# 2015 YEAR IN REVIEW – SECURITIES LITIGATION

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haynesboone

# MEET THE AUTHORS

**DAN GOLD** is Chair of the firm's Securities and Shareholder Litigation group. He also currently serves as Chair of the Securities Section of the Dallas Bar Association. Among other recent matters, Dan has been representing the Board of AT&T Inc. in shareholder derivative litigation, representing an exploration and production company in a shareholder case in Delaware Chancery Court, defending a hedge fund in a dispute with a placement agent, and advising hedge funds and managers in litigation and pre-litigation matters. In 2015, Dan also played a leading role in the successful defense at trial of the National Football League in the Super Bowl XLV ticket litigation.

**THAD BEHRENS** is Chair of the firm's Class Action Defense practice. He has successfully defended companies, directors and officers in securities class actions, derivative suits, M&A litigation, and proxy contests. In 2015, Thad led the firm's successful defense of the National Football League in a high profile federal jury trial involving Super Bowl XLV. Thad is a past president of the Dallas Federal Bar Association, and has been recognized as a Texas Super Lawyer.

**ODEAN VOLKER** is Chair of the firm's International Arbitration Practice, and previously served as Co-Chair of the Litigation Department. His practice includes securities and complex litigation, and domestic and international commercial arbitration. He has extensive experience in conducting internal investigations and addressing governance issues for public and private companies. Odean is AV® Peer Review Rated Preeminent by *Martindale-Hubbell® Law Directory*, was named a Texas Super Lawyer, 2012-2014 and recognized as a Best Lawyer in America in Arbitration in 2015.

**DAVID SIEGAL** heads up the firm's government and securities enforcement defense practice in New York. A former federal criminal prosecutor in Manhattan for almost a decade, David now defends and advises companies and executives facing criminal and regulatory scrutiny in all varieties of business related matters, including bank, securities and accounting fraud, insider trading, market manipulation, criminal tax, cybercrime and data security. David's practice also focuses on complex commercial civil litigation in state and federal court. David has been recognized as a New York Super Lawyer, Thomson Reuters, in Criminal Defense: White Collar, Business Litigation, 2011-2015, and one of The *Best Lawyers in America®*, Woodward/White, Inc., in Criminal Defense: White Collar, 2013-2016, and Commercial Litigation, 2016.

**KIT ADDLEMAN** chairs the firm's SEC Enforcement Defense Practice group. Kit defends companies, executives and directors against government charges of misconduct, particularly investigations and litigation by the Securities and Exchange Commission and Department of Justice. Many of her matters involve allegations of accounting and financial fraud, insider trading, hedge fund and advisor fraud, and Foreign Corrupt Practices Act violations. Prior to joining Haynes and Boone in 2009, Kit was the regional director of the Atlanta Regional Office of the SEC and spent more than 20 years prosecuting matters at the SEC.

**GEORGE W. BRAMBLETT, JR.** has been involved in high stakes litigation with significant experience in securities and shareholder litigation. He was named in *Best Lawyers of America* for Commercial Litigation, Securities Law, and "Bet–the-Company" Litigation in 2009-2016. He was named *Best Lawyers'* Dallas Litigation Lawyer of the Year for 2013. He has been recognized by *Chambers USA* as a leading practitioner for General Commercial Litigation. In 2013, he was awarded the Luther (Luke) H. Soules Award for Outstanding Service to the Practice of Law by the Litigation Section of the State Bar of Texas.

**CARRIE HUFF** is a partner with more than 25 years of experience in class action, shareholder and fiduciary litigation. A major part of her practice is advising attorneys on ethics issues, and Carrie is an assistant general counsel of the firm. She also has continued to represent the trustees of family trusts involved in a high-profile, multi-court dispute, and has secured favorable rulings by the Fifth Circuit affirming the comprehensive settlement of the dispute. Carrie is AV® Peer Review Rated Preeminent by *Martindale-Hubbell® Law Directory*.

**STEVE CORSO** leads the firm's government litigation and SEC enforcement defense practice in Houston. Before joining the firm, Steve was a federal criminal prosecutor in Houston focused on investigating and litigating white-collar crime, and he served as a staff attorney in the Enforcement Division of the U.S. Securities and Exchange Commission in Atlanta. His practice concentrates on representing individuals and companies in connection with allegations of fraud and corruption, including securities and commodities fraud, financial and accounting fraud, insider trading, commercial bribery, and violations of the Foreign Corrupt Practices Act. Steve began his career as an assistant district attorney, where he successfully first-chaired numerous criminal jury trials to verdict.

**SPECIAL THANKS** to the following attorneys and staff for their contributions and assistance: Emily Westridge Black, David Dodds, Benjamin Goodman, Richard Guiltinan, Kathy Gutierrez, Taryn McDonald, Matt McGee, Casey McGovern, William Marsh, Tim Newman, Phong Tran, and Chris Quinlan.

Clients and Friends,

Each year our ***Year in Review*** comments on significant securities-related decisions by the Supreme Court, federal appellate courts and district courts, notes key developments in SEC enforcement, and summarizes significant rulings in state law fiduciary litigation against directors and officers of public companies.

We begin with a discussion of the Supreme Court's 2015 decision in ***Omnicare***, which clarified when statements of opinion are considered false or misleading for purposes of public offering claims under Section 11 of the Securities Act.

Beyond the Supreme Court, there was notable activity at the Circuit Courts of Appeals and district courts, including early applications of ***Halliburton II***, application of ***Comcast*** in a securities class action, and significant decisions on scienter, loss causation and other securities issues. Last year also saw Delaware decisions that are likely to change the landscape of M&A litigation and interesting developments in the area of SEC enforcement.

In 2015 our team spent the year winning cases at trial and representing clients in securities, fiduciary duty and SEC enforcement matters. Among other highlights, in March we obtained a complete victory after a two week trial and broke the SEC's winning streak in cases before an Administrative Law Judge; we represented the Board of AT&T in shareholder litigation; we are company counsel in the SEC investigation related to the indictment of the Texas Attorney General; we are defending shareholder derivative claims in Delaware challenging the fairness of an oil and gas transaction; and we helped companies and executives avoid SEC enforcement charges.

Outside the securities context, our lawyers also successfully defended the National Football League in a jury trial against fraud claims brought by Super Bowl XLV ticketholders and helped win a sweeping trial victory in a federal civil rights class action on behalf of 12,000 Texas children in long-term foster care.

If you have any questions about the issues covered in this 2015 Review, or about our practice, please let us know. We look forward to working with our friends and clients in 2016.

**Haynes and Boone — Securities Litigation Practice Group**

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# I. Supreme Court Summary: *Omnicare* Standard for Statements of Opinion or Belief

In 2015, the Supreme Court continued its recent trend of issuing landmark decisions that will shape securities litigation for years to come. This past March, the Court decided ***Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund***, 135 S.Ct. 1318 (2015). The decision identifies two avenues by which a company's statements of opinion or belief in registration statements for initial public offerings can lead to liability under Section 11 of the Securities Act of 1933. First, an issuer can be liable for statements of opinion that are not genuinely believed or that contain embedded statements of untrue facts. Second, an issuer can be liable if a registration statement omits specific material facts that render the opinion misleading, as determined by the statement's context and the foundation a reasonable investor would expect the issuer to have when expressing that opinion. Going forward, we expect the *Omnicare* analysis to spread beyond Section 11 cases and guide courts tasked with evaluating statements of opinion or belief under other provisions of the federal securities laws.

## BACKGROUND AND PROCEDURAL HISTORY

Plaintiffs in *Omnicare* challenged a registration statement by a pharmaceutical company that included management's opinions that company contracts were in compliance with federal and state law. Plaintiffs brought claims under Section 11 of the Securities Act, which provides liability for material misstatements or omissions in registration statements for public offerings. Section 11 is a strict liability statute: plaintiffs do not have to show that they relied on the alleged misrepresentation, or that a defendant acted with intent to deceive. Plaintiffs cited subsequent whistleblower litigation and other legal proceedings against the company and claimed that the company's opinions about its legal compliance had been materially misleading.

The district court granted the company's motion to dismiss. The court held that opinions are only actionable under the federal securities laws if the speaker did not believe the opinions when offering them. In other words, speakers cannot be held liable for genuinely-held beliefs. Applying this standard (the "subjective falsity" standard), the court found that the plaintiffs had not adequately alleged that the company did not believe that it was in compliance with the law when it offered the challenged opinions.

The Sixth Circuit reversed on appeal. Because Section 11 is a strict liability statute, the court noted, plaintiffs do not have to show scienter. For that reason, the Sixth Circuit found that plaintiffs did not have to make any allegations about management's state of mind when the company and its management offered the challenged opinions. Under the Sixth Circuit's analysis, statements of opinion – even if genuinely held – can be materially misleading under an "objective falsity" standard, and defendants that express misleading opinions in registration statements can be liable under Section 11. This holding created a split with other Circuits that had adopted subjective falsity standards for statements of opinion or belief. The company petitioned the Supreme Court to resolve the split.

Omnicare identifies two avenues by which a company's statements of opinion can lead to liability.

## WHEN IS AN OPINION MISLEADING UNDER SECTION 11?

In an opinion by Justice Kagan, the Court articulated two methods for alleging and assessing liability for opinions under Section 11: (1) where an opinion qualifies as a misstatement of fact; and (2) where an opinion is misleading due to the omission of material facts. Justices Scalia and Thomas filed concurring opinions.

With respect to the first basis for liability, the Supreme Court agreed with the company that a statement of opinion or belief does not qualify as a misstatement simply because it is or later proves to be erroneous. For an opinion to qualify as a material misstatement of fact, a plaintiff must show that the speaker did not actually believe the opinion at the time it was offered. The court also noted that an opinion or belief that embeds an untrue statement of material fact may also qualify as a material misstatement of fact.

With respect to omissions as a basis for liability, the Supreme Court held that opinions may lead to Section 11 liability if the registration statement "omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself." To determine whether an omission related to a statement of opinion or belief is materially misleading, the *Omnicare* decision instructs courts to consider "the foundation [a reasonable investor] would expect an issuer to have before making the statement," considering the statement's context, other facts provided by the issuer, and "any other hedges, disclaimers, or qualifications." As Justice Scalia observed in his concurrence, the holding flips the analysis from what the speaker believed when offering the opinion to what the listener perceived from that opinion. If a statement of opinion omits a material fact that goes to the reasonable basis forming that opinion, the speaker may be liable under Section 11. The Court also cautioned that an opinion is not misleading simply because an issuer fails to disclose some fact that cuts the other way.

## TAKEAWAYS FROM *OMNICARE*

While *Omnicare* affirms that honestly-held opinions cannot be actionable misstatements of fact, the *Omnicare* decision creates room for future disagreement as to what constitutes a reasonable basis for offering an opinion in light of the factual disclosures in a registration statement. Issuers should pay close attention to any statements that may qualify as opinions and carefully review the "hedges, disclaimers or qualifications" tied to those opinions. As the Supreme Court noted, such "context" is critical to determining whether an omission related to opinions or beliefs is material and misleading.

## APPLYING *OMNICARE* IN THE LOWER COURTS

Although *Omnicare* is a Section 11 decision, many lower courts have found its analysis instructive as to what makes a statement of opinion or belief misleading for purposes of Rule 10b-5 claims. ***Nakkhumpun v. Taylor***, 782 F.3d 1142 (10th Cir. 2015); ***In re Merck & Co., Inc. Sec., Deriv. & "ERISA" Litig.***, 2015 WL 2250472 (D.N.J. May 13, 2015); ***City of Westland Police & Fire Ret. Sys. v. MetLife, Inc.***, 2015 WL 5311196 (S.D.N.Y. Sept. 11, 2015); ***Starr Int'l U.S.A. Invs., LC v. Ernst & Young, LLP (In re Lehman Bros. Sec. & ERISA Litig.)***, 2015 U.S. Dist. LEXIS 125202 (S.D.N.Y. Sept. 18, 2015); ***In re Velti PLC Sec. Litig.***, 2015 WL 5736589 (N.D. Cal. Oct. 1, 2015). In Rule 10b-5 suits, some courts have read *Omnicare*'s first line of inquiry as consistent with existing "subjective belief" precedent but also cite *Omnicare* for the proposition that "in some circumstances, an omission may render a statement of opinion misleading." *See* ***In re Fairway Grp. Holding Corp. Sec. Litig.***, 2015 WL 4931357 (S.D.N.Y. Aug. 19, 2015), *report and recommendation adopted by* 2015 WL 5255469 (S.D.N.Y. Sept. 9, 2015); *see also* ***FHFA v. Nomura Holding Am., Inc.***, 104 F. Supp. 3d 441 (S.D.N.Y. 2015). Other courts have analyzed challenged opinions separately under both *Omnicare*'s omissions framework and their Circuit's "subjective belief" precedent for Rule 10b-5 claims. *See, e.g.*, ***In re BioScrip, Inc. Sec. Litig.***, 95 F. Supp. 3d 711 (S.D.N.Y. 2015); ***In re Genworth Fin. Inc. Sec. Litig.***, 103 F. Supp. 3d 759 (E.D. Va. 2015). In the coming year, circuit courts will likely refine and incorporate the *Omnicare* analysis into their Rule 10b-5 precedent for challenged statements of opinion or belief.

District courts have also begun to apply *Omnicare*'s omissions inquiry by evaluating whether challenged opinions or beliefs were "misleading to a reasonable person reading the statement fairly and in context." ***In re Fairway***, 2015 WL 4931357, at *20 (quoting *Omnicare*); ***City of Westland***, 2015 WL 5311196, at *13. Some courts have focused on whether the alleged omissions indicate that the challenged statement of opinion or belief did not "rest on some meaningful inquiry." ***City of Westland***, 2015 WL 5311196, at *13; ***Starr***, 2015 U.S. Dist. LEXIS 125202, at *26-27. Other courts have analyzed whether the defendant was in possession of facts that did not "fairly align" with the expressed opinion. ***In re Merck***, 2015 WL 2250472, at *20 (involving opinion that a favorable hypothesis was the "likeliest" explanation for certain test results); *see also* ***Nomura***, 104 F. Supp. 3d at 565-66 (noting that "defendants were aware of information contradicting the representations").

At the pleading stage, lower courts recognize that *Omnicare* requires plaintiffs to offer more than "conclusory allegations" or recitations of the "statutory language" to challenge a statement of opinion or belief under an omissions theory. To survive a motion to dismiss, plaintiffs must identify "particular (and material) facts going to the basis for the issuer's opinion" that were omitted. ***City of Westland***, 2015 WL 5311196, at *12 ("That is no small task for an investor.") (quoting *Omnicare*). Courts have dismissed omissions claims where plaintiffs failed to meet this requirement. *See, e.g.*, ***In re Fairway***, 2015 WL 4931357, at *20 ("In context, the 'excluded facts' do not show that defendants 'lacked the basis for making the[ir] statements that a reasonable investor would expect.'"); ***In re Velti***, 2015 WL 5736589, at *19-26; ***City of Westland***, 2015 WL 5311196, at *20 (finding that plaintiff had not adequately alleged that defendant "omitted to state a fact (or facts) necessary to prevent its view . . . from misleading reasonable investors reading the Company's financial statements fairly and in context"). *Omnicare*'s pleading standard for omissions claims has not proved insurmountable for plaintiffs, however. *See, e.g.*, ***In re BioScrip***, 95 F. Supp. 3d at 730-31 (denying motion to dismiss where company expressed opinions about legal compliance without disclosing that it had received an information request from the government); ***In re Genworth***, 2015 WL 2061989, at *15 ("Plaintiffs have adequately pled that these excluded facts illustrate that Defendants lacked the basis for making their alleged misrepresentations.").

Courts also had an opportunity in 2015 to apply *Omnicare* at the summary judgment stage. Because the omissions analysis depends heavily on context, some plaintiffs have been able to point to genuine disputes of fact to survive summary judgment. *See* ***In re Merck***, 2015 WL 2250472, at *21 ("The record contains evidence upon which a reasonable jury could conclude that Defendants not only lacked support for this assertion of belief but, additionally, knew that it did not 'fairly align' with other information in their possession."); ***Starr***, 2015 U.S. Dist. LEXIS 125202, at *38 (evidence would permit a jury to infer that defendant "had information in hand" that was not consistent with the challenged opinion.). For securities fraud defendants, these cases highlight the importance of challenging alleged omissions at the pleading stage.

One overarching trend from these cases is clear: *Omnicare* is joining the pantheon of landmark securities litigation decisions issued by the Roberts Court. As plaintiffs challenge more statements of opinion or belief in securities suits, courts will have more opportunities in the coming years to apply and develop *Omnicare*'s framework outside Section 11.

The omissions analysis under *Omnicare* depends heavily on context.

# II. Class Certification Issues: Applying *Halliburton II* and Beyond

Our 2014 Year in Review began with a discussion of the Supreme Court's decision in *Halliburton II*. In 2015, federal district court judge Barbara Lynn considered the next chapter of the "long and winding history" of the *Halliburton* case. *See* ***Erica P. John Fund, Inc. v. Halliburton Co.***, 309 F.R.D. 251, 255 (N.D. Tex. 2015). Other federal courts in 2015 also began to flesh out the contours of *Halliburton II* and continued to apply the Supreme Court's *Comcast* decision from two years ago.

## A. HALLIBURTON II

### 1. BACKGROUND

A plaintiff's reliance on a defendant's misrepresentation is an essential element in private federal securities fraud claims. However, requiring direct proof of reliance in class actions alleging securities fraud would make individual issues of reliance overwhelm the common ones, thereby making it impossible to satisfy the predominance requirement for class certification. In 1988, the Supreme Court in *Basic Inc. v. Levinson* considered this dilemma and held that investors could prove reliance in a federal securities fraud class action by invoking a presumption that the price of stock, traded in an efficient market, reflects all public, material information – including material misstatements. *See* 485 U.S. 224, 246-47. In such a case, investors who buy or sell the stock at the market price may be presumed to have relied on the misstatements. *See id.* at 247. This is known as the fraud-on-the-market presumption of reliance. The Court in Basic also held that a defendant could rebut this presumption in a number of ways, including by showing that the misstatements did not actually affect the stock's price. *See id.* at 248.

*Halliburton* has twice been before the Supreme Court on issues related to the Basic presumption of reliance in the context of class certification. In *Halliburton I*, the Supreme Court held that the element of loss causation need not be proved at the class certification stage. *See Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 804, 131 S. Ct. 2179, 2183-86 (2011). The Court observed that it had "never before mentioned loss causation as a precondition for invoking *Basic's* rebuttable presumption of reliance" and that "[l]oss causation addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock." *Id*. at 2186. The Supreme Court similarly held in *Amgen, Inc. v. Connecticut Retirement Plans and Trust Funds*, that proof of materiality is not required at the class certification stage, given that "the question of materiality is common to the class." 133 S. Ct. 1184, 1197 (2013). The Court found that Amgen's attempt to disprove materiality "[was] properly addressed at trial or in a ruling on a summary judgment motion." *Id*.

In *Halliburton II*, the Supreme Court declined a request to abandon the fraud-on-the-market presumption but held that defendants may rebut the presumption at the class certification stage by showing that the alleged misrepresentations did not impact the stock price. *See Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2407-17 (2014). The Court vacated the judgment of the Fifth Circuit and remanded the case for further proceedings. *See id*. at 2417.

### 2. JUDGE LYNN'S DECISION ON REMAND FROM *HALLIBURTON II*

On remand at the district court in *Halliburton*, "the parties . . . submitted event studies, *i.e.*, regression analyses, to show that Halliburton's stock price was, or was not, affected on days when an alleged misrepresentation or corrective disclosure reached the market." *Halliburton*, 309 F.R.D. at 257. Judge Lynn considered "the competing methodologies of the parties' experts" and found that Halliburton had shown a lack of price impact for five of the six corrective disclosures alleged by the plaintiff. *See Halliburton*, 309 F.R.D. at 262-80. Accordingly, the court denied the plaintiff's motion for class certification except as to the single corrective disclosure regarding asbestos liabilities for which Halliburton had failed to rebut the fraud-on-the-market presumption. *Id.* at 254, 276-280.

Several of Judge Lynn's comments shed light on the contours of *Halliburton II*. First, the court placed both the burdens of production and persuasion to show lack of price impact on Halliburton rather than on the plaintiff. *See Halliburton*, 309 F.R.D. at 258-60. Halliburton had the burden to "ultimately persuade the Court that its expert's event studies [were] more probative of price impact than the [plaintiff's] expert's event studies." *Id*. at 260.

Second, the court held that Halliburton could not rebut the fraud-on-the-market presumption at class certification by showing that the alleged corrective disclosure was not, in fact, corrective. Judge Lynn found that "Halliburton's arguments regarding whether the disclosures were corrective [were], in effect, a veiled attempt to assert the 'truth on the market' defense, which pertains to materiality and is not properly before the Court at this stage of the proceedings." *Id*. at 260-61 (citations omitted). Based on *Halliburton I, Amgen and Halliburton II*, the court found that "class certification is not the proper procedural stage . . . to determine, as a matter of law, whether the relevant disclosures were corrective." *Id*. at 260 (citations omitted).

Judge Lynn's decision on remand from *Halliburton II* illustrates that class certification will remain a major battleground in securities fraud cases and will typically involve competing expert reports and event studies on the question of price impact.

## 3. PENDING FEDERAL APPEALS REGARDING THE APPLICATION OF *HALLIBURTON II*

The Fifth Circuit recently granted Halliburton's motion for leave to appeal Judge Lynn's rulings on the burden of persuasion and whether a court may consider whether the alleged corrective disclosure was actually corrective. *See* ***Erica P. John Fund, Inc. v. Halliburton Co.***, No. 15-90038, 2015 BL 369058, at *1 (5th Cir. Nov. 04, 2015). Judge James Dennis of the Fifth Circuit "reluctantly concur[red]" in granting Halliburton leave to appeal but expressed skepticism regarding Halliburton's argument. *See id*. at *1-4. In addition, in October 2015, the Eighth Circuit in ***IBEW Local 98 Pension Fund v. Best Buy Co.*** heard oral arguments in the appeal of a federal district court's class certification rulings on price impact and whether the alleged corrective disclosures were actually corrective. *See* No. 14-3178 (8th Cir. Oct. 22, 2015). The Fifth and Eighth Circuits' determination of these pending appeals will shed additional light on the utility of defendants' ability under *Halliburton II* to rebut the fraud-on-the-market presumption at the class certification stage.

## 4. FEDERAL DISTRICT COURT CASES APPLYING *HALLIBURTON II*

Several federal district courts also issued decisions in 2015 that reveal several key principles regarding the application of *Halliburton II*. For example, in ***In re Bridgepoint Education, Inc. Securities Litigation***, the district court rejected a "truth-on-the-market" defense at the class certification stage. *See* No. 12-cv-1737 JM (JLB), 2015 WL 224631, at *7 (S.D. Cal. Jan. 15, 2015) (Miller, J.). The defendants had argued that the second of two alleged corrective disclosures was unrelated to the purported fraud, and therefore the class period should end on the date of the first corrective disclosure. *See id.* The court considered this to be a

> Pending appeals will shed light on defendants' ability to rebut the fraud-on-the-market presumption at class certification.

"truth-on-the-market" defense and noted that "*Halliburton* did not change" the rule that "a truth-on-the-market defense cannot be used to rebut the presumption of reliance at the class-certification stage." *Id*. The court left open that it could shorten the class period at a later stage of the case if it were later shown that the presumption of reliance did not apply after the first corrective disclosure. *See id.*

In ***Carpenters Pension Trust Fund of St. Louis v. Barclays PLC***, the court found that defendants "ignore[d] the Supreme Court's invitation [in *Halliburton II*] to offer their own evidence to prove lack of price impact" and instead challenged price impact based on the event studies and testimony of the plaintiffs' expert. *See* 310 F.R.D. 69, 94 (S.D.N.Y. 2015) (Scheindlin, J.). The plaintiffs' theory was that the allegedly false statements "artificially maintained the stock price, not that they artificially inflated the price of the stock." *Id.* at 95. Thus, the purported failure of the plaintiffs' event study "to show statistically significant price movements on the days" in which the alleged false statements were made "[did] not necessarily sever the link between" the alleged misrepresentations and "'the price received (or paid) by the plaintiff[s.]'" *Id*. In sum, the defendants' failure to "present[] compelling evidence of lack of price impact" relieved the plaintiffs of the burden "to present evidence of price impact." *Id*. at 97. The court found that the plaintiffs were "entitled to rely on the *Basic* presumption of reliance" and granted their motion for class certification. *Id*. at 97, 100.

In ***In re Goldman Sachs Group, Inc. Securities Litigation***, "there [was] no real dispute concerning the market efficiency for Goldman's stock," and the court found that "[d]efendants . . . failed to demonstrate a complete lack of price impact." No. 10-cv-3461 (PAC), 2015 WL 5613150, at *6 (S.D.N.Y. Sep. 24, 2015) (Crotty, J.), *appeal filed* (2nd Cir. Oct. 8, 2015). The district court therefore granted the plaintiffs' motion for class certification. *Id*. at 8. The plaintiffs alleged that Goldman's purported misstatements and omissions "were revealed as untrue" through a series of corrective disclosures announcing SEC and DOJ "investigations and enforcement actions against Goldman," which triggered a "decline in Goldman's stock price." *Id*. at *1. The defendants failed to show "the *total* decline in the stock price on the corrective disclosure dates [was] attributable simply to the market reaction to the announcement of enforcement actions and not to the revelation to the market that Goldman had made material misstatements about its conflicts of interest policies and business practices." *Id.* at *6 (emphasis added). In other words, "whether or not the market was focused to some degree on the impact the enforcement actions would have on the stock price does not mean that no decline in stock price is attributable to the revelation of misstatements." *Id*. at *7.

In ***In re Vivendi Universal, S.A. Securities Litigation***, the defendant succeeded in making an "individualized rebuttal" of the fraud-on-the-market presumption. *See* __ F. Supp. 3d __, No. 02-cv-5571 (SAS), 2015 WL 4758869, at *8-11 (S.D.N.Y. Aug. 11, 2015) (Scheindlin, J.). After a jury verdict in favor of the class, the district court permitted the defendant, Vivendi, to conduct discovery to attempt to rebut the presumption of reliance as to individual class members. *Id*. at *1. This discovery revealed that an institutional asset manager, which had exercised full investment discretion on behalf of a group of class members, was itself indifferent to the fraud. *Id*. at *1, 3, 8-11.

The court in ***Vivendi*** noted that "*Halliburton II* did not disturb a central holding of *Basic*: that '[a]ny showing that severs the link between the alleged misrepresentation and . . . [the plaintiff's] decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance.'" 2015 WL 4758869, at *10. The court granted summary judgment for Vivendi on the claims submitted by the asset manager and its clients, finding that the link had been severed with respect to these class members. *Id*. at *1, 10-11. The court observed that a plaintiff's "successful[] navigat[ion]" of "the choppy waters of class certification on a sturdy ship named *Basic* does not guarantee safe passage for the rest of the journey." *Id*. at *9

## B. APPLYING COMCAST TO FEDERAL SECURITIES CASE

In *Comcast Corp. v. Behrend*, the Supreme Court held that the predominance requirement was not met in a proposed antitrust class action in which the plaintiffs' damages model did not attempt to identify the damages attributable to the plaintiffs' only viable theory of liability. *See* 133 S. Ct. 1426, 1433-35 (2013). Following *Comcast*, federal courts agree that a class plaintiff's measure of damages must match its theory of liability to satisfy the predominance requirement. Federal courts have differed, however, as to whether *Comcast* requires a class-wide damages methodology.

The Fifth Circuit in 2015 applied *Comcast* in the context of a federal securities class action. *See* ***Ludlow v. BP, P.L.C.***, 800 F.3d 674 (5th Cir. 2015). The case arose from the 2010 Deepwater Horizon oil spill. *See id.* at 678. The plaintiffs, shareholders of BP, alleged the company made two series of misrepresentations: "one series regarding [BP's] pre-spill safety procedures, and one regarding the flow rate of the oil after the spill occurred." *Id*. at 677. The district court certified the post-spill class, concluding the plaintiffs had shown "a model of damages consistent with their liability case and capable of measurement across the class." *Id*. However, the district court refused to certify the pre-spill class, concluding "the plaintiffs had not satisfied *Comcast's* common damages burden." *Id*. The Fifth Circuit affirmed. *Id*.

### CERTIFICATION OF POST-SPILL CLASS

Regarding plaintiffs' post-spill class, their damages expert had used an "out-of-pocket losses" measure based on a "corrective disclosure methodology to proxy the inflated stock price." *Ludlow*, 800 F.3d at 683-685. Plaintiffs relied on a theory that the artificial inflation in BP's stock price was exposed when "six corrective events" brought the "true" information to the market's attention. *Id*. at 680, 687. BP challenged the adequacy of the nexus between these corrective events and the underlying misstatements. *See id*. at 686-87. The Fifth Circuit cited *Amgen* in affirming the district court's refusal to resolve BP's challenge at the class certification stage, noting that "the question of whether certain corrective disclosures are linked to the alleged misrepresentations . . . is undeniably common to the class, and is 'susceptible of a class-wide answer.'" *Id*. at 688 (citing *Amgen*, 133 S. Ct. at 1196).

The Fifth Circuit similarly held the district court did not abuse its discretion in not requiring the plaintiffs to prove at the class certification stage "that all of the corrective events measured the effect of the misrepresentation, rather than the spill itself." *Ludlow*, 800 F.3d at 688. The Fifth Circuit noted "[t]he core dispute" was about "the 'fit' between the corrective events and the misstatements," which "is a question common to the class" that does "not require proof at the certification stage." *Id.* To conclude otherwise would "require bringing forward the plaintiff's proof of loss causation," in violation of "*Halliburton I*'s requirement that loss causation need not be proved at this stage." *Id*. The Fifth Circuit also noted that the plaintiffs' damages methodology allowed for the removal of any corrective events later found to not "correct" the misrepresentations, which is "what *Comcast* requires at this stage." *Ludlow*, 800 F.3d at 689.

### REFUSAL TO CERTIFY PRE-SPILL CLASS: REJECTION OF "MATERIALIZATION OF THE RISK" THEORY

Regarding the pre-spill class, the plaintiffs' damage theory was "'based on [a] materialization of the risk theory,'" in which the "'investors are harmed by [ ] corrective events that represent materializations of the risk that was improperly disclosed.'" *Ludlow*, 800 F.3d at 689 (internal quotation marks omitted). The Fifth Circuit framed the question as "whether a damages model based on this theory is 'susceptible of measurement across the entire class for purposes of Rule 23(b)(3),' as required by *Comcast.*" *Id.* at 690. It held the district court did not abuse its discretion in concluding the pre-spill damages theory was incapable of class-wide determination. *Id.* "That theory hinges on a determination that each plaintiff would not have bought BP stock *at all* were it not for the alleged misrepresentations—a determination not derivable as a common question, but rather one requiring individualized inquiry." *Id.* (emphasis in original).

The Fifth Circuit noted that some risk-averse investors may not have bought BP stock at all had they known of the true risk of a catastrophe, while others still may have purchased the stock, even had they known of the "true" risk, albeit for a "lower price that accounted for the increased risk." *Ludlow*, 800 F.3d at 690. The plaintiffs' damages model "[did] not provide any mechanism for separating these two classes of plaintiffs," and therefore it "[could not] provide an adequate measure of class-wide damages under *Comcast*." *Id.* It also "presume[d] substantial reliance on factors other than price, a theory not supported by *Basic* and the rationale for [the] fraud-on-the-market theory." *Id.* at 691.

In *Ludlow* the Fifth Circuit applied *Comcast* in a securities case.

## III. Loss Causation

Plaintiffs are required to show loss causation, the causal relationship between an alleged material misrepresentation and a shareholder's economic loss when the truth is revealed to the market. The Supreme Court did not address this requirement in 2015, but several circuit and district courts in the Second, Seventh, Ninth, and Tenth Circuits did issue rulings on loss causation that tended to be favorable for plaintiffs.

In ***Financial Guaranty Insurance Co. v. The Putnam Advisory Co.***, 783 F.3d 395 (2d Cir. 2015), the Second Circuit reversed a district court's dismissal of the Financial Guaranty Insurance Company's ("FGIC") suit against Putnam Advisory Company, LLC ("Putnam") alleging fraud relating to Putnam's management of a collateralized debt obligation ("CDO") called Pyxis. FGIC alleged that Putnam gave control of significant aspects of the Pyxis CDO to a hedge fund, Magnetar Capital LLC ("Magnetar"), that held a substantial short position in Pyxis such that Magnetar stood to profit millions of dollars in the event that Pyxis failed. FGIC alleged that Putnam made misrepresentations regarding the delegation to Magnetar and that if Putnam had disclosed the extent of Magnetar's involvement, FGIC would not have engaged in the transaction. Furthermore, FGIC alleged that Magnetar's CDOs defaulted more frequently and much more quickly than comparable CDOs. The district court held that FGIC failed to plead loss causation because in light of the market-wide downturn, FGIC could not show that it would have been "spared all or an ascertainable portion of the loss absent the fraud." But the Second Circuit disagreed, finding that by alleging that Magnetar's assets defaulted more frequently and more quickly than other CDOs, FGIC raised a reasonable inference that Magnetar's involvement caused an ascertainable portion of the loss.

Shortly after its decision in Putnam, the Second Circuit took another look at loss causation and reaffirmed its plaintiff-friendly stance in ***Loreley Fin. (Jersey) No. 3 Ltd. v. Wells Fargo Sec., LLC***, 797 F.3d 160 (2d Cir. 2015). The factual bases of *Loreley* were very similar to *Putnam*: plaintiff investors in three CDOs alleged that defendants represented that independent managers would make important decisions for the CDOs while in fact defendants permitted entities with substantial short positions in the CDOs to make those decisions. Not surprisingly, the Second Circuit again ruled that plaintiffs had adequately alleged loss causation. Judge

Calabresi went on to articulate a lower bar for survival of a 12(b)(6) motion to dismiss for failure to allege loss causation: "It is sufficient under Rule 12(b)(6) that the allegations themselves give Defendants 'some indication' of the risk concealed by the misrepresentations that plausibly materialized in Plaintiffs' ultimately worthless multimillion-dollar investment in these CDO notes." 797 F.3d at 188-89. Together, *Putnam* and *Loreley* suggest that, at least at the pleading stage, a market-wide financial crisis will not provide a basis for dismissal of plaintiffs' securities fraud claims in the Second Circuit.

In ***Glickenhaus & Co. v. Household Int'l, Inc.***, 787 F.3d 408 (7th Cir. 2015), the Seventh Circuit generally approved of the plaintiff's use of a leakage model to prove loss causation and damages. The leakage model at issue estimated the true value of the stock using historical data and data from the S&P 500 and the S&P Financials Index. Rather than measure the purported artificial price inflation based on the stock price declines that occurred following specific negative disclosures, as is typical in plaintiff's damages models, the leakage model attributed all the difference between the predicted value and actual value of the stock during the disclosure period to the alleged fraud and calculated damages accordingly. This method purportedly has the ability to handle situations where disclosures are gradually made public over a period of time better than traditional models. The defendant argued that several corresponding weaknesses rendered the model legally insufficient. The Seventh Circuit rejected defendants' fundamental challenge to the model: that it impermissibly attributed the full inflation amount to fraud despite evidence that the price only increased by a small percentage of the inflationary amount on the date of the misrepresentation. The court did remand, however, to correct for two inadequacies in the specific application of the leakage model: first, because both plaintiffs and defendants failed to develop a sufficient record regarding the expert's treatment of firm-specific, non-fraud effects, which could undermine the results, and second, because the jury was instructed to use the inflation amount starting on the first date of a material misrepresentation, not on the first date when misrepresentations on all material subjects had been made. Despite the remand, *Glickenhaus* represents an important decision accepting a leakage disclosure model, even in light of their inherent limitations. Leakage models have not historically been accepted by courts in securities fraud cases, and if that changes, it could represent a major increase in the potential liability for defendants.

The Tenth Circuit found that a plaintiff had met its 12(b)(6) burden to allege loss causation in ***Nakkhumpun v. Taylor***, 782 F.3d 1142 (10th Cir. 2015). The plaintiff alleged that the defendant misled investors about the true reason for termination of a potential transaction when the defendant announced the potential buyer was unable to arrange financing. The plaintiff claimed the true reason was that the potential buyer valued the company's assets at far less than the $400 million that had previously been announced. Although defendants argued that plaintiff failed to show when the truth was revealed to the market, the Tenth Circuit disagreed and accepted plaintiffs' theory that the allegedly concealed risk (that the company's assets were not worth $400 million) materialized when the market learned that company was unable to find another buyer. The court's acceptance of this disclosure as a materialization of the risk is significant because it has a looser nexus with the original misrepresentation than is typical in many securities fraud cases.

> Loss causation continues to be a heavily-litigated battleground.

In ***Smilovits v. First Solar, Inc.***, 2015 U.S. Dist. LEXIS 105355 (D. Ariz. Aug. 10, 2015), a district court in Arizona analyzed two competing Ninth Circuit tests for establishing loss causation. The plaintiff alleged that the defendant company misrepresented and failed to disclose the extent of its exposure resulting from flaws in its manufacturing process. The district court analyzed the *Nuveen* test finding loss causation when "the loss was due to the very facts that were misrepresented" and the *Metzler* test under which "the complaint must allege that the practices that the plaintiff contends are fraudulent were revealed to the market and caused the resulting losses … that the market learned of and reacted to [the] fraud, as opposed to merely reacting to reports of the defendant's poor financial health generally." The court concluded that it should apply the less restrictive *Nuveen* test and found that the plaintiff adequately alleged loss causation, but also certified the issue for interlocutory appeal. This appeal is currently pending before the Ninth Circuit. If the Ninth Circuit upholds the district court's decision, it will continue the general trend towards less restrictive standards for loss causation.

Together, these 2015 loss causation cases suggest a trend of courts focusing less on specific corrective disclosures, which would make it more difficult for defendants to achieve early dismissal on loss causation grounds.

# IV. Scienter

An essential element of a securities fraud claim under Section 10(b) and Rule 10b-5 is scienter — the mental state to deceive, manipulate, or defraud. To sufficiently plead scienter, a plaintiff is required to state with *particularity* facts giving rise to a "strong inference" of the requisite mental state – at least deliberate or severe recklessness. A strong inference arises when the inference of scienter is at least as compelling as any plausible, opposing inference that the court must take into account. In 2015 we saw decisions from seven circuits shedding light on how scienter is and should be analyzed in those jurisdictions.

### FIRST CIRCUIT

In ***Fire & Police Pension Ass'n of Colo. v. Abiomed, Inc.***, 778 F.3d 228 (1st Cir. 2015), the First Circuit analyzed the materiality of alleged misleading statements as one indicator of scienter. The putative class alleged that a company failed to disclose that its top-selling product's revenue grew as a result of unlawful, off-label marketing.

The court held that the plaintiffs did not adequately plead scienter. The marginal materiality of the company's failure to attribute revenue growth to off-label marketing weighed against a strong inference of scienter, especially because the company cautioned investors that the FDA might disagree with the legality of its marketing practices which would, in turn, adversely affect sales. Furthermore, the company told investors that the FDA was investigating it and that it could not promise a positive resolution.

Moreover, the court did not credit the plaintiffs' confidential witnesses. These witnesses did not describe particularized facts showing a strong inference of scienter. They also were not in management positions and had little interaction with senior executives. Thus, even if the witnesses did provide facts from which improper activity could be inferred, they did not suggest it was done with intent. The plaintiffs' allegations of insider trading also did not support scienter because the plaintiffs showed neither an unusual nor suspicious pattern of trading, and the trading did not personally benefit the defendants.

In the end, the court held that the company's marketing was risky and likely to prompt FDA investigation—as it did. But this was not enough to show intent to defraud because the plaintiffs premised their case on securities fraud, not FDA violations.

## SECOND CIRCUIT

In ***Employees' Ret. Sys. v. Blanford***, 794 F.3d 297 (2d Cir. 2015), the plaintiffs adequately pleaded scienter where strong circumstantial evidence showed the company's intent to deceive or defraud investors. Defendants allegedly concealed excess inventory while assuring investors the company had positive business performance and growth prospects and appropriate inventory levels. Thereafter, the executives prospered from increasing stock prices by strategically selling their shares to realize significant personal gain. Even though the executives entered into pre-determined 10b5-1 trading plans, they did so during the relevant time period, not before it, allegedly knowing that the stock sales would correspond to the misleading statements. Thus, plaintiffs showed defendants' motive and opportunity to commit fraud, as well as strong circumstantial evidence of such intent.

In ***Acticon AG v. China N. E. Petroleum Holdings Ltd.***, 615 F. App'x 44 (2d Cir. 2015), a former CEO had financial motive and opportunity to commit fraud because of the personal and concrete benefit he received from the alleged fraud. He signed all relevant SEC filings attesting to adequate internal controls while simultaneously stealing company money. The court imputed the CEO's scienter to the company. On the other hand, the plaintiffs could not show scienter for the remaining defendants, corporate directors and officers, under the recklessness standard. The defendants' alleged failure to identify defects in the company's internal controls and errors in the company's accounting statements did not demonstrate severe recklessness, especially without particularized facts showing fraudulent intent.

Alleged violations of subjective GAAP concepts are less likely to give rise to an inference of scienter.

## FOURTH CIRCUIT

The Fourth Circuit found a strong inference of scienter due to a company's failure to disclose damaging information in ***Zak v. Chelsea Therapeutics Int'l, Ltd.***, 780 F.3d 597 (4th Cir. 2015). The plaintiffs alleged that the company made materially misleading statements and omissions regarding the likely regulatory approval of a new drug. The company chose to reveal to investors select, less damaging information about the FDA's possible approval of the drug. At the same time, it did not disclose additional information about the FDA's critical view of the drug. This selective disclosure made the statements incomplete and misleading, which supported a strong inference of scienter.

The Fourth Circuit clarified that the mere failure to disclose information does not create a strong inference of scienter on its own; rather, the court must assess scienter relating to omissions within the context of the statements that a defendant affirmatively makes.

## FIFTH CIRCUIT

In ***Owens v. Jastrow***, 789 F.3d 529 (5th Cir. 2015), the Fifth Circuit held that the plaintiffs' circumstantial evidence did not create a strong inference of scienter absent particularized facts of severe recklessness.

The court addressed several procedural issues at the outset. First, the inquiry is whether all allegations taken collectively show scienter, not whether individual allegations scrutinized in isolation do. Nevertheless, the Fifth Circuit affirmed the district court's two-step method of analyzing scienter: analyzing each allegation individually to see whether it contributed to an inference of scienter, and then concluding whether the allegations as a whole raised the requisite inference.

Next, the court reiterated its rejection of the group pleading doctrine. Under the PSLRA, scienter allegations against defendants as a whole are impermissible; plaintiffs must specifically plead individualized allegations for each defendant. Yet, dismissal was not warranted because this was not a case where plaintiffs made no attempt to make specific allegations. Instead, the court held it could disregard group-pleaded allegations and determine whether the remaining, properly pleaded allegations created a strong inference of scienter for each defendant.

As to the substantive issues, the plaintiffs alleged that the defendants made materially false and misleading statements regarding the company's assets. The plaintiffs claimed that the defendants had knowledge of the company's undercapitalization; that the company continued to rely on an inaccurate valuation method despite internal warnings and a large misstatement; and that the defendants signed the SEC filings in question.

The court held that these inferences were not strong enough to prove scienter, especially given the competing ones. The defendants, for example, disclosed the various red flags alleged by the plaintiffs and also told investors that its valuations were uncertain. Furthermore, although the magnitude of the accounting errors was large, its inference of scienter was small because they involved subjective concepts under GAAP. Moreover, the defendants relied on AAA ratings and believed that its internal models were accurate, even if they did so negligently. In sum, the plaintiffs' allegations did not give rise to a strong inference of scienter that was at least as likely as the alternative inferences of admittedly negligent conduct.

## NINTH CIRCUIT

The Ninth Circuit addressed what it described as an issue of first impression in ***Costa Brava P'ship III LP v. ChinaCast Educ. Corp.***, 2015 U.S. App. LEXIS 18462 (9th Cir. Oct. 23, 2015): whether the court can impute an executive's scienter to a company even if the executive's acts were adverse to the company's interests. In the case, all parties agreed that a CEO committed securities fraud with scienter: he embezzled millions of dollars from the company and misled investors through false statements. Although the actions of a corporate agent are usually imputed to the company when acting within the scope of employment, the question was whether the adverse interest exception applied. This exception bars imputation when a rogue agent acts adversely to the principal's interests.

The court held it could impute the CEO's scienter to the company. The CEO acted with apparent authority on behalf of the corporation so his scienter was imputed to the company, his principal, under the law of agency. More importantly, the adverse interest exception did not apply even though the CEO's conduct was adverse to the company's interest. The court held that, similar to other circuits, the exception does not apply and scienter is imputed to the corporation when necessary to protect the rights of innocent third parties. Here, innocent shareholders relied on the CEO's representations. The court importantly noted that the adverse interest exception will rarely apply in private securities fraud cases because the plaintiffs—shareholders—are usually innocent third parties. The court explained that its narrow view of the adverse interest exception supports the policy goals of deterring fraud and promoting confidence in the securities markets.

## TENTH CIRCUIT

In three decisions this year, the Tenth Circuit reiterated that plaintiffs must plead with particularity facts giving rise to a strong inference of scienter under the PSLRA's heightened standards.

In ***Banker v. Gold Res. Corp.***, 776 F.3d 1103 (10th Cir. 2015), the court held that the defendants' overbilling issues, misleading profit statements, and GAAP violations did not, on their own, raise a strong inference of scienter. There must be specific factual allegations of fraudulent intent. And other facts created plausible, opposing inferences. Regarding overbilling, the company's employees delayed disclosing the overbilling issues to executives, the executives wanted to investigate the matter before publicly reporting it, and the buyer contracted to pay the amounts in question. Moreover, the plaintiffs' allegation that the defendants concealed severe production problems did not create a strong inference of scienter. The defendants issued cautionary statements to investors explaining the volatile and unpredictable nature of mining operations. This opposing inference was as plausible as plaintiffs' inferences of scienter.

Several months later, in ***Nakkhumpun v. Taylor***, 782 F.3d 1142 (10th Cir. 2015), the court held that two defendants lacked scienter but that one possessed it.

The Chairman of the Board acted with scienter when misleading investors as to the true reason why a deal to sell some of its assets fell through. The Chairman said that the other party lacked adequate financing, while the real reason was that the other party believed the company's assets were worth less than the asking price. The court held that scienter allegations may suffice without a motive to commit securities fraud. The Chairman argued he made the statements to entice prospective buyers and maximize shareholder value, not mislead shareholders. Even so, he recklessly disregarded the likelihood of misleading shareholders into thinking the assets were more valuable than they actually were. Furthermore, because the Chairman chose to affirmatively explain why the deal terminated, rather than simply saying that it had, he assumed a duty to fully disclose all material facts and not mislead investors.

As to the other two defendants, executives at the company, they lacked scienter in making an alleged misleading statement about the company's liquidity. The executives spoke about indicia of liquidity in publicly filed earnings data. Although it was "overly rosy" and the executives should have known the company's financial condition was poor, the executives made the statements with sincerity and without intent to deceive or recklessness.

In the final case, ***Swabb v. Zagg, Inc.***, 797 F.3d 1194 (10th Cir. 2015), the former CEO and Chairman did not act with scienter in failing to disclose that he had pledged half of his company shares as collateral in a margin account. His reporting violation and signature of certification was insufficient to show knowledge that he omitted a required disclosure—and his position did not, on its own, impute such knowledge. Moreover, the officer's forced resignation and the company's subsequent policy change prohibiting pledging shares in margin accounts did not show an *earlier* intent to defraud. Lastly, the plaintiffs could not show that the defendant had a motive to conceal the margin account; he disclosed it to the SEC after each margin call. Although the plaintiffs' allegations were all relevant to an inference of scienter, the plaintiffs lacked particularized facts of intent required by the PSLRA. The opposing inference, that the defendant lacked knowledge of the requirement, was more compelling.

## ELEVENTH CIRCUIT

In ***Brophy v. Jiangbo Pharms., Inc.***, 781 F.3d 1296 (11th Cir. 2015), the Eleventh Circuit held that a CFO's opposing inferences were more compelling than the plaintiffs' inferences of scienter in her misrepresentation of the company's cash balances.

The plaintiffs alleged that the court should infer scienter based on the CFO's position; her suspicious activity during the period in question, including her resignation and alleged obstruction of an internal investigation; the scope of the fraud; and certain red flags indicating fraud, such as an SEC investigation and weak internal controls.

The court held that these allegations did not create a strong inference of scienter. First, the plaintiffs relied wholly on circumstantial evidence and pleaded no particularized facts showing intent or recklessness. There were also several factual omissions that weakened any inference of scienter, such as an amount by which she overstated cash balances or how the alleged red flags should have alerted the CFO to the fraud. The court noted that any inference of scienter is diluted when drawn from predicate inferences lacking specific facts to back them up.

Dismissals can be won by pointing to competing inferences of nonfraudulent intent.

Lastly, the CFO alleged equally compelling competing inferences of no scienter. For example, she explained that she resigned for family reasons and that she continued to work part-time. And although she failed to turn over certain documents for the internal investigation, she also personally prepared many of the materials to aid in it. Moreover, she did not reside at the company's principal location and could not observe day-to-day operations, and she did not make any stock sales to profit from the alleged fraud.

Thus, the court found that plaintiffs' allegations did not create a strong inference of scienter and, at most, showed negligent behavior. The CFO propounded equally compelling competing inferences, and the plaintiffs failed to provide more particularized evidence of intent other than layers of circumstantial evidence.

## V. Duty to Disclose and Materiality

This past year saw several notable decisions regarding whether a defendant's alleged misstatements or omissions were material. Among those decisions, the Second Circuit in ***IBEW Local Union No. 58 Pension Trust Fund & Annuity Fund v. Royal Bank of Scotland Group, PLC***, 783 F.3d 383 (2d Cir. 2015), affirmed the dismissal of a putative securities class action brought against the Royal Bank of Scotland Group (RBS) for alleged false and misleading statements RBS made leading up to the 2008 mortgage crisis. Among the allegations, the plaintiffs alleged that RBS misrepresented its subprime exposure in December 2007 and falsely stated its obligation to conduct a Rights Issue related to a capital raise in April 2008. In affirming the dismissal of plaintiffs' claims with respect to the subprime exposure, the Second Circuit held the misstatement immaterial under factors identified in the SEC's Staff Accounting Bulletin No. 99 (SAB 99). The particular quantitative factor in play specified that a misstatement is presumptively immaterial if it involves less than 5% of a registrant's financial statement. Further, the court held that the plaintiffs failed to adequately plead sufficient facts to meet SAB 99's qualitative factors that could overcome this presumption of immateriality. With respect to the alleged false Rights Issue statements, the court held, among other things, that the statement was immaterial because a reasonable investor would not deem the alleged falsity "as having significantly altered the total mix of information made available." The decision is notable in that it confirms that defendants can seek dismissal of securities fraud claims on materiality grounds, which is often considered a highly factual inquiry more appropriate for summary judgment. Moreover, the decision demonstrates the applicability of the SEC's qualitative and quantitative factors to assess materiality, providing an additional tool for defendants at the motion to dismiss stage.

In another Second Circuit decision—***Stratte-McClure v. Morgan Stanley***, 776 F.3d 94 (2d Cir. 2015)—the court held that an issuer's alleged failure to comply with disclosure obligations under Item 303 of SEC Regulation S-K can give rise to Section 10(b) liability. Generally, Section 10(b) prohibits materially untrue statements and omissions of information that would be necessary to avoid misleading investors, but does not create an affirmative duty to disclose any and all material information. In this case, the court concluded that Morgan Stanley had a duty to disclose certain long positions it took in 2007 on collateralized debt obligations as a "known trend or uncertainty" under Item 303. Although the Item 303 violation in ***Stratte-McClure*** was sufficient to impose Section 10(b) liability, the court clarified that not all Item 303 violations can create such liability because Item 303's materiality standard is not as onerous as the materiality standard under Section 10(b). Notably, this decision directly conflicts with the Ninth Circuit's decision in ***In re Nvidia Corp. Securities Litigation***, 768 F.3d 1046 (9th

Cir. 2014), which concluded that Item 303 disclosure duties are not actionable in a Section 10(b) claim. Although ***Stratte-McClure*** was dismissed for failing to meet pleading standards, this decision potentially exposes issuers to increased Section 10(b) liability under the various general disclosure obligations outlined under Item 303.

In the Ninth Circuit—in ***In re Yahoo! Inc. Securities Litigation***, No. 12-17080, 2015 U.S. App. LEXIS 8050 (9th Cir. May 15, 2015)—the court affirmed the dismissal of a securities class action regarding certain alleged misstatements Yahoo! made about its stake in Chinese e-commerce giant, Alibaba Holding Group Ltd. The plaintiffs alleged that Yahoo! made two misrepresentations when it did not disclose estimates about the value of Alibaba's privately-held businesses and later when it did not disclose details about the value or fact of Alibaba's restructuring. In affirming the dismissal, the court held that the alleged misstatements regarding Yahoo!'s stake in Alibaba "neither stated nor implied anything regarding" the value of the company and that the alleged misstatements about Alibaba's restructuring—although less detailed—"was entirely consistent" with the actual facts. The court held that these statements did not "affirmatively create an impression of a state of affairs that differed in a material way from the one that actually existed." Consequently, the court held that the statements were immaterial and not actionable.

Two recent decisions involving the SEC and the DOJ also significantly touched upon the issue of materiality. In ***Flannery v. S.E.C.***, No. 15-1080, 2015 WL 8121647 (1st Cir. Dec. 9, 2015), the First Circuit vacated a SEC order imposing sanctions against two former employees of State Street Bank and Trust Company for alleged misstatements made to investors. Among the reasons for vacating the sanctions, the First Circuit found that a misstatement in a slide deck presented to investors was immaterial. The misstatement consisted of a slide representing the fund's typical allocation as 55% in a certain investment, when in fact the fund's investment was nearly 100%. Although the slide was deemed misleading by the court, the materiality showing was "marginal" because investors had numerous other avenues to obtain accurate information about the fund's actual allocation. For example, accurate information was available upon request and through fact sheets, a website, and financial statements. Moreover, the First Circuit concluded—based on expert testimony—that "a typical investor" would perform additional due diligence and not rely solely on a single slide in a twenty- slide presentation. According to the court, the inaccurate slide did not "significantly alter[] the 'total mix' of information made available" to investors.

In ***United States v. Litvak***, No. 14-2902-CR, 2015 WL 8123714 (2d Cir. 2015), the Second Circuit reversed the conviction of a securities broker for alleged misrepresentations he made about the prices paid for residential mortgage-backed securities (RMBS). In remanding the case for retrial, the court found that the district court improperly excluded expert testimony offered by the defendant concerning the "sophisticated valuation methods and computer model" institutional investors employ to determine pricing for RMBS. According to the court, this information could potentially lead a jury to reasonably conclude that the alleged misrepresentations about RMBS pricing was immaterial."

> Materiality can be a winning argument even at the dismissal stage.

The ***Flannery*** and ***Litvak*** decisions reflect that materiality is a viable issue for defendants to raise in cases brought by the DOJ or SEC. Moreover, these decisions support the continued use of expert testimony to determine what is material to the "actual" investors in a security.

# VI. Pleading Alleged Misstatements

Rule 10b-5(b) prohibits “mak[ing] any untrue statement of a material fact . . . in connection with the purchase or sale of a security.” In ***Janus Capital Group, Inc. v. First Derivative Traders***, 131 S. Ct. 2296 (2011), the Supreme Court adopted a narrow definition of who may qualify as the “maker” of an untrue statement of material fact. Specifically, in private suits, the Court held that the maker of an untrue statement is limited to “the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.” Under that definition, those who contribute to an untrue statement, but do not ultimately control the statement, are not subject to private 10b-5 liability. In 2015, courts continued to grapple with ***Janus***, and attempted to clarify both its definition of “maker” and its application.

In ***In re CytRx Corp. Securities Litigation***, No. 14-1956, 2015 U.S. Dist. LEXIS 91447 (C.D. Cal. July 13, 2015), the judge applied ***Janus*** to dismiss claims against the CytRx defendants because the claims lacked specific allegations about their level of control over the drafting and release of certain statements. The statements at issue were made in promotional articles *authored by* The DreamTeam Group marketing firm, but *edited and approved by* CytRx management. Plaintiffs argued that the CytRx defendants should be liable for these statements because it is enough, even after ***Janus***, to allege that the CytRx defendants made certain statements intending they be relayed to the public. In the alternative, the plaintiffs argued that the CytRx defendants should be liable for the statements because they had a duty to correct the misimpression created by them.

The court disagreed. Relying on ***Janus***, the judge found that these claims against the CytRx defendants should be dismissed for two reasons. First, the plaintiffs did not sufficiently allege that CytRx defendants “made” these statements as defined by Rule 10b-5(b). Plaintiffs did not point to “any allegations within the published DreamTeam articles that ‘clearly originated’ from or were controlled by any CytRx Defendant.” Rather, the plaintiffs merely alleged that the articles were drafted by DreamTeam writers, and then reviewed, edited, and approved by CytRx defendants prior to distribution. The court stated that “generalized control allegations are insufficient when DreamTeam employees drafted the articles, worked for a different company, and did not explicitly attribute any of their statements to the CytRx Defendants.” Without more specific allegations about the CytRx defendants’ level of control over the drafting and release of the published articles, the court could not discern whether the CytRx defendants had “ultimate authority” over the alleged false statements. Second, the CytRx defendants did not have a duty to “‘correct the misimpression created among investors’” by the statements in the articles if they did not “make” the statements in question. The court followed other courts in declining to “get around” ***Janus*** by finding that such a duty exists.

Generalized allegations of control will not suffice under *Janus*.

The Central District of California addressed ***Janus’s*** complexities again in ***Schaffer Family Investors, LLC v. Sonnier***, No. 2:13-cv-5814, 2015 U.S. Dist. LEXIS 106932 (C.D. Cal. Aug. 13, 2015). At issue were statements contained in emails sent to an agent and subsequently forwarded by that agent (on behalf of a principal) to the plaintiffs. Plaintiffs argued that the *agent* should be liable as the "maker" of the statements in the forwarded emails, but the court only agreed in part. The court agreed that the agent was properly charged as the "maker" of the statements in those forwarded emails that he allegedly first altered and then falsely attributed to the principal. However, the court stated that the inquiry as to those emails that were simply *accurately forwarded* by the agent according to the principal's instructions was a bit more complicated. Under the court's reading of ***Janus***, the court held that the agent was not liable as the "maker" of the statements in the unaltered, forwarded emails because he merely published the statements on behalf of the principal. According to the court, "[g]iven that [the agent] was allegedly . . . acting within the scope of his agency, it does not appear that [the agent] had control over the statement's contents or whether or how to communicate them" sufficient to give rise to liability as the "maker" under ***Janus***.

These cases indicate that in order to be a "maker" under ***Janus***, courts want to see active participation of some level in creation or alteration of the statement at issue, clarifying that generalized control allegations are not enough. Defining "maker" in such a narrow fashion may protect defendants who merely approved or forwarded a statement, but did not actively assist in its creation.

## JANUS'S APPLICATION TO SECTION 17

The Eleventh Circuit in ***SEC v. Big Apple Consulting USA Inc., et al.***, No. 13-11976 (11th Cir. April 9, 2015) refused to apply Janus's limitation on primary liability under Rule 10b5-(b) to claims arising under § 17(a)(2). At issue were statements appearing in certain CyberKey Solutions, Inc. press releases. The SEC alleged that in promoting CyberKey stock, Big Apple (CyberKey's marketing consultant) violated § 17(a) of the Exchange Act and aided and abetted violations of § 10(b) and SEC Rule 10b-5. At the conclusion of the SEC's case at trial, the defendants moved for judgment as a matter of law. The district court reserved ruling, and the defendants orally renewed their motion at the conclusion of their defense, adding that in light of ***Janus***, the § 17(a) claims should not have gone to the jury. The jury returned a verdict in favor of the SEC, and Big Apple appealed.

On appeal, Big Apple argued that ***Janus*** should apply because § 17(a)(2) is analogous to 10b-5. Therefore, because the defendants did not have "ultimate authority" over the press release content, they were not "makers" of material misstatements, and thus not liable under § 17(a). Big Apple based its argument that ***Janus*** should apply on the text of each of the two sections, which both prohibit untrue statements with one slight difference. Rule 10b-5 specifically prohibits the "making" of an untrue statement, whereas § 17(a)(2) merely states that it is unlawful for any person to obtain money or property *by means of* any untrue statement. The Eleventh Circuit focused on this slight difference, stating that they were persuaded by a First Circuit decision that found the text of § 17(a)(2) suggests "it is irrelevant for purposes of liability whether the seller uses his own false statement or one made by another individual." Further, the court stated that it agreed with the SEC's recent opinion holding that "'*Janus*'s limitation on primary liability under Rule 10b-5(b) does not apply to claims arising under § 17(a)(2),'" indicating that courts will follow the SEC guidance and will not extend ***Janus*** and its progeny outside of Rule 10b5-(b).

# VII. The PSLRA "Safe Harbor"

In 2015, courts continued to wrestle with what statements are covered under the PSLRA's safe harbor provision for forward-looking statements. Under the provision, a company is not liable if the forward-looking statement is identified as forward-looking and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.

Three circuit court decisions in 2015 analyzed the applicability of the safe harbor. In ***Julianello v. K-V Pharmaceutical Co.***, 791 F.3d 915 (8th Cir. 2015), the Eight Circuit concluded that certain challenged statements made by a defendant fell within the PSLRA's safe harbor for forward-looking statements and affirmed dismissal of the related securities fraud complaint. The defendant pharmaceutical company made statements to investors regarding the launch of a newly developed drug and its anticipated results. At issue in this case was whether those statements were actually "forward-looking." To make this determination, the court noted that the truth or falsity of the statements could only be determined after some future event occurred—*i.e.*, with the launch of the drug. The court, therefore, concluded that the statement was "forward-looking" under the safe harbor. Further, the court held that the cautionary language that accompanied the defendant's forward-looking statement was specifically tailored to the circumstances surrounding the launch of the defendant's drug. Consequently, the PSLRA's safe harbor did apply to the challenged statements.

Similarly, the Sixth Circuit in ***Pension Fund Group v. Tempur-Pedic International***, 614 Fed. App'x. 237 (6th Cir. 2015), upheld the dismissal of a putative securities class action brought against mattress manufacturer Tempur-Pedic International. The plaintiffs alleged that Tempur-Pedic and its executives issued rosy financial guidance without adequately disclosing diminishing sales growth and the risk of industry competition. The Sixth Circuit affirmed dismissal of plaintiffs' claim, concluding that Tempur-Pedic's statements fell within the PSLRA's safe harbor for forward-looking statements. Importantly, the court found that the guidance included warnings "about competitive risks and incorporated warnings in other SEC filings by reference," including warnings about the plaintiffs' central premise: "industry competition." According to the court, these statements "adequately disclosed the risk that Tempur-Pedic would fail to sustain its current rate of growth due to increased competition" by competitors. Moreover, the court held that these cautionary statements remained "meaningful" even though sales diminished prior to the issuance of the guidance because to "deny safe-harbor protection any time a plaintiff could show that a defendant perceived a general negative trend . . . would undermine the PSLRA's pro-disclosure objective." Notably, the court held that an earnings call in which Tempur-Pedic executives spoke of recent positive results did not obligate the company to "disclose all facts contributing to or undermining the company's recent successes"

In some circuits the harbor is not that safe.

because "[s]uch a rule would require almost unlimited disclosure on any conceivable topic . . . whenever an issuer released any kind of financial data."

In contrast to the rulings above, the D.C. Circuit in In ***In re Harman International***, 791 F.3d 90 (D.C. Cir. 2015), concluded that the PSLRA's safe harbor provision did not cover certain statements made by a defendant and revived a securities fraud class action complaint. In making this determination, the court found that several of the defendant's statements—in which the defendant touted it sales as "very strong"—were actionable because, among other things, the accompanying cautionary language was allegedly misleading, and therefore not meaningful. According to the court, "cautionary language cannot be meaningful if it is misleading in light of historical facts." In this case, the cautionary statements that accompanied the defendant's sales claims were allegedly misleading because they did not reveal the defendant's then-growing inventory of obsolete products that posed a risk to the company's business. The court's conclusion was reinforced in light of the fact that the "cautionary statements remained unchanged despite a significant change in circumstances of material importance to an investor." Instead, the defendant "rel[ied] on the same general prefatory language" which "belies any contention that the cautionary language was tailored to the specific future projection." Accordingly, the defendant's statements were not entitled to safe harbor protection. The defendants in ***Harman*** have filed a petition for writ of certiorari asking the Supreme Court to address two questions regarding the safe harbor: "1. Whether a purported misrepresentation is sufficient to preclude safe harbor protection?" and "2. Whether courts can consider an issuer's alleged knowledge to determine whether cautionary statements are 'meaningful'?"

These rulings should serve as a reminder to companies to tread carefully when making forward-looking statements. At least some courts will refuse to apply the "safe harbor" where a company's cautionary language discloses risks that have allegedly begun to materialize. Cautionary language should also be tailored to the company's specific forward-looking statement and reviewed and updated regularly.

# VIII. Extraterritoriality/Post-*Morrison*

Courts continued to address issues related to the domestic transaction requirement announced in *Morrison v. National Australia Bank, Ltd.*, 561 U.S. 247 (2010) for claims brought under Section 10(b) of the Exchange Act. In Morrison, the Supreme Court held that Section 10(b) applies only to claims where the security at issue was (1) listed on a domestic exchange or (2) purchased or sold in the United States. To determine whether the purchase or sale of the security occurred in the United States, several courts have adopted the "irrevocable liability" test. Under this test, a transaction is a domestic transaction if: (1) title to the underlying interest was transferred within the United States or (2) the parties incurred an obligation to transfer or pay for the interest in the United States.

In ***United States v. Georgiou***, 777 F.3d 125 (3d Cir. 2015), the Third Circuit held that the purchase and sale of securities through U.S. market makers satisfied the domestic transaction requirement from *Morrison*. Georgiou was convicted of securities fraud for his participation in a scheme to manipulate the prices of the stocks of four U.S. issuers traded in over-the-counter markets. The government alleged that Georgiou and his co-conspirators used foreign brokerage accounts to initiate trades through domestic market makers to make it appear as though the stocks were actively traded, and in turn fraudulently manipulated the price. On appeal, Georgiou argued that the convictions were improperly based on extraterritorial application of Section 10(b) because there was no proof that the security transactions actually occurred in the United States. The Third Circuit held that over-the-counter market stock price listings, such as the OTC Bulletin Board and the Pink Sheets, do not qualify as stock exchanges under the first prong of *Morrison*. To determine whether Georgiou's purchase and sale of securities in over-the-counter markets involved domestic transactions, the Third Circuit adopted the "irrevocable liability" test. The Third Circuit noted that at least some of the fraudulent transactions underlying Georgiou's conviction were executed through U.S. market makers (a domestic market maker bought the stock from the seller and sold it to the buyer), and therefore the evidence was sufficient to show that the scheme involved domestic transactions satisfying the domestic transaction requirement. The practical effect of *Georgiou* is to extend the coverage of Section 10(b) to over–the-counter trades in securities executed through U.S. entities acting as intermediaries for foreign entities.

In ***Atlantica Holdings, Inc. v. BTA Bank JSC***, 2015 WL 144165 (S.D.N.Y. Jan. 12, 2015), the plaintiffs brought claims under Section 10(b) relating to the sale of subordinated debt securities issued in connection with the restructuring of BTA Bank, one of the largest banks in Kazakhstan. In order to purchase the subordinated debt securities, investors had to complete and send "Electronic Instruction Forms" to UBS Financial Services in Miami. UBS then transmitted the order to a U.S. broker dealer and transferred funds from accounts the plaintiffs maintained with UBS in Miami to a UBS back office in Connecticut to fill the order and complete the transaction. Applying the irrevocable liability test, the court held that the plaintiffs incurred irrevocable liability in the United States when they sent the Electronic Instruction Form to UBS in Miami. BTA Bank argued that since all Electronic Instruction Forms were sent to UBS from outside the United States, the Exchange Act could not apply to these transactions given the holdings in *City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173, 181 (2d Cir. 2014), and *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings S*E, 763 F.3d 198 (2d Cir. 2014) (per curiam). In *City of Pontiac*, the Second Circuit held that the mere placement of a buy order in the United States for the purchase of foreign securities on a foreign exchange did not establish irrevocable liability in the United States. The court found *City of Pontiac* distinguishable because the sale of BTA Bank securities was actually executed in the United States. In *Parkcentral*, the Second Circuit held that even if the purchase of swaps pegged to the price of a foreign stock not traded on a U.S. exchange was a domestic transaction, the claims were "so predominately foreign" that the Exchange Act did not apply. The court held that *Parkcentral* was limited to the facts specific to that case and that *Parkcentral* had no bearing on the claims at issue.

BTA Bank also argued that the "mailbox rule" should apply and that investors incurred irrevocable liability outside the United States when investors sent the Electronic Instruction Form from locations outside the United States to UBS. The court rejected BTA Bank's "mailbox rule" argument because nothing in the Electronic Instruction Form indicated that it became binding when sent. *Atlantica* reinforces the application of Section 10(b) to the purchase and sale of foreign securities *executed* in the United States.

In ***SEC v. Brown***, 2015 U.S. Dist. LEXIS 25787 (N.D. Ill. Mar. 4, 2015), the SEC brought an enforcement action against defendants Brown and Alliance Investment Management Limited ("AIM") for securities fraud under Section 10(b). AIM was a Bahamian broker-dealer. Brown, a resident of the Bahamas, was AIM's president and director. The SEC alleged that AIM participated in a scheme as a custodian of an investment program named "Private International Wealth Management" ("PIWM"). An Arizona-based investment adviser, The Planning Group ("TPG"), invested more than $5 million in the PIWM program. The SEC alleged that TPG's clients made their investment in PIWM in the United States because the investment documents were signed in the United States and the investment proceeds were wired from U.S. bank accounts to AIM's Bahamian bank account. The SEC made similar allegations with respect to investments made through two other U.S.-based investment advisers. In their motion to dismiss, the defendants argued that the SEC failed to allege a domestic transaction. The defendants contended that PIWM sales occurred abroad when the asset manager for PIWM executed investor subscription agreements. The court applied a deferential standard to SEC's allegations at the motion to dismiss stage and held that it was sufficient that the SEC alleged that the parties incurred irrevocable liability in the United States when investors executed transaction documents in the United States and wired funds from U.S. bank accounts. The court noted that the subscription agreements were not in the record, nor was there any evidence in the record regarding the circumstances of execution. The holding in *Brown* may allow future securities fraud cases involving extraterritorial conduct to survive motions to dismiss as long as the complaint contains sufficient allegations to show liability may have been irrevocably incurred in the United States.

In ***SEC v. Sabrdaran***, 2015 U.S. Dist. LEXIS 25051 (N.D. Cal. Mar. 2, 2015), the SEC alleged that Sabrdaran, an employee of InterMune Inc., engaged in insider trading when he tipped his co-defendant and close friend Afsarpour, a citizen of the United Kingdom, to material non-public information regarding European regulatory approvals of one of InterMune's pharmaceutical products. The day after Sabrdaran spoke with Afsarpour on the phone, Afsarpour opened a spread betting account with a London-based broker. Afsarpour later placed spread bets in the London-based account on InterMune common stock listed on the NASDAQ stock exchange, betting that the price of InterMune stock would increase. Sabrdaran moved to dismiss the complaint, arguing that the complaint improperly attempted to apply Section 10(b) of the Exchange Act extraterritorially. Sabrdaran argued that the spread bets were placed in the United Kingdom, and the defendants did not purchase or sell securities listed on an American exchange. However, the court noted that Afsarpour's broker told Afsarpour that it may hedge spread bets by purchasing shares of InterMune stock before posting the spread bets to his account. Relying on *SEC v. Compania Internacional Financiera S.A.*, 2011 WL 3251813 (S.D.N.Y. July 29, 2011) and *SEC v. Maillard*, 2014 WL 1660024 (S.D.N.Y. Apr. 23, 2014) which allowed claims involving "contracts for difference" (derivative products similar to spread bets) sold in foreign markets to proceed, the court held that because Afsarpour's broker actually purchased InterMune stock in connection with Afsarpour's spread bets, the SEC had sufficiently alleged that Afsarpour's spread bets involved a transaction of a security traded on a domestic exchange. This case expands the reach of Section 10(b) to *fraudulent* schemes connected to the purchase and sale of securities domestically.

In both ***Brown*** and ***Sabrdaran***, the SEC argued that Congress overruled *Morrison* with respect to actions brought by the SEC through Section 929P(b) of the Dodd-Frank Act. Section 929P(b) amends Section 27 of the Exchange Act to provide jurisdiction to federal district courts over SEC enforcement actions for violations of antifraud provisions of the Exchange Act that involve conduct occurring outside the United States that has a foreseeable and substantial effect within the United States. The SEC argued in both cases that Section 929P(b) reinstated the pre-*Morrison* "conduct and effect" test. The court in Brown noted that the SEC's interpretation of Section 929P(b) was problematic because it provides *jurisdiction* to hear such actions, which was not the basis of the *Morrison* decision, but does not express a clear intent to apply the antifraud provisions of the Exchange Act to foreign transactions. As the courts in *Brown* and *Sabrdaran* concluded that the SEC had sufficiently alleged domestic transactions, neither court addressed applicability of Section 929P(b) to extraterritorial transactions. However, courts will likely be forced to directly address this issue in the future.

# IX. Jurisdictional Issues

An important jurisdictional issue soon to be addressed by the Supreme Court is whether Section 27 of the Securities Exchange Act of 1934, which gives federal courts exclusive jurisdiction over cases brought to enforce duties created under the federal statute, grants federal jurisdiction over state law claims establishing liability based on violations of the federal law. In December 2015, the Supreme Court heard oral arguments on this question in ***Merrill Lynch, Pierce, Fenner, & Smith, Inc. v. Manning.*** The plaintiffs, shareholders in Escala Group, Inc., filed a lawsuit against financial institutions in the Superior Court of New Jersey alleging that the financial institutions engaged in "naked" short selling of Escala stock. The Amended Complaint pleads ten causes of action, all asserted under New Jersey state law. However, the Amended Complaint also "repeatedly mentions the requirements of Regulation SHO, its background, and enforcement actions taken against some of the defendants regarding Regulation SHO."

The defendants removed the suit to federal court based on federal question jurisdiction, and the plaintiffs sought remand. The district court refused, but the Third Circuit held that federal courts lacked jurisdiction over the state law claims because no causes of action were necessarily predicated on a violation of Regulation SHO. The Third Circuit clarified that where the plaintiffs' state law RICO claims alleged both federal and state predicate acts, no federal question is necessarily raised because plaintiffs could prevail upon their New Jersey RICO claims or any of their other state law claims without needing to prove or establish a violation of federal law.

In the Supreme Court in December, Merrill Lynch argued that Section 27's "exclusive" grant of jurisdiction to federal courts bars New Jersey state courts from hearing the action. The plaintiffs argued that the case can be heard in state court because they seek no relief under federal law, and the complaint is limited to state law causes of action. Taken at face value, the justices' questions at oral argument suggest that members of the court were not persuaded that the federal courts have jurisdiction over the case. The Court's awaited opinion in this case will certainly shed some light on the limits of state-court securities litigation.

> The Supreme Court continues to take securities cases.

In ***In re Kingate Management Litigation***, 784 F.3d 128 (2d Cir. 2015) the Second Circuit addressed another important jurisdictional issue – ambiguities as to the scope of the Securities Litigation Uniform Standards Act ("SLUSA"), which prohibits certain state-law-based securities class actions in connection with transactions in "covered securities." The case was brought by investors as a class action against individuals and entities associated with Kingate Global Fund, Ltd. and/or Kingate Euro Fund, Ltd. The plaintiffs alleged that the defendants were supposed to invest in common stock of S&P 100 companies. Defendants delegated the custody of those investments to Bernard Madoff, who instead made entirely fictitious investments.

Plaintiffs brought various claims alleging false conduct under state law, based on allegations that the managers and auditors failed in their obligations to evaluate and monitor the investment advisor and audit the funds' financial statements according to established accounting principles. The district court dismissed all of plaintiffs' claims, holding that the claims were precluded by SLUSA because each of the claims included false conduct **in connection with**

**transactions in covered securities.** On appeal, the Second Circuit vacated the district court's judgment, stating that the district court applied an improper SLUSA analysis.

The Second Circuit held the following and vacated the district court's decision for further consideration:

1. Plaintiffs' purchase of non-covered securities (shares of the funds) with the expectation that the funds were investing in covered securities (S&P 100 stocks) was sufficient to satisfy the "in connection with the purchase or sale of a covered security" requirement. In reaching this conclusion, the court followed its own ruling in *In re Herald*, which interpreted the Supreme Court's 2014 decision in *Chadbourne & Parke LLP v. Troice*.
2. SLUSA's preclusion applies when the success of the state law claim depends on a false conduct of the sort specified in SLUSA, even if that false conduct is not an essential element of the state law claim. The court noted that this standard prevents a plaintiff from avoiding preclusion by "camouflaging allegations" that satisfy SLUSA "in the guise of allegations that do not." However, SLUSA does not preclude a claim if any false conduct alleged is "extraneous to the complaint's theory of liability."
3. SLUSA precludes only actions alleging the *defendant*'s complicity in the false conduct.
4. SLUSA requires a claim-by-claim analysis. The entire action need not be dismissed merely because one of its claims is precluded by SLUSA.

Of particular note is the Second Circuit's holding that SLUSA precludes only actions alleging the *defendant*'s complicity in the false conduct, and *does not preclude* actions alleging false conduct by *third persons* (in this case, Madoff) without the defendant's complicity. This decision conflicts with Third and Sixth Circuit decisions which may be read to allow preclusion whenever the false conduct "is alleged to have been done by third persons without the defendant's complicity." As a result, the ***Kingate*** holding likely makes it easier for plaintiffs in the Second Circuit and the state courts therein to bring state law claims in cases involving covered securities, possibly avoiding the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995.

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# X. Limitations Issues

### THE SUPREME COURT ADDRESSES THE STATUTE OF LIMITATIONS FOR BREACH OF FIDUCIARY DUTY CLAIMS UNDER ERISA

A unanimous Supreme Court reversed the Ninth Circuit in ***Tibble v. Edison Intern.***, 135 S.Ct. 1823 (2015), and held that an action for breach of fiduciary duty under the Employee Retirement Income Security Act ("ERISA") is timely if filed within six years of a breach of the fiduciary's continuing duty to monitor investments. The case began in 2007, when several individual beneficiaries of a defined-contribution plan brought a class action on behalf of the plan and all similarly situated beneficiaries against the defendants, who were fiduciaries to the plan. The plaintiffs alleged that the defendants violated their fiduciary duties by adding to the plan's investment six higher-priced retail-class mutual funds, when materially identical institutional-class funds were available at lower prices. Three of the funds were added as investments in 1999, and three in 2002.

The district court found for plaintiffs with respect to the funds added in 2002, but held that the plaintiffs' claims with respect to the funds added in 1999 were time-barred because (i) the funds were added more than six years before the complaint was filed, and (ii) the plaintiffs had not shown that changed circumstances during the six year limitations period triggered an obligation to undertake a due diligence review of the funds. The Ninth Circuit affirmed.

The Supreme Court vacated and remanded. Under trust law, which the Court noted often determines "the contours of an ERISA fiduciary's duty," a trustee has "a continuing duty of some kind to monitor investments and remove imprudent ones." The Court held that the Ninth Circuit erred by applying the limitations period "based solely on the initial selection of the three funds" and remanded the case for the Ninth Circuit to consider whether the defendants had breached their duties during the limitations period by failing to monitor and remove the funds. The ***Tibble*** opinion underscores for ERISA fiduciaries the importance of conducting (and documenting) regular diligence on behalf of plans they advise.

## THE FIFTH CIRCUIT HOLDS THAT THE FDIC EXTENDER STATUTE PREEMPTS STATES' STATUTES OF LIMITATIONS AND REPOSE

In ***Federal Deposit Insurance Corp. v. RBS Securities, Inc.***, 798 F.3d 244 (5th Cir. 2015), the Fifth Circuit joined the Second and Tenth Circuits in holding that all state law limitations periods – including statutes of limitations and statutes of repose – are preempted by 12 U.S.C. § 1821(d)(14), the FDIC's "extender statute." The extender statute applies to claims brought by the FDIC as conservator or receiver for a failed bank. For tort claims existing at the time the FDIC takes over as receiver, the statute provides that "the applicable statute of limitations shall be" the longer of (i) three years from the date the FDIC is appointed as receiver, or (ii) the period applicable under state law.

In this case, the FDIC (as receiver) filed suit under the Securities Act of 1933 and the Texas Securities Act, alleging that the defendant financial institutions made false statements or omitted material facts in connection with the sale of residential mortgage-backed securities to a failed bank. The Texas Securities Act includes a statute of repose which provides that all claims must be brought within five years from the date the securities at issue were sold. The FDIC brought its claims within three years of the date it was appointed receiver, but more than five years after the securities sales. Thus, its claims were made within the federal limitations period, but after the expiration of the state law period of repose.

The defendants moved for judgment on the pleadings, arguing that the FDIC's claims were barred because the extender statute did not preempt state law statutes of repose, only state law statutes of limitations. (Statutes of limitations create a time limit for suing in a civil case, based on the date when the claim accrued, which is typically when the injury was discovered or, with the exercise of reasonable diligence, should have been discovered. Statutes of repose, on the other hand, establish a deadline by which a civil action must be filed that begins to run from the date of the last culpable act or omission of the defendant.) The defendants relied heavily on the Supreme Court's decision in *CTS Corp. v. Waldburger*, 134 S.Ct. 2175 (2014), that a provision of the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA") preempted only state law limitations periods, but not repose periods. The district court was persuaded, and granted defendants' motions.

The Fifth Circuit reversed, finding that any "superficial similarities" between the extender statute and the CERCLA provision were "unavailing," and that "many of the considerations the Court found disfavored preemption in *CTS* suggest preemption" when applied to the extender statute. The court held that the text of the extender statute "indicates that it prescribes a new, mandatory statute of limitations for actions brought by the FDIC as receiver." The court also found that even if the language of the extender statute was ambiguous, its structure, purpose, and legislative history all clearly show that Congress intended for the statute to preempt all limitations periods, "no matter their characterization as statutes of limitation or statutes of repose," in order to provide the FDIC "with a minimum period of time to investigate and evaluate potential claims on behalf of a failed bank."

# XI. SEC and Other Regulatory Enforcement Activities

## CHALLENGES TO SEC ADMINISTRATIVE LAW JUDGES

Litigants continued to challenge the constitutionality of the Securities and Exchange Commission's internal administrative proceedings in 2015, and they met with some success. A key issue in many of these challenges is whether a federal court has jurisdiction to decide constitutional challenges to the process despite the statutory scheme that gives the SEC the option of either pursuing its claims in an administrative proceeding or filing suit in federal court.

In March 2015 Haynes and Boone broke the SEC's winning streak in trials before ALJs.

In ***Hill v. S.E.C.***, a district court in the Northern District of Georgia enjoined an SEC administrative proceeding against a real estate developer accused of insider trading. 2015 WL 4307088 (N.D. Ga. June 8, 2015). The court found that it had subject-matter jurisdiction to hear the plaintiff's claims based on the three-factor test articulated in *Free Enterprise Fund v. Public Company Accounting Oversight Board*, 561 U.S. 477 (2010). According to the court, refusing to hear the plaintiff's claims would prevent meaningful judicial review, the plaintiff's constitutional challenge was wholly collateral to the SEC proceedings against him, and his constitutional claims were outside the SEC's expertise.

The court went on to hold that the plaintiff was likely to succeed on the merits of his claims and enjoined the Commission's administrative proceedings against him. The court held that SEC administrative law judges are inferior officers for purposes of the Appointments Clause of Article II of the Constitution, and as such, they must be appointed by the President, a department head, or a court of law. In *Hill*, this requirement had not been satisfied.

In ***Duka v. S.E.C.***, a district court in the Southern District of New York reached a similar conclusion. 2015 WL 4940057 (S.D.N.Y. Aug. 3, 2015). The SEC has appealed the ***Hill*** and ***Duka*** decisions to the Eleventh and Second Circuits, respectively.

Despite plaintiffs' success in *Hill*, *Duka*, and other similar cases, other courts were not persuaded. In ***Bebo v. S.E.C.***, 799 F.3d. 765 (7th Cir. 2015), and ***Jarkesy v. S.E.C.***, 803 F.3d 9 (D.C. Cir. 2015), the Seventh Circuit and D.C. Circuit affirmed district court rulings dismissing constitutional challenges to the SEC's use of the administrative process. Both courts concluded they did not have subject matter jurisdiction to hear the plaintiffs' claims. Instead, the plaintiffs must pursue their constitutional challenges through the administrative process and, if unsuccessful, appeal the Commission's adverse decision to a federal appellate court.

Amid public discussion, the Commission announced in September 2015 that it would be proposing amendments to its rules of practice with respect to administrative proceedings. SEC Press Release, "SEC Proposed Changes to Amend Rules Governing Administrative Proceedings," Sept. 24, 2015, http://www.sec.gov/news/pressrelease/2015-209.html. Among other things, the proposed rule changes would allow defendants to take depositions (which are not currently permitted in the administrative setting) and expand the Commission's time frame for hearing and deciding some cases.

## WHISTLEBLOWERS

In April, the SEC brought its first enforcement action based on confidentiality agreements that allegedly had the potential to "stifle the whistleblowing process." The SEC alleged that when Houston-based **KBR, Inc.** conducted internal investigations of potential illegal or unethical conduct by the company or its employees, KBR required employees and other witnesses to sign confidentiality agreements that prevented an individual from reporting misconduct to the SEC without first obtaining the approval of the company's legal department.

According to the SEC, the restrictions imposed by KBR's confidentiality agreements violated Rule 21F-17 of the Securities Exchange Act of 1934, a whistleblower provision enacted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") which prohibits acts that might impede an individual from communicating with the SEC about potential securities law violations. There was no allegation that KBR (1) actually prevented any communication between employees and the SEC about potential violations or (2) ever enforced the confidentiality agreements.

KBR settled the SEC's action without admitting or denying the SEC's charges, agreed to cease and desist from causing any future violations of Rule 21F-17, and agreed to pay a penalty of $130,000. KBR also agreed to make reasonable efforts to: (1) contact any KBR employees who had signed the statement between August 21, 2011 and the date of the SEC's order; (2) provide those employees with a copy of the SEC Order; and (3) advise those employees that they would not need to seek permission before reporting any possible violations.

Whistleblowers also obtained favorable rulings in civil retaliation suits against their former employers. In ***Berman v. Neo@Ogilvy, LLC***, the Second Circuit addressed the application of Dodd-Frank whistleblower protection to individuals who only report suspected violations internally and do not report them to the SEC. 801 F.3d 145 (2d Cir. 2015). In that case, the plaintiff alleged that he had reported suspected accounting fraud internally to his employer and had been fired as a result. He eventually reported the suspected misconduct to the Commission, but only after he had been fired.

Berman's employer moved to dismiss his claims, arguing that because he had reported suspected fraud only to the company before his termination (and not to the SEC), he was not entitled to whistleblower protection under the relevant provisions of Dodd-Frank. The defendant relied on Section 21F of Dodd-Frank which defines "whistleblower" to mean "any individual who provides . . . information relating to a violation of the securities laws to *the Commission*."

However, the anti-retaliation provision of Dodd-Frank Section 21F prohibits an employer from retaliating against a whistleblower who lawfully "mak[es] disclosures that are required or protected under the Sarbanes-Oxley Act of 2002." The Sarbanes-Oxley Act ("SOX") in turn includes several provisions related to internal reporting of suspected securities law violations and is not limited to scenarios in which an individual reports suspected violations to the Commission.

The Second Circuit found for the plaintiff, reversing and remanding for further proceedings. Finding that the interplay between Dodd-Frank and SOX made the meaning of Dodd-Frank Section 21F ambiguous, the court applied *Chevron* deference to the SEC's interpretive guidance on the matter. That guidance held that Dodd-Frank whistleblower protections extended not only to individuals who reported suspected violations to the Commission, but also to those who reported violations internally. Based on similar reasoning, a court in the Northern District of California reached a similar result. ***Somers v. Digital Realty Trust, Inc.***, 2015 WL 4483955 (N.D. Cal. July 22, 2015).

The reasoning of both the *Berman and Somers* courts stands in contrast to that of the Fifth Circuit. In ***Asadi v. G.E. Energy (USA), LLC***, 720 F.3d 620 (5th Cir. 2013), the Fifth Circuit found that the text of Dodd-Frank was not ambiguous and declined to give weight to the SEC's interpretive guidance. In the Fifth Circuit's view, Dodd-Frank whistleblower protection applies only to those individuals who first report suspected misconduct to the Commission.

In May 2015, the Sixth Circuit clarified the legal standard that applies to retaliation claims in that circuit, making it easier for whistleblowers to sustain a claim. In ***Rhinehimer v. U.S. Bancorp Investments, Inc.***, the defendant appealed a jury verdict finding that the plaintiff had been disciplined and fired after he reported suspected misconduct to the defendant, a violation of Section 1514A of SOX. 787 F.3d 797 (6th Cir. 2015). Citing a prior unpublished decision in the Sixth Circuit, the defendant argued on appeal that the plaintiff had failed to "definitively and specifically" allege suspected misconduct when he reported it to the defendant and thus had not engaged in protected conduct before he was disciplined and terminated.

The court rejected the defendant's argument and rejected the "definitively and specifically" standard. Instead, the court adopted "the emerging rule that the employee's reasonable belief is a simple factual question requiring no subset of findings that the employee had a justifiable belief as to each of the legally-defined elements of the suspected fraud." The court affirmed the district court's judgment in favor of the plaintiff.

Employers defending whistleblower retaliation claims did achieve some favorable rulings in 2015. In ***Wallace v. Tesoro Corp.***, 796 F.3d 468 (5th Cir. 2015), the Fifth Circuit held that the scope of a plaintiff's claims in a SOX retaliation suit are limited to the scope of the underlying administrative complaint filed by the plaintiff. In ***Wallace***, the plaintiff had complained to the Occupational Health and Safety Administration ("OSHA") that his employer had retaliated against him for engaging in protected activity. Following OSHA's dismissal of his complaint, the plaintiff sued Tesoro in federal court alleging retaliation in violation of Section 1514A of SOX. Specifically, the plaintiff alleged, among other things, that his employer had terminated him because he had investigated suspected wire fraud by his employer.

The district court dismissed all of the plaintiff's claims, including those related to the plaintiff's investigation of suspected wire fraud. With respect to those claims, the court held that the scope of the plaintiff's OSHA complaint had not included those allegations.

Although the Fifth Circuit reversed a portion of the district court's ruling and reinstated some of the plaintiff's claims, it affirmed the district court's opinion related to the plaintiff's wire fraud allegations. Citing Fourth Circuit precedent, the court held that "[l]itigation may encompass claims 'reasonably related to the original complaint, and those developed by reasonable investigation of the original complaint.'"

## SEC CYBERSECURITY ENFORCEMENT

In September 2015, the SEC brought its first cybersecurity enforcement action against an investment adviser, sending a clear message to regulated entities that cybersecurity is a priority.

According to the Commission, St. Louis-based **R.T. Jones Capital Equities Management**, stored personally identifiable information ("PII")—without modification or encryption—of more than 100,000 clients and other individuals on a third-party hosted web server. The server contained information belonging to R.T. Jones's clients and clients of a retirement plan administrator through which R.T. Jones offers investment advice. A hacker—using IP addresses that traced back to mainland China—gained full access and copyrights to the server in July 2013.

Despite a prompt response and extensive remedial efforts following the attack, the SEC brought an enforcement action against R.T. Jones under Rule 30(a) of Regulation S-P (the "Safeguards Rule"). Under the Safeguards Rule, "[e]very broker, dealer, and investment company, and every investment adviser registered with the Commission must adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information." At the time of the attack, R.T. Jones failed to have in place any written policies and procedures reasonably designed to safeguard customer information. For example, R.T.

Jones did not conduct periodic risk assessments, did not have a firewall on its webserver, did not encrypt PII on that server, and had not established an incident response plan.

R.T. Jones, without admitting or denying the findings, agreed to cease and desist from further violations of the Safeguards Rule, a censure, and a $75,000 civil penalty.

## SHIFT IN FCPA ENFORCEMENT STANDARD

The SEC's Foreign Corrupt Practices Enforcement (FCPA) actions in 2015 suggested that the Commission may continue to apply an aggressive legal standard related to suspected books and records violations. In an enforcement action against **Goodyear Tire and Rubber Company**, the SEC alleged that Goodyear failed to implement adequate FCPA compliance and controls sufficient to "prevent and detect" more than $3.2 million in bribes at two subsidiaries in sub-Saharan Africa.

The "failure to prevent and detect" standard articulated by the SEC does not appear in the FCPA. Instead the books, records, and internal control provisions of the FCPA require issuers to, among other things, adopt accounting controls that "provide reasonable assurances that . . . transactions are executed in accordance with management's authorization." The statutory language is arguably more flexible than a "failure to prevent and detect" standard. Moreover, holding companies accountable for any failure to "prevent and detect fraud" could be understood to suggest that any time a violation of the FCPA's anti-bribery provisions occurs, a violation of the books and records provision necessarily occurs as well. Similar language appeared in an SEC complaint against Archer-Daniels-Midland Company in December 2013. Case No. 2:13-cv-2279 (C.D. Ill. Dec. 20, 2013).

Goodyear agreed to settle the SEC's charges for $16.2 million in disgorgement and interest.

## INSIDER TRADING

In 2015, federal courts continued to sort out the impact of the Second Circuit's insider trading opinion in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014). The Ninth Circuit, with Southern District of New York Senior Judge Jed Rakoff sitting by designation, seemed to recoil at the Newman court's holding as it relates to personal benefit. *See* ***United States v. Salman***, 792 F.3d 1087 (9th Cir. 2015).

In *Newman*, the Second Circuit addressed the elements of tippee liability for insider trading. To sustain a case against a tippee, the court held that the government must show that the tippee was aware of a personal benefit received by the corporate insider who originally disclosed material nonpublic information, and the personal benefit cannot be inferred from the mere existence of a personal relationship between the insider and the tippee: "[W]e hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." The government sought to appeal the Second Circuit's opinion in *Newman*, but the Supreme Court declined to hear it.

In ***Salman***, the defendant–a downstream tippee–argued that this standard absolved him of any liability. In his view, *Newman* held that evidence of a friendship or close family relationship between a tipper and tippee is not enough to sustain the government's burden to prove personal benefit.

The Ninth Circuit disagreed, however. "To the extent *Newman* can be read to go so far, we decline to follow it." Citing *Dirks v. S.E.C.*, 463 U.S. 646 (1983), the court held that the government had sustained its burden by offering evidence that the tipper had provided material nonpublic information "for the purpose of benefitting and providing for his brother . . . . Proof that the insider disclosed material nonpublic information with the intent to benefit a trading relative or friend is sufficient to establish the breach of fiduciary duty element of insider trading."

The Supreme Court has agreed to hear Salman's appeal from the Ninth Circuit's opinion upholding his conviction.

# XII. Notable Developments in State Law Actions and Fiduciary Litigation

## DISCLOSURE-ONLY SETTLEMENTS – A THING OF THE PAST?

The shareholder plaintiffs' bar has continued its practice of recent years of filing lawsuits challenging virtually every merger involving a public company. These often meritless strike suits typically allege that the target company's board breached its fiduciary duties by conducting an inadequate process, agreeing to merger consideration that is too low, and/or failing to disclose sufficient information about the deal. Desiring to eliminate the threat of an injunction that could delay closing, defendants tend to settle these suits quickly. The settlement terms usually involve additional disclosures to shareholders about the deal process in exchange for broad class-wide releases of all claims related to the merger. Shareholders receive no monetary consideration in these settlements, though their counsel receives a fee for "benefitting" the shareholders by obtaining additional disclosures about the deal. Courts have become increasingly hostile to these settlements, and developments in 2015 suggest that disclosure-only settlements may be on their last breath, particularly in Delaware where many companies are incorporated.

In ***Acevedo v. Aeroflex Holding Corp.***, No. 7930-VCL (Del. Ch. July 8, 2015), Vice Chancellor Laster declined to approve a disclosure-based settlement that also included a modification to the merger agreement's termination fee, holding that the class of shareholders would get "nothing" from a few supplemental disclosures and "tweaks" to the merger agreement, while the defendants would get an "intergalactic" release and plaintiffs' counsel would be awarded fees. Similarly, in ***In re Aruba Networks, Inc. Stockholder Litigation***, No. 10765-VCL (Del. Ch. Oct. 9, 2015), the court rejected a disclosure-only settlement and observed that "we have reached the point where we have to acknowledge that settling for disclosure only and giving the type of expansive release that has been given has created a real systemic problem." Although the court in ***In re Riverbed Technology Inc. Stockholders Litigation***, 2015 WL 5458041 (Del. Ch. Sept. 17, 2015), did approve a disclosure-only settlement, it did so only upon finding that the parties had a reliance interest in having such settlements approved due to the Delaware courts' past practice. The case thus sends a new signal to the bar that disclosure-only settlements are unlikely to be approved in the future. This conclusion was confirmed in an opinion by Chancellor Bouchard in early 2016 in ***In re Trulia, Inc. Stockholder Litigation***, No. 10020-CB (Del. Ch. Jan. 22, 2016) where the court rejected a disclosure-only settlement and indicated that such settlements would "be met with continued disfavor" in Delaware unless they involve both "plainly material" disclosures and "narrowly circumscribed" releases.

New York courts similarly declined to approve disclosure-only settlements in 2015. In ***City Trading Fund v. Nye***, 9 N.Y.S. 3d 592 (Sup. Ct. Jan. 7, 2015), the court rejected a settlement upon finding that the agreed supplemental disclosures were "utterly immaterial" and of no value to shareholders. Approving a settlement in these circumstances "would incentive plaintiffs to file frivolous disclosure lawsuits shortly before a merger, knowing they will always procure a settlement and attorneys' fees under conditions of duress—that is, where it is rational to

> Expect a paradigm shift in how M&A cases are litigated.

settle obviously frivolous claims." The court in ***In re Allied Healthcare Shareholder Litigation***, 49 Misc. 3d 1210 (N.Y. Sup. Ct. Oct. 23, 2015), ruled similarly, finding that "this proposed settlement offers nothing to the shareholders except that attorneys they did not hire will receive a $375,000 fee and the corporate officers who were accused of wrongdoing, will receive general releases."

Courts' increasing reluctance to approve disclosure-only settlements could lead to less deal litigation in 2016 and beyond, as the shareholder plaintiffs' bar may be forced to abandon its long-standing practice of suing on every deal in favor of focusing on cases that appear to have more merit. At a minimum, merger litigation may decrease in Delaware courts as plaintiffs seek out courts in other states that might be less hostile to approving settlements that award attorneys' fees even where the shareholders receive no monetary consideration. Companies incorporated in Delaware may thus be more likely to be sued in the states of their principal place of business and should accordingly consult with outside counsel on the advisability of adopting Delaware choice of forum bylaws (discussed below).

## DELAWARE ENDORSES EXCLUSIVE FORUM CLAUSES AND PROHIBITS FEE SHIFTING

Delaware enacted important new legislation in 2015 that has the potential to impact every company incorporated in the state. Specifically, Delaware law now expressly (1) permits corporations to mandate that "internal corporate claims" may only be brought in Delaware courts, and (2) prohibits corporations from implementing "loser pays" attorneys' fees provisions for such claims brought by shareholders.

In recent years, courts across the country have grappled with the enforceability of provisions in a corporation's certificate of incorporation or bylaws designating an exclusive forum for intra-corporate litigation, such as shareholder claims that directors breached their fiduciary duties. Many courts, including courts in Delaware, had enforced such provisions, but the new legislation removes any lingering ambiguity as to whether Delaware authorizes them. However, the legislation also prohibits corporations from designating a non-Delaware forum as an exclusive venue. Practically, this means that corporations incorporated in Delaware but headquartered elsewhere will not be able to require that litigation be brought in the state of their headquarters but will have the option of requiring that suits be filed only in Delaware. It remains to be seen whether courts of other states will enforce the new Delaware legislation, but the new statute is definitely a tool in the arsenal of companies who seek to avoid multi-forum litigation. Companies incorporated in Delaware that do not have exclusive forum bylaws should consult with outside counsel regarding the advisability of adopting them.

In response to a 2014 Delaware Supreme Court decision upholding a fee shifting bylaw, the Delaware legislature this year banned such provisions. Corporations can no longer include provisions in their organizational documents that "would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an internal corporate claim."

## APPRAISAL CASES ADOPTING MERGER PRICE, BUT NOT ALWAYS

When a company is acquired, its shareholders who do not believe the price was fair generally have the right to have their shares appraised by a court under certain circumstances and receive the appraised price rather than the negotiated merger price. Some investors have sought to take advantage of appraisal statutes by investing in to-be-acquired companies for the sole purpose of seeking appraisal. Appraisal cases in 2015 suggest a hesitancy by courts to substitute their own views of a "fair" price, at least where the merger price was the result of a robust sales process.

In ***Merion Capital LP v. BMC Software, Inc.***, 2015 WL 6164771 (Del. Ch. Oct. 21, 2015), the court emphasized that unless there is some reason to believe that a sales process was deficient, then the "merger price [is] the most persuasive indication of fair value available." Accordingly, the court ruled that the stockholders seeking appraisal were not entitled to any additional consideration beyond the merger price. The court in ***In re Appraisal of Ancestry.com, Inc.***, 2015 WL 399726 (Del. Ch. Jan. 30, 2015) reached the same conclusion after conducting a detailed appraisal analysis only to ultimately decide that the merger price reflected fair value. Similarly, in 2015 the Delaware Supreme Court summarily affirmed a 2014 decision that awarded only the merger price where the court was "unconvinced . . . that the sales process . . . failed to achieve the full value available from the market." ***Huff Fund Investment Partnership v. CKx, Inc.***, 2014 WL 2042797 (Del. Ch. May 19, 2014), *aff'd*, 2015 WL 631586 (Del. Feb. 12, 2015); *see also* ***Merlin Partners LP v. AutoInfo, Inc.***, 2015 WL 2069417 (Del. Ch. Apr. 30, 2015) (awarding merger price after conducting appraisal analysis).

By contrast, in ***In re Dole Food Co., Inc. Stockholder Litigation***, 2015 WL 5052214 (Del. Ch. Aug. 27, 2015), the court awarded the plaintiffs a $2.74 per share premium over the $13.50 merger price. The case involved a cash out merger where Dole's CEO acquired all of the company's stock. The plaintiffs sued for breach of fiduciary duty and also sought appraisal for their shares. Upon concluding that the sale process was flawed due to the CEO's fraud, the court awarded the $2.74 per share increase as damages for breach of fiduciary duty, holding that "the stockholders [were] not limited to an arguably fair price. They are entitled to a fairer price." The court also observed that this award likely mooted the appraisal action. ***In re Dole Food Co.*** thus reinforces that plaintiffs seeking appraisal should not expect to receive a premium over the merger consideration unless they can demonstrate problems with the sale process.

While the case law is continuing to develop, these decisions could lead to a curtailment of opportunistic investments in companies for the sole purpose of seeking appraisal.

## CLARIFIED LIABILITY PROTECTION FOR INDEPENDENT DIRECTORS

The Delaware Supreme Court issued important guidance in 2015 regarding the ability of independent directors to be dismissed from cases challenging the approval of an interested or related-party transaction. ***In re Cornerstone Therapeutics Inc. S'holder Litig.***, 115 A.3d 1173 (Del. 2015). Depending on the underlying circumstances, Delaware courts provide for several different standards of review when a board member's conduct is challenged, the two most familiar being the deferential business judgment rule and the onerous entire fairness standard where board members have the burden to prove both fair dealing and fair price. The entire fairness standard often applies where the underlying challenged conduct involves a transaction involving directors or a controlling stockholder with a personal interest in the transaction.

> Independent directors now have a better shot at dismissal in entire fairness cases.

In ***Cornerstone***, plaintiffs challenged a merger where a controlling stockholder with representatives on the company's board acquired all of the remaining stock. The entire fairness standard applied under applicable Delaware precedent. The company's charter, however, exculpated directors for breaches of the fiduciary duty of care, and the independent directors that negotiated the transaction sought dismissal on the basis that the plaintiffs had not pled any non-exculpated claims against them. In response, the plaintiffs argued that a motion to dismiss cannot be granted at the pleading stage where entire fairness is the standard of review for the underlying transaction. The Supreme Court ultimately held that, "plaintiffs must plead a non-exculpated claim for breach of fiduciary duty against an independent director protected by an exculpatory charter provision, or that director will be entitled to be dismissed from the suit. That rule applies regardless of the underlying standard of review for the transaction."

As a result of the ***Cornerstone*** decision, independent directors of Delaware companies should generally have strong grounds to obtain early dismissal from lawsuits challenging related-party transactions in the absence of allegations that they acted disloyally to the corporation or in bad faith.

## EXPANDED SHAREHOLDER ACCESS TO CORPORATION'S PRIVILEGED DOCUMENTS?

In last year's Year in Review, we noted that the Delaware Supreme Court had adopted the so-called "fiduciary exception" to a corporation's attorney-client privilege as articulated in the Fifth Circuit's decision issued many years ago in *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970). *See Wal-Mart Stores v. Indiana Elec. Workers Pension Trust Fund IBEW*, 95 A.3d 1264 (Del. 2014). In *Wal-Mart*, Delaware permitted a shareholder to invade a corporation's attorney-client privilege upon a showing of "good cause" in order to prove fiduciary breaches by those running the corporation.

Although the *Wal-Mart* court stated that the fiduciary exception was intended to be narrow, the Court of Chancery's decision this year in ***In re Lululemon Athletica Inc. 220 Litigation***, 2015 WL 1957196 (Del. Ch. Apr. 30, 2015) suggests that the "exception" may not be so narrow in practice. In ***Lululemon***, the plaintiff shareholders brought a Section 220 books and records action to obtain information relating to the investigation of potential insider trading by the company's founder and then-chairman of the board of directors, as well as potential mismanagement claims against other directors. The court ordered Lululemon to produce two privileged email chains. The court reached this conclusion by applying a multi-factor test that is highly fact specific. The state of the law has thus developed to where corporations have little predictability in advance as to whether their privileged communications will remain truly privileged, particularly in the case of an internal investigation. Corporations should accordingly consider preparing investigation documents with an eye towards the possibility of eventual compelled production.

## BOOKS AND RECORDS LAWSUIT SEEKING DOCUMENTS RELATED TO DATA BREACH

Cybersecurity and data breach litigation has continued to be a hot area in the business world. This year it intersected with securities litigation when a shareholder brought a Delaware Section 220 books and records lawsuit against Home Depot for access to documents related to a large data breach that occurred in 2014. The plaintiff sought internal documents to investigate whether Home Depot's management and directors may have breached their fiduciary duties by failing to adequately protect customers' sensitive information despite similar problems that other companies had experienced in the recent past. Although Home Depot had provided some documents in response to the plaintiff's demand, the plaintiff deemed the document production insufficient and brought a lawsuit to obtain access to additional documents.

Shareholder requests for privileged documents may become more common.

As is frequently the case, the Section 220 demand and suit were precursors to a shareholder derivative suit regarding the data breach. Relying on the documents obtained in the Section 220 process, the same shareholder is now pursuing claims against Home

Depot directors and officers in federal court in Georgia, alleging that they breached their fiduciary duties by failing to prevent the data breach. It remains to be seen how this litigation will conclude, but the experience of Home Depot should serve as a reminder to corporations to be vigilant about protecting their customers' and employees' personal data and to directors to provide adequate oversight of the corporation's cybersecurity efforts. Not only do data breaches lead to suits by those directly affected, but they can lead to costly securities-related litigation as well.

## APPLICABILITY OF BUSINESS JUDGMENT REVIEW

Delaware Supreme Court decisions this year provide additional guidance on when the deferential business judgment rule will apply when transactions are challenged in court.

In ***Corwin v. KKR Financial Holdings LLC***, 2015 WL 5772262 (Del. 2015), the plaintiffs challenged a stock-for-stock merger and contended that the plaintiff-friendly entire fairness standard should apply because one of the parties was allegedly a controlling stockholder of the other, or alternatively "enhanced scrutiny" under *Revlon* should apply. Not only did the Chancery Court and Supreme Court find that there was no controlling stockholder, they found that the transaction was approved by a fully informed, uncoerced vote of the disinterested stockholders and that such approval brought the transaction within the realm of the business judgment rule. Parties who are considering merger transactions should thus consider making the transaction subject to ratification by the disinterested stockholders. This step could ultimately provide the parties with a more deferential standard of review if any shareholders sue regarding the transaction and make post-closing damages cases more difficult to bring.

The Delaware Supreme Court also reiterated this year that the business judgment rule can apply even to a buyout involving a controlling stockholder if the transaction is approved by both (1) a special committee of independent directors, and (2) a majority of the minority shareholders. In ***Swomley v. Schlecht***, 2015 WL 7302260 (Del. Nov. 19, 2015), the Court summarily affirmed a 2014 opinion of the Chancery Court that had applied the Supreme Court's decision in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014), in dismissing a suit at the pleading stage upon finding that the business judgment rule applied to a controlling party merger. Portions of the *MFW* case had left doubts whether a plaintiff could avoid dismissal under *MFW* merely by alleging an unfair price. The Supreme Court's affirmance in *Swomley*, and the discussion at the oral argument, confirm that defendants should be able to obtain pleading stage dismissals under *MFW* in appropriate circumstances despite allegations that the price was too low. Parties considering entering into a transaction involving a controlling stockholder merger should consult with outside counsel on how to structure the transaction under this line of cases so as to obtain business judgment review.