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This is the inaugural Simpson Thacher Securities Law Alert. Each month, the Alert will cover several of the most notable developments in private securities and corporate control litigation. The Alert is not a comprehensive survey of securities law rulings. Rather, we hope the Alert will be a convenient reference to help our clients and friends remain informed about significant decisions and statutory changes in the securities law arena. This first edition addresses: the aftermath of the Supreme Court's decision in *Morrison v. National Bank*; the Second Circuit's September ruling confirming that the bespeaks-caution doctrine applies only to forward-looking statements; the Seventh Circuit's decision establishing that plaintiffs do not need to show stock price impact for class certification purposes; a Southern District of New York ruling rejecting Martin Act preemption of most common law claims arising from New York securities transactions; and a Delaware Supreme Court decision addressing standing requirements for post-merger double derivative actions.

The Aftermath of *Morrison v. National Bank*

As has been widely reported and discussed, the Supreme Court ruled this past June that Section 10(b) of the Securities Exchange Act of 1934 only governs "transactions in securities listed on domestic exchanges, and domestic transactions in other securities." *Morrison v. Nat'l Australia Bank Ltd.*, 130 S. Ct. 2869, 2884 (2010). The *Morrison* decision established a new "transactional test" for determining the extraterritorial reach of Section 10(b): "whether the purchase or sale is made in the United States, or involves a security listed on a domestic exchange." *Id*. at 2886. Since the Court's ruling, Congress and the lower courts have been grappling with *Morrison's* application in a number of areas.

Clarifying the Scope of the SEC's Enforcement Authority Post-*Morrison*

Whether the *Morrison* ruling curtailed the SEC's authority to bring enforcement actions in connection with foreign securities transactions is a matter of debate. Because the Court's decision addressed the scope of Section 10(b) in its entirety, rather than limiting its analysis to the judicially-created private right of action under Section 10(b), *Morrison* could be read to hold that the extraterritorial limitations apply with equal force to both SEC enforcement actions and private actions. *See id*. at 2883 ("[T]here is no affirmative indication in the Exchange Act that §10(b) applies extraterritorially, and we therefore conclude that it does not."). Notwithstanding this language, Justice Stevens, in his dissenting opinion, wrote that the Court's decision had no impact on the SEC's ability to bring enforcement actions in cases involving transnational fraud. *See id*. at 2895 n.12 ("The Court's opinion does not, however, foreclose the Commission from bringing enforcement actions in

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additional circumstances, as no issue concerning the Commission's authority is presented in this case.").

Any uncertainty regarding the scope of the SEC's enforcement authority post-*Morrison* was promptly resolved the day after the Court's decision by the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act makes it clear that the jurisdiction of U.S. district courts to hear SEC antifraud actions extends to "(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." Pub. L. No. 111-203, § 929P, 124 Stat. 1376 (codified as amended at 15 U.S.C. § 78aa) (emphasis added).

The Dodd-Frank Act also requires a study to determine whether private rights of action should be expanded to reach foreign securities transactions; a report on the study is due within eighteen months of the enactment of the Act. *Id*. at § 929Y. Issues to be considered as part of this study include: whether an extraterritorially expanded private right of action should be available to all potential plaintiffs or just some subset (such as institutional investors); the implications of an expanded private right of action on international comity; the costs and benefits associated with broadening the private right of action; and whether a "narrower extraterritorial standard should be adopted." *Id*.

This study may ultimately result in legislation extending the reach of the Section 10(b) private right of action to foreign securities transactions and, perhaps, abrogating the Court's ruling in *Morrison*.

Defining the Contours of Section 10(b) Under *Morrison*

While the *Morrison* Court held that Section 10(b) governs "domestic transactions," *Morrison*, 130 S. Ct. at 2884, the decision did not provide complete guidance concerning when a "purchase or sale" is considered to have been "made *in the United States*." *Id*. at 2886 (emphasis added); *see, e.g.*, *Stackhouse v. Toyota Motor Co.*, 2010 WL 3377409, at *1 (C.D. Cal. July 16, 2010) ("The [*Morrison*] opinion unfortunately does not directly address what is meant by 'domestic transactions.'").

For example, if a U.S. citizen purchases securities on a foreign exchange without leaving the United States, does the purchase constitute a "domestic transaction" under *Morrison*? In *Stackhouse*, the Central District of California acknowledged that "[o]ne view of the Supreme Court's holding" would be to consider such a case a "domestic transaction" because a U.S. seller made the purchase on U.S. soil. *Id*. But the *Stackhouse* court chose to adopt the "alternative view" that "because the actual transaction takes place on the foreign exchange, the purchaser or seller has figuratively traveled to that foreign exchange … to complete the transaction." *Id*. The court determined that this "latter position is better supported by *Morrison*." *Id*.

When presented with this same fact pattern post-*Morrison*, the Southern District of New York articulated a bright-line rule: Section 10(b) does "*not* apply to transactions involving … a purchase

or sale, wherever it occurs, of securities listed only on a foreign exchange[.]" *Cornwell v. Credit Suisse Group*, No. 08 Civ. 3758(VM), 2010 WL 3069597, at *3 (S.D.N.Y. July 27, 2010) (emphasis in original); *see also Sgalambo v. McKenzie*, No. 09 Civ. 10087 (SAS), 2010 WL 3119349, at *17 (S.D.N.Y. Aug. 6, 2010) (citing *Cornwell* to reject the claims of potential class members who purchased Canadian Superior common stock on the Toronto Stock Exchange); *Terra Securities ASA Konkursbo v. Citigroup, Inc.*, No. 09 Civ. 7058 (VM), 2010 WL 3291579, at *4-*5 (S.D.N.Y. Aug. 16, 2010) (citing *Cornwell* to dismiss claims involving fund-linked notes listed on European stock exchanges and a total return swap sold in Europe); *In re Alstom SA Sec. Litig.*, No. 03 Civ. 6595 (VM), slip op. at 3, 7 (S.D.N.Y. Sept. 14, 2010) (citing *Cornwell* to dismiss the claims of potential class members who purchased Alstom securities on a French stock exchange). In *Cornwell*, the Southern District of New York determined that *Morrison* forecloses Section 10(b) relief for all "foreign securities trades executed on foreign exchanges even if purchased or sold by American investors, and even if some aspects of the transaction occurred in the United States." *Cornwell*, 2010 WL 3069597, at *5.

In the few short months since the *Morrison* decision, plaintiffs' attorneys have already attempted a number of creative arguments for shoehorning foreign securities transactions into the newly-circumscribed limits of Section 10(b). *See, e.g., In re Banco Santander Sec. - Optimal Litig.*, Nos. 09-MD-02073-CIV, 09-CV-20215-CIV, 2010 WL 3036990 (S.D. Fla. July 30, 2010) (rejecting the argument that Section 10(b) should apply to the claims of foreign plaintiffs who invested in a Bahamian fund, which in turn was to invest with Bernard Madoff's firm, because the plaintiffs ultimately intended to hold securities listed on American stock exchanges); *Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada*, No. 09-23248-CIV, 2010 WL 3119908, at *2-*3 (S.D. Fla. Aug. 6, 2010) (rejecting the argument that Section 10(b) should apply to a foreign corporation's purchase of another foreign corporation's stock because the parties had intended to close the transaction in the United States).

For now, most courts appear inclined to give *Morrison* the strictest interpretation possible. *See, e.g., Cornwell*, 2010 WL 3069597, at *2 ("The standard the *Morrison* Court promulgated to govern the application of §10(b) in transnational securities purchases and sales does not leave open any … back doors, loopholes or wiggle room."). But plaintiffs will no doubt continue to test the outer limits of Section 10(b) post-*Morrison*, and try to whittle away at its boundaries.

Applying *Morrison* Outside of the Securities Context

While *Morrison* dealt exclusively with the scope of Section 10(b), courts have begun referencing *Morrison* as the touchstone on issues of statutory interpretation even outside of the securities context. *See, e.g., Shlahtichman v. 1-800 Contacts, Inc.*, No. 09-4073, 2010 WL 3122786, at *7 (7th Cir. Aug. 10, 2010) (citing *Morrison* to limit the reach of the Fair and Accurate Credit Transactions Act of 2003 to printed receipts only, explaining that "to apply the statute to receipts that are emailed to the consumer would broaden the statute's reach beyond the words that Congress actually used"); *Love v. Associated Newspapers, Ltd.*, 611 F.3d 601, 612 n.6 (9th Cir. 2010) (finding no need to re-examine the extraterritorial reach of the Lanham Act in view of *Morrison* because "sweeping language [in the Lanham Act] contrasts so readily with the language in the Securities Exchange Act, not merely referring to foreign activities but expressly covering all commerce Congress can regulate").

Notably, in *Cedeño v. Intech Group, Inc.*, No. 09 Civ. 9716 (JSR), 2010 WL 3359468 (S.D.N.Y. Aug. 25, 2010), the Southern District of New York relied on *Morrison* to limit the extraterritorial reach of the Racketeer Influenced and Corrupt Organizations Act ("RICO"). *See id.* at *2 ("Although *Morrison* does not address the RICO statute, its reasoning is dispositive here."). Because RICO is "silent as to any extraterritorial application," *id.* (internal citations and quotations omitted), the court determined that "under *Morrison*," the statute

is "presumed not to apply to RICO claims that are essentially extraterritorial in focus." *Id*. The court emphasized that "nowhere does the statute evidence any concern with foreign enterprises, let alone a concern sufficiently clear to overcome the presumption against extraterritoriality." *Id*.

The *Cedeño* court accordingly dismissed RICO claims involving a pattern of criminal activity by Venezuelan government officials, despite allegations of "predicate acts of money laundering" involving U.S. banks. *Id*. Citing language from *Morrison*, the court explained that "*some* domestic activity" is insufficient to trigger the application of RICO, *id*. (internal citations and quotations omitted), particularly when the "alleged enterprise and the impact of the predicate activity upon it are entirely foreign." *Id*.

We will continue to monitor the impact of *Morrison* and the developing case law in this area, and keep you updated in future editions of the Securities Law Alert.

The Second Circuit Confirms That the Bespeaks-Caution Doctrine Only Applies to Forward-Looking Statements

In *Iowa Public Employees' Retirement System v. MF Global, Ltd*., No. 09-3919-cv, 2010 WL 3547602 (2d. Cir. Sept. 14, 2010) ("*MF Global II*"), the Second Circuit confirmed that the bespeaks-caution doctrine applies "only to statements that are forward-looking." *Id*. at *3. The court vacated in part the Southern District of New York's decision in *Rubin v. MF Global, Ltd*., 634 F. Supp. 2d 459 (S.D.N.Y. 2009) ("*MF Global I*"), finding that the court had applied the bespeaks-caution doctrine too broadly by looking beyond the plain language of the plaintiffs' allegations to assess whether the "[p]laintiffs are essentially alleging that [the] [d]efendants failed to disclose the risk of a future negative event." *Id*. at *3-*4 (quoting *MF Global I*, 634 F. Supp. 2d at 468).

The facts in *MF Global I* and *II* were as follows: a broker at MF Global lost more than $140 million on the morning of February 27, 2008 through speculation in wheat futures. The broker "accumulated the losses by taking positions vastly in excess of the firm's trading limits and collateral requirements." *MF Global II*, 2010 WL 3547602, at *1. When the market learned of the broker's losses, MF Global suffered a market capitalization decline in excess of $1.1 billion over the course of a two-day period. The value of MF Global stock plummeted because the trading losses "revealed to the public that MF Global's internal risk controls had not been applied to brokers trading for their own accounts (or taking client orders by phone)." *Id*.

The plaintiffs claimed that MF Global's prospectus and registration statement exaggerated the risk management procedures in place at the firm. For example, the plaintiffs alleged that the prospectus "failed to disclose the material fact that [MF Global's] Risk Management System protocols and procedures … did not apply to the Company's employees … [when] trading for their own accounts." *Id*. at *3 (quoting the complaint).

In *MF Global I*, the district court began its analysis of these allegations by noting that "the case law is ambiguous with respect to whether the 'bespeaks caution' doctrine applies only to forward-looking or prospective statements." 634 F. Supp. 2d at 472. The

court cited this ambiguity as one reason for looking beyond the face of the allegations in applying the bespeaks-caution doctrine:

> Because there is some ambiguity in the case law regarding the applicability of the 'bespeaks caution' doctrine, and because a skillful plaintiff may skirt application of the doctrine through artful pleading, the Court will examine whether Plaintiffs' allegations concerning representations or omissions of present or historical fact touch upon forward-looking or prospective concerns.

Id. at 468. The district court found that evaluating the real import of the misstatements or omissions at issue (rather than simply accepting what is stated in the plaintiffs' allegations) is appropriate because "[p]laintiffs in securities fraud actions can easily characterize many alleged misrepresentations or omissions regarding the risk of future negative events as statements that simply concern discrete present or historical fact[s]." *Id*.

Applying this analysis to the plaintiffs' claims regarding the adequacy of MF Global's risk management system, the district court found that "Plaintiffs are essentially complaining that Defendants failed to disclose that there was a higher or more specific risk that the MF Global risk management system would fail *at some point in the future*." *Id*. at 472 (emphasis added). The district court found that the "Plaintiffs' objections to misrepresentations about specific or general shortcomings in MF Global's risk management system that existed at the time the Prospectus was issued" were "in fact, objections to Defendants' alleged failure to disclose the possibility that the risk management system might be unable to prevent *future* negative outcomes." *Id*. (emphasis added). The district court accordingly dismissed these claims under the bespeaks-caution doctrine. *Id*. at 472-73. The plaintiffs appealed the dismissal to the Second Circuit.

In *MF Global II*, the Second Circuit first rejected the district court's view that there is ambiguity as to whether the bespeaks-caution doctrine applies only to forward-looking statements. Citing prior Second Circuit decisions, the *MF Global II* court found it to be "settled that the bespeaks-caution doctrine applies only to statements that are forward looking." *Id*. at *3. In *P. Stolz Family Partnership L.P. v. Daum*, 355 F.3d 92 (2d Cir. 2004), for example, the Second Circuit held that the bespeaks-caution doctrine insulated predictions about future events (such as an IPO), but not statements regarding an existing effort to plan an IPO. *Id*. at 97-98. The court in *P. Stolz* expressly limited the "application of the 'bespeaks caution' doctrine to forward-looking, prospective representations[.]" *Id*. at 96-97 (holding that "[t]his is a reasonable limitation on the 'bespeaks caution' doctrine and we adopt it here").

The Second Circuit disagreed with the district court's approach of looking beyond the allegations to determine whether "[p]laintiffs are essentially alleging that [the] [d]efendants failed to disclose the risk of a future negative event." *MF Global I*, 634 F. Supp. 2d at 468. The court found that the district court in *MF Global I* had "misstate[d] the threshold test, and applie[d] the bespeaks-caution doctrine too broadly." *MF Global II*, 2010 WL 3547602, at *4.

In the Second Circuit's view, the plaintiffs' allegations should be reviewed at face value, and courts should parse through complaints to separate claims regarding predictions about the future from allegations regarding present or past facts. The Second Circuit acknowledged that "predictions about the future can represent interpretations of present facts (and vice versa)," and thus "[t]he line can be hard to draw." *Id*. Nonetheless, the *MF Global II* court held that "there is a discernible difference between a forecast and a fact" and maintained that "courts are competent to distinguish between the two." *Id*. Although statements may "contain some elements that look forward and others that do not[,]" the Second Circuit held that "in each instance the forward-looking elements and the non-forward-looking are severable." *Id*.

Because the status of MF Global's risk management procedures was "ascertainable when the challenged statements were made[,]" the Second Circuit found

that it was "error for the district court to rely on the bespeaks-caution doctrine" to dismiss those claims. *Id*. at *3. The Second Circuit remanded the case to the district court to "analyze the plaintiffs' remaining allegations under the standard set out" in its decision. *Id*. at *5.

The Seventh Circuit Rules That Plaintiffs Need Not Establish Stock Price Impact for Class Certification

In *Schleicher v. Wendt*, No. 09-2154, 2010 WL 3271964 (7th Cir. Aug. 20, 2010), the Seventh Circuit unequivocally rejected the defendants' argument that "before certifying a class, the district judge must determine that the contested statements actually caused material changes in stock prices." *Id*. at *2. The court held that stock price impact was an issue of the merits of the case, *not* a question governing the viability of class certification. *See id*. at *5 (explaining that "whether the [stock price] effects were large enough to be called material, are questions on the merits"). Notably, the court went so far as to allow for the possibility of class certification even in cases where the stock price impact is negligible: "It is possible to certify a class under Rule 23(b)(3) even though all statements turn out to have only trivial effects on stock prices." *Id*.

In the Seventh Circuit's view, evaluating the stock price impact before certifying the class "gets the cart before the horse." *Id*. at *7. The proper time "to pin down *when* the stock's price was affected by any fraud" is "[a]fter a class has been certified, and other elements of the claim have been established." *Id*. (emphasis in original). To rule otherwise would "end the use of class actions in securities cases." *Id*. at *2.

The Seventh Circuit's ruling in *Schleicher* follows earlier decisions on this topic from the Fifth and Second Circuits. The Fifth Circuit has held that plaintiffs must show proof of stock price impact to qualify for the fraud-on-the-market presumption at the class certification stage. And the Second Circuit has ruled that while plaintiffs do not bear the burden of establishing an impact on stock prices for class certification purposes, defendants may defeat class certification by presenting evidence that the alleged misstatements or omissions had no effect on stock prices. These conflicting views are now the subject of a petition for *certiorari* pending before the Supreme Court.

The Fifth Circuit: Proof of Stock Price Impact is a Prerequisite to Class Certification

In *Oscar Private Equity Investments v. Allegiance Telecom, Inc*., 487 F.3d 261 (5th Cir. 2007), the Fifth Circuit held that plaintiffs must show that the alleged misstatement or omission "*actually moved* the market" to qualify for the fraud-on-the-market presumption at the class certification stage. *Id*. at 265 (emphasis in original). "Essentially, [the Fifth Circuit] require[s] plaintiffs to establish loss causation in order to trigger the fraud-on-the-market presumption." *Id*.

The Seventh Circuit in *Schleicher* expressly disapproved of the *Oscar* holding, finding the Fifth

Circuit's view "not compatible with [the Seventh Circuit's] decisional law[.]" 2010 WL 3271964, at *7. Courts around the country have held that *Oscar* reflects a misreading of *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). *See, e.g., Lapin v. Goldman Sachs & Co.*, 254 F.R.D. 168, 186 (S.D.N.Y. 2008) ("The Court agrees with the reasoning employed by the majority of courts in this District that have considered the issue, and finds that *Oscar* should be rejected as a misreading of *Basic*.").

The Fifth Circuit recently reaffirmed the position articulated in *Oscar*. In *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330 (5th Cir. 2010), the court upheld the denial of class certification because the plaintiff had failed to "prove loss causation, i.e., that the corrected truth of the former falsehoods actually caused the stock price to fall and resulted in the losses." *Id.* at 334. The *Halliburton* court declined to reconsider the reasoning in *Oscar*. *See id.* at n.2 ("Plaintiff may not assail *Oscar* as wrongly decided, as we are bound by the panel decision.").

The Second Circuit: Plaintiffs Do Not Bear the Burden of Proving Price Impact for Class Certification Purposes

The Second Circuit differs from both the Seventh and Fifth Circuits on the role of stock price impact at the class certification stage. Plaintiffs in the Second Circuit do not bear the burden of establishing stock price impact for class certification, but defendants may defeat class certification by rebutting the presumption of loss causation. *See In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 483-85 (2d Cir. 2008) (holding that "plaintiffs do not bear the burden of showing an impact on price" at the class certification stage, but permitting defendants to defeat class certification by "submitting evidence to show that the misrepresentations did not affect market price"); *see also In re AIG, Inc. Sec. Litig.*, 265 F.R.D. 157, 181 (S.D.N.Y. 2010) (finding that the Second Circuit's decision in *Salomon* "rejected the holding in *Oscar*").

The Southern District of New York Denies Class Certification Based on Lack of Stock Price Impact

The Second Circuit in *Salomon* left ample room for defendants to raise questions of price impact prior to class certification. Just a few weeks ago, the Southern District of New York used lack of stock price impact as the basis for denying class certification in *Berks County Employees' Retirement Fund v. First American Corporation*, No. 08 Civ. 5654 (LAK), 2010 WL 3430517 (S.D.N.Y. Aug. 31, 2010).

The *Berks* case centered on allegations that one of First American Corporation's subsidiaries, eAppraiseIT, engaged in improper appraisal practices to benefit its largest client, Washington Mutual. In support of its petition for class certification, the plaintiff presented an expert witness study purporting to demonstrate the materiality of First American's misstatements and corrective disclosures regarding these appraisal practices by illustrating their impact on the price of First American stock.

The *Berks* court acknowledged that under *Salomon*, the plaintiff did not bear the burden of establishing stock price impact to qualify for the fraud-on-the-market presumption. *See id.* at *4 n.40. However, because the plaintiff "attempt[ed] to establish the materiality of the alleged misstatements and omissions on the basis of their alleged effect on First American's share price," the court concluded that it was appropriate to delve into issues of stock price impact in evaluating materiality. *Id.*

Based on a point-by-point review of the plaintiff's expert report, the court in *Berks* determined that all statements or omissions regarding eAppraiseIT's allegedly improper appraisal practices "had no significant effect on the price of First American stock" and were therefore immaterial. *Id.* at *5. Because the plaintiff consequently could not "avail itself of a presumption of reliance," the court denied the plaintiff's motion for class certification. *Id.*

On the one hand, *Berks* potentially illustrates the extent to which courts in the Second Circuit

may consider issues of stock price impact in class certification decisions. On the other hand, courts may limit the applicability of *Berks* to cases where the plaintiffs themselves use stock price impact as the basis for establishing materiality.

Will the Supreme Court Intervene?

The plaintiff in the Fifth Circuit case of *Halliburton* has petitioned the Supreme Court for a *writ of certiorari* on the issue of whether proof of stock price impact is a prerequisite to class certification. Given the conflicting positions among the circuits on the significance of stock price impact at the class certification stage, it is possible that the Supreme Court will choose to address this issue.

We are following the *Halliburton* case closely and will keep you up-to-date of any developments in future editions of the Securities Law Alert.

The Southern District of New York Rejects Martin Act Preemption of Common Law Claims

In *Anwar v. Fairfield Greenwich Ltd.*, No. 09 Civ. 0118, 2010 WL 3022848 (S.D.N.Y. July 29, 2010), the Southern District of New York rejected the long-established principle of Martin Act preemption of common law claims (except for common law fraud actions) arising from New York securities transactions.[1] The *Anwar* court held that the rule reflected an "unwitting perpetuation of error" by court after court that would not survive scrutiny by the New York Court of Appeals. *Id.* at *2. The court accordingly refused to dismiss the plaintiffs' common law claims, including negligent misrepresentation and breach of fiduciary duty causes of action, arising from securities transactions governed by the Martin Act.

The principle of Martin Act preemption dates back more than twenty years ago to *CPC Int'l Inc. v. McKesson Corp.*, 70 N.Y.2d 268 (N.Y. 1987), in which the New York Court of Appeals held that "there is no implied private cause of action for violations of the antifraud provisions of the Martin Act"—New York's blue sky law. *Id.* at 275. An overwhelming majority of New York state and federal courts have since relied on *McKesson* to hold that the Martin Act preempts most common law claims (except for common law fraud actions) arising from conduct governed by the Act.

In *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171 (2d. Cir. 2001), the only Second Circuit decision to squarely address the issue of Martin Act preemption, the court adopted the majority view based on "principles of federalism and respect for state courts' interpretation of their own laws." *Id.* at 190 (upholding the dismissal of a breach of fiduciary duty claim on Martin Act grounds); *see also Abu Dhabi Commercial Bank v. Morgan Stanley & Co.*, 651 F. Supp. 2d 155, 181 (S.D.N.Y. 2009) (noting that "the Second Circuit has adopted the First Department's rule that the Martin Act preempts common law tort claims in the securities context").

Notwithstanding the long line of cases supporting Martin Act preemption of most common law claims, the Southern District of New York in *Anwar* anticipated that the New York Court of Appeals would ultimately rule that "the Martin Act does not preclude state common law causes of action that do not derive from or

1. Simpson Thacher represents many of the Fairfield Greenwich defendants named in the action.

rely upon the Martin Act to establish a required element of the claim." *Anwar*, 2010 WL 3022848, at *16. The court offered numerous grounds for this conclusion.

First, the court ruled that the principle of Martin Act preemption violated general rules of statutory construction. *See id.* at *3 (finding that "it is startling that the statute would be given a broad preemptive reading" given that the Martin Act "nowhere mentions or otherwise contemplates erasing common law causes of action").

Second, the *Anwar* court held that *McKesson* could not be used as authority for Martin Act preemption because the decision "did not expressly review whether the Martin Act broadly preempted causes of action arising out of the same facts that would support a Martin Act proceeding." *Id.* at *5. The court also found that subsequent New York appellate decisions applying *McKesson* had been given an overbroad reading: "These decisions did not hold that the Martin Act sweepingly preempted common law causes of action—they merely barred claims that relied on the Martin Act as the source of authority to frame and sustain a cause of action." *Id.* at *6.

Third, the court in *Anwar* interpreted the Court of Appeals ruling in *Kerusa Co. LLC v. W10Z/515 Real Estate Limited Partnership*, 12 N.Y.3d 236 (N.Y. 2009), to stand for the principle that "common law causes of action must have a legal basis independent from the Martin Act to be viable." *Anwar*, 2010 WL 3022848, at *11. In *Kerusa*, the Court of Appeals rejected the plaintiff's fraud claims on Martin Act grounds because the claims were based entirely on inadequate disclosures in the offering documents. The Court held that "to accept *Kerusa*'s pleading as valid would invite a backdoor private cause of action to enforce the Martin Act." *Kerusa*, 12 N.Y.3d at 245. Notably, just a few months before the court's decision in *Anwar*, the Southern District of New York in *Stephenson v. Citco Group Ltd.*, 700 F. Supp. 2d 599 (S.D.N.Y. 2010) rejected the argument that *Kerusa* "narrowed the scope of Martin Act preemption" as a "somewhat inverted reading of the case." *Id.* at 615 (explaining that "[a] significant body of precedent has developed regarding preemption of, *inter alia*, negligence and breach of fiduciary duty claims, and this Court is unwilling to conclude that the New York Court of Appeals tacitly overturned it.").

Finally, the court found that preemption undercuts the Martin Act's goals: "Forbidding private causes of action means that a large number of defrauded investors would go without justice in the many cases which the Attorney General does not or cannot prosecute." *Anwar*, 2010 WL 3022848, at *12. In support of this view, the court cited the Attorney General's amicus briefings opposing Martin Act preemption. *See id.* at *12.

The *Anwar* decision is against the weight of authority in New York state and federal courts. Of the dozens of courts to consider the issue of Martin Act preemption, less than a handful have held that plaintiffs may press forward with common law claims arising out of New York securities transactions. *See, e.g.*, *Caboara v. Babylon Cove Development, LLC*, 54 A.D.3d 79, 80, 862 N.Y.S.2d 535, 537 (2d Dep't. 2008) (holding that "private causes of action sounding in common-law fraud and breach of contract may rest upon the same facts that would support a Martin Act violation" and arguing that no Court of Appeals decision nor the plain text of the statute supports Martin Act preemption of common law claims); *Scalp & Blade, Inc. v. Advest, Inc.*, 281 A.D.2d 882, 883, 722 N.Y.S.2d 639, 640 (4th Dep't.

2001) (rejecting Martin Act-based challenges to breach of fiduciary and negligent misrepresentation claims on the grounds that "[n]othing in the Martin Act, or in the Court of Appeals cases construing it, precludes a plaintiff from maintaining common-law causes of action based on such facts as might give the Attorney General a basis for proceeding civilly or criminally against a defendant under the Martin Act"); *Cromer Fin. Ltd. v. Berger*, No. 00 Civ. 2498, 2001 WL 1112548, at *4 (S.D.N.Y. Sept. 19, 2001) (refusing to dismiss negligence claims on Martin Act grounds, explaining that "there is nothing in … the New York Court of Appeals cases cited … or in the text of the Martin Act itself to indicate an intention to abrogate common law causes of action").

Courts have, by and large, declined to follow the few cases that reject Martin Act preemption of common law claims. *See, e.g., Meridian Horizon Fund, LP v. Tremont Group Holdings, Inc.*, No. 09 Civ. 3708 (TPG), 2010 WL 1257567, at *8 (S.D.N.Y. Mar. 31, 2010) (declining to follow *Cromer* et al., finding that "the line of cases that plaintiffs advance has been rejected repeatedly by courts in this district"); *Stephenson.*, 700 F. Supp. 2d at 616 (finding that "the overwhelming weight of authority supports Martin Act preemption of negligence and breach of fiduciary duty claims arising in the securities context"); *In re Tremont Securities Law, State Law and Ins. Litig.*, 703 F. Supp. 2d 362, 373 (S.D.N.Y. 2010) (declining to give weight to *Caboara* et al. on the grounds that this "line of cases … has been rejected repeatedly by courts in this district"); *Ronald D. Kassover v. UBS* AG, 619 F. Supp. 2d 28, 39 (S.D.N.Y. 2008) (finding the plaintiffs' reliance on *Caboara* "unavailing" and holding that the plaintiffs' securities-related common law claims not sounding in fraud were preempted by the Martin Act); *Sedona Corporation v. Ladenburg Thallmann & Co.*, No. 03 Civ. 3120 (LTS) (THK), 2005 WL 1902780, at *23 (S.D.N.Y. Aug. 9, 2005) (rejecting "Plaintiff's request to follow the *Cromer* and *Scalp & Blade* decisions" "[i]n light of myriad holdings supporting preemption"); *Nanopierce Technologies, Inc. v. Southridge Capital Mgmt*, No. 02 Civ. 0767 (LBS), 2003 WL 22052894, at *4 (S.D.N.Y. Sept. 2, 2003) (distinguishing *Scalp & Blade* and *Cromer Finance* as "solitary islands in a stream of contrary opinion" and explaining that "neither persuades this Court to abandon the position adopted by the Second Circuit in *Castellano*").

Since the *Anwar* ruling, at least one Southern District of New York decision has relied on *Anwar* to hold that the Martin Act does not preempt common law claims arising out of New York securities transactions. *See Terra Securities ASA Konkursbo v. Citigroup, Inc.*, No. 09 Civ. 7058 (VM), 2010 WL 3291579, at *12 n.10 (S.D.N.Y. Aug. 16, 2010) (citing *Anwar* to reject the defendants' argument that "New York's Martin Act preempts Plaintiffs' negligent misrepresentation claim"). Notably, the same judge decided both *Anwar* and *Terra*.

Whether other courts will rely on *Anwar* to allow plaintiffs to bring common law claims arising out of the conduct governed by the Martin Act remains to be seen.

Delaware Supreme Court Paves the Way for Post-Merger Double Derivative Actions

In the case of *Lambrecht v. O'Neal*, No. 135, 2010, 2010 WL 3397451 (Del. Aug. 27, 2010), the Delaware Supreme Court held unanimously that "a shareholder [who] has lost standing to maintain a standard

derivative action by reason of an acquisition of the corporation in a stock-for-stock merger" may, in certain circumstances, "in his new capacity as a shareholder of the acquiring corporation, assert the claim double derivatively." *Id*. at *5-*6. The decision responded to a certified question of law in the Merrill Lynch/Bank of America litigation pending in the Southern District of New York. At issue was whether former Merrill Lynch shareholders had standing to bring double derivative actions to recover for losses Merrill Lynch suffered before Bank of America acquired Merrill Lynch in a stock-for-stock merger.

Delaware courts have allowed for the possibility of double derivative claims where standard derivative claims are extinguished by an intervening merger. *See, e.g., Lewis v. Ward*, 852 A.2d 896, 906 (Del. 2004) (affirming post-merger dismissal of derivative action but noting that "the plaintiff might have been able to bring a post-merger double derivative suit"). In a double derivative action, a shareholder of a parent corporation brings suit to enforce the claims of a wholly owned or majority-controlled subsidiary. *See, e.g., Sternberg v. O'Neil*, 550 A.2d 1105, 1107 n.1 (Del. 1987) ("A 'double derivative' action is a derivative action maintained by the shareholders of a parent corporation or holding company on behalf of a subsidiary company."). Until the Delaware Supreme Court's decision in *Lambrecht*, however, there was no clear guidance on when a plaintiff may bring a post-merger double derivative action.

Only one Chancery Court decision, *Saito v. McCall*, No. Civ. A. 17132-NC. 2004 WL 3029876 (Del. Ch. Dec. 20, 2004), touched on the requirements for bringing double derivative actions following a merger. In *Saito*, the Chancellor dismissed a post-merger double derivative claim on the grounds that: (1) the "'plaintiffs … were not [the parent company's] shareholders before [the merger]'" and (2) the "'plaintiffs [had] failed to allege that [the parent company] was a shareholder of [the subsidiary] at the time the alleged harm occurred.'" *Id*. at *9 & n.82; *see also In re Merrill Lynch & Co., Inc. Sec., Derivative and ERISA Lit*., 692 F. Supp. 2d 370, 372 (S.D.N.Y. 2010) (discussing the *Saito* holding).

The defendants in the Merrill Lynch/Bank of America litigation relied on *Saito* to argue that the plaintiffs—former shareholders of Merrill Lynch—could only bring double derivative claims if "they could show (a) that they were shareholders of [Bank of America], not just now but at the time of the underlying Merrill transactions complained of, and (b) that [Bank of America] was itself a shareholder of Merrill at the time of the underlying Merrill transactions complained of." *Merrill Lynch*, 692 F. Supp. 2d at 372.

The Southern District of New York found that imposing these requirements would "render double derivative lawsuits virtually impossible to bring except in bizarrely happenstance circumstances." *Id*. at 372-73. Nonetheless, the court acknowledged that *Saito* "seems to hold that just such requirements are part of Delaware law." *Id*. at 372. Instead of ruling on this issue, the court certified the following question to the Delaware Supreme Court:

> Whether plaintiffs in a double derivative action under Delaware law, who were pre-merger shareholders in the acquired company and who are current shareholders, by virtue of a stock-for-stock merger, in the post-merger parent company, must also demonstrate that, at the time of the alleged wrongdoing at the acquired company, (a) they owned stock in the acquiring company, and (b) the acquiring company owned stock in the acquired company.

Lambrecht, 2010 WL 3397451, at *2.

The Delaware Supreme Court in *Lambrecht* responded by emphasizing that state "precedents not only validate but also encourage the bringing of double derivative actions in cases where standing to maintain a standard derivative action is extinguished as a result of an intervening merger." *Id*. at *8. "[T]his Court should not undermine its own precedents by imposing procedural requirements that effectively would defeat that remedy." *Id*. Because "the defendants' argued-for double derivative model … would effectively eviscerate the double derivative action as a meaningful remedy,"

the Court found that rejection of the defendants' position was warranted "on that basis alone." *Id*. at *10.

The *Lambrecht* Court explicitly overruled *Saito* as a "misappli[cation] [of] Delaware law." *Id*. at *12. Noting that "[n]o reasoning is articulated to support *Saito*'s conclusory holding," the Court held that "*Saito* cannot be correct" and does not reflect "sound Delaware law." *Id*. at *11. The *Lambrecht* Court found that "no [other] Delaware decision or statute imposes [the] requirements" advanced by the defendants. *Id*. at *8.

With respect to the defendants' argument that Bank of America must have owned Merrill Lynch stock at the time of the alleged wrongdoing, the Court held that the defendants erroneously assume that Bank of America "must proceed *derivatively* against the persons who were Merrill Lynch directors at the time of the alleged wrongdoing." *Id*. (emphasis in original). The Court clarified that Bank of America's sole ownership of Merrill Lynch "empowers and entitles" the company to "use its direct control to cause its wholly owned subsidiary, Merrill Lynch, to do what is necessary to enforce Merrill Lynch's pre-merger claim." *Id*. "To accomplish that, the only Merrill Lynch shares [Bank of America] would have to own would be those it acquired as a result of the merger." *Id*.

The *Lambrecht* Court also found "fatally flawed" the defendants' assertion that the plaintiffs must have owned Bank of America shares at the time of the alleged wrongdoing at Merrill Lynch. *Id*. at *9. The Court explained that "[i]n a double derivative action, the plaintiffs stand in the shoes of [the acquiring company]; that is, they are enforcing [the acquiring company's] *post-merger* right, as 100 percent owner, to prosecute [the acquired company's] *pre-merger* claim." *Id*. "It suffices that the plaintiffs own shares of [the acquiring company] at the time they seek to proceed double derivatively on its behalf." *Id*.

Finally, in response to the defendants' policy argument that "allowing the plaintiffs' post-merger double derivative action to proceed would disrespect the corporate separateness of [Bank of America] and Merrill Lynch" and run afoul of Delaware precedent on the impact of a merger on a pending derivative action, *id*., the Court clarified that a "post-merger double derivative action is not a *de facto* continuation of the pre-merger derivative action. It is a new, distinct action in which standing to sue double derivatively rests on a different temporal and factual basis—namely, the failure of the [acquiring company's] board, post-merger, to enforce the pre-merger claim of its wholly owned subsidiary." *Id*. Furthermore, because of this "quite different structure, the policies favoring both the preservation of the corporate separateness of the parent and subsidiary and the prevention of abusive derivative suits are fully respected. That is because the double derivative suit cannot go forward except in the unusual case where the parent company board is shown to be incapable of deciding impartially whether or not to enforce the claim that the parent company now (indirectly) owns." *Id*.

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