, were losing market share and traditionally had low-performing second quarters.

The court reasoned that the company and the theater chain it acquired had disclosed the risk of losing market share and dismissed claims arising from that alleged omission, but the court determined that the plaintiff adequately pleaded that the remaining omissions were material. For example, concerning omissions about the state of disrepair of the acquired theaters, the court determined that the company's disclosures were at best partial and that "it is plausible that these partial disclosures were insufficient to inform a reasonable investor." The court further determined that the company had an affirmative duty pursuant to Item 303 of Regulation S-K to disclose the acquired chain's underinvestment in its theaters because remediating that issue would require "expenditures ... necessary to support a new, publicly announced product or line of business."

Similarly, the court determined that some of the company's statements were nonactionable opinion or puffery, and others were not. A statement from the company's executive regarding the quality of the company's personnel was not actionable because the plaintiffs failed to plead that the speaker did not hold the belief that the facts supplied in support of the belief were untrue or that the speaker omitted information to make the statement misleading to a reasonable investor. The company's statements about its plans to renovate the theaters in disrepair, however, were not protected because they omitted that there were "substantial, systemic obstacles to renovations." Finally, the court found that the plaintiffs had sufficiently pleaded loss causation because the drop in stock prices was plausibly directly tied to disappointing Q2 earnings, which in turn were related to the defendants' omissions.

SDNY Dismisses Claims That a Technology Development Company Issued Misleading Revenue Projections for a Web-Hosting Contract

Lefkowitz v. Synacor, Inc., No. 18 Civ. 2979 (LGS) (S.D.N.Y. Aug. 28, 2019)
Click here to view the opinion.

Judge Lorna G. Schofield dismissed claims brought by a putative class of investors against a technology development corporation alleging that it violated Section 10(b) of the Securities Exchange Act by making material misstatements and omissions related to a contract to host web and mobile (portal) services for AT&T. The plaintiffs alleged that the defendants made fraudulent representations concerning (i) the company's projected revenue from the AT&T contract, (ii) AT&T's control over monetizing the portal for the company and (iii) the company's weaknesses in internal controls for financial reporting.

First, the court determined that the complaint inadequately pleaded that the financial projections were materially misleading because it lacked sufficient facts to suggest that the company did not sincerely believe the financial projections were true, that the projections were supported by untrue facts or that the projections omitted material information. The court rejected the argument that the company's knowledge that AT&T sought to prioritize user engagement over monetization of the platform rendered the company's projections false because the complaint failed to provide "facts that suggest that prioritizing user engagement over monetization meant that [the company] knew that the projected revenues would never be realized, rather than delayed." The court also determined that the statements concerning the projections were not actionable because they were within the scope of the Private Securities Litigation Reform Act's (PSLRA) safe harbor provision for forward-looking statements.

Second, the court held that the public was already aware of AT&T's control over the portal. Further, the court found that even if the company had hidden AT&T's exercise of control, the complaint did not plausibly explain how that omission would have made the revenue projection statements misleading to a reasonable person "reading the statement fairly and in context" as, for example, the public filings described AT&T's control of marketing. Finally, concerning allegations that the company failed to disclose weaknesses in the company's internal controls for financial reporting, the court held that the complaint identified no connection between weak internal controls and revenue projections, observing that, as pleaded, the company's auditor identified control weaknesses related to the preparation of historical financial statements, not forecasts related to the AT&T contract. The court also held that the plaintiffs failed to plausibly plead scienter regarding the company's Sarbanes-Oxley internal control certifications because a plausible inference could be made that the company believed that any deficiencies were "not so acute as to rise to the level of an internal control weakness."

Securities Exchange Act

District of Connecticut Denies Motion To Dismiss Negligently Designed Software Claims Against Online Broker Dealer Company

Batchelar v. Interactive Brokers, LLC, Civil No. 3:15-cv-1836 (AWT) (D. Conn. Sept. 30, 2019)
Click here to view the opinion.

Judge Alvin W. Thompson denied a motion to dismiss claims brought by a customer of an online broker-dealer company against the company and its officer who was responsible for the company's trading software, alleging that the software was negligently designed, maintained and tested. The plaintiff alleged that, as a result of that negligence, the online platform declared a margin deficiency in the plaintiff's trading account and, pursuant to its trading algorithm, automatically liquidated all of the positions in the plaintiff's account in an approximately 20-minute span, at prices that were disproportionate with the market, causing the plaintiff to lose between approximately $95,000 and $115,000.

The court rejected the defendants' arguments that they had no duty of care to the plaintiff at all and that federal regulations barred the plaintiff's claim. Observing that the defendants had not contested the foreseeability of the alleged harm, the court determined that public policy — *i.e.*, "the normal expectations of the participants in the activity under review" — weighed in favor of holding that the plaintiff had sufficiently alleged defendants owed the plaintiff a duty of care. The court dismissed the defendants' argument that the Margin Disclosure Rule (Securities Exchange Act Rel. No. 34-44223, 66 Fed. Reg. 22274-01) gave the company the "unfettered right to liquidate" in the event of a margin deficiency and reasoned that the federal regulation did not affect the expectation that the company would not "liquidate the positions in the account in a negligent manner." The court further stated that there would not be increased litigation nor an adverse impact on the brokers' willingness to participate in the market based on having a duty of care because brokers "are in a position to identify and manage the resulting risks" of participating in the market.

Northern District of Illinois Grants Motion To Dismiss in Insufficiently Pleaded Securities Exchange Act Class Action

Walleye Trading LLC v. AbbVie, Inc., No. 18 C 05114 (N.D. Ill. Sept. 18, 2019)
Click here to view the opinion.

Judge Charles P. Kocoras granted a motion to dismiss a class action against AbbVie and its CFO alleging violations of the Securities Exchange Act. The plaintiffs claimed AbbVie and its CFO violated Section 14(e), Section 10(b) and Rule 10b-5, and that the CFO violated Section 20(a). In May 2018, AbbVie conducted a modified Dutch auction to repurchase $7.5 billion of its common stock and engaged Computershare as the depositary. The auction began on May 1, 2018, and continued until midnight on May 29, 2018. At 8 a.m. EST on May 30, 2018, AbbVie issued a statement announcing the auction's preliminary results, including that the purchase price would be $105. Thereafter, its stock rose 3.5% from its May 29, 2018, closing price of $99.47, closing at $103.01 on May 30, 2018. Forty-six minutes after the market closed on May 30, AbbVie filed a corrected statement noting that AbbVie's initial statement failed to account for approximately 5,495,581 shares, of which 3,785,725 were tendered by guaranteed delivery, which led AbbVie to lower its purchase price from $105 to $103. The next trading day, AbbVie stock traded down and closed at $98.94. Walleye brought the class action on behalf of all those who bought or otherwise transacted in AbbVie securities between 9:30 a.m. and 4 p.m. EST on May 30, 2018, and allegedly were damaged thereby.

AbbVie filed a motion to dismiss the complaint pursuant to Federal Rule of Civil Procedure 12(b)(6), arguing that Walleye failed to state a claim. The court agreed that Walleye did not sufficiently allege a false statement of material fact and scienter. Walleye alleged that AbbVie and its CFO misrepresented the number of validly tendered shares in the initial statement AbbVie issued on May 30, 2018. Walleye acknowledged in its complaint that Computershare notified AbbVie of the error after the initial statement was issued. The court found that the mere fact that AbbVie updated its first statement to reflect omitted shares does not show the statement was knowingly untrue when made, but rather only that AbbVie's statement was incorrect in retrospect. Moreover, the court found that Walleye only included general allegations of scienter, failing to satisfy the PSLRA's heightened pleading standard. To support its conclusion that AbbVie either knowingly made a false statement or recklessly disregarded a substantial risk that it was false when it had all of Computershare's information, Walleye only describes typical practice by depositaries and not facts specific to AbbVie.

The court also agreed that Walleye failed to state a claim under Section 14(e) of the Securities Exchange Act because the allegedly fraudulent statement was made after the tender offer's deadline expired and therefore cannot be used as the basis for a Section 14(e) claim because it would be impossible for the plaintiffs to rely on any alleged deception in that statement when deciding whether to tender.

Securities Fraud Pleading Standards

Fiduciary Duties

Fifth Circuit Holds That Shareholders of Fannie Mae and Freddie Mac May Challenge FHFA's Authority Regarding 'Treasury Sweep' Amendment

Collins v. Mnuchin, 938 F.3d 553 (5th Cir. Sept. 6, 2019)
Click here to view the opinion.

On September 6, 2019, the Fifth Circuit held that shareholders of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) could proceed with claims previously dismissed by the District Court for the Southern District of Texas. The shareholders alleged that the 2012 "Treasury sweep" amendment to preferred stock purchase agreements entered into between the Federal Housing Finance Agency (FHFA) and the U.S. Department of Treasury (Treasury) exceeded the FHFA's conservator powers. The Fifth Circuit reversed and remanded the district court's dismissal decision, holding that the shareholders had stated a plausible claim that the FHFA had exceeded its statutory authority under the Administrative Procedure Act (APA).

FHFA appointed itself a conservator for Fannie Mae and Freddie Mac in 2008. Under the Uniform Probate Code, a "conservator" is a fiduciary held to the same standard of care as a trustee. Shortly after FHFA became their conservator, Fannie Mae and Freddie Mac entered into preferred stock purchase agreements with the Treasury. In 2012, the FHFA and the Treasury adopted an amendment to these agreements, which replaced the quarterly dividend with variable dividends equal to Fannie Mae and Freddie Mac's entire net worth except a capital reserve. The Treasury announced that the amendment, which transferred substantially all of Fannie Mae and Freddie Mac's capital to the Treasury, was made to expedite the wind-down of the two entities. The shareholders of Fannie Mae and Freddie Mac sued FHFA and its director, and the Treasury and its secretary (collectively, the agencies), alleging, among other things, that in adopting the amendment, the FHFA exceeded its statutory conservator authority under the APA. The district court dismissed the case for failure to state a claim.

On appeal, the agencies argued that the 2012 amendment fell within the Treasury's temporary purchase authority because Congress had authorized the Treasury to "purchase any obligations and other securities issued by [Fannie Mae and Freddie Mac] … on such terms and conditions … and in such amounts as the Secretary may determine." The Fifth Circuit rejected that argument, holding that the temporary purchase authority "does not override the elaborate powers scheme in FHFA's enabling statute." The conservator powers of the FHFA authorize the agency to take actions "(i) necessary to put the regulated entity in a sound and solvent condition; and (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity." The court held that by transferring substantially all of Fannie Mae and Freddie Mac's capital to the Treasury, the "Treasury sweep" amendment exceeded the FHFA's statutory authority because the sweep "actively undermined pursuit of a 'sound and solvent condition,' and it did not 'preserve and conserve' [Fannie Mae and Freddie Mac's] assets."

The Fifth Circuit also considered a constitutional challenge brought by the shareholders and dismissed by the district court, alleging that the FHFA was unconstitutionally structured, in violation of the separation of powers provision of the U.S. Constitution. The court agreed that the structure — an independent agency with only one director, removable only "for cause" — violated the separation of powers clause, because the single director was insufficiently accountable to the president. The court held that the "for cause" provision must be replaced with one that allows the director to be replaced without good cause.

Scienter

WDNY Dismisses Claims That Banks Aided and Abetted in Ponzi Scheme Perpetuated by Certain Bank Customers

Heinert v. Bank of Am., N.A., No. 19-CV-6081L
(W.D.N.Y. Oct. 18, 2019)
Click here to view the opinion.

Judge David G. Larimer dismissed claims that certain commercial banks (bank defendants) aided and abetted fraud and breach of fiduciary duty and committed common law conspiracy by facilitating a Ponzi scheme perpetuated by certain bank customers (individual defendants) who used their accounts at the banks to defraud a putative class of investors and caused them to lose approximately $102 million. With respect to aiding and abetting fraud, the plaintiffs alleged that the banks knew about the individual defendants' scheme and assisted in carrying it out because, for example, those customers engaged in a number of suspicious transactions involving numerous accounts. The plaintiffs alleged that, with respect to one of the banks, a branch manager had a close relationship with the individual defendants and conducted a number of "atypical transactions and transfers on the individual defendants' behalf." The court, however, disagreed that the plaintiffs adequately pleaded actual knowledge because "a bank's negligent failure to identify warning signs of fraudulent activity, such as atypical transactions — even where such signs converge to form a veritable forest of red flags — is insufficient to impute actual knowledge of ongoing fraud."

Similarly, with respect to aiding and abetting the individual defendants' breach of fiduciary duty, the court determined that the plaintiffs failed to plead that the banks had actual knowledge of the breach of the duty and that the banks substantially assisted in the breach. The court rejected the plaintiffs' argument that the banks' account opening practices alerted the banks to the fact that the accounts contained investor funds because there was "no indication that the defendant banks had actual notice that the [bank's customers] were … using their accounts to perpetrate fraud." The court also rejected the argument that the banks assisted the individual defendants' scheme "by providing banking services, including making wire transfers, opening accounts, and clearing account holds" because "[s]uch routine matters, even where they are performed with atypical frequency, are insufficient to support an aiding and abetting claim." The court concluded that the plaintiffs likewise failed to adequately plead that the banks conspired with the individual defendants because the allegations "concern inaction rather than overt acts" and that to the extent any overt acts were pleaded, the plaintiffs failed to allege that they were pursuant "to any specific, knowing agreement" with the individual defendants to defraud their investors.

SDNY Dismisses State Law Claims That Several Financial Firms Defrauded Investors in Collateral Debt Obligations

Loreley Fin. (Jersey) No. 3, Ltd. v. Wells Fargo Sec., LLC,
No. 12 Civ. 3723 (PAC) (S.D.N.Y. Sept. 17, 2019)
Click here to view the opinion.

Judge Paul A. Crotty dismissed on summary judgment fraud and related state law claims that were brought by investors in three collateral debt obligations (CDOs) against the banks and collateral managers that had created the CDOs. The plaintiffs alleged that in the years preceding the financial crisis in 2008, the defendants failed to disclose that one of their hedge fund clients exerted an improper influence over the defendants to the plaintiffs' detriment. The plaintiffs alleged that the defendants misrepresented the diligence that went into creating and managing the CDOs by failing to disclose in the CDOs' marketing and offering materials that the hedge fund determined the quality of the assets underlying the CDOs. The plaintiffs alleged that, as a result of the hedge fund's improper influence, the plaintiffs lost all of their investment in the CDOs during the 2008 financial crisis.

On the summary judgment record, the court determined that there was insufficient evidence that the defendants "misrepresented the CDOs at issue or omitted a material fact to Plaintiffs, since the structural features of the CDOs were disclosed … and the collateral managers fulfilled their duties in selecting collateral that satisfied the CDOs' investment criteria." Similarly, while the court determined that there might have been a triable issue of material fact as to whether the defendants made a misrepresentation to the plaintiffs' investment adviser concerning the value of certain assets in one of the CDOs, the plaintiffs could not "sustain a claim of actual reliance against Defendants, who did not communicate with Plaintiffs directly." The court concluded that because there was insufficient evidence of a material misrepresentation and of reliance, the plaintiffs could not "create an inference of scienter … that Defendants intended to defraud them."

Northern District of California Finds Expert's Allegations Insufficient to Establish Scienter

Sgarlata v. PayPal Holdings, Inc., Case No. 17-cv-06956-EMC
(N.D. Cal. Sept. 9, 2019)
Click here to view the opinion.

The Northern District of California dismissed with prejudice a putative federal securities class action, holding that allegations from a supposed cybersecurity expert failed to establish a strong inference of scienter.

In this case, purported PayPal shareholders sued the company after it disclosed a data breach in December 2017. The plaintiffs claimed that the company's statement in November 2017 that it had identified certain security "vulnerabilities" was false or misleading because the company already was aware at the time that an actual data breach had occurred and that such breach potentially affected millions of customers.

In 2018, the court granted the defendants' motion to dismiss, holding that the plaintiffs failed to adequately plead scienter because their three purported confidential witnesses — all former employees — failed to reliably demonstrate that the PayPal executive who made the allegedly false statement knew that there had been an actual breach at the time he made the statement.

In their amended pleading, the plaintiffs attempted to bolster their scienter allegations by engaging a supposed cybersecurity expert to determine what information was "likely" available to defendants at the time of the alleged misstatement. The court agreed that a plaintiff is permitted to support a securities fraud claim with allegations provided by an expert, but stated that such allegations must still "satisfy the same standard applied to confidential informants." Thus, any expert statements (i) must be described with sufficient particularity to establish reliability and personal knowledge; and (ii) must themselves be indicative of scienter.

The court found that the expert allegations failed to meet that standard. While the expert stated that defendants were "likely" aware that all customer data had been potentially compromised at the time of the alleged misstatement, the expert relied on only (i) PayPal's public statements, (ii) the alleged confidential witness statements set forth in the complaint and (iii) publicly available information. The complaint did not allege, for example, that the expert (i) was familiar with the specific architecture of the defendants' privacy network, (ii) had spoken with any PayPal employees or (iii) had reviewed any documents supporting the executive's knowledge at the time of the alleged misstatement. Thus, the complaint failed to adequately plead scienter.

SDNY Dismisses in Part Claims Against Industrial Conglomerate Company and Its Executives

Sjunde AP-Fonden v. Gen. Elec. Co., No. 17-CV-8457 (JMF) (S.D.N.Y. Aug. 29, 2019)
Click here to view the opinion.

Judge Jesse M. Furman dismissed, in part, claims by a putative class of investors that an industrial conglomerate company violated Section 10(b) and Rule 10b-5 thereunder by making false or misleading statements concerning its insurance and power business lines. The plaintiffs alleged that the company misrepresented (i) its liabilities in the company's long-term care (LTC) insurance portfolio and (ii) the accounting and revenue recognition practices for certain long-term service agreements (LTSA) in its power division.

The court dismissed the plaintiffs' LTC liabilities claim, finding that they did not adequately plead scienter. The plaintiffs alleged that the presentation of LTC liabilities in the company's relevant Form 10-K filings was misleading because the LTC liabilities should have been included in a certain table that listed certain of the company's contractual liabilities. The court determined that the tables at issue were not misleading because they expressly directed readers to another section "located later in the Form 10-K, which broke out in tabular form" the company's liabilities, including the LTC liabilities. The court also determined that even if the statements were misleading, they were not made with the requisite scienter as "the disclosure of those liabilities — and the explicit directions to readers as to how to find those disclosures — strongly undercuts any inference" of fraud. The court similarly rejected the plaintiffs' argument that a variety of factors — including resignations of high-level executives, a $9 billion reserve adjustment, the company's eventual "reversion to more comprehensive disclosures regarding LTC liabilities" and the SEC's investigation into the company's LTC insurance business — amounted to a strong inference of scienter.

The plaintiffs alleged that the company made misleading statements concerning LTSAs that the company's power division sold to customers to monitor and service a variety of power products. Although the court determined that the company's earnings projections concerning the LTSAs were unactionable opinion statements, the court declined to dismiss claims that the defendants failed to adequately disclose, as required under Item 303, the extent and financial ramifications of the company's reliance on factoring, *i.e.*, selling the amounts receivable from LTSAs for cash. The court determined that the plaintiffs adequately pleaded "that factoring was a trend or event that was reasonably likely to result in a change in [the company's] liquidity."

SLUSA

Third Circuit Holds That SLUSA Does Not Prevent Opt-Out Plaintiffs From Bringing Individual Actions Under State Law

North Sound Capital LLC v. Merck & Co., Inc., Nos. 18-2317, 2318, 2319, 2320 (3d Cir. Sept. 12, 2019)
Click here to view the opinion.

The Third Circuit reversed the dismissal of opt-out plaintiffs' individual actions based on state law claims, holding that the Securities Litigation Uniform Standards Act (SLUSA) did not preclude the suits because they were not "joined, consolidated, or otherwise proceed[ing] as a single action for any purpose" with the original class action.

In 2008, purported shareholders of Merck and Schering-Plough filed putative class actions alleging that those companies made false or misleading statements in violation of Section 10(b) of the Securities Exchange Act. In 2012, the district court granted class certification and provided shareholders a 45-day window to opt out of the class. After the opt-out period ended, the court approved the parties' proposed settlement agreement and ultimately granted final approval in October 2013.

In November 2013 and January 2014, 16 opt-out shareholders filed individual actions against Merck and Schering-Plough. The complaints tracked — sometimes verbatim — the complaints filed in the class actions, except that the individual plaintiffs added a common law fraud claim under New Jersey law. The complaints identified the class action suits as "related" on their civil cover sheets. The district court dismissed the Securities Exchange Act claims based on the statute of repose and dismissed the state law fraud claim as precluded by SLUSA.

With respect to the dismissal of the state law fraud claim, the Third Circuit reversed. The court noted that SLUSA precludes only state law claims alleging securities fraud through a "covered class action." Whether the individual actions satisfied the definition of a "covered class action" in this case turned on whether, with respect to the prior class actions, the individual actions were "joined, consolidated, or otherwise proceed[ed] as a single action for any purpose." 15 U.S.C. § 78bb(f)(5)(B)(ii)(II). Interpreting that statutory phrase, the court held that joinder, consolidation or proceeding as a single action requires actual coordination between the individual actions and the class action. Thus, cases generally cannot proceed as a single action unless they coincide for some time period because, "[i]f two cases never overlap, a court cannot combine them for management of a common stage of the proceedings or for resolution of a common question."

Applying that standard, the court held that the individual actions did not proceed as a single action with the class action. As a threshold matter, the individual actions were not filed until after the class action had fully settled. Thus, the cases were never joined or consolidated in any way. The court rejected the defendants' arguments that the individual actions met the statutory definition because (i) the individual complaints mirrored the class action complaints, (ii) the plaintiffs identified the class action suits as "related," and (iii) the plaintiffs conceded that the discovery from the class action would be the same discovery sought in the individual actions. While such facts evidence that the cases are related, the court explained, they "do not suggest actual coordination." The court also rejected the argument that the individual actions should be considered as a single action merely because the plaintiffs would benefit from what had transpired in the class action.

The court noted that, on remand, it would be up to the district court's discretion whether to exercise supplemental jurisdiction over the state law claims, given that the Securities Exchange Act claims were dismissed.

Inside the Courts
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