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This month's Alert addresses the oral argument before the Supreme Court in *Halliburton Co. v. Erica P. John Fund* (No. 13-317), in which the Court will consider whether to overrule or modify the fraud-on-the-market presumption of reliance adopted in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

We also discuss two decisions handed down by the Supreme Court in the past several weeks: *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058 (2014) (Breyer, J.), in which the Court addressed the "in connection with" requirement of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"); and *Lawson v. FMR LLC*, 2014 WL 813701 (Mar. 4, 2014) (Ginsburg, J.), in which the Court held that the whistleblower protection provision of the Sarbanes-Oxley Act of 2002 applies to employees of privately held contractors of public companies.

In addition, we address two cases the Supreme Court recently agreed to review: *Omnicare, Inc. v. Laborers District Council* (No. 13-435), in which the Court will consider the requirements for pleading a claim under Section 11 of the Securities Act of 1933 based on an alleged misstatement of opinion; and *Public Employees' Retirement System of Mississippi v. IndyMac MBS, Inc.* (No. 13-640), in which the Court will determine whether the tolling rule established in *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974) applies to the three-year limitations period set forth in Section 13 of the Securities Act of 1933, which governs claims under Sections 11 and 12 of the Securities Act.

Finally, we discuss two rulings from the Delaware courts: a Delaware Supreme Court decision holding that the business judgment standard of review applies to controlling stockholder transactions when certain procedural protections are established at the outset; and a post-trial decision from the Delaware Chancery Court holding a financial advisor liable for aiding and abetting directors' breaches of fiduciary duty in connection with a company's sale.

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## Supreme Court Hears Oral Argument in *Halliburton Co. v. Erica P. John Fund*

On March 5, 2014, the Supreme Court heard oral argument in *Halliburton Co. v. Erica P. John Fund* (No. 13-317). The case presents two questions. First, the Court will consider whether to "overrule

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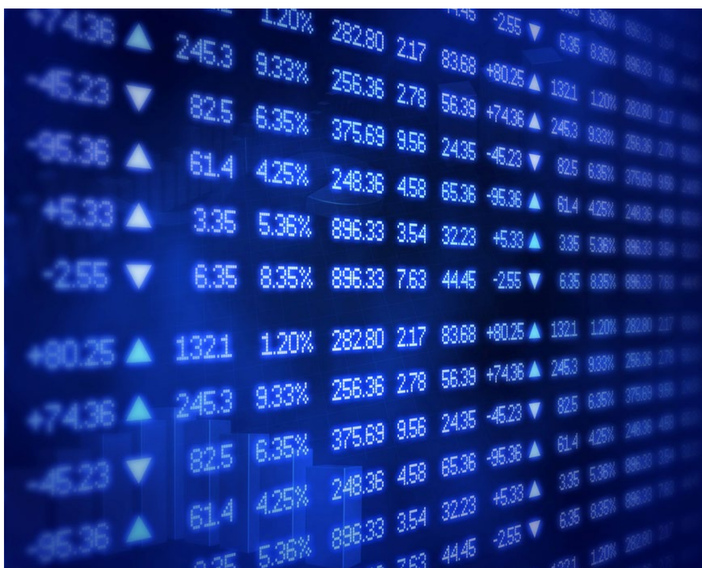
or substantially modify the holding of *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) [(Blackmun, J.)], to the extent that it recognizes a presumption of classwide reliance derived from the fraud-on-the-market theory." Second, the Court will determine whether a "defendant may rebut the [*Basic*] presumption and prevent class certification by introducing evidence that the alleged misrepresentations did not distort the market price of its stock."



Based on the questions posed by the Justices during oral argument, the Court does not appear inclined to reverse *Basic* or significantly modify the fraud-on-the-market presumption of reliance. However, a number of the Justices did seem open to the possibility of requiring plaintiffs to establish price impact through an event study in order to obtain the benefit of the *Basic* presumption at the class certification stage.

## *Basic*'s Fraud-on-the-Market Presumption of Reliance

In *Basic*, the Supreme Court found that "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would" prevent securities fraud plaintiffs "from proceeding with a class action, since individual issues" of reliance would "overwhelm[ ] the common ones." 485 U.S. 224. The *Basic* Court therefore held that courts may "apply a presumption of reliance supported by the fraud-on-the-market theory," which rests on the "premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." The Court further ruled that "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance."

## Background

The underlying litigation in *Halliburton Co. v. Erica P. John Fund* (No. 13-317) involves securities fraud claims brought against Halliburton Company and its CEO, President, and Chairman of the Board, David Lesar (collectively, "Halliburton") in connection with alleged misstatements concerning Halliburton's revenues, projected liability for asbestos claims, and the anticipated cost savings and efficiencies of Halliburton's 1998 merger with Dresser Industries.

In November 2008, the Northern District of Texas denied plaintiffs' motion for class certification based on plaintiffs' failure to establish loss causation as required under Fifth Circuit precedent. *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 2008 WL 4791492 (N.D. Tex. Nov. 4, 2008) (Lynn, J.). The Fifth Circuit affirmed the district court's ruling in February 2010. *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330 (5th Cir. 2010) (Reavley, J.) (*Halliburton I*).

On June 6, 2011, the Supreme Court unanimously held that the Fifth Circuit had "erred by requiring proof of loss causation for class certification." *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011)

(Roberts, C.J.) (*Halliburton II*). The Supreme Court remanded the action to the Fifth Circuit for consideration of any further arguments that Halliburton had preserved in opposition to class certification. The Fifth Circuit, in turn, remanded the case to the Northern District of Texas.

Before the district court, Halliburton argued that class certification was unwarranted in light of evidence that the alleged misrepresentations did not affect the price of the company's shares. The district court declined to consider this evidence, finding that defendants may not rebut the fraud-on-the-market presumption at the class certification stage by showing an absence of price impact. Halliburton appealed.

On April 30, 2013, the Fifth Circuit held that "price impact fraud-on-the-market rebuttal evidence should not be considered at class certification." *Erica P. John Fund, Inc. v. Halliburton Co.*, 718 F.3d 423 (5th Cir. 2013) (Davis, J.) (*Halliburton III*). Halliburton petitioned the Court for certiorari of the Fifth Circuit's decision in *Halliburton III*. On November 15, 2013, the Court granted Halliburton's petition.

## Petitioners Ask the Court to Overrule or at Least Substantially Modify *Basic*

Halliburton Company and its CEO, President, and Chairman of the Board, David Lesar (collectively, "Petitioners") argued that "the Court should overrule *Basic*" or "at least substantially modify the threshold for invoking its presumption of reliance." Brief for Petitioners, *Halliburton Co. v. Erica P. John Fund* (No. 13-317), 2013 WL 6907610 (Dec. 30, 2013). Petitioners contended that *Basic*'s "premises have proven unsound and are widely rejected by economists[.]" According to Petitioners, "'overwhelming empirical evidence' now 'suggests that capital markets are not fundamentally efficient.'"

Petitioners alternatively argued that "[i]f the Court retains *Basic*'s presumption," then "plaintiffs should first be required to demonstrate that the misrepresentations actually distorted the market price." Petitioners claimed that "[i]t makes scant sense to presume that plaintiffs relied on alleged misrepresentations by purchasing at a distorted market price without asking whether the misrepresentation actually distorted that price in the first place."

## Respondent Defends the Continuing Validity of the *Basic* Presumption

Respondent defended the *Basic* presumption, arguing that "securities-fraud class actions and many individual fraud actions simply could not be brought in 10(b) and 10b-5 cases based on affirmative misrepresentations" without it. Brief for Respondent, *Halliburton Co. v. Erica P. John Fund* (No. 13-317), 2014 WL 356636 (Jan. 29, 2014). Respondent claimed that "[o]verruling *Basic* would preclude certification in the vast majority of private securities-fraud class actions."

In Respondent's view, "the question of whether to overrule *Basic* [is] the prerogative of Congress under well-established principles of *stare decisis*." Respondent emphasized that *Basic* is "a twenty-five-year-old precedent that this Court has cited favorably five times within the last ten years[.]" Moreover, Respondent underscored that "Congress has not disturbed *Basic* despite twice engaging in a comprehensive reappraisal of the law governing private securities actions" when it enacted the Private Securities Litigation Reform Act ("PSLRA") and the Securities Litigation Uniform Standards Act ("SLUSA"). Respondent argued that Petitioners are asking "this Court to do something it has not done in decades—reverse a settled statutory precedent in a field that Congress has closely superintended without disturbing the Court's prior interpretation."

With respect to Petitioners' alternative claim "that the Court should permit defendants to rebut the presumption at class certification through evidence of

a lack of price impact," Respondent argued that such an approach "conflicts with Rule 23 and this Court's opinion in" *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*, 133 S. Ct. 1184 (2013) (Ginsburg, J.).[1] Respondent contended that "a successful rebuttal [on the issue of price impact] would not cause individual questions to predominate; rather, it would defeat the claims of all class members."

## Government Asks the Court to Leave the *Basic* Presumption Intact

The United States submitted an amicus brief arguing that *Basic*'s "fraud-on-the-market presumption has proved workable, and its essential premises remain sound." Brief for the United States as Amicus Curiae Supporting Respondent, *Halliburton Co. v. Erica P. John Fund* (No. 13-317), 2014 WL 466853 (Feb. 5, 2014). The United States emphasized that "Congress has declined to disturb the presumption but instead has taken it as given while enacting measures designed to curb potential abuses in private securities-fraud suits." In the Government's view, Petitioners have "identif[ied] no good reason to overturn *Basic*'s fraud-on-the-market holding."

The United States further argued that plaintiffs "need not additionally prove price impact in order to obtain class certification" because "[t]he question whether particular statements affected the market price of a publicly-traded stock will have the same answer for every class member." In the event that "class members … are ultimately unable to prove price impact, their claims will fail together because they will not be able to prove loss causation." The United States contended that "Petitioners' arguments are virtually indistinguishable from those that the Court rejected in *Amgen*."

## Group of Law Professors Urges the Court to Require Plaintiffs to Prove Price Impact at the Class Certification Stage with an Event Study

In an amicus brief, a group of law professors challenged "*Basic*'s understanding that a particular alleged fraud will necessarily be incorporated into the stock price." Brief of Law Professors as *Amici Curiae* in Support of Petitioners, *Halliburton Co. v. Erica P. John Fund* (No. 13-317), 2014 WL 60721 (Jan. 6, 2014). The law professors explained that "securities markets enjoy varying degrees of efficiency, and incorporate information at varying rates." Therefore, the law professors contended that "the Court should shift the focus of fraud on the market inquiries from a market's overall efficiency to the question [of] whether the alleged fraud affected market price."

The law professors stated that "a direct analysis of the market impact of a specific alleged misstatement … is a more straightforward and reliable test for whether the fraud on the market theory should be invoked" than an "examination of general market efficiency." They argued that "[s]uch an approach conforms *Basic* to current finance theory and research" and "offers better prospects for allowing meritorious class actions to continue while

1. Please click here to read our discussion of the *Amgen* decision in the March 2013 edition of the Alert.

preventing baseless ones."

According to the law professors, the most "reliable and practicable method for courts to determine whether misstatements distorted the market" is an "event study," which "measures the effect of an event, such as a firm's earnings announcement, on a firm's stock price." An event study can "determine whether the alleged misrepresentations caused any statistically significant stock price movements when made or when a supposedly corrective disclosure was made, controlling for other possible causes of stock price movements." The law professors explained that "if an event study shows that a misrepresentation or corrective disclosure had no statistically significant effect on the stock price, then the market cannot be said to have relied on the misrepresentation."

## Oral Argument Highlights

### Justices Question Petitioners' Rationale for Overturning *Basic*

During oral argument, Justice Kagan asked whether Petitioners were "just saying *Basic* is wrong" or whether "something has changed since *Basic*." She explained that "usually … what we look for when we decide whether to reverse a case" is "something that makes the question fundamentally different now than when we decided it," "especially [ ] in a case like this one where Congress has had every opportunity, and has declined every opportunity, to change *Basic* itself."

Petitioners' counsel responded that *Basic* was "both … wrong when decided and that certain things have changed." First, Petitioners' counsel argued that "this Court has fundamentally changed its approach to interpreting the Section 10(b) cause of action." In recent years, the Court has "consistently construed it narrowly, and *Basic* stands out like a sore thumb among that jurisprudence." Second, Petitioners' counsel contended that the Court "held in [*Comcast Corp. v. Behrend*, 133 S. Ct. 1426 (2013) (Scalia, J.)] and [*Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011) (Scalia, J)] that there cannot be presumptions of classified issues; instead, classified issues must be proved in fact." Third, Petitioners' counsel claimed that "[t]he economic premises of *Basic*, in particular, the premise that investors rely in common on the integrity of the market price" no longer apply. "Many investors, such as hedge fund, rapid fire, [and] volatility traders … have investment strategies that do not rely on the integrity of the market price whatsoever."

Justice Kagan later asked counsel for the United States, as amicus curiae, what the effect would be on the securities industry if the Court were to overrule *Basic*. The Deputy Solicitor General responded that "the consequences [would be] potentially dramatic."

### Justices Consider Whether Plaintiffs Should Have to Prove Price Impact at the Class Certification Stage

Petitioners' counsel argued that "if the Court were inclined to keep the presumption in some sense, it should at least place the burden on the plaintiff to establish that the misrepresentation actually distorted the market price, or give defendants the full right of rebuttal at the class certification stage to establish the price was not impacted."

Justice Kagan stated that "there's a real difference" between *Basic*'s predicates of market efficiency and publicity, on the one hand, and price impact. She explained that "what *Amgen* said" was "that when you rule on [market efficiency and publicity], it essentially splits up the class so that different members of the class are left in very different positions." However, "when you rule on a question like materiality, which leaves all members of the class in the exact same position, either with a viable claim or with no claim, … it doesn't split the class." Justice Kagan stated that she just doesn't "see how [the issue of price impact] splits the class at all because if you can't prove price impact, you can't prove loss causation and everybody's claims die." Petitioners' counsel responded that "if

the market price was not distorted, you could still have an individual reliance claim for exactly the same reasons" as you could if plaintiffs failed to establish market efficiency or publicity.

Justice Kennedy asked Petitioners' counsel to address what he referred to as "the midway position" taken by the law professors "that there should be an event study" of price impact at the class certification stage. In Justice Kennedy's view, this approach "seem[s] … to be a substantial answer" to Petitioners' challenge to the economic theories underpinning *Basic*. He explained that since "there has to be something that looks very much like an event study" of price impact at the merits stage, "why not have it at the class certification stage."

Petitioners' counsel responded that "if the Court were to accept the continuing validity of the [*Basic*] presumption," then requiring an event study of price impact prior to class certification would "at least make[ ] *Basic* consistent with its own premises."

Justice Sotomayor stated that she did not "see how" requiring an event study of price impact at class certification "is a midpoint." She asked why courts should "bother with *Basic* at all if we're going to … turn the class certification [proceedings] into a full-blown merits hearing on whether loss causation has been proven?" Petitioners' counsel answered by distinguishing loss causation from price impact: While "[l]oss causation deals with the later price declines after a corrected disclosure," price impact addresses "whether the price was distorted at the time of the misstatement and at the time the purchases were made."

Justice Kennedy asked Petitioners' counsel whether "undertaking an event study" of price impact would be "much more costly [and] much more time-consuming" than establishing that the securities at issue traded in an efficient market. Petitioners' counsel answered that "[t]hey're about the same" and stated that "[p]laintiffs are commonly using event studies right now as part of their market efficiency showing."

Justice Roberts expressed skepticism regarding the ease of conducting a price impact study as compared to just establishing market efficiency. He asked: "how hard is it to show that the New York Stock Exchange is an efficient market?" He suggested that an event study "would be a lot more difficult and laborious to demonstrate than market efficiency in a typical case."

Respondent's counsel later stated that conducting an event study of price impact is "very complicated," "takes a lot of time," is "very expensive," and involves "a lot of expert testimony." According to Respondent, "[t]rying to separate out all of the factors that you need to separate out in order to determine whether a culpable misrepresentation was the cause of a price change and how much of that price change was due to that culpable information is very complicated." On the other hand, "an event study that demonstrates the efficiency of the market is far simpler."

Justice Breyer questioned why price impact is "an appropriate issue at the certification stage." He acknowledged that in most instances, cases settle after class certification. But he stated that this "strikes [him] as a different legal issue."

Justice Alito asked Petitioners' counsel "[h]ow accurately" event studies "can distinguish between … the effect on price of the facts contained in a disclosure

and an irrational reaction by the market, at least temporarily, to the facts contained in the disclosure." Petitioners' counsel answered that "[e]vent studies are very effective at making that sort of determination."

Justice Alito later stated to Respondent's counsel that it is "quite different" "to say that [a] false representation affect[ed] the market price" than to say that a false representation "affect[ed] the market price almost immediately." He said that it was "hard to see how the *Basic* theory [could] be sustained" without a showing that the misrepresentation did "affect the market price almost immediately." Justice Alito questioned why "someone who purchased the stock [at issue] … an hour or two after the disclosure" should "be entitled to recovery if in that particular market there is some lag time in incorporating the new information." Respondent's counsel answered that "since *Basic* was decided that lag time has gotten shorter and shorter." In 1988, when *Basic* was handed down, "people were still sitting home reading Barron's to try to figure out what was happening in the stock market." But "[t]oday you have real-time information."

Justice Ginsburg asked Respondent's counsel whether it makes any "practical difference if the [price impact] inquiry is made at the certification stage rather than the merits stage." Respondent's counsel answered that courts would have to "delay class certification" until the completion of "merits discovery" on price impact. The need for "detailed event studies" would "increase enormously" the "cost and expense at the class certification stage."

Justice Kagan asked counsel for the United States what the effect would be of requiring plaintiffs to establish price impact at the class certification stage. The Deputy Solicitor General responded that "the consequences would not be nearly so dramatic" as overruling *Basic*. "[I]f anything, that would be a net gain to plaintiffs, because plaintiffs already have to prove price impact at the end of the day."

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The Court is expected to issue a decision in *Halliburton* in the upcoming months.

# Supreme Court Addresses SLUSA's "In Connection With" Requirement

The Securities Litigation Uniform Standards Act of 1998 ("SLUSA") precludes certain state law-based class actions alleging "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1)(A). For SLUSA purposes, a "covered security" is a security that is listed, or authorized for listing, on a national exchange or issued by a federally registered investment company. 15 U.S.C. § 78bb(f)(5)(E); 15 U.S.C. § 77r(b).

On February 26, 2014, the Supreme Court considered "the scope" of SLUSA's "in connection with" requirement. *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058 (2014) (Breyer, J.). In a majority opinion authored by Justice Breyer, the Court held that "[a] fraudulent misrepresentation or omission is not made 'in connection with' … a 'purchase or sale of a covered security' unless it is material to a decision by [or on behalf of] one or more individuals (other than the fraudster) to buy or to sell a 'covered security.'"

## Background

The case concerns an alleged multibillion-dollar Ponzi scheme run by Allen Stanford and a number of his companies and associates (the "Stanford entities"). The Stanford entities sold plaintiffs certificates of deposit in Stanford International Bank (the "Stanford CDs"). These debt instruments were not traded on any national exchange, but instead guaranteed plaintiffs a fixed rate of return.

The Stanford entities did not use the funds from the Stanford CDs "to buy highly lucrative assets," as plaintiffs had allegedly expected. Rather, the Stanford entities "used the money provided by new investors to repay old investors, to finance an elaborate lifestyle,

and to finance speculative real estate ventures." Allen Stanford was ultimately sentenced to prison for his role in the Ponzi scheme, and the SEC prevailed in a civil action brought under Section 10(b) against the Stanford entities.

Purchasers of the Stanford CDs brought state law-based class actions against the Stanford entities. In August 2010, the Northern District of Texas held that SLUSA precluded plaintiffs' consolidated class actions. The district court recognized that the Stanford CDs were not "covered securities" under SLUSA because they were not traded or listed on a national exchange. However, the court found it significant that the Stanford entities allegedly led plaintiffs to believe that Stanford International Bank "maintained significant holdings in 'highly marketable securities issued by stable governments and strong multinational companies,' and that the Bank's ownership of these 'covered' securities made investments in the uncovered certificates more secure." *Id.* (certain internal quotation marks and alterations omitted). The district court determined that "this circumstance provided the requisite statutory 'connection' between (1) the plaintiffs' state-law fraud claims, and (2) 'transactions in covered securities.'"

On March 19, 2012, the Fifth Circuit reversed the district court's decision. *Roland v. Green*, 675 F.3d 503 (5th Cir. 2012) (Prado, J.). The Fifth Circuit found the Stanford entities' alleged misrepresentations that the Stanford CDs were "backed by 'covered securities'" too "tangentially related to the 'heart,' 'crux,' or 'gravamen' of the defendants' fraud" to meet SLUSA's "in connection with" requirement.

On January 18, 2013, the Supreme Court granted certiorari to consider the scope of SLUSA's "in connection with" requirement.

## Court Holds SLUSA's "In Connection With" Requirement Does Not Extend Beyond Misrepresentations Material to the Purchase or Sale of a "Covered Security"

The Supreme Court explained that the "question before [it]" was whether SLUSA "encompasses a class action in which the plaintiffs allege" that they had purchased "uncovered securities" in reliance on defendants' misrepresentations "that the *uncovered* securities were backed by *covered* securities." *Chadbourne & Parke*, 134 S. Ct. 1058. The Court noted that in the case at hand, there was no allegation that "defendants' misrepresentations [had] led anyone to buy or to sell (or to maintain positions in) *covered* securities." Rather, "the complaints allege misrepresentations about [*Stanford International*] *Bank*'s ownership of covered securities—fraudulent assurances that the Bank owned, would own, or would use the victims' money to buy for *itself* shares of covered securities." The Court held that "[u]nder these circumstances," SLUSA "does not apply" because "there is not the necessary 'connection' between the materiality of the misstatements and the statutorily required 'purchase or sale of a covered security.'"

The Court found that SLUSA's "in connection with" requirement "does not extend further" "than misrepresentations that are material to the purchase or sale of a covered security … for several reasons."

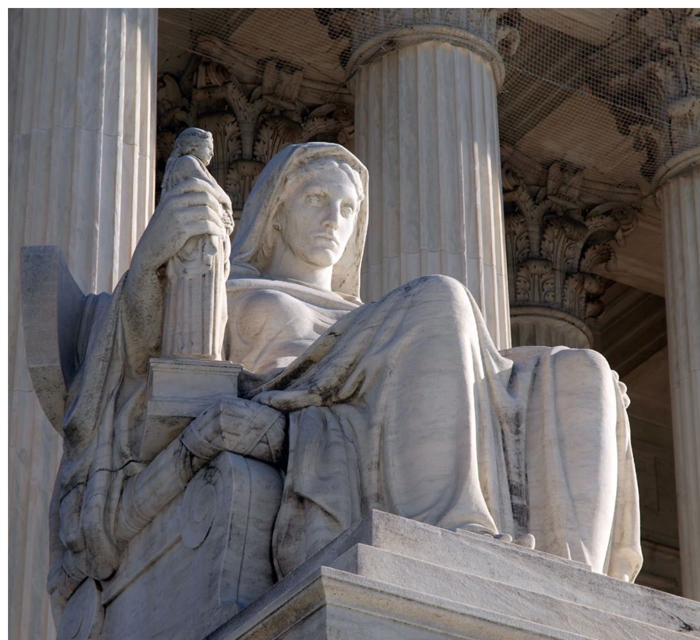
First, the Court emphasized that SLUSA "focuses upon transactions in covered securities, not upon transactions in uncovered securities."

Second, the Court explained that SLUSA's "in connection with" requirement "suggests a connection that matters." "[F]or present purposes, a connection matters where the misrepresentation makes a significant difference to someone's decision to purchase or to sell a covered security, not to purchase or to sell an uncovered security." The Court clarified that "the 'someone' making that decision to purchase or sell must be a party other than the fraudster" acting on his own behalf. "If the only party who decides to buy or sell a covered security as a result of the lie is the liar," using his own funds, then "that is not a 'connection' that matters."

Third, the Court underscored that "every securities case in which this Court has found a fraud to be 'in connection with' a purchase or sale of a security has involved victims who took, who tried to take, who divested themselves of, who tried to divest themselves of, or who maintained *an ownership interest* in financial instruments that fall within the relevant statutory definition." The Court explained that in "[e]very one of these cases … the relevant statements or omissions were material to a transaction in the relevant securities by or on behalf of someone other than the fraudster." For example, in *SEC v. Zandford*, 535 U.S. 813 (2002), the Court held that SLUSA's "in connection with" requirement was met where a broker misrepresented that he would conservatively invest *customer* funds, but instead liquidated *his customers*' securities and misappropriated the proceeds.

Fourth, the Court explained that its interpretation of SLUSA's "in connection with" requirement was "consistent with the underlying regulatory statutes, the Securities Exchange Act of 1934 and the Securities Act of 1933." The Court found "[n]othing" in these statutes "suggest[ing] their object is to protect persons whose connection with the statutorily defined securities is more remote than words such as 'buy,' 'sell,' and the like, indicate."

Finally, the Court noted that "interpret[ing] the necessary statutory 'connection' more broadly … would interfere with state efforts to provide remedies for victims of ordinary state-law frauds." The Court observed that "[a] broader interpretation would allow [SLUSA] to cover, and thereby to prohibit, a lawsuit brought by creditors of a small business that falsely represented it was creditworthy, in part because it owns or intends to own exchange-traded stock."



The Court clarified that its "holding does *not* limit the Federal Government's authority to prosecute 'frauds like the one here.'" The Court noted that these types of frauds "will continue to be within the reach of federal regulation because the authority of the SEC and [the] Department of Justice extends to all 'securities,' not just to those traded on national exchanges." Thus, "[w]hen [a] fraudster peddles an uncovered security like the CDs here, the Federal Government will have the full scope of its usual powers to act."

The Court further noted that its decision did not "modify" its earlier opinion in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006). There,

the Court "held that [SLUSA] precluded a suit where the plaintiffs alleged a 'fraudulent manipulation of stock prices' that was material to and 'coincide[d] with' third-party securities transactions, while also inducing plaintiffs to 'hold their stocks long beyond the point when, had the truth been known, they would have sold.'" *Chadbourne & Parke*, 134 S. Ct. 1058 (quoting *Dabit*, 547 U.S. 71) (certain internal quotation marks omitted).

## In a Concurring Opinion, Justice Thomas Finds the Court's Decision Establishes a "Limiting Principle" on SLUSA's "in Connection with" Requirement

In a one-paragraph concurring opinion, Justice Thomas observed that SLUSA's "in connection with" requirement "provides little guidance without a limiting principle consistent with the structure of the statute and its other provisions." *Chadbourne & Parke*, 134 S. Ct. 1058 (quoting *Maracich v. Spears*, 133 S. Ct. 2191 (2013) (internal quotation marks omitted)). He noted that "the opinion of the Court resolves this case by applying a limiting principle to the phrase 'in connection with' that is 'consistent with [SLUSA's] statutory framework and design' … and also consistent with [the Court's] precedents." *Id.*

## Justices Kennedy and Alito Dissent, Finding the Majority's Interpretation of SLUSA's "in Connection with" Requirement Too Narrow

In a dissenting opinion, Justice Kennedy, joined by Justice Alito, took issue with what they described as "[t]he Court's narrow reading of the statute." The dissent stated that SLUSA "has broad application and must be construed flexibly in order to encompass new and ever more ingenious fraudulent schemes." Instead of the test adopted by the majority, the dissent posited that "[t]he key question" for SLUSA preclusion purposes should be "whether the misrepresentation coincides with the purchase or sale of a covered security or the purchase or sale of the securities is what enables the fraud."

In the dissent's view, "[t]he Court's narrow interpretation of [SLUSA's] language … will subject many persons and entities whose profession it is to give advice, counsel, and assistance in investing in the securities markets to complex and costly state-law litigation based on allegations of aiding or participating in transactions that are in fact regulated by the federal securities laws." This "serious burden … on attorneys, accountants, brokers, and investment advisers nationwide … will make the national securities markets more costly and difficult to enter." The dissent stated that "[b]y permitting the very state-law claims Congress intended to prohibit, the Court will undermine the primacy of federal law in policing abuses in the securities markets."

Justice Breyer, writing for the majority, found that the test proposed by the dissent "unquestionably would limit the scope of protection under state laws that seek to provide remedies to victims of garden-variety fraud." The Court further explained that "the *only* issuers, investment advisers, or accountants that [its] decision [would] continue to subject to state-law liability are those who do not sell or participate in selling securities traded on U.S. national exchanges." The Court noted, for example, that "a bank, chartered in Antigua and whose sole product is a fixed-rate debt instrument not traded on a U.S. exchange, will not be able to claim the benefit of preclusion under [SLUSA]." However, the Court found it "difficult to see why the federal securities laws would be—or should be—concerned with shielding such entities from lawsuits."

# Supreme Court Holds Sarbanes-Oxley Act Whistleblower Protections Extend to Employees of Privately Held Contractors of Public Companies

On March 4, 2014, the Supreme Court held that the whistleblower protection provision of the Sarbanes-Oxley Act of 2002 "extends to employees of contractors and subcontractors" of public companies. *Lawson v. FMR LLC*, 2014 WL 813701 (Mar. 4, 2014) (Ginsburg, J.) (*Lawson III*).

## The Whistleblower Protection Provision of the Sarbanes-Oxley Act

Congress enacted the Sarbanes-Oxley Act in order "[t]o safeguard investors in public companies and restore trust in the financial markets following the collapse of Enron Corporation." Among other provisions, Section 806(a) of the Sarbanes-Oxley Act, codified at 18 U.S.C. § 1514A(a), establishes that "[n]o [public] company … , or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of [whistleblowing or other protected activity]."

## Background

The two plaintiffs in the case before the Court were employees of "privately held companies that provide[d] advisory and management services to the Fidelity family of mutual funds." *Lawson*, 2014 WL 813701. As is typical in the mutual fund industry, the Fidelity funds "themselves are public companies that have no employees."

Plaintiff Jackie Hosang Lawson alleged that she had "suffered a series of adverse actions, ultimately amounting to constructive discharge" after she "raised concerns about certain cost accounting methodologies" that allegedly "overstated expenses associated with operating the mutual funds." Plaintiff Jonathan M. Zang claimed "that he was fired in retaliation for raising concerns about inaccuracies in a draft SEC registration statement concerning certain Fidelity funds." Both Lawson and Zang separately filed whistleblower retaliation suits under Section 1514A against their respective employers in the District of Massachusetts. Plaintiffs' employers, in turn, moved to dismiss their complaints on the grounds that Section 1514A "protects only employees of public companies."

In a joint order issued in March 2010, the District of Massachusetts denied defendants' motions to dismiss both suits. *Lawson v. FMR LLC*, 724 F. Supp. 2d. 141 (D. Mass. 2010) (Woodlock, J.). The court determined that "[t]he legislative history of [the Sarbanes-Oxley Act] makes clear that Congress was concerned about

the related entities of a public company becoming involved in performing or disguising fraudulent activity, and wanted to protect employees of such entities who attempt to report such activity." Accordingly, the court held that Section 1514A protects not only employees of public companies but also "employees of any related entity of a public company." Defendants appealed.

On February 3, 2012, the First Circuit reversed the district court's decision and held that "the term 'employee'" in Section 1514A "refers only to employees of the public companies" and does not extend to "employees of officers, employees, contractors, subcontractors, and agents of public companies." *Lawson v. FMR LLC*, 670 F.3d 61 (1st Cir. 2012) (Lynch, J.) (*Lawson II*). Judge Thompson dissented from the First Circuit's majority opinion, finding that it "impose[d] an unwarranted restriction on the intentionally broad language of the Sarbanes-Oxley Act" and consequently "bar[red] a significant class of potential securities-fraud whistleblowers from any legal protection."

Several months after the First Circuit's decision, the U.S. Department of Labor's Administrative Review Board ("ARB") held in a separate case that "whistleblower protection [under Section 1514A] is not limited solely to employees of publicly traded companies." *Spinner v. David Landau & Assoc., LLC.*, ALJ No. 2010-SOX-029 (May 31, 2012). The ARB explained that in the Department of Labor's view, Section 1514A "protect[s] the employees of publicly traded companies as well as the employees of contractors, subcontractors, and agents of those publicly traded companies." Significantly, the ARB "decline[d] to adopt" the First Circuit's holding in *Lawson II*, finding that it breaks with the "body of ARB case authority" establishing a broader interpretation of the term "employee" in Section 1514A.

In June 2012, plaintiffs in the *Lawson* action petitioned the Supreme Court for certiorari. On May 20, 2013, the Court granted certiorari to determine whether "an employee of a privately-held contractor or subcontractor of a public company [is] protected from retaliation by [S]ection 1514A" of the Sarbanes-Oxley Act.

## Supreme Court Relies on the Statutory Text, Congressional Intent, and Earlier Legislation to Hold Section 1514A Applies to Employees of Contractors and Subcontractors of Public Companies

The Court explained that the case before it "concern[ed] the definition of the protected class" under Section 1514A. *Lawson III*, 2014 WL 813701. Does the statute "shield only those employed by the public company itself, or does it shield as well employees of privately held contractors and subcontractors—for example, investment advisers, law firms, accounting enterprises—who perform work for the public company?" The Court held that "the provision shelters employees of private contractors and subcontractors, just as it shelters employees of the public company served by the contractors and subcontractors."

### Court Finds No Basis in the Statutory Text for Limiting the Term "Employee" to Public Company Employees

The Court first considered the statutory text of Section 1514A, and found that "nothing in § 1514A's language confines the class of employees protected to those of a designated employer." In order to adopt the narrow interpretation of the term "employee" advanced by defendants-respondents, the Court explained that it would have to read in the words "'of a public company' after 'an employee'" in Section 1514A. The Court pointed out that "where Congress meant 'an employee of a public company'" in other provisions of the Sarbanes-Oxley Act, "it said so." Since there is no "textual qualification" in Section 1514A, the Court "presume[d] [that] the operative language

means what it appears to mean: A contractor may not retaliate against its own employee for engaging in protected whistleblowing activity." The Court determined that this was the "most sensible reading" of Section 1514A given other relevant provisions of the Sarbanes-Oxley Act, which contemplate "an employer-employee relationship between the respondent and the claimant."

The Court stated that holding otherwise would result in a "huge hole" in whistleblower protection under the Sarbanes-Oxley Act. "Contractors' employees … would be vulnerable to retaliation by their employers for blowing the whistle on a scheme to defraud the public company's investors, even a scheme engineered entirely by the contractor." The Court explained that "[n]ot only would mutual fund advisers and managers escape § 1514A's control," but "[l]egions of accountants and lawyers would [also] be denied § 1514A's protections."

### Court Finds Congressional Intent Supports Its Interpretation of "Employee" in Section 1514A

The Court next considered Congressional intent, observing that "Congress installed whistleblower-protection in the Sarbanes-Oxley Act as one means to ward off another Enron debacle." The Court found "clear from the legislative record … Congress' understanding that outside professionals bear significant responsibility for reporting fraud by the public companies with whom they contract, and that fear of retaliation was the primary deterrent to such reporting by the employees of Enron's contractors." Based on the "legislative history" of the Sarbanes-Oxley Act, the Court determined that it could "safely conclude that Congress enacted § 1514A aiming to encourage whistleblowing by contractor employees who suspect fraud involving the public companies with whom they work."

### Court Considers Interpretation of Earlier Legislation on Which Section 1514A Was Modeled

Finally, the Court turned to the 2000 Wendell H. Ford Aviation Investment and Reform Act for the 21st Century (AIR 21), codified at 49 U.S.C. § 42121, from which Congress "borrowed … the wording" for Section 1514A. AIR 21 provides in relevant part that "[n]o air carrier or contractor or subcontractor of an air carrier may discharge an employee or otherwise discriminate against an employee" for reporting violations concerning "air carrier safety" to his or her employer or to the federal government. 49 U.S.C. § 42121. The Court found it significant that "AIR 21 has been read to cover, in addition to employees of air carriers, employees of contractors and subcontractors of the carriers." *Lawson III*, 2014 WL 813701. In view of "the parallel statutory texts and whistleblower protective aims," the Court "read the words 'an employee' in AIR 21 and in § 1514A to have similar import."

The Court reversed the First Circuit's decision, and remanded the case for further proceedings consistent with its opinion.

### In a Concurring Opinion, Justices Scalia and Thomas Take Issue with the Court's Reliance on the Legislative History of the Sarbanes-Oxley Act

Justice Scalia, joined by Justice Thomas, concurred in "the Court's conclusion that 18 U.S.C. § 1514A protects employees of private contractors from retaliation when they report covered forms of fraud." However, they did "not endorse … the Court's occasional excursions … into the swamps of legislative history." The concurrence emphasized that "the sole object of the interpretive enterprise is to determine what a law *says*," not what Congress meant. In the view of the concurrence, "congressional 'intent' apart from enacted text is fiction."

### Dissent Finds Majority's Interpretation of "Employee" Overbroad

In a dissenting opinion, Justice Sotomayor, joined by Justices Kennedy and Alito, found that the "Court's interpretation gives § 1514A a stunning reach" that is not supported by "the text, context, or purpose of the Sarbanes-Oxley Act." The dissent stated that under the majority's interpretation, "the law encompasses any household employee of the millions of people who work for a public company and any employee of the hundreds of thousands of private businesses that contract to perform work for a public company."

The dissent posited that "§ 1514A is deeply ambiguous." According to the dissent, "[t]hree indicators of Congress' intent clearly resolve this ambiguity in favor of a narrower interpretation of "§ 1514A: the statute's headings, the statutory context, and the absurd results that follow from the majority's interpretation." The dissent found that "Congress intended § 1514A to apply only to employees of public companies."

## Supreme Court Will Review the Pleading Requirements for a Section 11 Claim Based on an Alleged Misstatement of Opinion

On March 4, 2014, the Supreme Court granted certiorari to address the requirements for pleading a claim under Section 11 of the Securities Act of 1933 based on an alleged misstatement of opinion. *Omnicare, Inc. v. Laborers Dist. Council* (No. 13-435). The Court will consider whether a plaintiff may "plead that a statement of opinion was 'untrue' merely by alleging that the opinion itself was objectively wrong" or whether the plaintiff must also allege that "the speaker's actual opinion was different from the one expressed."

### Section 11 of the Securities Act of 1933

Section 11 establishes a private remedy for purchasers of securities issued under a registration statement that "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). Plaintiffs may bring suit against the issuer and underwriters of the securities, as well as other signatories of the registration statement.

### Sixth Circuit Holds a Defendant's Knowledge of Falsity Has No Relevance to a Section 11 Claim

On May 23, 2013, the Sixth Circuit held that Section 11 "does not require a plaintiff to plead a defendant's state of mind" even if the claim concerns a statement of opinion or belief. *Indiana State District*

*Council of Laborers v. Omnicare, Inc.*, 719 F.3d 498 (6th Cir. 2013) (Cole, J.).

The Sixth Circuit explained that Section 11 "provides a remedy for investors who have acquired securities pursuant to a registration statement that was materially misleading or omitted material information." While "Section 10(b) and Rule 10b-5 require a plaintiff to prove scienter," the court emphasized that "§ 11 is a strict liability statute" that "does not require a plaintiff to plead a defendant's state of mind."

"[O]nce a false statement has been made" in a registration statement, the court found that "a defendant's knowledge is not relevant to a strict liability claim" under Section 11. A complaint asserting a Section 11 claim "may survive a motion to dismiss without pleading knowledge of falsity."

## Sixth Circuit Expressly Disagrees with Second and Ninth Circuits on the Standard for Pleading a Section 11 Claim Based on an Alleged Misstatement of Opinion

Significantly, the Sixth Circuit expressly declined to follow the Second Circuit's decision in *Fait v. Regions Financial Corp.*, 655 F.3d 105 (2d Cir. 2011)[2] and the Ninth Circuit's decision in *Rubke v. Capitol Bancorp Ltd.*, 551 F.3d 1156 (9th Cir. 2009). In *Fait*, the Second Circuit held that "when a plaintiff asserts a claim under [S]ection 11 … based upon a belief or opinion alleged to have been communicated by a defendant, liability lies only to the extent that the statement was both objectively false and disbelieved by the defendant at the time it was expressed." 655 F.3d 105. Similarly, in *Rubke*, the Ninth Circuit held that statements of opinion "can give rise to a claim under [S]ection 11 only if the complaint alleges with particularity that the statements were both objectively and subjectively false or misleading." 551 F.3d 1156. Both the Second and Ninth Circuits relied on the Supreme Court's ruling in *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991) in reaching their decisions.

2. Please click here to read our discussion of the *Fait* ruling in the September 2011 edition of the Alert.

### Supreme Court's Decision in *Virginia Bankshares*

In *Virginia Bankshares*, the Court addressed the question of "whether a statement couched in conclusory or qualitative terms purporting to explain directors' reasons for recommending certain corporate action can be materially misleading within the meaning of" Section 14(a) of the Exchange Act and SEC Rule 14a-9 promulgated thereunder.[3] 501 U.S. 1083. The Court first considered "the actionability *per se* of statements of reasons, opinions, or belief." Specifically, the Court addressed whether "statements of reasons, opinions, or beliefs are statements 'with respect to … material

3. These provisions "prohibit[ ] the solicitation of proxies by means of materially false or misleading statements." *Virginia Bankshares*, 501 U.S. at 1087.

fact[s]'" within the meaning of Rule 14a-9.[4] The Court found that "directors' statements of reasons or belief … are factual" and therefore actionable under Rule 14a-9 "in two senses: as statements that the directors do act for the reasons given or hold the belief stated and as statements about the subject matter of the reason or belief expressed."

The *Virgina Bankshares* Court next determined "whether [the speaker's] disbelief [in his stated opinion], or undisclosed belief or motivation, standing alone, should be a sufficient basis to sustain an action under § 14(a), absent proof by … objective evidence … that the statement also expressly or impliedly asserted something false or misleading about its subject matter." The Court ruled that "proof of mere disbelief or belief undisclosed should not suffice for liability under § 14(a)." Rather, the plaintiff must also "demonstrate something false or misleading in what the statement expressly or impliedly declared about its subject."

Justice Scalia, concurring in part and concurring in the judgment, wrote that he understood the Court's opinion to mean that directors could be held liable under Section 14(a) for their opinion that an offer represented a "high value for the [company's] shares' … if in fact it was not a high value and the directors knew that." However, the directors' opinion "would not produce liability if in fact it was not a high value but the directors honestly believed otherwise."

4. Rule 14a-9 provides in relevant part that "[n]o solicitation … shall be made by means of any proxy statement … containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading."

### Sixth Circuit Finds *Virginia Bankshares* Inapplicable to Section 11 Claims

The Sixth Circuit found "nothing in *Virginia Bankshares* that alter[ed] the outcome" of the case before it. *Omnicare*, 719 F.3d 498.

In the Sixth Circuit's view, "[t]he Second and Ninth Circuits ha[d] read more into *Virginia Bankshares* than the language of the opinion allows and ha[d] stretched to extend [a] § 14(a) case into a § 11 context."

## Citing a Circuit Split on the Interpretation of *Virginia Bankshares*, Omnicare Petitions the Supreme Court for Certiorari

Omnicare petitioned the Supreme Court for certiorari to review the Sixth's Circuit decision and "resolve" what it described as "a sharp conflict among the circuits over … the standard for pleading falsity in a statement of opinion or belief" under Section 11. Petition for a Writ of Certiorari, *Omnicare, Inc. v. The Laborers District Council* (No. 13-435), 2013 WL 5532735, (Oct. 4, 2013). Omnicare stated that "[t]his conflict flows from a fundamental disagreement among the circuits about the meaning of this Court's decision in *Virginia Bankshares*."

According to Omnicare, a statement of opinion "is actionable only as 'a misstatement of the psychological fact of the speaker's belief in what he says.'" *Id.* (quoting *Virginia Bankshares*, 501 U.S. at 1095). "To establish that such a statement was a material misstatement, therefore, the plaintiff must show that the speaker in fact 'did not hold the beliefs or opinions expressed.'" *Id.* (quoting *Virginia Bankshares*, 501 U.S. at 1090).

Omnicare asserted that three circuits—the Second,

Third[5] and Ninth circuits—have held that under *Virginia Bankshares*, "pleading that a statement of opinion was materially untrue requires allegations of both objective and *subjective* falsity" regardless of "which provision of the federal securities laws is at issue." In order to state a Section 11 claim based on a misstatement of opinion in these circuits, "the plaintiff must allege that the opinion expressed was both wrong *and* inconsistent with the opinion actually held by the speaker."

However, "[t]he Sixth Circuit has taken a contrary position, explicitly rejecting the view of its sister circuits." Omnicare stated that "in the Sixth Circuit, a plaintiff in a Section 11 case may now plead that a statement of opinion was 'false' merely by showing that the opinion was objectively wrong, even if the defendant honestly held the expressed opinion at the time." This means that "[i]n the Sixth Circuit, a plaintiff may state a claim under Section 11 based on an honestly expressed opinion, merely by alleging that the opinion turned out to be wrong."

Omnicare argued that "[t]he Sixth Circuit's approach" will "expose corporations, auditors, underwriters, and other professionals to a sharp increase in the cost of litigation" because opinion-based Section 11 claims will "become far more difficult to resolve at the pleading stage." Moreover, the Sixth Circuit's standard will "serve as a powerful disincentive for corporations and their executives to disclose their honestly held opinions on subjects that investors may find important and useful."

5. Omnicare cited *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357 (3d Cir. 1993) (Becker, J.). There, the Third Circuit stated that "opinions, predictions and other forward-looking statements … may be actionable misrepresentations" under the federal securities laws, including Section 11 "if the speaker does not genuinely and reasonably believe them."

## Respondents Contend that *Virginia Bankshares* Does Not Impact Section 11 Claims

In their Brief in Opposition, plaintiffs-respondents ("Respondents") argued that Omnicare had misread *Virginia Bankshares*. Brief in Opposition to Petition for a Writ of Certiorari at 19, *Omnicare, Inc. v. The Laborers District Council* (No. 13-435) (Jan. 9, 2014). Respondents stated that the *Virginia Bankshares* Court "held that statements must be objectively misleading—not merely subjectively disbelieved—to impose liability under § 14(a)." *Id.* According to Respondents, the *Virginia Bankshares* Court "clearly did not hold that an objectively misleading statement of opinion cannot be actionable under § 14(a), let alone that it cannot be actionable under § 11's strict-liability standard, absent a showing of subjective falsity or scienter."

Respondents distinguished Section 11 claims from claims under Section 14(a): "if statements are objectively misleading, § 11's statutory standard of liability is satisfied—whether or not any particular defendant personally disbelieved them." Respondents emphasized that "*Virginia Bankshares* [did] not purport to insert a new state-of-mind requirement in § 11's text." Moreover, Respondents argued that "[n]othing in Justice Scalia's concurrence [in *Virginia Banks*] concerning the scope of implied liability under § 14(a) suggests that the Court should disregard § 11's clear text."

* * *

The Court will hear arguments in the *Omnicare* case in October Term 2014; a date for oral argument has not yet been set.

# Supreme Court Will Consider Whether *American Pipe* Tolling Applies to Section 13's Three-Year Limitations Period

On March 10, 2014, the Supreme Court granted certiorari to determine whether the tolling rule set forth in *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974) applies to the three-year limitations period set forth in Section 13 of the Securities Act of 1933, which governs claims under Sections 11 and 12 of the Securities Act. *Public Employees' Ret. Sys. of Mississippi v. IndyMac MBS, Inc.* (No. 13-640). Specifically, the Court will consider whether "the filing of a putative class action serve[s], under the *American Pipe* rule, to satisfy the three-year time limitation in § 13 of the Securities Act with respect to the claims of putative class members." Petition for a Writ of Certiorari, *Public Employees' Ret. Sys. of Mississippi v. IndyMac MBS* (No. 13-640), 2013 WL 6185615 (Nov. 22, 2013).

## Section 13 of the Securities Act

Section 13 provides that "[i]n no event shall any such action be brought to enforce a liability created under" Sections 11 or 12(a)(1) "more than three years after the security was bona fide offered to the public," or, under Section 12(a)(2), "more than three years after the sale." 15 U.S.C. § 77m.

## The *American Pipe* Tolling Rule

In *American Pipe*, the Supreme Court considered whether members of a proposed class could intervene in a class action that had been dismissed for failure to meet Rule 23's numerosity requirements where the applicable statute of limitations had run on the intervenors' claims. The Supreme Court held that plaintiffs could intervene because "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." *American Pipe*, 414 U.S. 538.

## Second Circuit Finds Section 13's Three-Year Statute of Repose Creates a Substantive Right to Freedom from Liability That Cannot Be Modified by *American Pipe* Tolling

On June 27, 2013, the Second Circuit considered "an unsettled question of law: whether the [*American* Pipe] tolling rule … applies to the three-year statute of repose in Section 13." *Police & Fire Ret. Sys. of City of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95 (2d Cir. 2013) (*IndyMac II*).

The Second Circuit first addressed the difference between a statute of repose and a statute of limitations. "[W]hile statutes of limitations are 'often subject to tolling principles,' a statute of repose 'extinguishes a

plaintiff's cause of action after the passage of a fixed period of time, usually measured from one of the defendant's acts." The court explained that unlike "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." The Second Circuit underscored that "a statute of repose is 'subject [only] to legislatively created exceptions.'"

Turning to the question before it, the Second Circuit held that "*American Pipe*'s tolling rule … does not extend to the statute of repose in Section 13" regardless of whether it is "grounded in equitable authority or on Rule 23."

The Second Circuit acknowledged the *IndyMac* intervenors' argument "that a failure to extend *American Pipe* tolling to the statute of repose in Section 13 could burden the courts and disrupt the functioning of class action litigation." However, the court found that this is a type of problem that "only Congress can address; judges may not deploy equity to avert the negative effects of statutes of repose."

## Tenth Circuit's Ruling in *Joseph v. Wiles*

In *Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000), the Tenth Circuit held that "*American Pipe* tolling applies to the statute of repose" in Section 13.

The Tenth Circuit stated that "[t]olling the limitations period for class members while class certification is pending serves the purposes of Rule 23" because it "encourages judicial economy by eliminating the need for potential class members to file individual claims."

Moreover, unlike the Second Circuit in *IndyMac*, the Tenth Circuit found that "[t]olling the limitations period while class certification is pending does not compromise the purposes of statutes of limitation and repose." The court explained that "[s]tatutes of limitation are intended to protect defendants from being unfairly surprised by the appearance of stale claims, and to prevent plaintiffs from sleeping on their rights." The court observed that "these ends are met when a class action is commenced."

## Citing a Circuit Split, the Proposed Intervenors in the *IndyMac* Action Petition the Supreme Court for Certiorari

On November 22, 2013, one of the proposed intervenors in the *IndyMac* action ("Petitioner") petitioned the Supreme Court for certiorari to review the Second Circuit's decision. Petition for a Writ of Certiorari, *Public Employees' Ret. Sys. of Mississippi v. IndyMac MBS* (No. 13-640), 2013 WL 6185615 (Nov. 22, 2013). Petitioner argued that "[t]he Second Circuit's holding creates a direct and acknowledged conflict with the Tenth Circuit's holding" in *Joseph*.

Moreover, Petitioner contended that "under [the Second Circuit's] rule, investors can no longer safely rely on *American Pipe* to protect their claims in the event that class certification is denied." Petitioner claimed that "[t]he result will be needless and duplicative filings, or inadvertently defaulted claims by unwary investors, and unnecessary work for district courts." According to Petitioner, this is "precisely the *opposite* of how this Court determined in *American Pipe* that Federal Rule of Civil Procedure 23 was intended to operate."

Petitioner further asserted that the Second Circuit's holding in *IndyMac* is "incorrect." Because "Section 13 does not specify what it means for an action to be 'brought'" for purposes of the three-year limitations period, Petitioner contended that courts "must look to procedural law" in order "[t]o make that determination." Petitioner claimed that "[f]or a putative class action, the governing standard is found in Rule 23 as interpreted by *American Pipe*: the action is 'brought' for all putative members when the class

complaint is filed." Under this interpretation, "the filing of a timely complaint on behalf of a putative class of which petitioner was a member satisfied § 13's three-year time-for-suit provision."

In *IndyMac*, the Second Circuit reasoned that "[i]f [*American Pipe*'s] tolling rule is properly classified as 'equitable,' then application of the rule to Section 13's three-year repose period is barred by *Lampf*." *IndyMac II*, 721 F.3d 95. Petitioner argued that "*American Pipe*'s rule is not properly understood as 'equitable tolling' … in the sense used by the Court in *Lampf*." Petition for a Writ of Certiorari, 2013 WL 6185615. Rather, "*American Pipe*'s holding derives from statutory … authority" because the Court based its holding on an interpretation of Rule 23.

Alternatively, the *IndyMac* court found that if "the *American Pipe* tolling rule is 'legal'—based upon Rule 23, which governs class actions," then "its extension to the statute of repose in Section 13 would be barred by the Rules Enabling Act." *IndyMac II*, 721 F.3d 95. Petitioner contended that the Second Circuit's reasoning "rest[ed] on the premise[ ] that § 13's three-year time-for-suit provision actually is a 'statute of repose'" that "'creates a *substantive* right' to be free from claims after three years." Petition for a Writ of Certiorari, 2013 WL 6185615. However, Petitioner claimed that "nothing in § 13 suggests that Congress 'create[d] a substantive right' … when it enacted that provision." Moreover, Petitioner argued that "§ 13's language provides no support" for treating the three-year limitations period as a statute of repose to which *American Pipe* tolling is inapplicable.

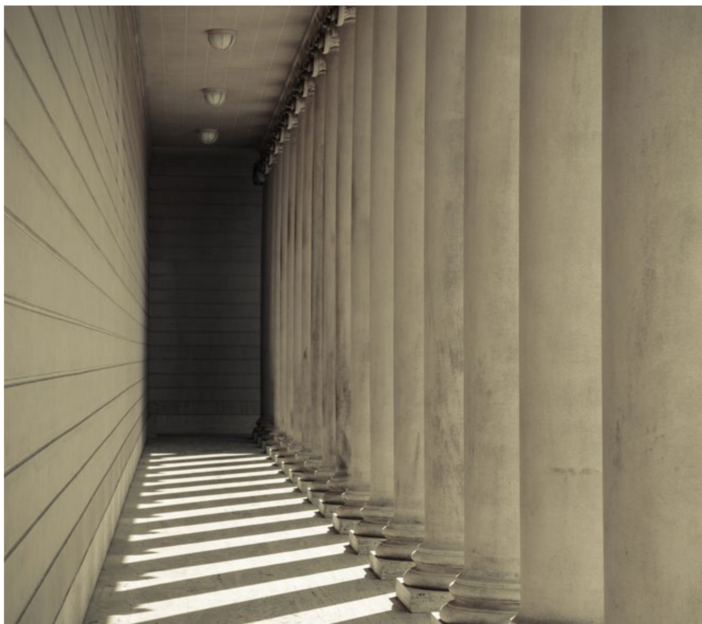
"[E]ven assuming that § 13's three-year limitation creates a substantive right," Petitioner claimed that "applying *American Pipe* does not 'abridge' that right." Petitioner argued that "*American Pipe* does not postpone the start of the time for bringing suit" but instead "defines when the claim is brought."

## IndyMac's Underwriters Respond That Section 13's Three-Year Statute of Repose Establishes an Absolute Bar to All Forms of Tolling, Including *American Pipe* Tolling

In opposition to the petition for certiorari, IndyMac's underwriters ("Respondents") argued that Section 13's "three-year bar is, by its terms and design, immune to judicially engrafted exceptions, and 'inconsistent with tolling.'" Brief in Opposition for Respondents Credit Suisse Securities (USA) LLC, Deutsche Bank Securities Inc., Goldman, Sachs & Co., and Morgan Stanley & Co. LLC, *Public Employees' Ret. Sys. of Mississippi v. IndyMac MBS* (No. 13-640), 2014 WL 316657 (Jan. 24, 2014).

Respondents explained that in *American Pipe*, the Court held that the "'commencement of a class action suspends the applicable *statute of limitations* as to all asserted members of the class' while the putative class action is pending." *Id.* (quoting *American Pipe*, 414 U.S. 538) (emphasis added)). Respondents asserted that *American Pipe*'s tolling rule "has no application to Section 13's three-year bar because … it is *not* a statute of limitations" but is instead a statute of repose. Respondents emphasized that

"[t]he distinction between statutes of limitations and statutes of repose … is deeply rooted." Unlike statutes of limitations, statutes of repose "eliminate[ ] the underlying cause of action" and "provide an absolute end-point for claims." Therefore, "[p]ermitting [P]etitioner to pursue its untimely claims after the three-year repose period ends would … revive causes of action that no longer exist."



Respondents contended that the Tenth Circuit's decision in *Joseph* "does not conflict" with the Second Circuit's decision in *IndyMac* because the Tenth Circuit only addressed "whether application of *American Pipe*'s tolling principle to Section 13's three-year time bar is foreclosed by this Court's decision in *Lampf*." The Tenth Circuit did not consider "the additional, *independent* barrier that the Second Circuit here held would prevent tolling of Section 13's statute of repose": whether the Rules Enabling Act precludes tolling of Section 13's statute of repose.

As to Petitioner's contention that "requiring plaintiffs to file their own claims within the repose period, or at least to monitor pending class actions, would impose unbearable burdens," Respondents emphasized that the plaintiffs in question are typically "institutional investors with tens or even hundreds of billions of dollars in assets" and thus this argument "deserve[s] no credence."

## Several Amici Urge the Court to Overturn the Second Circuit's Decision in *IndyMac* to Avoid Duplicative Individual Actions

A number of amici have submitted amicus briefs arguing that the Court should reverse the Second Circuit's decision in *IndyMac* and allow *American Pipe* tolling of Section 13's three-year statute of repose. Amici contend that "[i]f absent class members did not enjoy protection under *American Pipe*, … [t]he result would be wasteful and burdensome protective filings, a significant drain on federal court resources, and, most important of all, curtailment of rights." Brief of Civil Procedure and Securities Law Professors as *Amici Curiae* in Support of Petition for a Writ of Certiorari, *Public Employees' Ret. Sys. of Mississippi v. IndyMac MBS* (No. 13-640), 2013 WL 8114524 (Dec. 26, 2013).[6]

* * *

The Court will hear arguments in the *IndyMac* case in October Term 2014; a date for oral argument has not yet been set.

6. *See also* Brief of Public Pension Funds as Amici Curiae in Support of Petition for a Writ of Certiorari, *Public Employees' Ret. Sys. of Mississippi v. IndyMac MBS* (No. 13-640), 2013 WL 6843346 (Dec. 26, 2013) (arguing that if the Second Circuit's decision is "allowed to stand," it will "force institutional investors to file hundreds of protective individual actions or seek to intervene in class actions, which would impose undue burden and expense on the investors and on the district courts"); Brief of Amicus Curiae National Association of Shareholder and Consumer Attorneys in Support of Petitioner, *Public Employees' Ret. Sys. of Mississippi v. IndyMac MBS* (No. 13-640), 2013 WL 6917440 (Dec. 26, 2013) (contending that "[b]y preserving the timeliness of the claims of putative class members during the pendency of a class action, *American Pipe* saves shareholders from filing duplicative individual suits out of concern that their claims will be time-barred if certification is denied").

# Delaware Supreme Court Holds Business Judgment Standard of Review Applies to Controlling Stockholder Transactions under Certain Circumstances

Last May, the Delaware Chancery Court addressed "[t]he question of what standard of review should apply to a going private merger conditioned upfront by the controlling stockholder on approval by both a properly empowered, independent committee and an informed, uncoerced majority-of-the-minority vote." *In re MFW S'holders Litig.*, 67 A.3d 496 (Del. Ch. May 29, 2013) (Strine, C.) (*MFW I*). The court ruled that the business judgment rule standard of review, rather than the entire fairness standard, applies in such circumstances.[7]

On March 14, 2014, the Delaware Supreme Court affirmed the Delaware Chancery Court's decision. *Kahn v. M & F Worldwide Corp.*, 2014 WL 996270 (Del. Mar. 14, 2014) (Holland, J.) (*MFW II*).

## Background

MacAndrews & Forbes ("M&F"), a holding company owned by Ronald Perelman, was the controlling shareholder of M&F Worldwide ("MFW") and owned 43% of MFW's shares. On June 13, 2011, M&F "offered to purchase the rest of the corporation's equity in a going private merger for $24 per share." *MFW I*, 67 A.3d 496. On June 10, 2011, the last business day before M&F's offer, MFW's shares closed at a price of $16.96.

From the outset, M&F made it clear that "it would not proceed with any going private transaction that was not approved: (i) by an independent special committee; and (ii) by a vote of a majority of the stockholders unaffiliated with the controlling stockholder (who, for simplicity's sake, are termed the 'minority')." MFW's board formed a special committee, which selected its own legal and financial advisors. The special committee met eight times in three months, and negotiated with M&F to obtain a higher price of $25 per share. A majority of the minority of MFW stockholders (65%) approved the transaction, and the merger closed on December 21, 2011.

Shareholders brought suit challenging the merger as unfair, and sought a post-closing damages remedy for breach of fiduciary duty. Defendants moved for summary judgment, arguing that "the merger was conditioned up front on two key procedural protections that, together, replicate[d] an arm's-length merger." Defendants contended that "the judicial standard of review should [therefore] be the business judgment rule." Under this standard, defendants argued that "summary judgment [was] warranted" "[b]ecause the merger's terms [were] indisputably ones that a rational person could think fair to minority stockholders."

Plaintiffs countered that defendants' use of these procedural protections only shifted the burden of proof under the rigorous entire fairness standard, pursuant to which a court must determine whether

7. Please click here to read our discussion of the Chancery Court's decision in the June 2013 edition of the Alert.

the transaction was the result of both fair dealing and fair price.

On May 29, 2013, the Delaware Chancery Court found that the appropriate standard of review was the business judgment rule, and granted summary judgment in defendants' favor. Plaintiffs appealed.

## Delaware Supreme Court Holds Business Judgment Rule Standard of Review Applies to Controlling Stockholder Transactions Conditioned on Special Committee Approval and a Majority-of-the-Minority Vote

Affirming the Delaware Chancery Court's ruling, the Delaware Supreme Court held that "business judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned *ab initio* upon both the approval of an independent, adequately empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders." *MFW II*, 2014 WL 996270.

The Delaware Supreme Court offered several reasons for its decision. First, the court explained that "where the controller irrevocably and publicly disables itself from using its control to dictate the outcome of the negotiations and the shareholder vote, the controlled merger then acquires the shareholder-protective characteristics of third-party, arm's-length mergers, which are reviewed under the business judgment standard."

Second, the court agreed with the Chancery Court's determination that "the dual procedural protection merger structure optimally protects the minority stockholders in controller buyouts." Quoting the Chancery Court, the Delaware Supreme Court explained that "the controlling stockholder knows that it cannot [either] bypass the special committee's ability to say no" or "dangle a majority-of-the-minority vote before the special committee late in the process as a deal-closer rather than having to make a price move."

Third, the court concurred with the Chancery Court's finding that "the adoption of this rule will … provide a strong incentive for controlling stockholders to accord minority investors" with "the benefits of independent, empowered negotiating agents to bargain for the best price" as well as "the critical ability to determine for themselves whether to accept any deal that their negotiating agents recommend to them."

Finally, the Delaware Supreme Court observed that "the underlying purposes of the dual protection merger structure utilized here and the entire fairness standard of review both converge and are fulfilled at the same critical point: price." The court explained that it has "consistently held that … in a non-fraudulent transaction 'price may be the preponderant consideration outweighing other features of the merger.'" *Id.* (quoting *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983)). The Delaware Supreme Court found that "[t]he dual protection merger structure" in question here "requires two price-related determinations: first, that a fair price was achieved by an empowered, independent committee that acted with care; and second, that a fully informed, uncoerced majority of the minority stockholders voted in favor of the price that was recommended by the independent committee."

The Delaware Supreme Court clarified that "the business judgment standard of review will be applied *if and only if*" all of the following requirements are met:

> [T]he controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating

a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.

The court explained that if a plaintiff "can plead a reasonably conceivable set of facts showing that any or all of those enumerated conditions did not exist, that complaint would state a claim for relief that would entitle the plaintiff to proceed and conduct discovery." Moreover, "[i]f, after discovery, triable issues of fact remain about whether either or both the dual procedural protections were established," then the court stated that "the case will proceed to a trial in which the court will conduct an entire fairness review."

### Delaware Supreme Court Finds Business Judgment Rule Standard of Review Applicable

The Delaware Supreme Court found that "[b]ased on a highly extensive record," the Chancery Court had correctly "concluded that the procedural protections upon which the Merger was conditioned—approval by an independent and empowered Special Committee and by an uncoerced informed majority of MFW's minority stockholders—had *both* been undisputedly established *prior to trial*." Therefore, the court determined that the applicable standard of review was the business judgment rule, pursuant to which "the claims against the Defendants must be dismissed unless no rational person could have believed that the merger was favorable to MFW's stockholders." Finding this standard met in the case before it, the Delaware Supreme Court affirmed the Chancery Court's grant of summary judgment in defendants' favor.

## Delaware Chancery Court Holds Financial Advisor Liable for Aiding and Abetting Fiduciary Duty Breaches

In a post-trial decision dated March 7, 2014, the Delaware Chancery Court held financial advisor RBC Capital Markets, LLC "liable for aiding and abetting breaches of fiduciary duty by the Board" of Rural/Metro Corporation ("Rural") in connection with Rural's 2011 acquisition by Warburg Pincus LLC. *In re Rural Metro Corp. S'holdr. Litig.*, 2014 WL 971718 (Del. Ch. Mar. 7, 2014) (Laster, V.C.).

### Background

According to the court's findings, Rural's board of directors authorized a Special Committee to review strategic alternatives in August 2010. The board "did not authorize a Special Committee to pursue a sale" of the company. Nevertheless, in December 2010 the Special Committee hired RBC as Rural's financial advisor to sell the company.

The court found that RBC disclosed to the Special Committee its plan to offer staple financing to potential buyers in a company sale process, but did not divulge its interest in cross-selling its engagement as sell-side advisor to Rural to try

to secure financing work from bidders for the acquisition of Emergency Medical Services Corporation ("EMS"), a Rural competitor that was also up for sale at the same time. The court found that "[t]he maximum financing fees" RBC potentially stood to earn "were more than ten times the advisory fee, giving RBC a powerful reason to take steps to promote itself as a financing source at the expense of its advisory role" for Rural.

The court noted that in selecting potential purchasers, "RBC prioritized the EMS participants so they would include RBC in their financing trees." However, as "RBC pressed forward with a near-term sale" of Rural, it "encountered the readily foreseeable problems associated with trying to induce financial buyers to engage in two parallel processes for targets who were direct competitors." Of the 21 private equity firms that executed confidentiality agreements in connection with the Rural sale, 15 eventually "declined to participate."

Only one company, Warburg Pincus, submitted a final bid. In March 2011, Warburg offered to acquire Rural for $17.25 per share. The offer did not contemplate a buy-side financing role for RBC. Instead of "accepting defeat, however, RBC re-doubled its efforts to win the business." The court found that "[a]t the same time that RBC's leveraged finance bankers were engaging in last-minute lobbying with Warburg, the RBC M&A team was working to lower the analyses in its fairness presentation to make Warburg's bid of $17.25 look more attractive." Notwithstanding its efforts, RBC ultimately failed to secure a buy-side financing role for Warburg.

The court found that RBC did not provide the Special Committee or Rural's board with "any valuation materials whatsoever" in connection with Warburg's offer "until after 9:30 p.m. … on March 27, 2011, less than twelve hours before the expiration of Warburg's bid." The Board approved a merger agreement with Warburg less than three hours later. The court noted that because of the tight timing, "the directors did not have an opportunity to examine [RBC's valuation] materials critically and understand how the value of the merger compared to Rural's value as a going concern." Moreover, "there was no time" for the directors "to seek follow-up information or probe inconsistencies."

Rural's shareholders brought suit in connection with the Warburg acquisition, which closed on June 30, 2011. Shortly before trial, Rural's directors and its secondary financial advisor settled plaintiffs' claims. The case proceeded to trial against RBC on grounds of aiding and abetting the directors' breaches of fiduciary duty. Plaintiffs' claims against RBC "[fell] under two broad headings: (i) misconduct leading to breaches of duty during the sale process and (ii) misconduct leading to disclosure violations."

## Court Finds RBC Induced the Board to Breach its Fiduciary Duties During Rural's Sale Process

The Chancery Court first considered plaintiffs' contention that "RBC [had] induced the Board to breach its fiduciary duties during the sale process." Based on the evidence established at trial, the court concluded that "for improper motives of its own," RBC had "[misled] the directors into breaching their duty of care."

### Court Holds Exculpatory Clause Does Not Insulate Aiders and Abettors

As an initial matter, the court rejected RBC's claim that "the exculpatory provision in Rural's certificate of incorporation should apply equally to a party charged with aiding and abetting a breach of fiduciary duty." The court found that "[t]he literal language of Section 102(b)(7) only covers directors; it does not extend to aiders and abettors." Deeming Section 102(b)(7)'s structure "rational," the court expressed its view that "the prospect of aiding and abetting liability for investment banks who induce

boards of directors to breach their duty of care creates a powerful financial reason for the banks to provide meaningful fairness opinions and to advise boards in a manner that helps ensure that the directors carry out their fiduciary duties when exploring strategic alternatives."

### Court Finds Directors Breached Their Fiduciary Duties in Connection with the Sale Process

The court then considered whether there was any predicate breach of fiduciary duty by the directors, and concluded that certain of the directors' decisions "fell outside the range of reasonableness" under the "enhanced scrutiny" standard established in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). In particular, the court concluded that the directors had "failed to provide active and direct oversight of RBC" during the critical last round of negotiations with RBC. *Rural Metro*, 2014 WL 971718. The court found that at the time that "it approved the merger, the Board was unaware of RBC's last minute efforts to solicit a buy-side financing role from Warburg, had not received any valuation information until three hours before meeting to approve the deal, and did not know about RBC's manipulation of its valuation metrics." The court held that "[u]nder the circumstances, the Board's decision to approve Warburg's bid lacked a reasonable informational basis and fell outside the range of reasonableness."

### Court Determines RBC Knowingly Participated in the Directors' Breaches of Fiduciary Duty

Next, the court found that "RBC [had] knowingly participated in the Board's breach of its duty of care" by "*creat[ing]* the unreasonable process and informational gaps that led to the Board's breach of duty." *Rural Metro*, 2014 WL 971718. RBC was aware that it had not "disclos[ed] its interest in obtaining a role financing the acquisition of EMS" or its plan "to use the Rural process to capture the EMS financing business." According to the court, RBC "knew that the Board and the Special Committee were uninformed about Rural's value when making critical decisions" because of RBC's failure to provide the directors with valuation materials. What the court found "[m]ost egregious[ ]" was the fact that "RBC never disclosed to the Board its continued interest in buy-side financing and plans to engage in last-minute lobbying of Warburg."

The court deemed irrelevant "the fact that RBC ultimately did not provide staple financing and receive the buy-side fees it coveted." Moreover, the court held that the "generalized acknowledgment" in the engagement letter providing that RBC "might extend acquisition financing to other firms" was not sufficient to "waive or preclude a claim against RBC for failing to inform the Board about specific conflicts of interest."

### Court Finds the Fiduciary Duty Breaches Harmed Rural's Stockholders

Finally, the court determined that "[t]he evidence at trial established that the value of Rural as a going concern exceeded what stockholders received in the merger." The court found that "RBC's actions [had] led to (i) an ill-timed sale of Rural that did not capture

value attributable to its acquisition strategy; (ii) a mismanaged sale process that generated only one final bid by a bidder that knew it had the upper hand in bidding and price negotiations; and (iii) uninformed board approval based on manipulated valuation analyses." Had it not been "for RBC's actions," the court concluded that "a fully-informed Board would have had numerous opportunities to achieve a superior result."

## Court Holds RBC Aided and Abetted the Board's Breach of its Fiduciary Duty of Disclosure

The court found that "plaintiffs proved at trial that the Proxy Statement contained materially misleading disclosures in the form of false information that RBC presented to the Board in its financial presentation." Specifically, the court determined that "[t]he information that RBC provided for the Proxy Statement about its precedent transaction analysis was material and false." The court further held that "[t]he Proxy Statement contained false and misleading information about RBC's incentives." For example, "[t]he Proxy Statement [did] not describe how RBC used the initiation of the Rural sale process to seek a role in the EMS acquisition financing" and said "nothing about RBC's lobbying of Warburg after the delivery of Warburg's fully financed bid."

The court held that "RBC knowingly participated in both of the disclosure violations," which "resulted in stockholders voting on the merger based on a proxy statement that contained materially false disclosures and omissions about RBC's valuation analyses and conflicts." Consequently, "[s]tockholders were denied the information necessary to make an informed decision whether to seek appraisal."

* * *

After finding RBC liable on its aiding and abetting claims, the court concluded that it was "not yet in a position to determine an appropriate remedy." The court has asked the parties to provide revised expert submissions on valuation and additional briefing on RBC's contribution defense prior to addressing damages.

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