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Securities Law Alert

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– Chambers USA 2016

Supreme Court: Grants Certiorari to Address Whether Item 303 of Regulation S-K Creates a Duty to Disclose for Purposes of Section 10(b) and Rule 10b-5

On March 27, 2017, the Supreme Court granted certiorari to resolve a circuit split on the issue of whether Item 303 of SEC Regulation S-K creates a duty to disclose that is actionable under Section 10(b) and Rule 10b-5. *Leidos v. Indiana Pub. Ret. Sys.* (No. 16-581).

Item 303 of Regulation S-K sets forth the disclosure requirements for the Management's Discussion and Analysis (MD&A) section of a public company's Form 10-Qs and other SEC filings. In relevant part, Item 303 states that a public company must "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." 17 C.F.R. § 229.303(a)(3)(ii).

On January 12, 2015, the Second Circuit held that "a failure to make a required Item 303 disclosure … is indeed an omission that can serve as the basis for a Section 10(b) securities fraud claim." *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015) (Livingston, J.) (*Stratte-McClure*).[1] However, the Second Circuit stated that "such an omission is actionable only if it satisfies the materiality requirements outlined in *Basic v. Levinson*, 485 U.S. 224 (1988)."

1. Please click here to read our prior discussion of the Second Circuit's decision in *Stratte-McClure*.

The Second Circuit in *Stratte-McClure* acknowledged that its ruling was "at odds" with the Ninth Circuit's decision in *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046 (2014) (O'Connell, J.).[2] There, the Ninth Circuit found that "[m]anagement's duty to disclose under Item 303 is much broader than what is required under … *Basic,*" and concluded that "Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5." In so holding, the Ninth Circuit relied on the Third Circuit's reasoning in *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000) (Alito, J.). The *Oran* court stated that "[b]ecause the materiality standards for Rule 10b-5 and [Item 303] differ significantly, the demonstration of a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5."

The *Stratte-McClure* court found that the Ninth Circuit had read the Third Circuit's decision in *Oran* too broadly. The *Stratte-McClure* court stated that "*Oran* actually suggested, without deciding, that in certain instances a violation of Item 303 *could* give rise to a material [Rule] 10b-5 omission … so long as the omission is material under *Basic*." *Stratte-McClure*, 776 F.3d 94.

On March 29, 2016, the Second Circuit relied on its prior decision in *Stratte-McClure* to deny a motion to dismiss a claim brought under Section 10(b) and Rule 10b-5 alleging the failure to disclose a known trend or uncertainty as required under Item 303. *Indiana Pub. Ret. Sys. v. SAIC*, 818 F.3d 85 (2016) (*SAIC*) (Lohier, J.).[3] Defendants successfully petitioned the Supreme Court for certiorari to address the question of whether the Second Circuit erred in holding that the failure to make a required Item 303 disclosure is actionable under Section 10(b) and Rule 10b-5.

The Court is expected to hear the case in October Term 2017.

2. Please click here to read our prior discussion of the Ninth Circuit's decision in *NVIDIA*.

3. Please click here to read our prior discussion of the Second Circuit's decision in *SAIC*.

District of Utah: Notwithstanding *Morrison*, Section 929P(b) of the Dodd-Frank Act Permits the SEC to Bring Extraterritorial Claims Under Sections 10(b) and 17(a) Provided the "Conduct and Effects" Test Is Satisfied

On March 28, 2017, the District of Utah held that Section 929P(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") permits the SEC to bring extraterritorial securities fraud actions under Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act provided the "conduct and effects" test is satisfied.[4] *SEC v. Monsoon*, 2017 WL 1166333 (D. Utah 2017) (Parrish, J.). The court determined that the transactional test for the extraterritorial application of Section 10(b) set forth in *Morrison v. National Australia Bank*, 561 U.S. 247 (2010)[5]—issued a month prior to the enactment of the Dodd-Frank Act—does not apply to SEC claims brought under Sections 10(b) and 17(a).

Section 929P(b) Supersedes *Morrison* Even Though It Does Not Explicitly Overturn *Morrison*'s Transactional Test

The court rejected defendant's contention that "Section 929P(b) left the *Morrison* transaction test in place" because "the plain language of Section 929P(b) did not explicitly overturn the core holding of *Morrison*." The court emphasized that *Morrison* was issued on the last day the Dodd-Frank conference

4. The court explained that "Section 929P(b) of [the Dodd-Frank Act] added the following language to both Section 22 of the Securities Act and Section 27 of the Exchange Act:

> The district courts of the United States and the United States courts of any Territory shall have jurisdiction of an action or proceeding brought or instituted by the Commission or the United States alleging a violation of [either Section 10(b) of the Securities Exchange Act or Section 17(a) of the Securities Act] involving--
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> (1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or
>
> (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States."

5. Please click here to read our prior discussion of the *Morrison* decision.

committee met and five days before the committee published a final version of the bill. While "courts generally presume that Congress is familiar with the precedents of the Supreme Court when it enacts legislation," the District of Utah found "the close proximity between the date when *Morrison* was issued and the date when the language of Dodd-Frank was finalized, greatly undermines this presumption." The court determined "the more reasonable assumption is that *Morrison* was issued too late in the legislative process to reasonably permit Congress to react to it." The court stated that it did not "presume that Congress intended Section 929P(b) to be a nullity."

Congress Intended the "Conduct and Effects" Test to Apply to SEC Claims Brought Under Sections 10(b) and 17(a)

The District of Utah explained that "the judicial presumption against the extraterritorial application of a statute may be rebutted by referring to all available evidence about the meaning of a statute." Here, the court found that "the text of Section 929P(b), the legal context in which this amendment was drafted, legislative history, and the expressed purpose of the amendment all point to a congressional intent that, in actions brought by the SEC, Sections 10(b) and 17(a) should be applied to extraterritorial transactions to the extent that the conduct and effects test can be satisfied." The court held "these clear indications that Congress intended Sections 10(b) and 17(a) to be applied to foreign transactions are sufficient to overcome the presumption against extraterritorial application" of Sections 10(b) and 17(a) in actions brought by the SEC.

Delaware Supreme Court: "Commercially Reasonable Efforts" Clause in a Merger Agreement Imposes an Affirmative Obligation on the Parties to Take All Reasonable Steps to Ensure Performance

On March 23, 2017, the Delaware Supreme Court affirmed a June 2016 Chancery Court decision holding that a buyer had not breached its requirement to use "commercially reasonable efforts" to obtain a tax opinion required as a condition precedent to a merger agreement. *The Williams Cos. v. Energy Transfer Equity*, 2017 WL 1090912 (Del. 2017) (Vaughn, J.) (*Williams II*). However, the court found that the Chancery Court had "erred … by focusing on the absence of any evidence to show that [the buyer] caused [the law firm] to withhhold the [tax] opinion." The Delaware Supreme Court held that the "commercially reasonable efforts" clause "placed an affirmative obligation on the parties to take all reasonable steps to obtain the [tax] opinion."

The court further ruled that "once a breach of a covenant is established, the burden is on the breaching party to show that the breach did not materially contribute to the failure of the transaction."

Chancery Court Took an "Unduly Narrow" View of *Hexion* in Interpreting the "Commercially Reasonable Efforts" Clause

In considering whether the buyer had breached the "commercially reasonable efforts" clause, the Chancery Court found dispositive the absence of any evidence either that the buyer had "obstruct[ed] [the law firm's] issuance of the condition-precedent [tax] [o]pinion" or that the buyer's actions "had a material effect on [the law firm's] decision" not to issue the tax opinion. *The Williams Cos. v. Energy Transfer Equity*, 2016 WL 3576682 (Del. Ch. June 24, 2016) (Glasscock, V.C.) (*Williams I*).[6]

The *Williams I* court distinguished the Chancery Court's earlier decision in *Hexion*

6. Please click here to read our prior discussion of the Chancery Court's decision in *Williams I*.

Specialty Chemicals v. Huntsman Corp., 965 A.2d 715 (Del. Ch. 2008). There, the court held a buyer in breach of a contractual obligation to use "reasonable best efforts" to obtain financing for a merger transaction. The *Williams I* court found that "in *Hexion*, the buyer [had] actively and affirmatively torpedoed its ability to finance" the merger by "knowingly" providing its financial advisor with misleading information concerning the transaction. The *Williams I* court reasoned that "[i]f the record here reflected affirmative acts by [the buyer] to coerce or mislead [the law firm], by which actions it prevented the issuance of the [tax opinion], the facts here would more resemble *Hexion* and the outcome here would likely be different."

On appeal, the Delaware Supreme Court found the *Williams I* court had taken "an unduly narrow view of *Hexion*." *Williams II*, 2017 WL 1090912. The Delaware Supreme Court explained that in *Hexion*, the court stated that "to the extent that an act was both commercially reasonable and advisable to enhance the likelihood of consummation of the financing, the onus was on [the buyer] to *take that act*." *Id.* (quoting *Hexion*, 965 A.2d 715) (emphasis added by the *Williams II* court). The Delaware Supreme Court determined that "*Hexion* … recognized that covenants like the ones involved here impose obligations to take all reasonable steps to solve problems and consummate the transaction."[7] The Delaware Supreme Court agreed with the seller that the *Williams I* court had erroneously interpreted the "commercially reasonable efforts" clause "as imposing only a negative duty not to thwart or obstruct performance … rather than an affirmative duty to help ensure performance."

Even If the Buyer Breached the "Commercially Reasonable Efforts" Clause, the Breach Did Not Materially Contribute to the Failure of the Tax Opinion Condition

The Delaware Supreme Court found that "once a breach of a covenant is established, the burden is on the breaching party to show that the breach did not materially contribute to the failure of the transaction." The court made it clear that "[t]he plaintiff has no obligation to show what steps the breaching party could have taken to consummate the transaction."

The Delaware Supreme Court explained that here, the Chancery Court "did not separately analyze in the text of its opinion whether a breach of the covenant materially contributed to the failure of the transaction" because the court found no predicate breach by the buyer. However, the Chancery Court did observe in a footnote that the result would have been the same regardless of how it allocated the burden of proof because there was no evidence in the record that "the action or inaction of the [buyer] … contributed materially to [the law firm's] inability to issue the [tax] [o]pinion." *Id.* (quoting *Williams I*, 2016 WL 3576682). The Chancery Court determined that this would have been "true regardless of whether [the buyer's] actions were commercially reasonable." *Id.* (quoting *Williams I*, 2016 WL 3576682).

The Delaware Supreme Court found the Chancery Court's analysis was "based on findings of fact which [were] not clearly erroneous," and affirmed the Chancery Court's decision.

Chief Justice Strine, Dissenting, States the Buyer Should Have Been Required to Prove That Its Conduct Did Not Materially Contribute to the Failure of the Tax Opinion Condition

In a lengthy dissent, Chief Justice Strine expressed his view that the Chancery Court "did not view the case through the appropriate lens" and applied an incorrect standard in evaluating the buyer's actions. He stated that because the "commercially reasonable efforts" clause "obligated [the buyer] to take affirmative steps to make sure the [tax] opinion condition was satisfied and, instead, [the buyer] did not," the buyer was required to "prove that the [tax] opinion condition would not have been satisfied had it acted appropriately."

Chief Justice Strine explained that he would have "remand[ed] and require[d] a new trial at which [the buyer] would [have been] required to prove that its breach did not materially contribute to the failure of the [law firm] to deliver the [tax] opinion."

7. The merger agreement at issue in *Williams I* and *II* not only "required the parties to use 'commercially reasonable efforts' to obtain the [tax] opinion" but also obligated the parties "to use 'reasonable best efforts' to consummate the transaction." *Williams II*, 2017 WL 1090912.

Delaware Supreme Court: Directors Have No Obligation to Disclose Details About Offers the Directors Deemed Not Worth Pursuing

On March 23, 2017, the Delaware Supreme Court affirmed an August 2016 Chancery Court decision holding that the board of C&J Energy Services had no obligation to provide shareholders with details concerning an offer that the directors deemed not worth pursuing. *City of Miami Gen. Emps. and Sanitation Emps. Ret. Trust*, 2017 WL 1093185 (Del. 2017) (en banc).[8]

C&J shareholders contended that the company "should have given stockholders more information regarding the potential alternate bidders who materialized during the [c]ourt-ordered solicitation process", in particular details regarding a competing bid from Cerberus. *City of Miami Gen. Emps. and Sanitation Emps. Ret. Trust v. Comstock*, 2016 WL 4464156 (Del. Ch. Aug. 24, 2016) (Bouchard, C.). The Chancery Court found that "Delaware law does not require disclosure of a play-by-play of negotiations leading to a transaction or of potential offers that a board has determined were not worth pursuing."

The Proxy Statement did disclose that "the Special Committee had determined that the Cerberus bid was not reasonably likely to lead to a proposal superior to the" offer from a subsidiary of Nabors Industries, which the C&J Board ultimately accepted. The Chancery Court found that plaintiffs' "substantive disagreement with that decision [could not] be recast as a disclosure claim."

On appeal, the Delaware Supreme Court held that plaintiffs "failed to plead facts supporting a rational inference that the one bid made [by Cerberus] would have been regarded as material." The court found plaintiffs "pled no fact supporting the inference that the one bid was financially superior, much less that the bidder was willing to raise its bid to a level that was in fact superior to the Nabors deal." The court also emphasized that "the go-shop process involved a broad outreach to every plausible bidder, [and] the investment bank running the go-shop process had a large incentive to get a superior deal." The court concluded that plaintiffs failed to allege that the proxy statement was materially misleading.

Delaware Chancery Court: (1) *Corwin* Does Not Apply If the Shareholder Vote Was Not Fully Informed and Inequitably Coerced; and (2) Inequitable Coercion Can Exist When a Fiduciary Fails to Act When There Is a Duty to Act

In *Corwin v. KKR Financial Holdings*, 125 A.3d 304 (Del. 2015),[9] the Delaware Supreme Court held that the business judgment rule applies to transactions approved by "a fully informed, uncoerced vote of the disinterested stockholders." On March 31, 2017, the Delaware Chancery Court declined to apply *Corwin* to a stockholder-approved transaction where plaintiffs alleged the vote was neither fully informed nor uncoerced. *In re Saba Software Stockholder Litig.*, 2017 WL 1201108 (Del. Ch. 2017) (Slights, V.C.). Significantly, the court held that plaintiffs need not plead any affirmative action by a fiduciary in order to allege inequitable coercion in connection with a stockholder vote. Rather, the court found that "[i]nequitable coercion can exist … when the fiduciary fails to act when he knows he has a duty to act."

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8. Please click here to read our discussion of a related decision in the case issued by the Delaware Supreme Court.

9. Please click here to read our prior discussion of the *Corwin* decision.

Background

The company at issue allegedly "engaged in a fraudulent scheme ... to overstate its pre-tax earnings." When the alleged scheme came to light, the company "repeatedly promised regulators, its stockholders and the market that it would ... restate its financial statements by a certain date." However, "each time [the company] inexplicably failed to deliver the restatement by the promised deadline." Ultimately, the SEC set a deadline and informed the company that its stock would be deregistered in the event of noncompliance.

Just days before the SEC's deadline, the company executed a merger agreement. The company subsequently missed the SEC's deadline. The SEC responded by revoking registration of the company's stock, causing the stock price to drop substantially.

Following SEC deregistration, the company's board presented stockholders with a choice either to vote in favor of the merger at a per-share price "well below [the stock's] average trading price over the past two years, or continue to hold their now-deregistered, illiquid stock." A majority of the company's shareholders voted to approve the merger.

A former stockholder later brought suit asserting a breach of fiduciary duty claim against the directors. Among other allegations, plaintiff contended that "the [b]oard rushed to complete the transaction ... to enable the [b]oard and members of management to cash-in on their equity awards knowing that deregistration would ultimately render the awards practically worthless."

Business Judgment Rule Standard of Review Is Inapplicable Because the Vote Was Not Fully Informed

The court rejected defendants' contention that the merger had "been 'cleansed' by a fully informed, uncoerced stockholder vote." The court explained that "the business judgment rule is not invoked" under *Corwin* "if troubling facts regarding director behavior were not disclosed that would have been material to a voting stockholder." *Id.* (quoting *Corwin*, 125 A.3d 304).

Here, the court found there were two categories of alleged "material omissions from the [p]roxy [statement] that undermined the stockholder approval of the [m]erger": (1) "the reasons why [the company] was unable to complete the restatement;" and (2) "the post-deregistration options available" to the company.

With respect to the first category of omissions, the court reasoned that "unless the stockholders were armed with information that would allow them to assess the likelihood that [the company] would ever complete a restatement of its financials, they would have [had] no means to evaluate the choice that they were being asked to make."

As to the "post-deregistration options available to" the company, the court recognized that "Delaware law does not require management to discuss the panoply of possible alternatives to the course of action it is proposing ... in a typical case."

However, the court found that this was "hardly a typical case." Here, "a reasonable stockholder would have needed to understand what alternatives to the [m]erger existed" when "considering whether or not [the company] was viable as a going-concern without the [m]erger."

Plaintiff Adequately Alleged the Vote Was Coerced

The court stated that "[i]n addition to requiring a fully informed stockholder vote as a predicate to cleansing, *Corwin* also directs that the court consider whether the [c]omplaint supports a reasonable inference that the stockholder vote was coerced." The court explained that "[i]n the deal context, the vote must be structured in such a way that allows shareholders a free choice between

maintaining their current status or taking advantage of the new status offered by the proposed deal."

The court rejected defendants' argument that "to find 'actionable coercion' the court must identify 'some *affirmative action* by the fiduciary'" that impacted stockholders' freedom of choice. The court held that "[i]nequitable coercion can exist as well when the fiduciary fails to act when he knows he has a duty to act and thereby coerces stockholder action." Moreover, the court found that "whether the fiduciary's motives were benign or unfaithful when creating the circumstances that cause coercion is not dispositive."

In this case, the court found "the [allegedly] inequitable coercion flowed from the situation in which the [b]oard placed its stockholders as a consequence of its allegedly wrongful action and inaction." The court held plaintiff adequately alleged the existence of "'situationally coercive factors' [that] may have wrongfully induced ... stockholders to vote in favor of the [m]erger for reasons other than the economic merits of the transaction."

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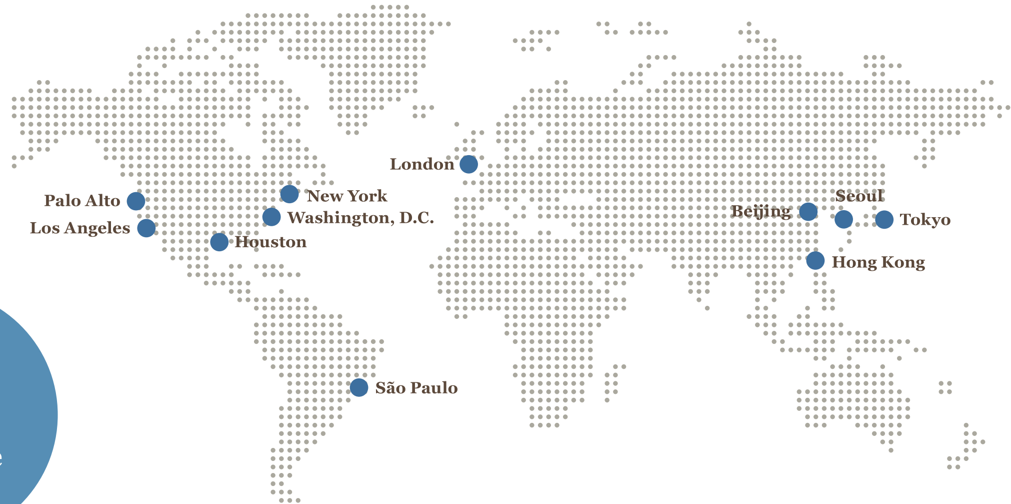

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