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This month's Alert addresses a Second Circuit opinion holding that federal common law governs insider trading restrictions, and that those restrictions apply with equal force to unregistered securities. We also discuss a Ninth Circuit decision reinstating a securities fraud action against BP on the grounds that plaintiffs had adequately pled scienter.

In addition, we address a Southern District of New York opinion holding that the tolling rule set forth in *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974), does not apply to the five-year statute of repose for Section 10(b) claims. Finally, we discuss a Delaware Chancery Court decision granting defendants' motion for summary judgment in a shareholder class action arising out of the acquisition of Answers Corporation.

On February 26, 2014, the Supreme Court issued its decision in *Chadbourne & Parke LLP v. Troice* (Nos. 12-79, 12-86, and 12-88), in which the Court addressed the "in connection with" requirement of the Securities Litigation Uniform Standards Act ("SLUSA").

Second Circuit Holds Federal Common Law Governs Insider Trading Restrictions, Which Apply with Equal Force to Unregistered Securities

On January 27, 2014, the Second Circuit held that "the duty of corporate insiders to either disclose material nonpublic information or abstain from trading is defined by federal common law and applies to unregistered securities." *Steginsky v. Xcelera Inc.*, 2014 WL 274419 (2d Cir. Jan. 27, 2014) (Walker, Jr., J.) (*Xcelera II*).

Background

Xcelera is a technology conglomerate "controlled by two billionaire brothers, Alexander and Gustav Vik, and their financier father through a company called VBI Corporation" (collectively, the "Vik Defendants").

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Steginsky v. Xcelera, Inc., 2013 WL 1087635 (D. Conn. Mar. 14, 2013) (Underhill, J.) (*Xcelera I*). At the height of the dot-com bubble, Xcelera stock had traded at $110 per share on the American Stock Exchange. But in 2004, when the price fell to $1 per share, the Vik Defendants ceased complying with SEC filing requirements. As a result, the American Stock Exchange delisted Xcelera stock, and the SEC revoked Xcelera's registration.

Xcelera has made no financial disclosures since 2005. However, in December 2010, OFC Ltd. made a tender offer to Xcelera's shareholders in the amount of $0.25 per share. Xcelera did not provide shareholders with any information concerning its financial condition as part of the tender offer.

An Xcelera shareholder subsequently brought suit alleging that OFC was "only a shell company, and that the tender offer was in fact orchestrated by Xcelera and the Vik [D]efendants." *Xcelera II*, 2014 WL 274419. Plaintiff contended that the Vik Defendants' "real aim ha[d] always been to drive down share prices so they could eventually buy back their company at a bargain-basement price." *Xcelera I*, 2013 WL 1087635. Among other claims, plaintiff asserted insider trading violations under Section 10(b).

On March 14, 2013, the District of Connecticut dismissed plaintiff's insider trading claims on the grounds that "the Xcelera defendants [had] shed their statutory obligation to disclose financial information the minute the SEC deregistered [Xcelera's] stock." The court emphasized that "[i]nsider trading requires that a company have some obligation to disclose its confidential financial data to the public." When no such disclosure obligation applies, the court explained that "corporate officers are not in possession of any 'non-public' information, but rather merely know how well their private company is doing." The district court further found that defendants had no "common law duty to disclose information to shareholders" under Cayman Island law, which the court applied because Xcelera is a Cayman Island corporation. Plaintiff appealed.

Second Circuit Reinstates Plaintiff's Insider Trading Claims

On appeal, the Second Circuit found that the district court's "conclusions [were] in error: unregistered securities are not immune from the duty to disclose, and Cayman law is inapplicable" in determining whether defendants had a "duty to disclose any information before trading in Xcelera securities." *Xcelera II*, 2014 WL 274419.

The Second Circuit explained that "Section 10(b) explicitly applies to 'any security registered on a national securities exchange *or any security not so registered*.'" *Id*. (quoting 15 U.S.C. § 78j(b) (emphasis added by the court)). Therefore, the Second Circuit determined that "the duty of corporate insiders to abstain from trading or to disclose material inside information applies to unregistered securities." The court further noted that closed corporations are subject to "special obligation[s] to disclose to sellers all material information" when purchasing their own stock. *Id*. (quoting *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171 (2d Cir. 2001)).

As to the governing law, the Second Circuit held "that the fiduciary-like duty against insider trading under [S]ection 10(b) is imposed and defined by federal common law, not the law of the Cayman Islands." The court observed that "looking to idiosyncratic differences in state law would thwart the goal of promoting national uniformity in securities markets."

Finally, the Second Circuit found baseless defendants' argument that applying the duty to disclose here "would impose an affirmative duty on small, unregistered corporations to disclose audited financial statements." The court clarified that insiders in possession of material inside information must "*either* disclose" such information "to the investing public" or "*abstain from trading in or recommending* the securities concerned while such inside information remains undisclosed." *Id*. (quoting *Castellano*, 257 F.3d 171 (emphasis added by the court)). Although Xcelera and the Vik Defendants "had no general affirmative duty to disclose once Xcelera was deregistered by the

SEC," the Second Circuit explained that "they could not trade in Xcelera shares based on undisclosed material inside information that they possessed."

The Second Circuit vacated dismissal of plaintiff's Section 10(b) insider trading claims.

Ninth Circuit Reinstates BP Securities Fraud Action, Finding Plaintiffs Adequately Alleged Scienter

On February 13, 2014, the Ninth Circuit reversed in part the dismissal of a securities fraud action against BP in connection with two Prudhoe Bay pipeline leaks in 2006. *Reese v. Malone*, 2014 WL 555911 (9th Cir. Feb. 13, 2014) (Dearie, J.)[1] (*BP II*). The Ninth Circuit found that plaintiffs had adequately alleged scienter with respect to several of the alleged misstatements at issue.

Background

BP-Alaska ("BP") operates three pipelines in Prudhoe Bay, Alaska: the Western Operating Area ("WOA") pipeline; the Eastern Operating Area ("EOA") pipeline; and the Lisburne line. On March 2, 2006, BP discovered an oil leak in the WOA pipeline that ultimately caused 200,000 gallons of oil to spill onto the Alaskan tundra. "Subsequent investigation found that the leak was the result of … internal corrosion." It soon "came to light that BP had not tested the integrity of the WOA [pipeline] with a smart pig," which "detect[s] the presence of cracks, corrosion, and pitting within the pipeline," since 1998. On March 15, 2006, the U.S. Department of Transportation Pipeline and Hazardous Materials Safety Administration ("PHMSA") issued a Corrective Action Order requiring BP to inspect all three Prudhoe Bay pipelines with smart pigs by certain deadlines. The Corrective Action Order described the three pipelines as "similar" and noted that they all "transport the same quality crude oil that contributed to the … internal corrosion" in the WOA pipeline.

In August 2006, BP discovered a leak in the EOA pipeline, which caused a much smaller spill of about 1,000 gallons. "Following the second spill, BP temporarily shut down the Prudhoe Bay oil field, which account[ed] for more than eight percent of total U.S. oil production."

In October 2007, BP pled guilty to a misdemeanor violation of the Clean Water Act in connection with the oil spills, and agreed to pay a $20 million fine to settle federal and state criminal charges. BP admitted in the plea agreement "that it was aware of the corrosion in the WOA pipelines in 2005," and "conceded knowledge of the company's 'insufficient inspection data' on the EOA line." As to BP's "corrosion monitoring practices," BP acknowledged that it was aware that "the WOA line had not been pigged since 1998, eight years before the leak, and that the EOA line had not been pigged since 1990."

In 2008, BP shareholders filed the instant class action alleging that BP had "knowingly, or with

1. The Honorable Raymond J. Dearie, Senior United States District Judge for the Eastern District of New York, was sitting by designation on the Ninth Circuit Court of Appeals.

deliberate recklessness, made false and misleading statements about the condition of the [Prudhoe Bay] pipelines and BP's pipeline maintenance and leak detection practices prior to and in the wake of the first spill." In March 2012, the district court dismissed plaintiffs' claims for failure to allege scienter. *Reese v. Browne*, slip op. (W.D. Wash. Mar. 14, 2012) (Pechman, J.) (*BP I*). The court found that the allegations "portray a company that poorly understood the challenges it faced in Prudhoe Bay, not one that engaged in securities fraud." Plaintiffs appealed.

Ninth Circuit Finds Complaint Adequately Alleges Scienter With Respect to Statements Concerning Low Corrosion Rates

On appeal, the Ninth Circuit first considered whether plaintiffs had "adequately pled the element of scienter" with respect to a March 15, 2006 press statement by Maureen Johnson, BP-Alaska Senior Vice President and Greater Prudhoe Bay Performance Unit Leader, in which she reported a "low manageable corrosion rate." *BP II*, 2014 WL 555911. The district court had found it "unlikely" that Johnson "intended that her statement[ ] deceive investors about the possibility of future spills in other areas" because she "had no way of knowing in March 2006 that another oil leak would occur just six months later in a separate pipeline on the other side of Prudhoe Bay." *BP I*, slip op.

Contrary to the district court's determination, the Ninth Circuit found that the timing of Johnson's statement actually "support[ed] the inference that she [had] made [her statement] with scienter." *BP II*, 2014 WL 555911. The court explained that "[i]n the wake of a crisis that [had] the potential to repeat itself, Johnson had every reason to review the results of BP-Alaska's corrosion monitoring to understand what [had] happened, as well as to assess the possibility of future

leaks in similar pipelines." The Ninth Circuit also found that Johnson "had a clear motive for omitting information about the detection of high corrosion levels" given that the information would have been "central" to pending public and government inquiries into "BP's monitoring practices and the question of whether the spill could have been prevented."

The Ninth Circuit deemed erroneous the district court's conclusion that an inference of scienter was "not as strong as the opposing inferences that Johnson [had] misunderstood BP's data or that she did not have access to the data." The Ninth Circuit explained that in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), "the Supreme Court imposed a duty upon courts to weigh *plausible* competing inferences."

Here, the Ninth Circuit found "the inference that Johnson [had] misunderstood the data … simply not plausible" given that Johnson was "directly responsible for the Prudhoe Bay pipeline operations." As to "the inference that Johnson did not have access to the corrosion data," the court explained that this was "directly contradicted by the fact that she specifically addressed [the data] in her statement." The Ninth Circuit also noted that "Johnson is not like the CEO of a large enterprise, who may be removed from the details of a specific business line or remote business activity." In view of her position as Greater Prudhoe Bay Performance Unit Leader, "not only would Johnson be aware of corrosion problems, but she would be among the first to know."

Ninth Circuit Determines Complaint Sufficiently Alleges Scienter as to Statements Comparing Conditions in the WOA and EOA Pipelines

The Ninth Circuit then turned to two press statements Johnson had made distinguishing conditions in the WOA and EOA pipelines. She noted, for example, that "the highly corrosive conditions were unique to [the WOA] line." The district court had found that "plaintiffs did not show that Johnson was aware of information making her statements false."

The Ninth Circuit "disagree[d]." According to the complaint, "Johnson indisputably had access" to the PHMSA's Corrective Action Order, which enumerated many similarities among the three BP Prudhoe Bay lines. Moreover, the complaint referenced documents "directly contradicting Johnson's statements," which the district court had disregarded because they post-dated Johnson's statements. The Ninth Circuit found that the district court had "overlooked significant evidence of scienter that [could] be gleaned from these later disclosures." The court explained that the "[t]emporal proximity of an allegedly fraudulent statement or omission and a later disclosure can be circumstantial evidence of scienter."

Finally, the Ninth Circuit "impute[d] scienter" to Johnson "based on the inference that key officers have knowledge of the 'core operations' of the company." The court found it "absurd to think that Johnson, as head of the Prudhoe Bay operations and an experienced chemical engineer, was without knowledge of the comparable condition of the WOA and EOA lines" when she made the statements at issue. The Ninth Circuit explained that such information would have been "fundamental to operations of [Johnson's] business over the tenure of her career."

Ninth Circuit Holds Complaint Adequately Alleges Scienter Concerning Management's Belief of Compliance with Environmental Laws

The Ninth Circuit next determined that there was "no reasonable basis" for the following representation in BP's 2005 Annual Report (issued on June 30, 2006): "Management believes that the Group's activities are in compliance in all material respects with applicable environmental laws and regulations."

The district court had found this statement "too 'vague and ambiguous' to support the allegation of falsity." On appeal, the Ninth Circuit considered "whether BP escape[d] possible liability by prefacing the statement with the phrase 'management believes,' and using the qualifier *material* compliance." While the Ninth Circuit agreed that "these terms weigh against falsity," the court explained that there were no "facts supporting management's 'belief' in material compliance under the circumstances." The Ninth Circuit found it significant that at the time the statement was made, "defendants had yet to take critical steps towards" meeting the requirements of the PHMSA's Corrective Action Order, including "follow[ing] orders to pig the EOA line."

The Ninth Circuit acknowledged that the issue of scienter presented "[a] more difficult question," particularly because the statement was "not attributed

to a particular individual." However, "[i]n light of the magnitude of the violations, the immense public attention on BP in the wake of the spills, and the contemporaneous documents demonstrating management's awareness of the company's non-compliance with the Corrective Action Order," the Ninth Circuit "[found] it 'absurd' that management was not aware of BP's significant, existing compliance issues that rendered the statement misleading." The Ninth Circuit determined that "the inference of an intent to mislead investors with respect to [ ] BP's role in causing the spill is strong and as compelling as the possibility that top management simply lacked information about the company's compliance issues."

Holistic Analysis Supports a Finding of Scienter, Ninth Circuit Holds

After reviewing plaintiffs' scienter allegations individually, the Ninth Circuit then "review[ed] all the allegations holistically" as the Supreme Court instructed in *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011), and *Tellabs*, 551 U.S. 308.

The Ninth Circuit determined that the "facts alleged in the complaint support the conclusion that BP had been aware of corrosive conditions for over a decade, and yet chose not to address them." Moreover, the court found the complaint "suggests that BP had every reason to know … that [it] did not have accurate information regarding the condition of the Prudhoe Bay pipelines." Considering the allegations as a whole, the Ninth Circuit found "the inference that BP was, at the very least, deliberately reckless as to the false or misleading nature of [its] public statements … 'at least as compelling as any competing inference.'" *BP II*, 2014 555911 (quoting *Matrixx*, 131 S. Ct. 1309). The court therefore reversed in part the district court's dismissal of plaintiffs' complaint.

Southern District of New York Holds *American Pipe* Tolling Does Not Apply to the Five-Year Statute of Repose for Section 10(b) Claims

In *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974), the Supreme Court held that "the commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class who would have been parties had the suit been permitted to continue as a class action." On February 5, 2014, the Southern District of New York held that *American Pipe* tolling does not apply to the five-year statute of repose for Section 10(b) claims. *In re Bear Stearns Cos., Inc. Sec., Der., & ERISA Litig.*, 2014 WL 463582 (S.D.N.Y. Feb. 5, 2014) (Sweet, J.).

Background

Following the "near-collapse" of Bear Stearns in March 2008, purchasers of Bear Stearns stock and stock options filed a consolidated class action (the "Class Action") against The Bear Stearns Companies, Deloitte & Touche, and several individual defendants, among others. The parties reached a class settlement in 2012. SRM, a Cayman Islands hedge fund, did not participate in the class settlement proceedings.

On April 24, 2013, SRM brought suit in the Southern District of New York against Defendants based on "many of the same factual allegations as the Class Action Complaint." SRM asserted Section 10(b) claims against the Bear Stearns and Deloitte defendants in connection with its purchases of Bear Stearns stock, as well as its transactions in "security-based swaps representing approximately 3.5 million shares of Bear Stearns common stock." The swaps were "synthetic instruments designed to mimic all aspects (i.e., the 'total return') of [Bear Stearns] stock as though the stock had been purchased itself."

In essence, the swaps "were the functional equivalent of shares of Bear Stearns common stock." Defendants moved to dismiss SRM's claims on, *inter alia*, statute of limitations grounds.

Southern District of New York Relies on Second Circuit's Decision in *IndyMac* to Find *American Pipe* Tolling Inapplicable to SRM's Section 10(b) Claims

Section 10(b) claims "may be brought not later than the earlier of (1) 2 years after the discovery of facts constituting the violation; or (2) 5 years after such violation." 28 U.S.C. § 1658(b). Here, the court found that "SRM's claims [were] based on an alleged valuation fraud that revealed itself when Bear Stearns nearly collapsed in mid-March 2008." *Bear Stearns*, 2014 WL 463582. The court determined that "[u]nder the five-year statute of repose, any Section 10(b) claims based on even the latest of these statements were required to be brought before March 12, 2013."

SRM argued that "the pendency of the Class Action tolled the statute of repose for its Section 10(b) claims pursuant to *American Pipe*." The Southern District of New York relied on the Second Circuit's recent decision in *Police and Fire Retirement System of the City of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95 (2d Cir. 2013) (Cabranes, J.)[2] to hold that "*American Pipe* tolling does not apply to SRM's 10(b) claims."

In *IndyMac*, the Second Circuit held that *American Pipe* tolling does not apply to the three-year statute of repose set forth in Section 13 of the Securities Act of 1933, which governs claims under Sections 11 and 12 of the Securities Act. The Second Circuit reasoned that "in contrast to statutes of limitations, statutes of repose 'create[ ] a *substantive* right in those protected to be free from liability after a legislatively-determined period of time.'" *IndyMac*, 721 F.3d 95. Significantly, the Second Circuit stated that "a statute of repose is 'subject [only] to legislatively created exceptions.'"

The Southern District of New York explained that "[l]ike Section 13, Section 10(b) is subject to two time periods: a two-year statute of limitations, which is subject to tolling or extension … , and a five-year statute of repose, which is not." *Bear Stearns*, 2014 WL 463582. The court rejected SRM's "conten[tion] that *IndyMac*'s holding is confined to the Section 13 statute of repose, because that was the only statute directly at issue." Rather, the Southern District of New York found that "the Second Circuit's reasoning in *IndyMac* was based on general principles applicable to all statutes of repose." The Southern District of New York observed that "courts have repeatedly found that Section 1658(b)(2) is a statute of repose." Moreover, the court deemed "the difference in language between the statute of repose in Section 1658(b)(2) and Section 13" "immaterial" for *American Pipe* tolling purposes because "both create a substantive right."

Finally, the court pointed out that "*American Pipe* tolling can apply to a statute of limitations only when the earlier-filed class action 'involved exactly the same cause of action subsequently asserted.'" Here, the court explained that there could "be no tolling of the five-year statute of limitations for SRM's Section 10(b) claims … because the Class Action did not involve

2. Please click here to read our discussion of the *IndyMac* decision in the July 2013 edition of the Alert.

swap claims," which are "fundamentally different from the claims asserted in the Class Action for common stock traded on the New York Stock Exchange."

The court therefore dismissed SRM's Section 10(b)'s claims as "time-barred."

Delaware Chancery Court Grants Defendants' Motion for Summary Judgment in Answers.com Shareholder Class Action

On February 3, 2014, the Delaware Chancery Court granted summary judgment for defendants in a shareholder class action arising out of the acquisition of Answers Corporation. *In re Answers Corp. S'holders Litig.*, 2014 WL 463163 (Del. Ch. Feb. 3, 2014) (Noble, V.C.) (*Answers II*). In evaluating the evidence, the court found it significant that plaintiffs could offer no "persuasive reason" explaining why the four disinterested directors of the Answers Board were allegedly willing to violate their fiduciary duties in approving the transaction.

Background

Answers Corporation operated Answers.com, a question-and-answer website that "utilized wiki-based technologies to provide community-generated social knowledge." The site depended on Google for both traffic and advertising revenues.

On February 2, 2011, the Answers Board approved the sale of the company to a buyout group led by AFCV Holdings, LLC (the "Buyout Group") at a price of $10.50 per share (the "Merger"). The following month, Answers shareholders brought the instant action seeking, *inter alia*, to enjoin a shareholder vote on the Merger. On April 11, 2011, following expedited discovery, the Chancery Court denied plaintiffs' motion for an injunction. Three days later, a majority of Answers' shareholders approved the Merger.

On April 11, 2012, the Chancery Court denied defendants' motion to dismiss the complaint. *In re Answers Corp. S'holders Litig.*, 2012 WL 1253072 (Del Ch. Apr. 11. 2012) (Noble, V.C.) (*Answers I*). The court found that the complaint adequately alleged that three of the directors "were financially interested in the Merger." Plaintiffs alleged that Robert Rosenschein, Answers' CEO, "knew that he would lose his job … if he did not sell the Company, and thus, it was in [his] self-interest to have Answers engage in a change of control transaction." Plaintiffs further alleged that the two directors nominated to the Board by Redpoint Ventures, Answers' largest shareholder, were motivated to "manipulate the sales process" because of their "desire to gain liquidity for Redpoint."

The Chancery Court also determined that the complaint adequately alleged that the remaining Board members had "consciously disregarded their duty to seek the highest value reasonably available for Answers' shareholders." According to the complaint, the remaining directors "agreed to manipulate the sales process to enable the Board to enter quickly into the Merger Agreement" "before the market price for Answers' stock rose above AFCV's offer price." The court found this to be "a well-pled allegation … that the Board [had] breached its duty of loyalty by conducting a flawed sales process."

Finally, the court held that the complaint adequately alleged that the Buyout Group had used "confidential information showing that the market price for Answers' stock would likely be rising" in order to pressure the Board to execute the Merger Agreement "before Answers' shareholders learned of the Company's favorable prospects."

Following discovery, defendants moved for summary judgment.

Chancery Court Grants Defendants' Motion for Summary Judgment, Emphasizing the Broad Latitude Boards Have in Conducting Sales

Because a disinterested Board majority had approved the Merger, the Chancery Court explained that plaintiffs had to demonstrate either "that the Board [had] acted in bad faith or that it was controlled by an interested party" in order "to survive [defendants'] motions for summary judgment." *Answers II*, 2014 WL 463163. The court determined that plaintiffs had failed to raise any "genuine issues of material fact" with respect to either issue.

Turning first to plaintiffs' bad faith claims, the Chancery Court underscored that boards have "latitude to determine how to conduct an appropriate sales process" and need not follow any "single blueprint." Directors' decisions must only "be reasonable, not perfect." *Id*. (quoting *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235 (Del. 2009)). The court explained that the appropriate inquiry is "whether [the] directors utterly failed to attempt to obtain the best sales price." *Id*. (quoting *Lyondell*, 970 A.2d 235).

Here, plaintiffs' primary "objections … concern[ed] the length of the [market] check and the decision to pursue only ten strategic acquirers instead of a larger number of strategic and financial" acquirers. The court found that plaintiffs' evidence "support[ed] their argument that the market check lasted only slightly longer than two weeks during [a] holiday season and focused only on strategic, rather than financial, buyers." Nevertheless, the court concluded that "even this limited market check [did] not constitute a complete abandonment of fiduciary duty." The court emphasized that "there is a vast difference between a flawed, inadequate effort to carry out fiduciary duties and a conscious disregard for them." Although the "Board's efforts could have been more robust," the court held that the Answers "Board did not consciously disregard [its] duties."

The court also deemed meritless plaintiffs' contention that "the Board knew it was undercutting the true value of the Company" when it "rushed the deal." The court found that "prior to approving the merger," the Board had "reviewed the business challenges that the Company faced," particularly its "dependence on Google for both its traffic and ad revenue." The court explained that "[a]fter weighing [the] business risks, the Board was entitled to make a determination that selling the Company was in the best interest of the shareholders without a judicial second-guessing of its decision."

Notably, the court stated that "a plaintiff's inability to explain a Board's motivation to act in bad faith may also be relevant in analyzing bad faith claims." In the case at hand, plaintiffs had "fail[ed] to advance a persuasive reason why the Board favored AFCV or consciously abdicated its fiduciary duties."

Finally, as to plaintiffs' claims that the interested directors "dominated and controlled" the Board, the court found that plaintiffs had not "demonstrate[d] any specific acts of control." Moreover, plaintiffs offered no explanation for what could have "motivated the four disinterested directors to … favor the allegedly conflicted directors."

The court therefore granted defendants' motion for summary judgment in its entirety.

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