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This month's Alert discusses three decisions from the Second Circuit: two concerning the application of the presumption of prudence in employee stock drop cases, as well as a ruling that FINRA may not bring judicial actions to enforce its fines. We also address an Eleventh Circuit decision holding that defendants may be liable for misstatements that "prop up" an already inflated stock price.

In addition, we discuss a number of rulings from the Southern District of New York: three noteworthy decisions in Madoff-related cases involving the owners of the New York Mets, Madoff's family members, and funds run by J. Ezra Merkin; two rulings addressing the question of whether corporations have "ultimate authority" over statements made by their wholly owned subsidiaries within the meaning of the Supreme Court's holding in *Janus Capital Group, Inc. v. First Derivative Traders*; and the dismissal of the Lehman ERISA action for a second time.

Finally, we address two decisions from the Delaware courts: an opinion from the Delaware Supreme Court on when transactions should be aggregated for purposes of a successor obligor provision in an indenture agreement; and the Chancery Court's $1.26 billion damages award in the Southern Peru shareholder derivative litigation.

The Second Circuit Adopts the *Moench* Presumption of Prudence for Fiduciaries of Employee Stock Ownership Plans

In *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995), the Third Circuit held that "an [employee stock ownership plan ("ESOP")] fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision." *Id.* at 571. The Third Circuit further ruled that a plaintiff may only "overcome that presumption by establishing that the fiduciary abused its discretion by investing in employer securities." *Id.* The Fifth, Sixth and Ninth Circuits have since adopted the *Moench* presumption of prudence, and no court of appeals has rejected it.

On October 19, 2011, in two related cases, the Second Circuit "join[ed] [its] sister circuits in adopting the *Moench* presumption" both "with respect to … [eligible individual account plans ("EIAPs")] and ESOPs." *In re Citigroup ERISA Litig. (Citigroup ERISA II)*, 2011 WL 4950368, at *7 (2d Cir. Oct. 19, 2011) (Walker, J.); *see also Gearren v. McGraw-Hill Cos, Inc. (McGraw-Hill II)*, 2011 WL 4952628, at *2 (2d Cir. Oct. 19, 2011) (per

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curiam).[1] The Second Circuit found that the *Moench* presumption "provides the best accommodation between the competing ERISA values of protecting retirement assets and encouraging investment in employer stock." *Citigroup ERISA II*, 2011 WL 4950368, at *7.

Background

The *Citigroup ERISA II* and *McGraw-Hill II* cases involved "substantially similar" allegations and "raised similar issues." *McGraw-Hill II*, 2011 WL 4952628, at *1.

In the *Citigroup ERISA II* action, two of Citigroup's 401(k) plans offered participants the opportunity to invest in the Citigroup Common Stock Fund, which in turn invested in Citigroup stock. On September 15, 2008, "following a sharp drop in the price of Citigroup stock that began in late 2007 and continued into 2008," participants in Citigroup's 401(k) plans brought suit "challeng[ing] [the] management of the [p]lans and, in particular, the Stock Fund." *Citigroup ERISA II*, 2011 WL 4950368, at *2. The plaintiffs contended that "Citigroup's participation in the ill-fated subprime-mortgage market caused the price drop." *Id*.

The *McGraw-Hill II* action involved two retirement plans provided by The McGraw-Hill Companies. Both plans offered as an investment option the McGraw-Hill Stock Fund, which invested primarily in company stock. On June 12, 2009, "following a drop in the price of McGraw-Hill stock," the plaintiffs brought suit alleging, among other things, that "McGraw-Hill became an imprudent investment option during the [c]lass [p]eriod." *McGraw-Hill II*, 2011 WL 4952628. at *1.

Both the *Citigroup ERISA II* plaintiffs and the *McGraw-Hill II* plaintiffs asserted ERISA breach of fiduciary duty claims by alleging that the defendants had failed to divest the retirement plans of the company stock fund even though the company stock was allegedly an imprudent investment (the "prudence claims"). Specifically, the *Citigroup ERISA II* plaintiffs alleged that the defendants, including Citigroup's Investment and Administration Committees, had "breached their fiduciary duties of prudence and loyalty by refusing to divest the [p]lans of Citigroup stock even though Citigroup's 'perilous operations tied to the subprime securities market' made it an imprudent investment option." *Citigroup ERISA II*, 2011 WL 4950368, at *2. Similarly, the *McGraw-Hill II* plaintiffs claimed that the defendants had "breached their fiduciary duties by continuing to offer the [McGraw-Hill] Stock Fund as an investment option in the [p]lans throughout the [c]lass [p]eriod" even though its "financial services division, Standard & Poor's (S&P), [had] knowingly provided inflated ratings to financial products." *McGraw-Hill II*, 2011 WL 4952628, at *1.

Both sets of plaintiffs also asserted that the defendants had violated ERISA by failing to disclose non-public information to plan participants regarding the companies' respective financial conditions, and had made misstatements in filings with the SEC (collectively, "the disclosure claims"). In particular, the *Citigroup ERISA II* plaintiffs alleged that the Administration Committee and certain other defendants had "breached their fiduciary duties by

1. Simpson Thacher represented the Securities Industry and Financial Markets Association (SIFMA) in its amicus briefing in the *McGraw-Hill* action.

failing to provide complete and accurate information to [p]lan participants regarding the [Citigroup Stock] Fund and its exposure to the risks associated with the subprime market." *Citigroup ERISA II*, 2011 WL 4950368, at *2. The *McGraw-Hill II* plaintiffs asserted that the defendants had "violated their duty of loyalty by making misrepresentations and nondisclosures regarding McGraw-Hill's financial condition and S&P's ratings practices." *McGraw-Hill II*, 2011 WL 4952628, at *2.

The Southern District of New York dismissed both complaints in their entirety. *In re Citigroup ERISA Litig. (Citigroup ERISA I)*, 2009 WL 2762708 (S.D.N.Y. Aug. 31, 2009) (Stein, J.); *Gearren v. McGraw-Hill Cos., Inc. (McGraw-Hill I)*, 690 F. Supp. 2d 254 (S.D.N.Y. 2010) (Sullivan, J.). In both cases, the Southern District of New York held that the *Moench* presumption applies to the prudence claims, and found that the plaintiffs had not alleged facts sufficient to overcome the presumption. *See Citigroup ERISA I*, 2009 WL 2762708, at *19 (explaining that "[w]hile Citigroup suffered losses during the class period as a result of the collapse of the subprime mortgage market, the situation was … 'much less grave than facts other courts routinely conclude are insufficient to rebut the *Moench* presumption'"); *McGraw-Hill I*, 690 F. Supp. 2d at 270 (determining that the "[p]laintiffs' allegations of a 64% drop in share price, while significant, do[ ] not amount to the sort of catastrophic decline necessary to rebut the [*Moench*] presumption").

The Southern District of New York also dismissed the disclosure claims in both cases, holding that ERISA fiduciaries "have no affirmative duty … to disclose information about the company's financial condition to plan participants." *McGraw-Hill I*, 690 F. Supp. 2d at 271; *see also Citigroup ERISA I*, 2009 WL 2762708, at *20 (finding that none of the defendants "had a duty to disclose financial information regarding 'the [c]ompany and Citigroup stock.'"). Both sets of plaintiffs appealed, and the cases were argued together before the Second Circuit.

The Second Circuit Relies on the *Moench* Presumption to Affirm the Dismissal of the Prudence Claims

In reviewing the prudence claims, the Second Circuit observed that ERISA "does not … explain when, if ever, plan language requiring investment in employer stock might become inconsistent with the statute's fiduciary obligations, such that fiduciaries would" have to "halt the purchase of, or perhaps even require the sale of, the employer's stock." *Citigroup ERISA II*, 2011 WL 4950368, at *5. The court found that the *Moench* presumption "balances the duty of prudence against a fiduciary's explicit obligation to act in accordance with plan provisions to the extent they are consistent with ERISA." *Id*.

Adopting the *Moench* presumption, the Second Circuit found that "only circumstances placing the employer in a 'dire situation' that was objectively unforeseeable by the settlor could require fiduciaries to override plan terms." *Id*. at *8; *see also McGraw-Hill II*, 2011 WL 4952628, at *2. Courts "cannot rely, after the fact, on the magnitude of [a] decrease in the employer's stock price" when evaluating a fiduciary's conduct. *Citigroup ERISA II*, 2011 WL 4950368, at *9. "[R]ather," courts "must consider the extent to which plan fiduciaries at a given point in time reasonably could have predicted the outcome that followed." *Id*.

In the *Citigroup ERISA II* action, the "plaintiffs allege[d] that Citigroup [had] made ill-advised investments in the subprime-mortgage market while hiding the extent of those investments from [p]lan participants and the public." *Id*. The Second Circuit held that these allegations of "bad business decisions" were "insufficient to show that the company was in a 'dire situation,' much less that the Investment Committee or the Administration Committee knew or should have known that the situation was dire." *Id*. Even if the Committees had launched investigations to "uncover [the details of] Citigroup's subprime investments," the Committees "would not have been compelled to find that Citigroup, with a market capitalization of almost $200 billion, was in a dire situation." *Id*. at *10.

The Second Circuit explicitly rejected the district court's holding in *Citigroup ERISA I* that the defendants "were insulated from liability because they had no discretion to divest the [p]lans of employer stock." *Id*. at *8. Instead, the court endorsed a "'guiding principle'" that "judicial scrutiny should increase with the degree of discretion a plan gives its fiduciaries to invest." *Id*. at *7.

In the *McGraw-Hill II* action, the plaintiffs alleged that the Credit Market Services division of S&P, one of McGraw-Hill's three operating segments, had "provided inflated ratings to two structured-finance products: collateralized debt obligations and residential mortgage backed securities." *McGraw-Hill II*, 2011 WL 4952628, at *3. The Second Circuit held that "[e]ven if the defendant fiduciaries were aware of these problems … , the facts alleged do not support [the] plaintiffs' contention that [the] defendants should have determined that McGraw-Hill itself was in a dire situation." *Id*. Moreover, the court found that the defendants "could not reasonably have foreseen, based on the information alleged to have been available to them at the time, the sharp decline in the price of McGraw-Hill stock that occurred after the problems with S&P's rating practices became public." *Id*.

The Second Circuit Affirms the Dismissal of the Disclosure Claims

The Second Circuit dismissed the failure to disclose claims in both actions, holding that "fiduciaries have no duty to provide [p]lan participants with non-public information that could pertain to the expected performance of [p]lan investment options." *Citigroup ERISA II*, 2011 WL 4950368, at *10; *see also McGraw-Hill II*, 2011 WL 4952628, at *3. The court explained that "ESOP fiduciaries do 'not have a duty to give investment advice or to opine on the stock's condition.'" *Citigroup ERISA II*, 2011 WL 4950368, at *11.

As for the plaintiffs' allegations that the defendants had made misstatements in SEC filings, the Second Circuit held that "only the plan administrator is responsible for meeting ERISA's disclosure requirements." *Id*. at *12. In the *Citigroup ERISA II* action, the court determined that "Citigroup and [its former Chief Executive Officer] were not [p]lan administrators … responsible for communicating with [p]lan participants" and therefore could not be "held liable, at least under ERISA, for any alleged misstatements made to Citigroup employees." *Id*. In the *McGraw-Hill II* action, the Second Circuit found that the defendants could not be held liable for alleged misstatements "contained in SEC filings that were later incorporated into the [p]lans' Summary Plan Descriptions" because the "defendants who signed or prepared the SEC filings were acting in a corporate, rather than ERISA fiduciary, capacity when they did so." *McGraw-Hill II*, 2011 WL 4952628, at *3.

The Second Circuit also held that neither the *Citigroup ERISA II* plaintiffs nor the *McGraw-Hill II* plaintiffs "adequately alleged that the defendants [had] made statements they *knew* to be false." *Citigroup ERISA II*, 2011 WL 4950368, at *13; *see also McGraw-Hill II*, 2011 WL 4952628, at *4. Finally, the Second Circuit dismissed all remaining claims in both actions as derivative of the prudence and disclosure claims.

Circuit Judge Straub Dissents and Rejects the *Moench* Presumption of Prudence

In an opinion dissenting in part and concurring in part, Circuit Judge Straub rejected the *Moench* presumption as "fundamentally unsound." *Citigroup ERISA II*, 2011 WL 4950368, at *16. "[F]ind[ing] no justification for cloaking fiduciaries' investment decisions in a mantle of presumptive prudence," Judge Straub stated that the investment decisions of ERISA fiduciaries should instead be subject to plenary review.

Id. at *15.

As to the communications claim, Judge Straub took the position that ERISA fiduciaries have "a duty to disclose material, adverse information regarding an employer's financial condition or its stock, where such information could materially and negatively affect the expected performance of plan investment options." *Id*. at *27. He rejected the majority's "formalistic" rule that only a [p]lan administrator can be held liable for misrepresentations to [p]lan participants. *Id*. at *31. In Judge Straub's view, "the making of intentional representations about the future of plan benefits 'is an act of plan administration' within the meaning of ERISA." *Id*. at *30.

The Southern District of New York Dismisses the Lehman ERISA Action for a Second Time

On October 5, 2011, the Southern District of New York again dismissed in its entirety an ERISA action brought in connection with the Lehman Brothers Savings Plan (the "Plan"), "which held Lehman [Brothers Holdings, Inc.] stock and suffered a large loss when the firm failed." *In re Lehman Bros. Sec. and ERISA Litig. (Lehman ERISA II)*, 2011 WL 4632885, at *1 (S.D.N.Y. Oct. 5, 2011) (Kaplan, J.).[2] The court did not grant the plaintiffs leave to replead.

Background

"Lehman sponsored the Plan as a retirement savings device for its employees." *Id*. One of the investment options offered through the Plan was the Lehman Stock Fund, "which invested solely in

Lehman's common stock, cash, and short-term fixed income investments." *Id*. The plaintiffs alleged that "the Plan, through the Lehman Stock Fund, continued to hold and invest in Lehman stock before, during and after Lehman's collapse." *Id*. On June 10, 2009, Lehman's Employee Benefits Plans Committee (the "Plan Committee") "decided that the Plan should liquidate its Lehman stock holdings." *Id*. By then, however, "those holdings allegedly were worthless." *Id*.

The plaintiffs subsequently brought suit against eleven of Lehman's former directors and one of the members of the Plan Committee, alleging, *inter alia*, that the defendants had "'failed to manage the Plan's assets prudently and loyally in that they continued to acquire and hold Lehman stock (the 'prudence claim') and misstated and omitted material information about Lehman's financial condition (the 'disclosure claim').'" *Id*. at *2.

In February 2010, the Southern District of New York dismissed the complaint in its entirety. *In re Lehman Bros. Sec. and ERISA Litig. (Lehman ERISA I)*, 683 F. Supp. 2d 294 (S.D.N.Y. 2010) (Kaplan, J.). The court found that the plaintiffs' claims failed as to the director defendants because the complaint did "not sufficiently allege that any of the [d]irector [d]efendants [we]re fiduciaries in any respect material to th[e] case." *Id*. at 300. As to the sole Plan Committee defendant, the court found that the prudence claim failed because

2. Simpson Thacher represents the Plan Committee defendants in this action.

there were no allegations that she "knew or should have known about Lehman's dire financial condition prior to its bankruptcy filing." *Id*. at 303. The court also dismissed the remaining claims.

The plaintiffs then filed a second amended complaint ("SCAC"), which differs from the prior complaint in "two general respects." *Lehman ERISA II*, 2011 WL 4632885, at *2. First, the SCAC names six additional Plan Committee defendants. Second, the SCAC "specifie[s] the date by which [the] defendants allegedly knew or should have known that Lehman was in a dire situation: March 16, 2008, when Bear Stearns was sold to JP Morgan Chase for $2 per share." *Id*. The "[p]laintiffs' theory is that the combination of Bear Stearns's collapse, Lehman's alleged status as the most highly leveraged of the remaining investment banks, and market-wide subprime risks put Lehman in an obviously dire situation." *Id*. The defendants once again moved to dismiss.

The *Lehman ERISA II* Court Dismisses the Prudence Claim against the Plan Committee Defendants

In *Lehman ERISA I*, the court held that the *Moench* presumption applies to the prudence claims against the Plan Committee defendant. The Second Circuit has since adopted the *Moench* presumption of prudence for fiduciaries of employee stock ownership plans (see pages 1 – 5 above).

Applying this presumption to the prudence claims against the Plan Committee defendants, the *Lehman ERISA II* court found that the SCAC "alleges no facts explaining *why* Bear Stearns suffered a run, let alone why those circumstances alerted or ought to have alerted Leman that it would suffer the same fate." *Id*. at *5. While "Bear Stearns' failure … no doubt was a cause for concern at Lehman and the other firms," the court held that "cause for concern is not a dire situation" sufficient to overcome the *Moench* presumption. *Id*.

The Court Dismisses the Disclosure and Conflict of Interest Claims against the Plan Committee Defendants

With respect to the plaintiffs' claim that the Plan Committee defendants had "breach[ed] an affirmative duty to disclose known negative information about Lehman," the court determined that "ERISA fiduciaries 'have no affirmative duty … to disclose information about the company's financial condition to plan participants.'" *Id*. at *5. The court also dismissed the plaintiffs' misrepresentation claim, finding that there were no allegations "that the Plan Committee [d]efendants [had] intentionally connected any misrepresentations or omissions in Lehman's SEC filings to the [Summary Plan Description]." *Id*. at *6. Finally, the court dismissed the conflict of interest claim on the grounds that "the SCAC is devoid of any allegations that the Plan Committee defendants had any conflicts of interest that violated or even threatened to violate the ERISA duty of loyalty." *Id*.

The Court Dismisses All Claims against the Director Defendants

Because the plaintiffs conceded that the director defendants were not fiduciaries for purposes of either the "management of the Plan" or "communications with Plan participants," the court held that the prudence and disclosure claims "must be dismissed as against the [d]irector [d]efendants." *Id*. at *7.

The court further found that "the conflict claim against the [d]irector [d]efendants is entirely conclusory" as "[t]here are no allegations as to what personal interests the [d]irector [d]efendants had or elevated above those of the Plan participants." *Id*. The only "concrete conflict allegation" is that Richard S. Fuld, Lehman's former Chief Executive Officer, "sold his personal holdings of Lehman stock for profit." *Id*. However, the court found this assertion "insufficient" because "an allegation that a plan fiduciary sold stock ordinarily does not suffice to state a conflict of interest claim." *Id*.

The court also dismissed the plaintiffs' duty to appoint claim, on the grounds that the SCAC "does not even squarely claim that [the director defendants] actually did appoint unqualified plan fiduciaries." *Id*. Finally, the court dismissed the duty to monitor claim as derivative of the prudence claim.

The Second Circuit Holds That FINRA May Not Bring Judicial Actions to Enforce Disciplinary Fines

On October 5, 2011, the Second Circuit ruled that the Financial Industry Regulatory Authority, Inc. ("FINRA")—the successor to the National Association of Securities Dealers ("NASD")—"lacks the authority to bring court actions to collect disciplinary fines it has imposed." *Fiero v. Fin. Indus. Regulatory Auth., Inc.*, 2011 WL 4582436, at *1 (2d Cir. Oct. 5, 2011) (Winter, J.).

Background

In December 2000, a NASD hearing panel held that Fiero Brothers and John J. Fiero (collectively, the "Fieros") had violated Section 10(b) and Rule 10b-5, as well as certain FINRA Conduct Rules. The panel expelled Fiero Brothers from FINRA, barred John Fiero from associating with any FINRA member firm, and instituted a fine of $1,000,000 plus costs. The National Adjudicatory Council affirmed the hearing panel's decision, and the Fieros did not appeal to the SEC.

When the Fieros refused to pay the fine, FINRA filed suit in New York state court. In May 2006, the court awarded the NASD a judgment of $1.3 million; the First Department affirmed later that year. In February 2008, however, the Court of Appeals reversed the decision on subject matter jurisdiction grounds, finding that "the FINRA complaint constituted an action to enforce a liability or duty created under the Exchange Act, and therefore, fell within the exclusive jurisdiction of the federal courts pursuant to 15 U.S.C. § 78aa." *Id*. at *2.

The day after the Court of Appeals' ruling, the Fieros filed suit in the Southern District of New York "seeking a declaratory judgment that, *inter alia*, FINRA has no authority to collect fines through judicial proceedings." *Id*. at *3. On March 30, 2009, the district court granted FINRA's motion to dismiss the Fieros' claim. The Fieros appealed.

The Second Circuit Finds That Congress Did Not Authorize FINRA to Use Courts to Collect Disciplinary Fines

On appeal, the Second Circuit considered "whether the Exchange Act provides FINRA with the necessary authority" to "bring judicial actions to collect monetary sanctions." *Id*. While "[t]he statutory scheme carefully particularizes an array of available remedies, including permissible actions in the federal courts," there is "no express statutory authority for [self-regulatory organizations ("SROs"), such as FINRA] to bring judicial actions to enforce the collection of fines." *Id*. The Second Circuit determined that the absence of "explicit provisions in the statute authorizing SRO's to seek judicial enforcement of the variety of sanctions they can impose … is significant evidence that Congress did not intend to authorize FINRA to seek judicial enforcement to collect its disciplinary fines." *Id*. at *4.

The Second Circuit stated that "an inference of congressional intent to authorize such legal actions by FINRA [could arguably] be drawn from the seemingly inexplicable nature of a gap in the FINRA enforcement scheme [in that] fines may be levied but not collected." *Id*. at *5. However, the Second Circuit held that this "gap does not support an inference of inadvertent omission because … FINRA fines are already enforced by a draconian sanction not involving court action[:]" revocation of a member's FINRA registration, "resulting in exclusion from the [securities] industry." *Id*.

In 1990, the NASD did file a rule with the SEC establishing a new policy of bringing court actions to collect fines (the "1990 Rule Change"). *See* Nat'l Ass'n of Sec. Dealers, Notice to Members 90-21, Collection of Fines and Costs in Disciplinary Proceedings (1990), *available* here. The action against the Fieros is "said to be the first case brought under that policy." *Fiero*, 2011 WL 4582436, at *5. Because the Second Circuit determined that the 1990 Rule Change "was never properly promulgated," the court held that the new rule "cannot authorize FINRA to judicially enforce the collection of its disciplinary fines." *Id*. at *8.

The Eleventh Circuit Holds That Defendants May Be Liable for Misstatements That "Prop Up" an Already Inflated Stock Price

On September 30, 2011, the Eleventh Circuit held that "a defendant may be liable for fraudulent statements intentionally made that have the purpose and effect of propping up an already inflated stock price in an efficient market." *FindWhat Investor Group v. FindWhat.com*, 2011 WL 4506180, at *1 (11th Cir. Sept. 30, 2011) (Marcus, J.). The court found that "the securities laws prohibit corporate representatives from knowingly peddling material misrepresentations to the public—regardless of whether the statements introduce a new falsehood to the market or merely confirm misinformation already in the marketplace." *Id*.

Background

The plaintiffs alleged that MIVA, Inc. (previously known as FindWhat.com, Inc.), an Internet commerce company providing "pay-per-click" advertising services, and three of its officers had made "a series of eleven false or misleading statements" with respect to MIVA's efforts to detect and prevent click fraud. *Id*. at *1-*3. In March 2007, the district court dismissed claims involving nine of the allegedly misleading statements for pleading deficiencies.

With respect to the two remaining misstatements, the plaintiff's loss causation expert "acknowledged that MIVA's stock price was inflated by 26.44 percent *before* the [d]efendants' first actionable misrepresentation, and remained inflated at the same level *after* the [d]efendants made the two allegedly actionable misstatements [at issue]." *Id*. at *17. "[B]ecause the inflation level in MIVA's stock price did not change as a result of the alleged misrepresentations," the district court "reasoned that … these otherwise actionable statements by the [d]efendants could not have 'caused' the [p]laintiffs' losses." *Id*. The court therefore "concluded as a matter of law that [the expert's] report did not create triable issues of fact concerning either loss causation or damages." *Id*. Accordingly, in November 2009, the district court granted summary judgment in the defendants' favor with respect to claims involving these two statements.

The Eleventh Circuit Vacates the District Court's Summary Judgment Ruling

While the Eleventh Circuit affirmed the district court's dismissal of the plaintiffs' inadequately pled claims, the appellate court determined that the district court's summary judgment ruling "constituted legal error." *Id.* "The district court erroneously assumed that simply because confirmatory false statements have no immediate effect on an already inflated stock price in an efficient market, these statements cannot cause harm." *Id.* at *23. "But the inflation level need not change for new investors to be injured by a false statement." *Id.* "Fraudulent statements that *prevent* a stock price from falling can cause harm by *prolonging* the period during which the stock is traded at inflated prices." *Id.*

The Eleventh Circuit explained that "[t]he securities laws do not immunize defendants who knowingly disseminate materially false or misleading information simply because their fraud concerns false information already believed by the market." *Id.* at *25. The court "decline[d] to erect a *per se* rule that, once a market is already misinformed about a particular truth, corporations are free to knowingly and intentionally reinforce material misconceptions by repeating falsehoods with impunity." *Id.* "Defendants whose fraud *prevents* preexisting inflation in a stock price from dissipating are just as liable as defendants whose fraud introduces inflation into the stock price in the first instance." *Id.*

A Trio of Noteworthy Rulings in Madoff Litigations

Nearly three years after the revelation of the Madoff fraud, courts are continuing to rule on dismissal motions in actions arising from the collapse of Bernard L. Madoff Investment Securities LLC ("Madoff Securities"). Below we discuss three decisions in Madoff-related cases involving the owners of the New York Mets, Madoff's family members, and funds run by J. Ezra Merkin.

The Southern District of New York Holds That the SIPA Trustee May Only Recover "Profits" Distributed to Madoff's Customers within the Past Two Years

On September 27, 2011, the Southern District of New York substantially narrowed the claims brought by the trustee for the Securities Investor Protection Act liquidation of Madoff Securities (the "SIPA Trustee") against Saul B. Katz and Fred Wilpon, owners of the New York Mets. *Picard v. Katz*, 2011 WL 4448638 (S.D.N.Y. Sept. 27, 2011) (Rakoff, J.). The case concerns the extent to which "prior payments made" to the Mets owners by Madoff Securities "can be, in effect, rescinded—or, in the language of bankruptcy law, 'avoided'—and the money returned ('clawed back') to [the Madoff Securities] estate … ." *Id.* at *1. While the *Katz* court dismissed "all [of the Trustee's] claims predicated on principles of preference or constructive fraud under the Bankruptcy Code, as well as all claims under New York law," the court permitted the Trustee's actual fraudulent transfer claims to proceed. *Id*. at *3.

The *Katz* Court Applies Section 546(e)'s Safe Harbor to Limit the Trustee's Claims

"Because Madoff Securities was a registered stockbrokerage firm," the *Katz* court held that "the liabilities of customers like the defendants here are subject to the 'safe harbor' set forth in [S]ection 546(e) of the Bankruptcy Code." *Id*. at *2. Section 546(e) provides, in relevant part, that a trustee "may not avoid a transfer that is a … settlement payment … made by or to (or for the benefit of) a … stockbroker … or that is a transfer made by or to (or for the benefit of) a … stockbroker, in connection with a securities contract … except under [S]ection 548(a)(1)(A) of this title [dealing with actual fraud]." 11 U.S.C. § 546(e). Applying this safe harbor provision, the *Katz* court held that the Trustee may not "bring[ ] any action to recover from any of Madoff's customers any of the monies paid by Madoff Securities to those customers except in the case of actual fraud." *Id*. at *2.

The Trustee urged the *Katz* court to consider the legislative history of Section 546(e)'s safe harbor, which was enacted to "'minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries.'" *Id*. at *3. Given that the Trustee's complaint alleged that "the Madoff fraud involved approximately $68 billion and 4,900 customers," the *Katz* court saw "'no reason to think that undoing' such large transfers involving so many customers from so long ago as 2002 'would not also have a substantial and similarly negative effect on the financial markets.'" *Id*. Moreover, the *Katz* court found that "resort to legislative history is inappropriate where, as here, the language of the statute is plain and controlling on its face." *Id*.

In contrast to the *Katz* court's ruling, two Bankruptcy Court decisions have held that Section 546(e)'s safe harbor does not apply to Madoff-related claims because Madoff "never in fact purchased any of the securities he claimed to have purchased for customer accounts" and therefore does not qualify as a "stockbroker" within the meaning of Section 546(e). *In re Bernard L. Madoff Inv. Sec., LLC*, 440 B.R. 243, 267 (Bankr. S.D.N.Y. 2010) (Lifland, J.), *appeal denied, In re Bernard L. Madoff Inv. Sec. LLC*, 2011 WL 3897970 (S.D.N.Y. Aug. 31, 2011) (Wood, J.); *see also In re Bernard L. Madoff Inv. Sec. LLC*, 2011 WL 4434632, at *15 (Bankr. S.D.N.Y. Sept. 22, 2011) (Lifland, J.) (discussed on pages 10 – 12 below).

The Bankruptcy Court Declines to Dismiss Most of the SIPA Trustee's Claims against Madoff Family Members

On September 22, 2011, the Bankruptcy Court of the Southern District of New York denied in large part motions to dismiss the SIPA Trustee's claims against Madoff's sons (one of whom is now deceased), his brother, and his niece. *In re Bernard L. Madoff Inv. Sec. LLC*, 2011 WL 4434632 (Bankr. S.D.N.Y. Sept. 22, 2011) (Lifland, J.). The Trustee asserted that these relatives "'operated [Madoff Securities] as if it was the family piggy bank,' with the [d]efendants living in multi-million dollar homes and relying on [Madoff Securities] funds to pay for vacations, travel, and other

personal expenses—all while failing to fulfill their responsibilities as high ranking employees of the business." *Id.* at *1.

The Bankruptcy Court Finds That the Trustee Adequately Alleged Intent for the Actual Fraudulent Transfer Claims

With respect to the Trustee's actual fraudulent transfer claims under the Bankruptcy Code and New York Debtor and Creditor Law ("NYDCL"), the Bankruptcy Court held that "the 'Ponzi scheme presumption' establishes the debtors' fraudulent intent" as "a matter of law." *Id.* at *5. "There is a presumption of actual intent to defraud [in Ponzi scheme cases] because 'transfers made in the course of a Ponzi scheme could have been made for no purpose other than to hinder, delay or defraud creditors.'" *Id*. Here, the court found that "[t]he breadth and notoriety of the Madoff Ponzi scheme leave[s] no basis for disputing the application of the Ponzi scheme presumption … , particularly in light of Madoff's criminal admission." *Id.*

The Bankruptcy Court Rules That Section 546(e)'s Safe Harbor Does Not Apply to the Trustee's Constructive Fraudulent Transfer Claims

While the *Katz* court held that Madoff's customers were entitled to Section 546(e)'s safe harbor protections (see page 10 above), the Bankruptcy Court here ruled that "Ponzi scheme operators" such as Madoff "do not affirmatively 'make securities transactions happen' on behalf of legal 'customers,' and thus do not fit the definition of 'stockbroker' for purposes of [S]ection 546(e)." *Id.* at *15. The court found it significant that "Madoff … 'never in fact purchased any of the securities he claimed to have purchased for customer accounts.'" *Id.*

Moreover, the Bankruptcy Court explained that "Section 546(e) was intended to promote stability and instill investor confidence in the commodities and securities markets." *Id.* at *16. "[E]xtend[ing] safe harbor protection in the context of a fraudulent securities scheme would … 'undermine, not protect or promote investor confidence … '." *Id*. The Bankruptcy Court found that "it defies credulity that the [d]efendants, who are insiders on the basis of the facts alleged, were ever contemplated to be the parties eligible to invoke the safe harbor provision under [S]ection 546(e)." *Id.*

The Bankruptcy Court Holds That the Trustee Adequately Alleged the Constructive Fraudulent Transfer Claims

To plead constructive fraudulent transfer claims under the relevant statutes, a trustee must allege that the bankrupt estate did not receive "reasonably equivalent value" or "fair consideration" in exchange for those transfers. *See id.* at *10. The Bankruptcy Court found that the Trustee had "adequately alleged" that the defendants' "withdrawals of fictitious profits and receipt of salaries, bonuses, gifts, and loans from [Madoff Securities]" were "made for less than 'reasonably equivalent' or 'fair equivalent' value." *Id.* at *11. "[C]ourts have consistently held that fictitious profits from a Ponzi Scheme are deemed to have been received for less than reasonably equivalent value and can be avoided." *Id.* at *11. As to the defendants' allegedly "astronomical" salaries and bonuses, the court found that "the Trustee ha[d] sufficiently alleged [that the defendants had] … breached fiduciary duties to [Madoff Securities], and thus did not provide services that might otherwise have constituted adequate consideration … ." *Id.* at *12.

The Bankruptcy Court Rules That the Trustee's Common Law Claims Are Not Preempted by the Martin Act

The Martin Act, New York's blue sky law, "empower[s] the New York State Attorney General

to take action against fraudulent practices involving securities." *Id*. at *22. Because the Trustee's common law claims "allege[ ] derelictions of internal management duties and misuses of company funds unrelated to any specific investment accounts under management or any particular investment advice or decision," the Bankruptcy Court determined that these claims do not implicate "conduct prohibited by the Martin Act." *Id*. at *23. Accordingly, the court held that the Martin Act does not preempt the Trustee's common law claims. *Id*. at *24.

The Southern District of New York Dismisses Madoff-Related Claims Involving the Merkin Funds

On September 23, 2011, the Southern District of New York dismissed claims brought by investors in funds run by J. Ezra Merkin. *In re J. Ezra Merkin and BDO Seidman Sec. Litig.*, 2011 WL 4435873 (S.D.N.Y. Sept. 23, 2011) (Batts, J.). These funds had "invested heavily" with Madoff Securities." *Id*. at *1.

The plaintiffs alleged that Merkin, the general partner of two of the funds at issue, and Gabriel Capital Corporation ("GCC"), the investment adviser to the third fund at issue, had "made a number of misrepresentations" with respect to Merkin's involvement in the funds and the funds' investment strategies, and "should have performed better due diligence" in connection with the Madoff investments. *Id*. at *1, *7. The plaintiffs also brought suit against the funds' auditors, alleging that they should have "conducted further work to ferret out Madoff's fraud." *Id*. at *1.

The *Merkin* Court Dismisses the Plaintiffs' Section 10(b) Claims

The court held that the plaintiffs' Section 10(b) claims against Merkin and GCC "fail[ed] because the [complaint] does not adequately allege a material misstatement or omission." *Id*. at *7. With respect to allegations that Merkin had "misrepresented his involvement in the [f]unds," the *Merkin* court held that the plaintiffs could not "'cherry pick' language from the offering memoranda and then ignore explicit cautionary language" to the effect that "third-party managers would have custody over the [f]unds' assets and that this custody carried a risk of loss." *Id*. The court found similarly "unavailing" allegations that the defendants had "misrepresented the [f]unds' investment strategies." *Id*. at *8. "While in hindsight the use of Madoff proved to be detrimental, the use of a third-party manager to execute a fund's overall investment strategy does not, without more, give rise to a claim under § 10(b)." *Id*.

In addition, the *Merkin* court deemed "without merit" allegations that the defendants had "improperly delegated investment authority to Madoff and did not conduct proper due diligence." *Id*. "[T]he Second Circuit has made clear that the alleged failure to conduct due diligence generally does not give rise to a securities fraud claim." *Id*. Moreover, the *Merkin* court declined to "recognize a § 10(b) claim against those who did business with Madoff, simply by imputing [to the defendants] the suspicions of a few … people who suspected Madoff's fraud before it was ever discovered." *Id*. The court held that "allegations of Madoff-related red flags do not adequately plead scienter." *Id*. at *9 (citing *In re Beacon Assocs. Litig.*, 745 F.

Supp. 2d 386 (S.D.N.Y. 2010)).

Finally, the court dismissed the plaintiffs' Section 10(b) claims against the auditor defendants on the grounds that there was "no competent allegation of actual or reckless fraudulent intent." *Id*. at *10.

The *Merkin* Court Dismisses Certain Common Law Claims on SLUSA Grounds

The court dismissed the plaintiffs' common law fraud, negligent misrepresentation and fraudulent concealment claims on grounds of preemption under the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").[3] The plaintiffs argued that "SLUSA does not reach their claims because they purchased shares in the [f]unds, rather than any covered securities within the meaning of SLUSA." *Id*. at *11. However, the *Merkin* court explained that for purposes of SLUSA preemption, "'it is enough that the fraud alleged 'coincide' with a securities transaction—whether by the plaintiff or by someone else.'" *Id*. (quoting *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 85-86 (2006)). Here, the plaintiffs invested in the funds, which in turn "invested [with] Madoff, who then purported to make further securities transactions." *Id*. at *12. The *Merkin* court held that "[t]his pass-through investment to Madoff 'coincided' with a securities transaction" for purposes of SLUSA preemption. *Id*.

The *Merkin* Court Dismisses the Plaintiffs' Remaining Common Law Claims on Martin Act Grounds

The court dismissed the plaintiffs' remaining non-fraud claims of breach of fiduciary duty, gross

3. "SLUSA mandates dismissal when: (1) a suit is a covered class action; (2) brought under state or local law; (3) concerning a covered security; (4) the defendant is alleged to have misrepresented or omitted a material fact or employed a manipulative device or contrivance; and (5) it is 'in connection with the purchase or sale' of that security." *Id*. at *10.

negligence (and mismanagement), and unjust enrichment on grounds of Martin Act preemption. "The vast majority of courts in [the Southern District of New York] have held that the Martin Act preempts New York state law claims brought by investors seeking to recover losses related to the Madoff scandal." *Id*. at *12. However, in *Anwar v. Fairfield Greenwich Ltd*., 728 F. Supp. 2d 354 (S.D.N.Y. 2010), the Southern District of New York held that the Martin Act does not preempt the common law claims of investors in Madoff feeder funds.[4] (To read our discussion of the *Anwar* decision in the September 2010 edition of the Alert, please click here.) The plaintiffs relied on *Anwar* to contend that "the line of cases establishing that the Martin Act precludes private causes of action is erroneous." *Id*. at *13.

Because "the New York Court of Appeals has not examined this specific issue," the *Merkin* court explained that it was "bound" to follow "the only Second Circuit case that has addressed this subject: *Castellano v. Young & Rubicam*, 257 F.3d 171, 190 (2d Cir. 2001)." *Id*. The *Castellano* court dismissed a breach of fiduciary duty claim on Martin Act preemption grounds based on "principles of federalism and respect for state courts' interpretation of their own

4. Simpson Thacher represents certain defendants in the *Anwar* litigation.

laws." *Castellano*, 257 F.3d at 190. While the *Merkin* court acknowledged that "there has been some recent disagreement in the application of the Martin Act," the court found that "Martin Act preemption remains a viable defense until the New York Court of Appeals (or the Second Circuit in interpreting existing New York law) revisits this area." *Merkin*, 2011 WL 4435873, at *13 n.15.

Notably, a New York state court recently reached the opposite conclusion in a different Madoff-related action involving the Merkin funds. *CRT Invest., Ltd. v. Merkin*, 918 N.Y.S. 2d 397 (N.Y. Sup. 2010), *aff'd*, *CRT Invest., Ltd. V. BDO Seidman, LLP*, 925 N.Y.S. 2d 439 (N.Y. App. Div. 1st Dep't. 2011), *reh'g granted*, *CRT Invest., Ltd. v. Merkin*, No. 601052/09 (N.Y. Sup. 2011). In May 2010, the court had originally dismissed the plaintiffs' negligent misrepresentation and gross negligence claims on Martin Act grounds. Six months later, the First Department held in a different case that the Martin Act does not preempt breach of fiduciary duty and gross negligence claims. *See Assured Guar. (UK) Ltd. v. J.P. Morgan Inv. Mgmt. Inc.*, 80 A.D. 3d 293, 303-04 (N.Y. App. Div. 2010). (To read our discussion of the *Assured Guaranty* decision in the December 2010 edition of the Alert, please click here.) The plaintiffs in *CRT Investments* moved to renew their common law claims in light of the First Department's ruling.

In a decision filed on September 14, 2011, the *CRT Investments* court reinstated the plaintiffs' common law claims on the grounds that "there has been a change in the law [on Martin Act preemption] effected by the First Department's November 23, 2010 decision [in *Assured Guaranty*]." *CRT Invest., Ltd. v. Merkin*, No. 601052/09 (N.Y. Sup. 2011). The *Assured Guaranty* ruling has been appealed to the New York Court of Appeals, and oral arguments are scheduled for November 15, 2011. We are closely following the case, and will report any notable developments in future editions of the Alert.

Two District Courts Consider Whether Corporations Have "Ultimate Authority" over Statements Made by Wholly Owned Subsidiaries under *Janus*

In *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), the Supreme Court held that Janus Capital Management LLC ("JCM"), the investment adviser and administrator for Janus Investment Fund, could not be held liable under Section 10(b) and Rule 10b-5 for helping to create allegedly "false statements in mutual fund prospectuses filed by Janus Investment Fund." *Id.* at 2297. The Court ruled 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." *Id.* at 2302 (emphasis added). Just as a speechwriter does not "make" a speech delivered by someone else, the *Janus* Court explained that a person or entity who "prepares or publishes a statement on behalf of another is not its maker." *Id.* (To read our discussion of the *Janus* decision in the June edition of the Alert, please click here.)

Among the questions to arise in the district courts out of the *Janus* ruling is whether corporations have "ultimate authority" over statements made by wholly owned subsidiaries. Below we discuss two recent conflicting decisions from the Southern District of New York on this issue.

The *EnergySolutions* Court Finds That a Corporation May Have "Ultimate Authority" over Statements Made by a Wholly Owned Subsidiary

On September 30, 2011, the Southern District of New York declined to dismiss Section 10(b) and

Rule 10b-5 claims against ENV Holdings, Inc. based on statements made by EnergySolutions, Inc. ("ES"), ENV's wholly owned subsidiary, in connection with ES's initial public offering ("IPO"). *City of Roseville Emps.' Ret. Sys. v. EnergySolutions, Inc.*, 2011 WL 4527328 (S.D.N.Y. Sept. 30, 2011) (Koeltl, J.)[5]

The defendants argued that the claims should be dismissed because "ENV and ES are legally distinct entities," "[a]s was the case with JCM and the Janus Investment Fund." *Id*. at *17. This is "'precisely the kind of claim that the Supreme Court rejected in *Janus*,'" the defendants explained. *Id*. at *18.

However, the *EnergySolutions* court found that "there are important distinctions between the role of ENV in this case and JCM in *Janus*." *Id*. at *17. Here, "ENV was the sole owner of outstanding stock in ES at the time of the IPO" and "had 'ultimate authority' over the … [o]fferings." *Id*. at *17-18. In view of "ENV's ownership of ES, its direct control over all corporate transactions, and its authority to determine when and whether to sell the shares being sold," the court concluded that "[a] reasonable jury could find that … ENV's role went well beyond that of 'a speechwriter draft[ing] a speech.'" *Id*. at *18 (quoting *Janus*, 131 S. Ct. at 2302).

Notably, the *EnergySolutions* court found that "explicit attributions" to ES in the registration statements at issue did "not preclude attribution to ENV as well." *Id*. The court pointed to language in the *Janus* opinion "recogniz[ing] that attribution could be 'implicit from surrounding circumstances.'" *Id*. (quoting *Janus*, 131 S. Ct. at 2302). Since "the [r]egistration [s]tatements contain so many indicia of [ENV's] control," the *EnergySolutions* court held that "the lack of an explicit statement that ENV was speaking through the [r]egistration [s]tatements does not control the answer to the question of whether it made those statements." *Id*.

5. Simpson Thacher represents EnergySolutions Inc., ENV Holdings, Inc., and a number of individual defendants in this action.

The *Optimal* Court Takes the Opposite View, Holding That a Corporation Cannot Face Liability under *Janus* for Statements Made by a Wholly Owned Subsidiary

Just two weeks after the *EnergySolutions* ruling, the Southern District of New York dismissed Section 10(b) and Rule 10b-5 claims brought against Optimal Investment Management Services ("OIS") arising from statements made by its wholly owned subsidiary, Optimal Multiadvisors, Ltd. ("Multiadvisors"), in Explanatory Memoranda ("EMs"). *In re Optimal U.S. Litig.*, 2011 WL 4908745 (S.D.N.Y. Oct. 14, 2011) (Scheindlin, J.). Rejecting the "[p]laintiffs' attempt to avoid *Janus* by conflating shareholder control with 'ultimate authority,'" the *Optimal* court held that "Multiadvisors, not OIS, 'made' the statements in the EMs for purposes of Rule 10b-5." *Id*. at *5.

Although the plaintiffs made "much of the fact that OIS owned one-hundred percent of Multiadvisors," the *Optimal* court found that "it was the board of directors of Multiadvisors, not the shareholders, which had 'ultimate authority' to issue the EMs." *Id*. "OIS had the authority to select the board of Multiadvisors," but there were no allegations that "OIS directly issued the EMs or had the 'ultimate authority' to do so." *Id*. The plaintiffs alleged only that OIS's in-house counsel "suggested changes to the EMs, which Multiadvisors adopted." *Id*. Finding these allegations insufficient, the court explained that under *Janus*, "a statement is 'made' not by the entity that drafted it—here OIS—but rather by the entity that delivers it—here Multiadvisors." *Id*.

The *Optimal* court expressly declined to attribute Multiadvisors' statements to OIS. While the court found that "the extent to which there is Rule 10b-5 liability solely on the basis of attribution is not clear," the court determined that the "issue need not be resolved in the context of this case because the facts are so closely analogous to *Janus*." *Id*.

Finally, the *Optimal* court held that "Rule 10b-5 liability for a one-hundred percent shareholder of an

entity 'making' a misleading statement is inappropriate; rather, [S]ection 20(a) is the appropriate source of liability." *Id*. at *6. The *Optimal* court explained that "[a]lthough *Janus* did not involve a defendant that owned a one-hundred percent stake in the issuer of the alleged misstatements, the Court caution[ed] against expanding the narrow private right of action under Rule 10b-5 to impose liability where Congress [has] already imposed liability under other statutory provisions, such as those found in [S]ection 20." *Id*. at *5.

The *Optimal* Court Distinguishes the *EnergySolutions* Ruling

In a footnote, the *Optimal* court acknowledged that the Southern District of New York had reached the "opposite result" in *EnergySolutions*. *Id*. at *6 n.50. However, the *Optimal* court found that *EnergySolutions* was "distinguishable" because "the indicia of control here are not so overwhelming as to justify disregarding which corporate entity issued the statements." *Id*. In *EnergySolutions*, "there were explicit statements in registration statements indicating that the defendant had 'direct control over all corporate transactions, and … authority to determine when and whether to sell the shares being sold.'" *Id*. In the *Optimal* case, on the other hand, "the Multiadvisors board expressly retained the ability to amend the EMs without consulting its shareholders (OIS) in numerous situations—indicating its 'ultimate authority' over the contents of the EMs." *Id*. The *Optimal* court concluded that "the facts here, showing that Multiadvisors exercised some discretion independently of OIS, do not justify disregarding which corporate entity issued the statements, as [the court] did in [*EnergySolutions*]." *Id*.

Additionally, the *Optimal* court noted that *EnergySolutions* "does not address the discussion in *Janus* that imposing liability on an entity that influenced or controlled the 'maker' of the statement would improperly broaden the scope of Rule 10b-5 liability, where Congress has already enacted a provision for such a scenario—[S]ection 20(a)." *Id*. (citing *Janus*, 131 S. Ct. at 2304).

The Delaware Supreme Court Considers When Transactions Should Be Aggregated for Purposes of a Successor Obligor Provision in an Indenture Agreement

On September 21, 2011, the Delaware Supreme Court held that a proposed splitoff transaction by Liberty Media Corporation was not "'sufficiently connected'" to Liberty's prior asset distributions to warrant aggregation for purposes of a successor obligor provision in an indenture agreement. *Bank of New York Mellon Trust Co., N.A. v. Liberty Media Corp.*, 2011 WL 4376552, at *16 (Del. Sept. 21, 2011) (Holland, J.).

Background

In June 2010, Liberty announced the "Capital Splitoff" transaction, pursuant to which it proposed to "split off the businesses allocated to its Capital and

Starz Groups into Splitco, a new public entity." *Id*. at *9. The Capital Splitoff was Liberty's "fourth major distribution of assets since March 2004." *Id*. at *1.

Following the announcement, an anonymous bondholder challenged the proposed transaction, claiming that it was part of a "'disaggregation strategy' designed to remove substantially all of Liberty's assets from the corporate structure against which the bondholders have claims." *Id*. "[T]he bondholder contended that the [proposed] transaction might violate the [s]uccessor [o]bligor [p]rovision" in Liberty's indenture agreement with the Bank of New York Mellon Trust Company (the "Trustee"). *Id*. "This provision prohibits Liberty from selling, transferring, or otherwise disposing of 'substantially all' of its assets unless the entity to which the assets are transferred assumes Liberty's obligations under the Indenture . . . ." *Id*. at *3. While the provision specifically references the possibility that such a disposition may occur through a "'series of transactions,'" the indenture agreement "does not define the phrase 'substantially all.'" *Id*. The indenture agreement is governed under New York law.

In response to the bondholder's challenge, Liberty brought suit against the Trustee seeking "injunctive relief and a declaratory judgment that the proposed Capital Splitoff [would] not constitute a disposition of 'substantially all' of Liberty's assets in violation of the [i]ndenture." *Id*. at *1.

The Chancery Court Finds That the Transactions Should Not Be Aggregated

There was no dispute that the Capital Splitoff transaction, "standing alone," would not involve "'substantially all' of Liberty's assets" within the meaning of the successor obligor provision. *Id*. at *9. Thus, the "threshold question" was whether the Capital Splitoff transaction should be aggregated with Liberty's prior transactions for purposes of the "substantially all" analysis. *Id*.

The Chancery Court looked to the Second Circuit's decision in *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039 (2d Cir. 1982), which it found to be "'the leading decision on aggregating transactions for purposes of a 'substantially all' analysis' in the context of a successor obligor provision." *Liberty Media*, 2011 WL 4376552, at *10. In *Sharon Steel*, the Second Circuit held that the transactions in question should be aggregated because they were part of a "plan of piecemeal liquidation" and an "overall scheme to liquidate." *Sharon Steel*, 691 F.2d at 1050.

Applying *Sharon Steel* to the facts at hand, the Chancery Court determined that there was no evidence that "Liberty had developed a plan or scheme to dispose of its assets piecemeal with a goal of liquidating nearly all its assets, or removing assets from the corporate structure to evade bondholder claims." *Liberty Media*, 2011 WL 4376552, at *12. "Rather, each transaction reflected a context-driven application of [Liberty's] overarching business strategy . . . ." *Id*.

The Chancery Court then added a "second layer of analysis" based on the step-transaction doctrine set forth in *Noddings Investment Group, Inc. v. Capstar Communications, Inc.*, 1999 WL 182568 (Del. Ch. Mar. 24, 1999), *aff'd*, 741 A.2d 16 (Del. 1999). *Liberty Media*, 2011 WL 4376552, at *13. This doctrine "treats the 'steps' in a series of formally separate but related transactions involving the transfer of property as a single transaction, if all the steps are substantially

linked." *Noddings*, 1999 WL 182568, at *6. The Chancery Court found that the Liberty transactions should not be aggregated under the step-transaction doctrine because "'[e]ach of the transactions was a distinct corporate event'" that "'stood on its own merits,'" and "none of the transactions was contractually tied to any of the others." *Liberty Media*, 2011 WL 4376552, at *13.

The Delaware Supreme Court Affirms the Chancery Court's Decision

On appeal, the Delaware Supreme Court endeavored to "predict what the law of New York would be on this important question of first impression." *Id.* at *10. "[G]iven the near absence of any authoritative New York case law," the Delaware Supreme Court "conclude[d] that the principles articulated in *Sharon Steel* are the proper basis for determining, under New York law, the nature and degree of interrelationship that will warrant aggregation of otherwise separate and individual transactions as part of a 'series.'" *Id.* at *16. The court found that the "'series of transactions' language in a post-*Sharon Steel* successor obligor provision (such as the one at issue here)" was "included … to clarify that the [s]uccessor [o]bligor [p]rovision should be interpreted in the same manner as the one at issue in *Sharon Steel*." *Id.* at *15.

The Delaware Supreme Court determined that the Chancery Court had "carefully considered and applied *Sharon Steel*," and had appropriately concluded that the Capital Splitoff transaction was "'not sufficiently connected'" to Liberty's prior transactions to warrant aggregation. *Id.* at *16. Because the Chancery Court "cited only the *Sharon Steel* decision as authority for its holding," the Delaware Supreme Court found it "unnecessary to reach or decide whether the step-transaction doctrine … would be adopted by the New York Court of Appeals as definitive New York law to determine whether to aggregate a series of transactions in a 'substantially all' analysis." *Id.* at *16-*17.

The Delaware Chancery Court Grants a $1.26 Billion Award in the Southern Peru Shareholder Derivative Litigation

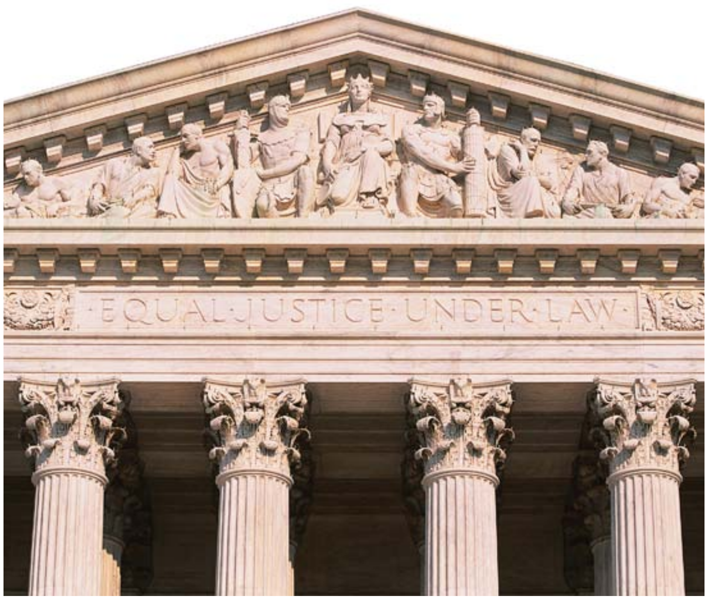
On October 14, 2011, the Delaware Chancery Court issued a post-trial award of $1.263 billion in shareholder derivative litigation arising from Southern Peru Copper Corporation's purchase of a 99.15% stake in Minera Mexico, a Mexican mining company, from Grupo Mexico, Southern Peru's controlling shareholder. *In re S. Peru Copper Corp. S'holder Derivative Litig.*, 2011 WL 4889231 (Del. Ch. Oct. 14, 2011) (Strine, C.). The court found that the director defendants had breached their fiduciary duty of loyalty by approving a "manifestly unfair transaction" in which Southern Peru paid "$3.1 billion in real value" for "something worth … hundreds of millions of dollars less." *Id.* at *2.

Background

In February 2004, Grupo Mexico approached Southern Peru with a proposal to sell its 99.15% stake in Minera for 72.3 million shares of newly-issued Southern Peru stock (worth $3.05 billion at the time). Because "Minera was almost wholly owned by Grupo Mexico," it "had no market-tested value." *Id.* at *3.

Southern Peru formed a "Special Committee" of disinterested directors to evaluate the proposed transaction. The Special Committee retained Goldman, Sachs & Co. as well as a "specialized mining consultant to help Goldman with certain technical aspects of mining valuation." *Id.* at *6. On June 11, 2004, Goldman provided the Special Committee with "preliminary valuation analyses of the standalone equity value of Minera." *Id.* at *7. "Goldman summed up the import of these various analyses in an 'Illustrative Give/Get Analysis,' which made patent the stark disparity between Grupo Mexico's asking price and Goldman's valuation of Minera: Southern Peru would 'give' stock with a market price of $3.1 billion to Grupo Mexico and would 'get' in return an asset worth no more than $1.7 billion." *Id*. at *7.

On June 23, 2004, Goldman advised the Special Committee that "Southern Peru was being overvalued by the stock market." *Id*. at *8. The Special Committee then "embarked on a 'relative valuation' approach" to assess the Minera transaction, and "assured itself that a deal could be fair so long as the 'relative value' of the two companies was measured on the same metrics." *Id*. at *1. Goldman subsequently "generated complicated scenarios pegging the relative value of the companies" and, in the court's view, "went to strenuous lengths to equalize the values of Southern Peru and Minera." *Id*. at *1, *29.



On October 21, 2004, after eight months of "awkward back and forth," the Special Committee approved Southern Peru's acquisition of 99.15% of Minera's stock in exchange for 67.2 million newly-issued shares of Southern Peru stock (worth $3.1 billion at the time). *Id*. at *3. The Special Committee insisted on a fixed exchange ratio pursuant to which "[t]he dollar value of the [m]erger consideration at the time of closing would vary with the fluctuations of Southern Peru's market price." *Id*. at *10. Although the value of Southern Peru stock rose substantially in the months leading up to the closing, the Special Committee did not ask Goldman to update its fairness analysis, nor did it attempt to rescind the transaction.

Southern Peru shareholders ultimately brought suit against "the Grupo Mexico subsidiary that owned Minera, the Grupo Mexico-affiliated directors of Southern Peru, and the members of the Special Committee, alleging that the [m]erger was entirely unfair to Southern Peru and its minority stockholders." *Id*. at *3. On December 21, 2010, the Chancery Court dismissed the Special Committee defendants from the case based on Southern Peru's exculpatory provision. The case proceeded to trial against the Grupo Mexico-affiliated director defendants. The Chancery Court found that the director defendants' "liability … rises or falls with the issue of fairness." *Id*. at *19.

The Delaware Chancery Court Finds That the Merger Was Not Fundamentally Fair

In accordance with the Delaware Supreme Court's decision in *Kahn v. Tremont Corp*., 694 A.2d 422 (Del. 1997), the parties agreed that "the appropriate standard of review for the [m]erger is entire fairness." *S. Peru*, 2011 WL 4889231, at *20. The entire fairness standard has "two basic aspects": (1) *fair dealing*, which "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained[;]" and (2) *fair price*, which "relates to the economic and financial considerations of the proposed merger … ." *Id*. (internal quotations omitted).

The Chancery Court held that "the process by which the [m]erger was negotiated and approved was not fair and did not result in the payment of a fair price." *Id*. at *26. "[A]lthough the Special Committee members were competent businessmen [who] may have had the best of intentions," the court found that "they allowed themselves to be hemmed in by the controlling stockholder's demands." *Id.* at *29. The "focus was on finding a way to get the terms of the [m]erger structure proposed by Grupo Mexico to make sense, rather than aggressively testing the assumption that the [m]erger was a good idea in the first place." *Id.* "A reasonable special committee would not have taken the results of those [initial] analyses by Goldman and blithely moved on to relative valuation, without any continuing and relentless focus on the actual give-get involved in real cash terms." *Id.* at *30. The court explained that "[w]hat [the Special Committee essentially] did was to turn the gold that it held (market-tested Southern Peru stock worth in cash its trading price) into silver (equating itself on a relative basis to a financially-strapped, non-market tested selling company) … ." *Id.* at *32.

Concluding that "the deal was unfair," the Chancery Court ruled that "the defendants [had] breached their fiduciary duty of loyalty." *Id.* at *38.

The Delaware Chancery Court Awards $1.26 Billion

Under the entire fairness standard, a "court has broad discretion to fashion equitable and monetary relief," and "'mathematical certainty is not required.'" *Id.* at *39. Given "the plaintiff's delay in litigating the case," the Chancery Court agreed with the defendants that it would be "inequitable to use a rescission-based approach." *Id.* at *40. The court opted instead for "a damage award that approximates the difference between the price that the Special Committee would have approved had the [m]erger been entirely fair (i.e., absent a breach of fiduciary duties) and the price that the Special Committee actually agreed to pay." *Id.*

"To calculate a fair price for remedy purposes," the Chancery Court "balance[d] three values: (1) a standalone [discounted cash flow] value of Minera … ; (2) the market value of the Special Committee's 52 million share counteroffer made in July 2004, which was sized based on months of due diligence by Goldman about Minera's standalone value … ; and (3) the equity value of Minera derived from a comparable companies analysis … ." *Id.* at *41. The court arrived at a value of $2.409 billion for a 99.15% stake in Minera. Because the value of 67.2 million Southern Peru shares as of the merger date was $3.672 billion, the court determined that the remedy "amounts to $1.263 billion," plus "interest at the statutory rate, without compounding." *Id.* at *43. The court ruled that "Grupo Mexico may satisfy the judgment by agreeing to return to Southern Peru such number of its shares as are necessary to satisfy this remedy," and held that "[a]ny attorneys' fees shall be paid out of the award." *Id.*

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