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Supreme Court Holds a Fiduciary's Allegedly Imprudent Retention of an Investment May Be an "Action" or "Omission" for Purposes of Triggering the Six-Year Statute of Repose for ERISA Claims

On May 18, 2015, the Supreme Court considered "whether a fiduciary's allegedly imprudent retention of an investment is an 'action' or 'omission' that triggers the running" of the six-year statute of repose for breach of fiduciary duty claims brought under the Employee Retirement Income Security Act of 1974 ("ERISA").[1] *Tibble v. Edison Int'l*, 2015 WL 2340845 (May 18, 2015) (Breyer, J.).

Background

In 2007, beneficiaries of the Edison 401(k) Savings Plan (the "Plan") brought suit in the Southern District of California against Edison International and the Plan's fiduciaries alleging that defendants had

1. Pursuant to ERISA, "a breach of fiduciary duty complaint is timely if filed no more than six years after 'the date of the last action which constituted a part of the breach or violation' or 'in the case of an omission the latest date on which the fiduciary could have cured the breach or violation'" (*quoting* 29 U.S.C. § 1113).

"acted imprudently by offering six higher priced retail-class mutual funds as Plan investments when materially identical lower priced institutional-class mutual funds were available." Three of these funds were added to the Plan in 1999, more than six years before plaintiffs filed suit.

The district court dismissed plaintiffs' claims in connection with these three funds on timeliness grounds. The Ninth Circuit affirmed, finding plaintiffs' claims "untimely because [plaintiffs] had not established a change in circumstances that might trigger an obligation to review and to change investments within the 6-year statutory period." The Ninth Circuit focused "upon the act of 'designating an investment for inclusion' to start the 6-year period" (quoting *Tibble v. Edison Int'l*, 729 F.3d 1110 (9th Cir. 2015)). In the Ninth Circuit's view, "'[c]haracterizing the mere continued offering of a plan option, without more, as a subsequent breach would render' the statute meaningless and could even expose present fiduciaries to liability for decisions made decades ago" (quoting *Tibble*, 729 F.3d 1110). Plaintiffs appealed.

Supreme Court Holds a Plaintiff May State an ERISA Breach of Fiduciary Duty Claim by Alleging That the Fiduciary Failed to Monitor Plan Investments and Remove Imprudent Investments Within the Six Year Statute of Repose

The Supreme Court determined that "the Ninth Circuit [had] erred by applying a 6-year statutory bar based solely on the initial selection of the three funds without considering the contours of the alleged breach of fiduciary duty." The Court explained that "under trust law," which courts "often must look to" when "determining the contours of an ERISA fiduciary's duty," "a fiduciary is required to conduct a regular review of its investment with the nature and timing of the review contingent on the circumstances."

Examining trust law, the Court found that "a trustee has a continuing duty to monitor trust investments and remove imprudent ones." The Court stated that "[t]his continuing duty exists separate and apart from the trustee's duty to exercise prudence in selecting investments at the outset." A trustee may not "assume that if investments are legal and proper for retention at the beginning of the trust, or when purchased, they will remain so indefinitely." Instead, a trustee must systematically review trust investments "'at regular intervals' to ensure that they are appropriate."

Applying these trust law principles to ERISA fiduciaries, the Court held that "[a] plaintiff may allege that a fiduciary breached the duty of prudence [under ERISA] by failing to properly monitor investments and remove imprudent ones." The Court further ruled that an ERISA claim "is timely" "so long as the alleged breach of [this] continuing duty occurred within six years of [the] suit."

The Court remanded the action to the Ninth Circuit for consideration of whether the ERISA duty of prudence "require[d] a review of the contested mutual funds here, and if so, just what kind of review" was required. Notably, the Court "express[ed] no view on the scope of respondents' fiduciary duty in this case."

Sixth Circuit Applies the *Reves* Factors to Find That Promissory Notes Are "Securities" Subject to the Federal Securities Laws

On May 21, 2015, the Sixth Circuit considered whether promissory notes representing what turned out to be "fake investments in Saudi Arabian oil" that were sold "to dozens of unsuspecting victims" were "securities" subject to the federal securities laws. *SEC v. Zada*, 2015 WL 2402136 (6th Cir. 2015) (Kethledge, J.). Applying the four-factor test set forth in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), the Sixth Circuit determined that all four *Reves* factors "reinforce[d] [the] presumption" that the notes were "securities" subject to the federal securities laws.

The Sixth Circuit explained that in order "[t]o rebut the presumption that a particular note is a security, a defendant must show that the note bears a 'family resemblance'" to "instruments that are not securities," such as "consumer debt, home-mortgage loans, character loans to bank customers,

and short-term commercial debt." "Whether the note bears a resemblance to one of those instruments depends on four factors" established in *Reves*: (1) "the motivation prompting the transaction;" (2) the "plan of distribution;" (3) the "'reasonable expectations of the investing public;'" and (4) "whether a 'risk-reducing factor' (for example, another regulatory scheme) makes 'application of the [federal securities laws] unnecessary.'"

The Sixth Circuit stated that "[t]he first *Reves* factor—the motivations that prompted the buyers to enter into the transactions—turns on whether the buyers' purpose was 'investment (suggesting a security) or commercial or consumer (suggesting a non-security).'" In the case before it, "the SEC [had] presented testimony from several investors and an affidavit from another, all to the effect that [defendant had given] them the notes as part of a scheme to invest in Saudi oil." With respect to defendant's contention that "some of the investors referred to the transactions as 'loans,'" the Sixth Circuit explained that a financial instrument can be at once a loan and a security. The court noted that "[a] corporate bond, for example, is both a loan to the corporation and an investment for the lender." The Sixth Circuit underscored that "economic realities" are what matter most when determining whether an instrument is a security. Here, the court found it "doubtful that 60 investors—including several firefighters and a horse trainer—would make personal loans to a self-styled multimillionaire."

The Sixth Circuit next considered the "plan of distribution" for the promissory notes at issue. The court stated that "[i]f notes are sold to a wide range of unsophisticated people, as opposed to a handful of institutional investors, the notes are more likely to be securities." Here, defendant "sold the notes to a variety of laypersons." The court found that this supported the SEC's claim that the notes constituted "securities."

As to the third *Reves* factor ("the reasonable expectations of the investing public"), the Sixth Circuit explained that notes are likely to be "securities if a reasonable person would expect the securities laws to apply" to those notes. In the case at hand, the court observed that defendant's "victims thought they were making lucrative investments in oil, which is traded on global markets." Because the "federal securities laws are broad enough to cover 'virtually any' marketable investment," the Sixth Circuit determined that "a reasonable person who gave [defendant] money to invest in oil markets would expect that the securities laws appl[ied] to the transaction."

Finally, the Sixth Circuit found that "[t]he final *Reves* consideration—whether a risk-reducing factor makes application of the Securities Acts unnecessary—likewise suggest[ed] that [defendant] sold securities." The court explained that "[i]f the notes that [defendant] sold were not securities, then they 'would escape federal regulation entirely.'" The court determined that "this factor favor[ed] the SEC as well."

Based on the *Reves* analysis, the Sixth Circuit concluded that the notes were securities subject to the requirements of the federal securities laws.

Seventh Circuit Vacates Jury Verdict in HSBC Securities Fraud Action on Loss Causation Grounds, Finding Plaintiffs' Loss Causation Model Failed to Eliminate Firm-Specific, Nonfraud Factors That May Have Impacted HSBC's Stock Price

On May 21, 2015, the Seventh Circuit vacated a jury verdict finding Household International, Inc., now known as HSBC Finance Corp. ("HSBC"), and several of its executives liable for $2.46 billion in damages for securities fraud. *Glickenhaus & Co. v. Household Int'l, Inc.*, 2015 WL 2408028 (7th Cir. 2015) (Sykes, J.). Relying on the Supreme Court's decision in *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336 (2005), the Seventh Circuit held that defendants were entitled to a new trial because plaintiffs' leakage model of loss causation "did not adequately account for the possibility that firm-specific, nonfraud related information may have affected the decline in [HSBC's] stock price during the relevant time period."

Background

Plaintiffs brought suit "alleging that on numerous occasions [HSBC] and its executives [had] misrepresented [HSBC's] lending practices, delinquency rates, and earnings from credit-card agreements." The case proceeded to trial before a jury. During trial, plaintiffs' expert presented two different models—the specific-disclosure model and the leakage model—for measuring the amount by which HSBC's stock price was "overpriced" as a result of defendants' alleged misrepresentations.

The specific-disclosure model measured the effect of each "major disclosure event" on HSBC's stock price on the specific day of that event. Plaintiff's expert determined "[t]he effect of a disclosure event" based on "the actual return on the day of the disclosure minus the predicted return (using [a] regression model and the broader market returns that day)." The leakage model accounted for the possibility that "the information contained in a major disclosure event often leaks out to some market participants before its release." The leakage model factored in "every difference, both positive and negative, between the stock's predicted returns … and the stock's actual returns during the disclosure period." Pursuant to the leakage model, plaintiffs' expert assumed that the effect of defendants' disclosures was equal to "[t]he total sum of these residual returns."

During trial, the jurors were asked to determine "which model more accurately measured the effect of disclosures," among other issues. The jury "adopted and applied the leakage model," and found defendants liable for $2.46 billion in damages. Defendants appealed the jury verdict on the grounds that, *inter alia*, "the leakage model … did not account for firm-specific, nonfraud factors that may have affected the decline in [HSBC's] stock price."

Defendants also contended that the court had "incorrectly instructed" the jury "on what it means to 'make' a false statement in violation of the securities laws." The district court had advised the jury that in order "[t]o prevail on their 10b-5 claim against any defendant, plaintiffs must prove … the defendant made, approved, or furnished information to be included in a false statement of fact."

Defendants moved for a new trial based on the Supreme Court's decision in *Janus Capital Group v. First Derivative Traders*, 131 S. Ct. 2296 (2011), which was issued after the trial.[2] The *Janus* Court held that "[f]or purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." The district court denied defendants' motion, "reasoning that the [*Janus*] Court's holding applied only to legally independent third parties (like the investment advisor in *Janus* itself), not corporate insiders like the individual defendants here, all top executives at [HSBC]." Defendants appealed.

Seventh Circuit Finds a New Trial Is Warranted on Loss Causation Grounds Because the Leakage Model Did Not Account for Firm-Specific, Nonfraud Factors

On appeal, the Seventh Circuit found that "in order to prove loss causation" under *Dura*, 544 U.S. 336, "plaintiffs in securities-fraud cases need to isolate the extent to which a decline in stock price is due to fraud-related corrective disclosures and not other factors." The court observed that in *Dura*, the Supreme Court recognized that a stock price decline "may reflect, not the earlier misrepresentation, but [also] changed investor expectations, new industry-specific or *firm-specific facts, conditions, or other events*, which taken separately or together account for some or all of that lower price" (quoting *Dura*, 544 U.S. 336) (emphasis added by the Seventh Circuit).

The Seventh Circuit determined that plaintiffs' "leakage theory … did not adequately account for the possibility that firm-specific, nonfraud related information may have affected the decline in [HSBC's] stock price." The court found that "[t]he model assume[d] that any changes in [HSBC's] stock price—other than those that [could] be explained by general market and industry trends—[were] attributable to the fraud-related disclosures." In the event that "there was significant negative information [during the class period] about [HSBC] unrelated to these corrective disclosures (and not attributable to market or industry

2. Please click here to read our prior discussion of *Janus* decision.

trends)," then the court determined that "the model would [have] overstate[d] the effect of the disclosures and in turn of the false statements." Conversely, if "there was significant *positive* information about [HSBC]" during the class period, "then the model would [have] *understate*[d] the effect of the disclosures" (emphasis in the original).

The Seventh Circuit acknowledged that "[f]irm-specific, nonfraud factors were not entirely ignored" under plaintiffs' leakage model. Plaintiffs' expert "testified that he looked for company-specific factors during the relevant period and did not find any significant trend of positive or negative information apart from the fraud-related disclosures." However, defendants argued that "this was not enough" under *Dura* because the "loss-causation model must *itself* account for, and perfectly exclude, any firm-specific, nonfraud related factors that may have contributed to the decline in a stock price."

The Seventh Circuit observed that "[i]t may be very difficult, if not impossible, for any statistical model" to "perfectly exclude" nonfraud factors. The court found that "[a]ccepting the defendants' position likely would doom the leakage theory as a method of quantifying loss causation." However, the court also recognized that "if it's enough for a loss-causation expert to offer a conclusory opinion that no firm-specific, nonfraud related information affected the stock price during the relevant time period, then it may be far too easy for plaintiffs to evade the loss-causation principles explained in *Dura*."

Finding neither option perfect, the Seventh Circuit adopted a "middle ground" position. The court found that "[i]f the plaintiffs' expert testifies that no firm-specific, nonfraud related information contributed to the decline in stock price during the relevant time period and explains in nonconclusory terms the basis for this opinion," then defendants must "identify[ ] some significant, firm-specific, nonfraud related information that could have affected the stock price." If defendants cannot do this, then "the leakage model can go to the jury." If defendants can identify any firm-specific, nonfraud factors, however, then the burden "shifts back to the plaintiffs to account for that specific information or provide a loss-causation model that doesn't suffer from the same problem, like the specific-disclosure model." The court observed that "[o]ne possible way to address the issue is to simply exclude from the model's calculation any days identified by the defendants on which significant, firm-specific, nonfraud related information was released."

The Seventh Circuit vacated the jury verdict and remanded the action for a new trial on the loss causation issue "consistent with [this] approach."

Seventh Circuit Holds the District Court Erred by Limiting the *Janus* Holding to Corporate Outsiders

The Seventh Circuit further held that the district court had erred in concluding that the Supreme Court's decision in *Janus* "applie[s] only to legally independent third parties" and not "corporate insiders." The Seventh Circuit found that "[n]othing in *Janus* limits its holding to legally independent third parties." Rather, the Supreme Court's interpretation of Rule 10b-5 "applies generally, not just to corporate outsiders."

The Seventh Circuit determined that the district court's jury instruction on what it means to "make" a statement for Rule 10b-5 purposes "directly contradict[ed] *Janus*." The court had "instructed the jury that the plaintiffs could prevail on their Rule 10b-5 claim if they proved that the defendant 'made, *approved, or furnished information* to be included in a false statement'" (emphasis in the original). The Seventh Circuit found that "[t]his goes well beyond the narrow interpretation [of Rule 10b-5] adopted in *Janus*" and "plainly misstated the law."

The Seventh Circuit held that this instructional error did not prejudice HSBC itself, because "[t]he company stipulated that it [had] 'made' all statements in its SEC filings and press releases." However, the court found that the error did prejudice the individual defendants, including HSBC's CEO. For example, the Seventh Circuit found no basis for plaintiffs' claim that the CEO had "'made' the statements in the [company's] press releases." The court noted that the CEO "had authority over the press releases in the sense that he *could have* exercised control over their content" (emphasis in the original). However, the Seventh Circuit explained that "if that were enough to satisfy *Janus*, then

CEOs would be liable for *any* statements made by their employees acting within the scope of their employment." The court found that such an approach "wouldn't square with the Court's reminder about 'the narrow scope that we must give the implied private right of action' under Rule 10b-5." To satisfy *Janus*'s requirements, the Seventh Circuit explained that HSBC's CEO "must have *actually exercised* control over the content of the press releases and whether and how they were communicated" (emphasis in the original).

The Seventh Circuit held that all three HSBC executives were entitled to a new trial on the issue of whether they had "made" the statements alleged within the meaning of *Janus*.

Southern District of New York Dismisses Securities Fraud Action Against Prosensa, Finding Companies Have No Obligation to Spell Out Inferences or Draw Conclusions for Investors

On May 5, 2015, the Southern District of New York dismissed a securities action brought under Sections 11 and 15 of the Securities Act against Prosensa Holding on the grounds that plaintiffs had failed to allege any misstatements or omissions in the company's registration statement concerning the clinical trials for drisapersen, a muscular dystrophy drug. *Singh v. Schikan*, 2015 WL 2070222 (S.D.N.Y. 2015) (Buchwald, J.).[3] The court found that plaintiffs were "essentially" demanding "an extra level of disclosure spelling out inferences and drawing conclusions for investors" with respect to the likelihood that the Phase III trial for drisapersen would succeed. The court held that "defendants were not required to draw out such inferences or to make such forecasts in order to provide complete and accurate disclosures."

3. Simpson Thacher represents the underwriter defendants in this action. Plaintiffs' have moved for reconsideration of the court's May 5, 2015 decision.

Court Finds Prosensa Disclosed All Material Information Concerning the Phase II and Phase III Clinical Trials for Drisapersen, and Had No Obligation to Analyze That Information for Investors

At the outset of its analysis, the court observed that plaintiffs did not allege "any affirmative misstatements" in Prosensa's registration statement. Rather, plaintiffs "only alleged omissions regarding certain differences between" the Phase II and Phase III clinical trials for drisapersen ("DEMAND-II" and "DEMAND-III" respectively). Specifically, plaintiffs alleged that because of "DEMAND-III's reduced enrollment criteria and … its expanded testing locations," "defendants knew or should have known … the DEMAND-III study was fundamentally flawed and was not likely to produce positive results as DEMAND-II had." Plaintiffs claimed that "the Registration Statement should have highlighted these differences and should have disclosed the negative impact these differences would likely have on the study's findings and therefore on the drug's prospects."

The court determined that "no facts per se were omitted from the prospectus." Plaintiffs did not dispute that "the key details of both studies, including their respective enrollment criteria and DEMAND-III's expanded testing universe, were disclosed in the Registration Statement." The court found that what plaintiffs were "essentially" challenging was defendants' failure to "spell[ ] out inferences" and "draw[ ] conclusions" based on the differences between the DEMAND-II and DEMAND-III studies. The court held that the disclosure obligations of the securities laws do not require defendants to "draw out such inferences" or "make such forecasts."

Court Clarifies That Companies Have No Obligation to Present Material Facts in a Negative Light

The court found meritless plaintiffs' contention that defendants were required to "emphasize" the differences between the DEMAND-II and DEMAND-III studies and "to note that these changes were likely to negatively impact" the DEMAND-III study. The court explained that there was no need for defendants to "highlight these differences"

because "the relevant information—each study's design and results, if available—was easily located and … accurately described" in the Registration Statement, "allowing investors to compare the trials themselves." Moreover, the court held that "defendants' disclosures" were not actionable simply "because they failed to characterize the differences between the studies in a certain way." The court stated that "the law is clear that companies need not depict facts in a negative or pejorative light or draw negative inferences to have made adequate disclosures."

Court Finds Defendants Are Not Required to Speculate About the Possibility of Failure

The court also rejected "[p]laintiffs' broader claim that defendants should have disclosed that the differences in the DEMAND-III study would cause it to fail." The court found that plaintiffs had "made no allegations suggesting that defendants could have known that the study would in fact produce worse results." Given "the absence of data establishing that DEMAND-III would not meet its endpoints," the court held that "defendants were not required to predict negative results or to hypothesize [the study's] failure." The court found this conclusion "all the more appropriate where, as here, such speculation would have been based solely on facts disclosed in the Registration Statement, from which investors were equally free to assess the study's likelihood of success."

The court determined that "defendants [had] disclosed the facts known at the time of the IPO that would subsequently affect the study and the stock price, and were not required to foresee the failure of the study or the specific reasons for its hypothetical failure." The court held that defendants had "fulfilled their disclosure obligations" and therefore dismissed plaintiffs' claims.

Delaware Supreme Court Holds Plaintiffs Must Plead a Non-Exculpated Claim Against Disinterested, Independent Directors to Survive a Motion to Dismiss Even If the Transaction at Issue Is Subject to Entire Fairness Review

On May 14, 2015, the Delaware Supreme Court addressed the following question: "in an action for damages against corporate fiduciaries, where the plaintiff challenges an interested transaction that is presumptively subject to entire fairness review, must the plaintiff plead a non-exculpated claim against the disinterested, independent directors to survive a motion to dismiss by those directors?" *In re Cornerstone Therapeutics Inc., S'holder Litig.*, 2015 WL 2394045 (Del. 2015) (Strine, C.J.) (*Cornerstone II*). The court "answer[ed] that question in the affirmative," and held that "[a] plaintiff seeking only monetary damages must plead non-exculpated claims against a director who is protected by an exculpatory charter provision to survive a motion to dismiss, regardless of the underlying standard of review for the board's conduct."

Background

The Delaware Supreme Court considered appeals in two cases in which the Delaware Chancery Court had denied defendants' motions to dismiss claims against independent directors in transactions subject to the entire fairness standard of review even though plaintiffs had failed to plead non-exculpated claims against those directors. *In re Cornerstone Therapeutics Inc. Stockholder Litig.*, 2014 WL 4418169 (Del. Ch. Sept. 10, 2014) (*Cornerstone I*);[4] *In re Zhongpin Inc. Stockholders Litig.*, 2014 WL 6735457 (Del. Ch. Nov. 26, 2014).

Both cases "involve[d] damages actions by stockholder plaintiffs arising out of mergers in which the controlling stockholder, who had representatives on the board of directors, acquired the remainder of the

4. Please click here to read our prior discussion of the *Cornerstone I* decision.

shares that it did not own in a Delaware public corporation." *Cornerstone II*, 2015 WL 2394045. In both instances, the "mergers were negotiated by special committees of independent directors, were ultimately approved by a majority of the minority stockholders, and were at substantial premiums to the pre-announcement market price." However, because the companies "did not follow the process established in" *Kahn v. M&F Worldwide Corporation*, 88 A.3d 635 (Del. 2014)[5] "as a safe harbor to invoke the business judgment rule in the context of a self-interested transaction," the Chancery Court found in both cases that "the entire fairness standard presumptively applied."

In both cases, an exculpatory provision adopted in accordance with 8 *Del. C.* § 102(b)(7) protected the independent directors from monetary damages for breach of the duty of care. The Chancery Court interpreted Delaware precedent to find that "even if the plaintiffs could not plead a non-exculpated claim against any particular director, as long as the underlying transaction was subject to the entire fairness standard of review, and the plaintiffs were therefore able to state non-exculpated claims against the interested parties and their affiliates, all of the directors were required to remain defendants until the end of litigation." Defendants appealed.

Delaware Supreme Court Holds Plaintiffs Must Plead Non-Exculpated Claims Against Independent Directors to Survive Dismissal Regardless of the Applicable Standard of Review

On appeal, the Delaware Supreme Court 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." The court underscored that this "rule applies regardless of the underlying standard of review for the transaction." The Delaware Supreme Court explained that "the mere fact that a plaintiff is able to plead facts supporting the application of the entire fairness standard to the transaction, and can thus state a duty of loyalty claim against the interested fiduciaries, does not relieve the plaintiff of the responsibility to plead a non-exculpated claim against each director who moves for dismissal."

In so holding, the Delaware Supreme Court relied on its earlier decision in *Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001). There, the court "analyzed the effect of a Section 102(b)(7) provision on a due care claim against directors who [had] approved a transaction which the plaintiffs argued should be subject to review under the *Revlon* standard." The court found that "[b]ecause a director will only be liable for monetary damages if she has breached a non-exculpated duty, a plaintiff who pleads only a due care claim against that director has not set forth any grounds for relief" since the Section 102(b)(7) exculpatory provision bars such a claim as a matter of law.

Delaware Supreme Court Rejects an Automatic Inference of Director Disloyalty in Controller Transactions as Inconsistent with "Basic Tenets of Delaware Law" and Not in the Best Interests of Minority Stockholders

The Delaware Supreme Court in *Cornerstone II* determined that there were "several problems" with plaintiffs' contention that "they should be entitled to an automatic inference that a director facilitating an interested transaction is disloyal because the possibility of conflicted loyalties is heightened in controller transactions." First, the court explained that "each director has a right to be considered individually when the directors face claims for damages in a suit challenging board action." This "individualized consideration does not start with the assumption that each director was disloyal; rather, 'independent directors are presumed to be motivated to do their duty with fidelity.'"

Second, the Delaware Supreme Court found that such an inference "would likely create more harm than benefit for minority stockholders in practice." The court explained that Delaware law has long "recognized that the negotiating efforts of independent directors can help to secure transactions with controlling stockholders that are favorable to the minority." The court stated that it "decline[d] to adopt an approach that would create incentives for independent directors to

5. Please click here to read our prior discussion of the *M&F* decision.

avoid serving as special committee members, or to reject transactions solely because their role in negotiating on behalf of the stockholders would cause them to remain as defendants until the end of any litigation challenging the transaction." The *Cornerstone II* court observed that "the fear that directors who faced personal liability for potentially value-maximizing business decisions might be dissuaded from making such decisions is why Section 102(b)(7) was adopted in the first place."

Delaware Supreme Court Finds That *Emerald* Partners Does Not Support Plaintiffs' Position

The Chancery Court had relied on the Delaware Supreme Court's prior decision in *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001), in denying defendants' motion to dismiss claims against the independent directors. On appeal, the *Cornerstone II* court found *Emerald Partners* distinguishable because the case involved "a viable, non-exculpated loyalty claim against each putatively independent director." Given the circumstances, the *Emerald Partners* court "held that the determination of whether any failure of the putatively independent directors was the result of disloyalty or a lapse in care was best determined after a trial, because the substantive fairness inquiry would shed light on why the directors acted as they did." The *Cornerstone II* court explained that *Emerald Partners* "did not answer the specific question" of "whether the application of the entire fairness standard requires the Court of Chancery to deny a motion to dismiss by independent directors even when the plaintiffs may not have sufficiently pled a non-exculpated claim against those directors."

The Delaware Supreme Court in *Cornerstone II* held that "when the plaintiffs have pled no facts to support an inference that any of the independent directors breached their duty of loyalty, fidelity to the purpose of Section 102(b)(7) requires dismissal of the complaint against those directors." The court reversed the Chancery Court's judgments in both *Cornerstone I* and *Zhongpin* and "remand[ed] each case for the Court of Chancery to determine if the plaintiffs have sufficiently pled facts suggesting that the independent directors committed a non-exculpated breach of their fiduciary duty."

Delaware Chancery Court Rules That Self-Interested Director Compensation Decisions May, Under Certain Circumstances, Be Subject to Entire Fairness Review

A recent Delaware Chancery Court decision confirms that, as the court held three years ago in *Seinfeld* v. *Slager*, 2012 WL 2501105 (Del. Ch. June 29, 2012), there is no shareholder ratification defense for self-awarded director compensation granted under a stockholder-approved option or bonus plan that lacks "'sufficiently defined terms'" or "some *meaningful* limit" on director discretion. *Calma v. Templeton*, 2015 WL 1951930 (Del. Ch. Apr. 30, 2015) (Bouchard, C.) (quoting *In re 3COM Corp. Shareholders Litig.*, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999)).

I. General Standard

Director decisions are generally afforded wide latitude under the business judgment rule.[6] The protections of the business judgment rule, however, "can only be claimed by disinterested directors." *Aronson*, 473 A.2d 805. The "directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing …."

A decision by directors to award themselves compensation necessarily fails this test, subjecting the decision to the entire fairness standard—a higher level of scrutiny. However, the court will apply the more deferential business judgment rule to a director compensation decision if such decision was "made under a stock option plan approved by the corporation's shareholders." *In re 3COM Corp. S'holders Litig.*, 1999 WL 1009210 (Del. Ch. 1999) . This is known as a stockholder ratification defense.

6. When reviewing a business decision under the business judgment rule standard, the court presumes that in making the business decision, "the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

II. *Calma* and *Slager*: A Recent Trend

In a recent pair of shareholder derivative cases, the Delaware Court of Chancery narrowed the application of the stockholder ratification defense. Most recently, on April 30, 2015, the Court of Chancery held in *Calma v. Templeton* that a board decision to grant restricted stock units ("RSUs") to the non-employee directors of Citrix Systems, Inc. was subject to the entire fairness standard of review.

In *Calma*, 2015 WL 1951930, the board's compensation committee granted RSU awards under Citrix's 2005 Equity Incentive Plan (the "Plan"). The Plan was approved by a majority of Citrix's stockholders in a prior vote. While the majority of the directors' compensation consisted of these RSU awards, the Plan applied to multiple classes of beneficiaries—not just directors—including Citrix's officers, employees, consultants and advisors. The only limit on compensation imposed by the Plan was that "no beneficiary could receive more than one million shares (or RSUs) per calendar year." There were no sub-limits in the Plan based on the beneficiary's position within Citrix (e.g., separate limits for non-employee directors and consultants). Based on Citrix's stock price, one million RSUs were worth over $55 million on the date the lawsuit was filed.

Although Citrix's non-employee directors were awarded between 3,000 and 4,000 RSUs in each of 2011, 2012, and 2013—well below the one million RSU limit under the Plan—the stockholder plaintiff challenged the RSU grants for these years, arguing that they were "excessive" when compared to the compensation received by directors of Citrix's peers. The defendants took the position that the Board's decision to award directors RSUs should be subject to the business judgment rule standard of review because the decision was consistent with the Plan and stockholders had ratified the Plan. Relying on a prior case, *Seinfeld v. Slager*, the plaintiff argued that even though the RSU awards were granted under the stockholder-approved Plan, the defendants must "establish the entire fairness of the RSU Awards because the Plan 'has no meaningful limits' on the total equity compensation that the Company's non-employee directors could hypothetically receive."

The court agreed with the plaintiff, holding that "advance stockholder approval of a compensation plan with multiple classes of beneficiaries and a single generic limit on the amount of compensation that may be awarded in a given year" is not sufficient to establish a ratification defense. Accordingly, the court ruled that the board's decision was subject to the entire fairness standard of review under which the directors have the burden of establishing that "'the transaction was the product of both fair dealing and fair price.'" In distinguishing the case before it from the sixty years of precedent the defendants pointed to, the court noted that in prior cases the ratification defense was recognized because stockholders approved specific director compensation awards or Plans with director-specific compensation ceilings.[7] By contrast, in *Calma*, the stockholders "were never asked to approve—and thus did not approve—any *action bearing specifically on the magnitude of compensation for the Company's non-employee directors*" (emphasis in the original). The Citrix stockholders did not vote in favor of the specific RSU grants at issue or vote to impose a meaningful limit on directors specifically.

Calma continues a trend begun three years earlier in a similar case: *Seinfeld* v. *Slager*, 2012 WL 2501105. In *Slager*, a Republic Services, Inc. stockholder challenged the fairness of RSUs granted to the company's non-employee directors under the company's stockholder-approved compensation plan. As in *Calma*, the beneficiaries of the plan included the company's directors, officers, and employees. The plan similarly did not include specific RSU grants for directors or set forth a director-specific ceiling on compensation. Rather, the plan imposed generic limits of 10.5 million shares total and 1.25 million shares that any one beneficiary could receive per year. With twelve directors, the Board could have theoretically awarded each director 875,000 RSUs, which were worth over $21.6 million per recipient at the time. The court held that even though the stockholders approved the plan, the director

7. For cases in which the ratification defense was applied, *see, e.g.*, *Cambridge Retirement System v. Bosnjak*, 2014 WL 2930869 (Del. Ch. June 26, 2014) (stockholders specifically approved the awards at issue); *In re 3COM Corp. Shareholders Litig.*, 1999 WL 1009210 (the plan imposed a director-specific ceiling); *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997) (stockholders approved a plan that detailed the specific compensation to be paid to directors); *Steiner v. Meyerson*, 1995 WL 441999 (Del. Ch. July 19, 1995) (same); *Kerbs v. California E. Airways, Inc.*, 90 A.2d 652 (Del. 1952) (same).

compensation decision was still a self-dealing transaction because the stock plan lacked "sufficient definition."[8] Accordingly, the court held that the board's decision was subject to the entire fairness standard of review.

III. Pending Cases

At least two similar cases challenging director compensation decisions are currently pending before the Delaware Chancery Court: one involving Facebook, Inc. and one involving Celgene Corporation. In a shareholder derivative complaint filed against Facebook on June 6, 2014, the plaintiffs allege that Facebook's directors awarded themselves unfair, excessive compensation and are therefore liable for breach of fiduciary duty, waste of corporate assets, and unjust enrichment.[9] As in *Calma* and *Slager*, Facebook's shareholders approved an Equity Incentive Plan. However, the only limits in the plan are a total limit of 25 million shares and a per person annual limit of 2.5 million shares. At the time the complaint was filed, 2.5 million Facebook shares were worth approximately $145 million, which the complaint alleges is "not a true limit."[10]

8. The court opined:

> "The sufficiency of definition that anoints a stockholder-approved option or bonus plan with business judgment rule protection exists on a continuum. Though the stockholders approved this plan, there must be some meaningful limit imposed by the stockholders on the Board for the plan to … receive the blessing of the business judgment rule …. A stockholder-approved carte blanche to the directors is insufficient. The more definite a plan, the more likely that a board's compensation decision will be labeled disinterested and qualify for protection under the business judgment rule. If a board is free to use its absolute discretion under even a stockholder-approved plan, with little guidance as to the total pay that can be awarded, a board will ultimately have to show that the transaction is entirely fair."

Although this principle as it applies to director compensation was announced in *Slager*, the idea that a stockholder-approved carte blanche is insufficient to qualify for the protection of the business judgment rule is not new. As Chancellor Bouchard noted in *Calma*, this idea was actually announced years earlier in *Sample v. Morgan*, 914 A.2d 647 (Del. Ch. 2007). In *Sample*, the court explained that "the Delaware doctrine of ratification does not embrace a 'blank check' theory…. [T]he mere approval by stockholders of a request by directors for the authority to take action within broad parameters does not insulate all future action by the directors within those parameters from attack."

9. *See* Verified Shareholder Derivative Complaint for Breach of Fiduciary Duty, Waste of Corporate Assets, and Unjust Enrichment at 1-2, *Espinoza v. Zukerberg*, C.A. No. 9745-CB (Del. Ch. June 6, 2014).

10. Facebook filed a Motion to Dismiss and for Summary Judgment. The court is expected to hear oral arguments on the motion on July 28, 2015.

The shareholder derivative lawsuit on behalf of Celgene Corporation, filed in October 2014, alleges that the compensation made to non-employee directors in 2013 and 2014 was excessive compared to grants made to directors of peer companies.[11] As in *Calma*, *Slager*, and the case against Facebook, Celgene has a shareholder-approved Stock Incentive Plan. The only limit under Celgene's 2013 plan is that no individual can receive more than 1.5 million shares per year. As of the date of filing, 1.5 million shares were worth approximately $130 million.

Delaware Chancery Court Relies on the Merger Price in Appraising AutoInfo's Shares

On April 30, 2015, the Delaware Chancery Court determined that the merger price was "the best estimate" of the fair value of AutoInfo's shares in a Section 262 appraisal action brought in connection with Comvest Partners' acquisition of AutoInfo. *Merlin Parters LP v. AutoInfo, Inc.*, 2015 WL 2069417 (Del. Ch. Apr. 30, 2015) (Noble, V.C.).

Pursuant to 8 *Del. C.* § 262, "stockholders who elect against participating in certain merger transactions may petition the Court to determine the fair value of their stock." In assessing "fair value" for purposes of Section 262, a court must "independently evaluate[ ] the evidence concerning fair value" and may not "presumptively defer to any particular valuation metric." The court may consider a discounted cash flow ("DCF") analysis, "a comparable transactions analysis, a comparable companies analysis, or the merger price itself" in making its determination.

In evaluating the 'fair value'" of AutoInfo's shares, the court found plaintiffs' expert's DCF analysis unreliable because plaintiffs had "failed to establish the credibility" of the management projections on which that analysis was based. The court explained that AutoInfo's management had not prepared projections in the ordinary course of business, and that the projections "created during the

11. *See* Verified Stockholder Derivative Complaint for Breach of Fiduciary Duty, Waste of Corporate Assets, and Unjust Enrichment, *Steinberg v. Casey*, C.A. No. 10190-CB (Del. Ch. Oct. 2, 2014).

sales process" were "indisputably optimistic" and thus "deserve[d] little deference."

The court also gave "no weight" to plaintiffs' experts' comparable companies analyses because the comparable companies were "all significantly larger than AutoInfo." The court explained that it may "reject comparable companies analyses based on purported comparables that differ significantly in size from the company being appraised" because "smaller firms are riskier and thus [typically] face higher costs of equity capital" than larger firms. The court also faulted plaintiffs' expert for failing to consider business model differences between AutoInfo and the comparable companies selected.

In view of the absence of other "credible valuations," the court found that the merger price was "a strong indicator of value." The court reasoned that "the sales process was generally strong and [could] be expected to have led to a [m]erger price indicative of fair value." The court observed that the case did "not involve self-interest or disloyalty." Moreover, "[t]he [m]erger was negotiated at arm's length, without compulsion, and with adequate information." The court further observed that "[i]t was the result of competition among many potential acquirers." While "[a]ny real-world sales process may be criticized for not adhering completely to a perfect, theoretical model," the court determined that "AutoInfo's process was comprehensive" and there was no evidence "that the outcome [could] have been a merger price drastically below fair value."

Prior to "placing full weight on the [m]erger price, the [c]ourt performed its own DCF analysis" and arrived at a price of 0.93 per share—less than the merger price of $1.05 per share. Nevertheless, because the court found that "the [m]erger price appear[ed] to be the best estimate of value," the court "put full weight on that price" for purposes of plaintiffs' appraisal action.

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