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Securities Law Alert

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Supreme Court Considers Pleading Requirements for Section 11 Claims Based on Statements of Opinion

On November 3, 2014, the Supreme Court heard oral arguments in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, No. 13-435, a case in which the Court will determine whether a plaintiff in a private suit against an issuer under § 11 of the Securities Act of 1933 may plead that a statement of opinion was "untrue" merely by alleging that the opinion was objectively wrong, or whether the plaintiff must also allege that the statement was subjectively false, requiring allegations that the speaker's actual opinion was different from the one expressed.

Section 11 provides a private right of action for any investor who purchases a security pursuant to a registration statement which "contained an untrue statement of a material fact or omitted to state a material fact … necessary to make the statements therein not misleading." Section 11 further provides for strict liability and limited affirmative defenses. In *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991), the Supreme Court addressed the question of liability for statements of opinion in the context of a different but related provision, § 14(a) of the Securities Exchange Act of 1934, holding that statements of opinion are actionable under § 14(a) and that plaintiffs must establish proof of objective falsity, in addition to knowledge of falsity, in order to recover under § 14(a). However, because § 14(a), unlike § 11, has been interpreted by lower courts as requiring a showing of scienter for recovery, it is unsettled whether the logic of *Virginia Bankshares* is directly applicable to § 11.

The Second, Third, and Ninth Circuits have interpreted *Virginia Bankshares* to require plaintiffs pursuing recovery under § 11 to allege both that the statement of opinion was objectively false and that the speaker's actual opinion was different from the one expressed, or so-called "subjective falsity." *See Fait v. Regions Financial Corp.*, 655 F.3d 105 (2d Cir. 2011); *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357 (3d Cir. 1993); *Rubke v. Capital Bancorp Ltd.*, 551 F.3d 1156 (9th Cir. 2009). In the *Omnicare* matter, however, the Sixth Circuit held that a plaintiff may plead that a statement of opinion was "untrue" merely by alleging that the opinion

was objectively wrong. *Indiana State District Council of Laborers and Hod Carriers Pension and Welfare Fund v. Omnicare, Inc.*, 719 F.3d 498 (6th Cir. 2013) [“*Omnicare II*”]. The Court’s decision this term in *Omnicare* should offer guidance as to the pleading standard for § 11 claims.

Background

In *Virginia Bankshares*, the Supreme Court considered “the actionability *per se* of statements of reasons, opinion, or belief” under § 14(a) of the Securities Exchange Act of 1934. 501 U.S. at 1090. As implemented by Rule 14a-9, this section prohibits the solicitation of proxies by means of statements that are “false or misleading with respect to any material fact.” The Supreme Court held that statements of reasons, opinions, or beliefs can be actionable under § 14(a) as statements that are false as to a material fact. 501 U.S. at 1095. The Court reserved the question as to whether scienter was a necessary element for a § 14(a) private cause of action, assuming that the jury verdict finding the defendants liable in that case represented a determination by the jury that the directors did not subjectively believe the opinion included in the proxy statement. *Id.* at 1090 n.5. With this assumption in mind, the Court held that a statement of opinion, disbelieved by its maker, is actionable under § 14(a) only if it is also demonstrably false. *Id.* at 1095-96.

Omnicare involves the application of § 11 of the Securities Act of 1933 to the type of statement of opinion that was addressed in *Virginia Bankshares*. Petitioners are Omnicare, Inc., the country’s largest provider of pharmacy-related services for the elderly and other residents of long-term care facilities, and individuals who were officers or directors of Omnicare at the relevant time. Respondents are investors who purchased shares of Omnicare stock in Omnicare’s December 2005 public stock offering. In the registration statement filed in connection with that offering, Omnicare expressed its belief that it was in compliance with applicable laws, stating “[w]e believe our contract arrangements with other healthcare providers, our pharmaceutical suppliers and our pharmacy practices are in compliance with applicable federal and state laws” and that “our contracts with pharmaceutical manufacturers are legally and economically valid arrangements that bring value to the healthcare system and the patients that we serve.” *Omnicare II*, 719 F.3d at 500; Petitioners’ Merits Br. 4.

The instant litigation began in 2006, when a lawsuit was filed in the Eastern District of Kentucky on behalf of a putative class of investors in Omnicare stock. Following a series of interim rulings by the Sixth Circuit and remands to the district court, the operative version of the complaint, which was amended on a number of occasions, asserted only a § 11 claim with respect to the above-mentioned statements regarding compliance with the law expressed in Omnicare’s December 2005 registration statement. Respondents alleged that Omnicare’s statements about legal compliance were false or misleading at the time they were made because Omnicare was engaged in practices that were illegal. Respondents particularly allege that a number of contractual arrangements amounted to illegal kickbacks, as well as that Omnicare filed false Medicare, Medicaid, and state reimbursement claims. Omnicare has settled separate qui tam lawsuits alleging such conduct, but has not admitted liability or wrongdoing as part of any settlement.

The district court dismissed the complaint for failure to state a claim, following the lead of the Second, Third, and Ninth Circuits in holding that subjective falsity is required for a § 11 claim based on a statement of opinion, which was not pleaded here by respondents. The Sixth Circuit reversed in part, affirmed in part, and remanded; most relevantly, it reversed the district court’s dismissal of the § 11 claim premised on the statement of legal compliance in Omnicare’s registration statement. While recognizing its disagreement with the other circuits that have addressed the question, the Sixth Circuit distinguished *Virginia Bankshares*, focusing on the fact that, under Sixth Circuit precedent, § 14(a) claims require proof of scienter, while § 11 is universally acknowledged to be a strict liability provision. The Sixth Circuit held that it was inappropriate for the district court to require respondents to plead subjective knowledge to make out a § 11 claim, and that a § 11 plaintiff need only plead objective falsity. *Id.* at 506.

On March 3, 2014, the Court granted Omnicare’s petition for writ of certiorari.

Omnicare's petition argued that the Sixth Circuit's decision contradicts the precedent of *Virginia Bankshares* and other circuit court decisions, which Omnicare asserts require both objective and subjective falsity before § 11 liability may attach for a statement of opinion. On June 12, 2014, the United States filed a brief as amicus curiae, asserting its interest in the interpretation of the securities laws, particularly given the potential impact of this litigation on SEC enforcement actions. On October 2, 2014, the Supreme Court granted the Solicitor General's motion for leave to participate in oral argument as amicus curiae, allotting 10 minutes to the United States, to be subtracted from respondents' time for argument.

Summary of the Argument

At oral argument, counsel for Omnicare stressed that under their reading of the *Virginia Bankshares* precedent, the only fact that is communicated by a statement of opinion is the fact that the speaker in fact holds that opinion. When asked by the Chief Justice if putting "we believe" before an otherwise factual statement, such as "we believe that we have 3.5 million units of inventory," would inoculate the statement from liability absent subjective disbelief, counsel replied "probably," which was greeted with incredulity by the Chief Justice. Justices Breyer and Ginsburg queried whether, given the formal context of a registration statement, the kind of statements at issue in this case carried an implication that the speaker had at least made an investigation into the subject matter of the opinion. Justice Breyer offered the analogy of a scientist who stated that in his opinion a set of bones belonged to one species of dinosaur and not another; would a listener not reasonably believe, based on that statement, that the scientist had at least examined the bones? Omnicare's counsel maintained that the lack of a basis for an opinion amounted only to circumstantial evidence that the speaker did not actually hold the opinion, but could not independently be considered a false statement of fact. When asked by Justice Alito which person's subjective belief would be examined in the context of a registration statement issued by a corporate entity, Omnicare's counsel replied that existing case law for similar questions in the context of the securities laws could be a guide, such as in the context of § 10(b) claims. Justice Kagan picked up on a latent issue of pure textual statutory interpretation in this case. The language of § 11 makes actionable a registration statement which "contained an untrue statement of a material fact or omitted to state a material fact ... necessary to make the statements therein not misleading." 15 U.S.C. § 77k. Justice Kagan laid out a hypothetical situation in which an issuer's honestly held opinion was that its activities were lawful, but the issuer also knew "that the Government seems to disagree, that your competitors seem to disagree, and that most of the lawyers seem to disagree." She asked why failing to include these facts alongside the legal compliance opinion would not be an omission of a material fact necessary to make the statement of opinion not misleading. Counsel for Omnicare argued that the statutory language is most naturally read to mean that "statements" in the latter part of the above-quoted statutory language refers back to "statement of a material fact" only. Justice Kagan pointed out that the latter language does not say "statements of material fact," just "statements," and so it would seem that material facts necessary to make any statements of opinion not misleading must not be omitted under the language of the statute; however, no other justice picked up on this line of argument. Counsel for Omnicare later used his reserved time to emphasize the policy consequences of respondents' reasoning, including the need for predictability in the strict liability context of registration statements and the possibility that uncertainty in this area could lead issuers to avoid including any statements of opinion in registration statements, leading to less information being communicated to investors. Counsel also reminded the Court that it "has recognized in the securities context, obtaining resolution of these claims on a dispositive motion is often, as a practical matter, the only way in which defendants can avoid liability because of the pressures of settlement in cases of this variety."

Counsel for respondents began by arguing that Congress designed § 11 to put the financial risk of falsity in a registration statement on the issuer, not on investors. Respondents' counsel was forced to spend a lot of his time clarifying the difference between the government's position—the reasonable basis test—and respondents' position, which is that § 11 provides for liability as long as a statement of opinion is

objectively wrong, regardless of any subjective belief or basis for belief by the speaker. Respondents "endorse" the government's position, but also have a broader reading of the statute—a fact that was at times hard to convey, as Justices Breyer and Sotomayor especially seemed more comfortable with the government's narrower spectrum of liability. Counsel went so far as to say that on remand they were prepared to proceed to discovery and "show that a person would not reasonably conclude this activity was legal." Justice Alito seemed concerned about the application of a reasonable basis test, pushing counsel to present a more useful test for the justices to provide for the lower courts than an "open-ended" reasonableness test. Counsel responded that the common law has employed the reasonableness standard for "well over a hundred years," and that while this kind of inquiry is inherently fact-specific it is one the courts are equipped to handle.

The United States also participated in oral argument, arguing for a result that would favor the respondents in this context but trying to stake out a middle ground between the "two extreme positions" offered by the parties. Focusing on the requirement against omissions of material facts necessary to make statements in a registration statement not misleading, the government argued that in the context of a registration statement, a reader would assume that all statements of opinion were made at least with a reasonable basis for the opinion, and thus a failure to state that there was no basis or to state contravening facts would affect the weight the reader would place on the opinion. In an attempt to alleviate Justice Alito's concern about the application of the reasonable basis test, the government explained that it "mean[t] a basis that would be expected under the circumstances." Justice Alito argued that liability by hindsight could still arise under the government's test, at least in a practical sense, because it would be relatively easy for a plaintiff to plead "that the issuer did not make a reasonable investigation because if … they had done a reasonable investigation, they would have discovered that X wasn't true." The government responded that the heightened pleading standards for state of mind under *Twombly*, *Iqbal*, and Federal Rule of Civil Procedure 9(b) would present a sufficient barrier to plaintiffs, but Justice Alito was not convinced. Justice Breyer also expressed concern that the government's proposed test might make it too easy for plaintiffs to get to the discovery stage, increasing the pressure on defendants to settle even when they might otherwise ultimately prevail.

Throughout the argument, Justices Alito and Kennedy expressed concern about the impact the Court's decision would have on the procedural outcome of the case. As counsel for Omnicare argued, "This is the rarer case in which none of the parties is defending the reasoning of the court of appeals below." Respondents argued that if the Court agrees with their argument, they should affirm the Sixth Circuit's opinion but correct the reasoning below in the Supreme Court's own opinion. The government argued that the Sixth Circuit's opinion was incorrect because it opened the door to liability by hindsight, and thus the Court should vacate and remand. Finally, petitioners clearly desire a reversal of the court below.

Implications

In deciding this case, the Court is expected to clarify whether subjective falsity must be pleaded to state a claim for relief under § 11 for an objectively false statement of opinion in a registration statement. Affirmance of the Sixth Circuit's ruling could substantially expand the potential liability of issuers who include honestly held opinions in registration statements, dis-incentivizing the inclusion of such opinions. Following the rule suggested by the United States could mitigate this increased liability to an extent, but could also lead to new complexities in litigation as courts struggle to determine whether there was a "reasonable basis" for the opinion at the time it was expressed. However, a ruling in favor of Omnicare could make it difficult for investors to successfully challenge any statement in a registration statement that is phrased as an opinion. No matter which way it rules, the Court's decision will have significant impacts on litigation under § 11 going forward.

Ninth Circuit Reinstates Amgen ERISA Suit, Holding That Defendants Could Have Removed the Amgen Common Stock Fund as an Investment Option Without Violating Insider Trading Prohibitions

On October 30, 2014, the Ninth Circuit reversed the dismissal of an ERISA action against Amgen, Inc. for a second time. *Harris v. Amgen, Inc. (Amgen III)*, 2014 WL 5471651 (9th Cir. 2014) (Fletcher, J.). The Ninth Circuit reconsidered its earlier decision in light of the Supreme Court's decision in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014), which held that employee stock ownership plan ("ESOP") fiduciaries are not entitled to any "special presumption" of prudence under the Employee Retirement Income Security Act ("ERISA") when they invest plan assets in employer stock.[1] The Ninth Circuit explained that in its first decision, it had "assumed" "certain standards for ERISA liability" later "articulated … in *Fifth Third*" and had found that no presumption of prudence applied.

On reconsideration, the Ninth Circuit again deemed plaintiffs' allegations sufficient to state breach of fiduciary duty claims under ERISA. The Ninth Circuit found that defendants, certain of whom had allegedly made material misrepresentations and omissions in violation of the federal securities laws, could have removed the Amgen Common Stock Fund as an investment option under two Amgen-sponsored pension plans (the "plans") without violating the insider trading prohibitions of the federal securities laws. The court further ruled that ERISA fiduciaries are obligated to disclose "material information" concerning employer stock to plan participants "who must decide whether to invest in such stock."

Background

In 2007, participants in the plans brought suit in the Central District of California against Amgen, Amgen Manufacturing Limited, Amgen's board of directors, and the Fiduciary Committees of the plans (collectively, "the Amgen defendants"). Plaintiffs contended that the Amgen defendants had breached their fiduciary duties under ERISA by continuing to offer Amgen stock as an investment option under the plans through the Amgen Common Stock Fund, even though the Amgen defendants allegedly knew or should have known that the price of Amgen stock was artificially inflated because of material misrepresentations and omissions by company officers (including certain defendants), as well as improper off-label marketing of Amgen pharmaceuticals.

On March 2, 2010, the district court found that plaintiffs had failed to allege sufficient facts to rebut the presumption of prudence established in *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995). *Harris v. Amgen, Inc.*, 2010 WL 744123 (C.D. Cal. 2010). The *Moench* court held that an ESOP "fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision."

Several months after the district court's decision, the Ninth Circuit in *Quan v. Computer Scis. Corp.*, 623 F.3d 870 (9th Cir. 2010), expressly adopted the *Moench* presumption. The *Quan* court found that the *Moench* presumption "provides a substantial shield to fiduciaries when plan terms require or encourage the fiduciary to invest primarily in employer stock."

On October 23, 2013, the Ninth Circuit reinstated plaintiffs' ERISA claims against the Amgen defendants. *Harris v. Amgen* (*Amgen II*), 738 F.3d 1026 (9th Cir. 2013) (Fletcher, J.). The court found that the Amgen defendants "were neither required nor encouraged by the terms of the [p]lans to invest in Amgen stock," and therefore held that, under *Quan*, they were "not entitled to a presumption of prudence." The court found that plaintiffs' allegations were sufficient to state a claim under ERISA's "normal prudent man standard" of care.

On June 25, 2014, the Supreme Court unanimously held in *Fifth Third* that ESOP fiduciaries are not entitled to any "special presumption" of prudence under ERISA with respect to their decisions to invest plan assets in employer stock. The Supreme Court subsequently vacated the Ninth Circuit's decision in *Amgen II* for reconsideration in light of its decision in *Fifth Third*.

1 Please click here to read our discussion of the Fifth Third decision in the June/July 2014 edition of the Alert.

Ninth Circuit Finds the Amgen Defendants Could Have Removed the Amgen Common Stock Fund as an Investment Option Under the Plans Without Violating Federal Securities Laws

On reconsideration, the Ninth Circuit once again found that plaintiffs had adequately alleged that the Amgen defendants had violated their duty of care under ERISA "by continuing to provide Amgen common stock as an investment alternative when they knew or should have known that the stock was being sold at an artificially inflated price." *Amgen III*, 2014 WL 5471651.

Significantly, the Ninth Circuit found it "at least plausible that defendants could have removed the Amgen [Common] Stock Fund from the list of investment options available to the plans without causing undue harm to plan participants." The court explained that "[r]emoving the Fund as an investment option would not have meant liquidation of the Fund." Rather, "[i]t would have meant only that while the share price was artificially inflated, plan participants would not have been allowed to invest additional money in the Fund, and that the Fund would therefore not have purchased additional shares at the inflated price." The court found it "extremely unlikely that this decrease in the number of shares that would otherwise have been purchased, considered alone, would have had an appreciable negative impact on the share price."

The Ninth Circuit acknowledged that "removing the Amgen Common Stock Fund as an investment option would have sent a negative signal to investors if the fact of the removal had been made public, and that such a signal may have caused a drop in the share price." However, the court found that under the efficient market hypothesis, "the ultimate decline in price would have been no more than the amount by which the price was artificially inflated." Moreover, the court reasoned that if the Amgen defendants had removed the Amgen Fund as an investment option under the Plans "as soon as they knew or should have known that Amgen's share price was artificially inflated, … that action may well have caused [Amgen and company management] to comply with [their] obligations" under the securities laws.

The Ninth Circuit also rejected defendants' contention that "they could not have removed the Amgen [Common] Stock Fund based on undisclosed alleged adverse material information" without potentially violating the federal securities laws. The court found that "[t]he central problem in this case is that Amgen officials, many of whom are defendants here, made material misrepresentations and omissions in violation of the federal securities laws." Given that these individuals were subject to obligations under both the federal securities laws and ERISA, the Ninth Circuit determined that "[c]ompliance with ERISA would not have required defendants to violate [federal securities] laws." Instead, "compliance with ERISA would likely have resulted in compliance with the securities laws." The court explained that "[i]f defendants had revealed material information in a timely fashion to the general public (including plan participants), thereby allowing informed plan participants to decide whether to invest in the Amgen Common Stock Fund, they would have simultaneously satisfied their duties under both the securities laws and ERISA."

"Alternatively," the Ninth Circuit found that the Amgen defendants would not "have violated the prohibition against insider trading" if they "had made no disclosures but had simply not allowed additional investments in the Fund while the price of Amgen stock was artificially inflated." The court reasoned that "there is no violation" of the insider trading laws "absent purchase or sale of stock."

Ninth Circuit Holds That (1) the Amgen Defendants Were Required to Provide Plan Participants with Material Information Concerning Amgen Stock, and (2) Amgen's SEC Filings Incorporated by Reference into the Summary Plan Descriptions May Be Considered When Evaluating Plaintiffs' ERISA Claims

The Ninth Circuit further ruled that plaintiffs had adequately alleged that the Amgen defendants had violated ERISA's duties of loyalty and care "by failing to provide material information to plan participants about investment in the Amgen Common Stock Fund."

Notably, the court rejected the Amgen defendants' contention that they "owe no duty under ERISA to provide material information about Amgen stock to plan participants who must decide whether to invest in such stock." The Ninth Circuit explained that it has previously clarified that an ERISA "fiduciary has an obligation to convey complete and accurate information material to the beneficiary's circumstance," including "alleged material misrepresentations made by fiduciaries to participants regarding the risks attendant to fund investment." *Id.* (quoting *Quan*, 623 F.3d 870).

The Ninth Circuit also deemed meritless defendants' argument that plaintiffs were required "to show that they [had] relied on defendants' material omissions and misrepresentations." The court found "no reason why ERISA plan participants who invested in a company stock fund whose assets consisted solely of publicly traded common stock should not be able to rely on the fraud-on-the-market theory in the same manner as any other investor in a publicly traded stock."

Finally, the court determined that the Amgen "defendants' preparation and distribution of the [Summary Plan Descriptions (the "SPDs")], including their incorporation of Amgen's SEC filings by reference, were acts performed in their fiduciary capacities" for ERISA purposes. The court ruled that "statements made in Amgen's SEC filings and incorporated in the [p]lans' SPDs may therefore be used under ERISA to show that defendants knew or should have known that the price of Amgen shares was artificially inflated, and to show that plaintiffs presumptively detrimentally relied on defendants' statements under the fraud on the market theory."

The Ninth Circuit underscored that "incorporation by reference is an act performed in a fiduciary capacity." The court explained that "hold[ing] otherwise would authorize fiduciaries to convey misleading or patently untrue information through documents incorporated by reference, all while safely insulated from ERISA's governing reach," and that "[s]uch a result … would create a loophole in ERISA large enough to devour all its protections." *Id.* (quoting *Dudenhoefer v. Fifth Third Bancorp*, 692 F.3d 410 (6th Cir. 2012)).

Because the Ninth Circuit found that plaintiffs had sufficiently alleged violations of ERISA's duties of loyalty and care, the court again reversed the district court's dismissal and reinstated plaintiffs' ERISA claims.

Central District of California Holds That an "Offering Person" for Purposes of SEC Rule 14e-3 Is One Who Has "Some Degree of Control Over" Both the Tender Offer Terms and the Surviving Entity

On November 4, 2014, the Central District of California found that a tender offer "bidder" for purposes of Section 14(d) of the Exchange Act is not necessarily an "offering person" exempt from SEC Rule 14e-3's insider trading restrictions, which apply in the tender offer context. *Allergan, Inc. v. Valeant Pharm. Int'l, Inc.*, 2014 WL 5604539 (C.D. Cal. 2014) (Carter, J.). The court determined that an "offering person" for Rule 14e-3 purposes must have "some degree of control over the terms of the tender offer and over the surviving entity."

Background

On February 25, 2014, Valeant Pharmaceuticals International Inc. and hedge fund management company Pershing Square Capital Management entered into a relationship agreement (the "Relationship Agreement") to pursue a merger between Valeant and Allergan, a California-based pharmaceutical company. Over the next several months, a newly-created Pershing Square-owned entity, PS Fund 1, acquired 9.7% of Allergan's shares. In late April 2014, Valeant submitted a bid to acquire all of Allergan's remaining shares. Allergan's board rejected Valeant's proposal. In June 2014, Valeant announced a tender offer. At the urging of Pershing Square, a special shareholder meeting was scheduled to be held on December 18, 2014 to consider a proposal to remove six of Allergan's nine current board members. In light of subsequent developments involving Actavis PLC's proposed acquisition of Allergan,

Pershing Square withdrew its request for this shareholder meeting.

On August 1, 2014, Karah Parschaeur, an individual who sold Allergan stock during the time that PS Fund 1 purchased Allergan shares, and Allergan (collectively, the "plaintiffs") brought suit in the Central District of California against Valeant, Pershing Square and PS Fund 1 (collectively, the "defendants") alleging that PS Fund 1's acquisition of Allergan shares constituted insider trading in violation of Section 14(e) of the Exchange Act and SEC Rule 14e-3. Plaintiffs further asserted that defendants had violated Section 14(a) of the Exchange Act and SEC Rule 14a-9 by not disclosing this insider trading to Allergan shareholders in connection with the tender offer. Plaintiffs moved for a preliminary injunction (1) to enjoin PS Fund 1 from voting at the December 18, 2014 special shareholder meeting; and (2) to enjoin defendants from voting any proxies solicited by them pending corrective disclosures concerning the alleged insider trading violations.

To obtain preliminary injunctive relief in the Ninth Circuit, plaintiffs must, among other things, at least demonstrate "serious questions going to the merits" of their claims.

Court Finds Plaintiffs Raised "Serious Questions" as to Whether Pershing Square and PS Fund 1 Engaged in Insider Trading in Violation of Section 14(e) and Rule 14e-3

The court first addressed plaintiffs' "core" insider trading allegations under Section 14(e) and Rule 14e-3. "Section 14(e) prohibits 'fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer.'" *Allergan*, 2014 WL 5604539 (quoting 15 U.S.C. § 78n(e)). "Under Rule 14e-3(a), once an 'offering person' 'has taken a substantial step or steps to commence … a tender offer,' 'any other person who is in possession of material information relating to such tender offer' that he knows or has reason to know is nonpublic and that he received directly or indirectly from the offering person must either abstain from trading or disclose the information to the public before trading." *Id.* (quoting 17 C.F.R. § 240.14e-3(a)). Notably, the "offering person" itself is not subject to Rule 14e-3's "abstain or disclose" rule. *See* 17 C.F.R. § 240.14e-3(c).

As an initial matter, the court explained that "only contemporaneous traders who could have purchased from or sold to the alleged inside trader can bring suit under Rule 14e-3." The court determined that the individual plaintiff, Karah Parschaeur, had standing because she sold Allergan shares "during the time period that PS Fund 1 purchased shares." However, the court found that Allergan had no standing under Rule 14e-3 because it was not a contemporaneous trader.

The court then considered allegations that Pershing Square had violated Section 14(e) and Rule 14e-3 when it "possessed nonpublic information [concerning Valeant's plan to acquire Allergan] and did not disclose that information to the public before causing PS Fund 1 to purchase Allergan shares" prior to the tender offer. The parties disputed "whether any substantial steps toward a tender offer [had been] taken by then" as required under Rule 14e-3. In other words, was "the nonpublic information in Pershing Square's possession … related to a tender offer at that point"? The parties also disagreed on the question of "whether PS Fund 1 and other Pershing Square [d]efendants were 'offering person[s]'" exempt from the "disclose or abstain" requirements of Rule 14e-3.

Court Finds Plaintiffs Raised "Serious Questions" as to Whether Defendants Took Substantial Steps to Commence a Tender Offer Prior to PS Fund 1's Purchases of Allergan Shares

To evaluate whether defendants had taken any substantial steps to commence a tender offer prior to PS Fund 1's purchases of Allergan shares within the meaning of Rule 14e-3, the court first turned to the SEC's adopting release on tender offers. The release explains that "'substantial … steps to commence a tender offer include, but are not limited to, … the formulation of a plan or proposal to make a tender offer by the offering person … or activities which substantially facilitate the tender offer.'" *Id.* (quoting Tender Offers, 45 Fed Reg. 60,410, 60,413 n.33 (Sept. 12, 1980)).

The Central District of California observed that "[c]ourts have interpreted" the SEC's

adopting release as providing "only a list of examples." The court noted that in both *SEC v. Ginsburg*, 362 F.3d 1292 (11th Cir. 2004) and *SEC v. Mayhew*, 121 F.3d 44 (2d Cir. 1997), circuit courts had "found that substantial steps toward a tender offer had taken place even though the offeror had not yet settled on a tender offer as the form of the merger."

In the case before it, the Central District of California determined that plaintiffs had "at least raised serious questions as to whether substantial steps to commence a tender offer were taken before PS Fund 1 began purchasing Allergan shares." The court deemed it significant that the Valeant-Pershing Square Relationship Agreement "specifically provided that Valeant and Pershing Square would form a 'Co-Bidder Entity' and would be named as 'co-bidders' if a tender offer was launched for Allergan's shares." The court found that defendants had "not adequately explained why" the Relationship Agreement specifically addressed the possibility of a tender offer "if there was no plan for a tender offer at that time, or at least a strong possibility at that time that their actions would lead toward and facilitate a tender offer."

Notably, the court considered it immaterial that the Relationship Agreement expressly stated that no steps had been taken toward a tender offer and required both parties' consent prior to launching a tender offer. The court explained that "[d]efendants stating in a contract that they had not taken any steps toward a tender offer does not necessarily make it so."

Court Finds Plaintiffs Raised "Serious Questions" as to Whether Pershing Square Was an "Offering Person" or "'Co-Offering Person'" Exempt from Rule 14-e3's "'Disclose or Abstain'" Rule

The court next considered defendants' contention that "Pershing Square and Valeant are collectively an 'offering person'" exempt from Rule 14e-3(a)'s "'disclose or abstain'" requirement. The court first determined that "the term 'offering person' can include multiple persons." While the court acknowledged that the SEC has not made this "clear in the text of Rule 14e-3," the court found that the SEC "indicated through Regulation 14D that more than one person can act together to make a tender offer for purposes of Section 14(e)." The court explained that "Regulation 14D's definition of 'bidder,' which also contemplates multiple persons acting as one tender offeror, applies to … Section 14(e) of the Exchange Act." Moreover, the court noted that "Congress explicitly contemplated that tender offers could be made by co-offerors working together as a partnership or a group."

The court then turned to the question of who may be deemed a "co-offering person" for purposes of Rule 14e-3. The court explained that "[i]f a co-offering person exception is not to swallow the general rule that an offering person cannot tip off another person and other persons cannot then trade on that confidential tip, there must be certain characteristics that distinguish a co-offering person from 'any other person' for Rule 14e-3 purposes." Finding no Congressional or SEC guidance on this issue, the court agreed with plaintiffs that the term "'offering person' cannot be defined identically as 'bidder' or 'offeror'" for purposes of Regulation 14D's disclosure requirements.

The court found "persuasive" plaintiffs' contention that "ensur[ing] that investors have access to the material information they need to decide how they will respond to a tender offer … requires defining 'bidder' broadly to ensure broad disclosures under Sections 13(d) and 14(d) [of the Exchange Act] while defining 'offering person' [under Rule 14e-3] narrowly to restrict the number of persons allowed to trade on insider information about tender offers." Adopting plaintiffs' "proposed test for distinguishing an 'offering person' from a 'bidder' or 'offeror,'" the court held that "an offering person should be more than a financier" and "should actually make an offer to purchase shares and … have some degree of control over the terms of the tender offer and over the surviving entity."

Applying this test, the court acknowledged that "Pershing Square was active as a strategist and financier to Valeant" and had to "give its consent before a tender offer could be formally launched." However, "Pershing Square [would have] had no control over the price to be offered to Allergan's shareholders, whether the tender offer would involve cash and/or an exchange of stock, or even whether to call off the tender offer at some point." The

court also found it significant that Pershing Square would not have "actually acquire[d] any Allergan stock through the tender offer." "Based on these considerations," the court found that plaintiffs had "at minimum, raised serious questions regarding whether Pershing Square [was] an 'offering person' or 'co-offering person' exempt from Rule 14e-3's 'disclose or abstain' rule."

Court Requires Corrective Disclosures, But Declines to Enjoin PS Fund 1 From Voting Its Shares

With respect to plaintiffs' disclosure claims under Section 14(a) and Rule 14a-9, the court found that "[a] reasonable shareholder would consider facts regarding [d]efendants' potential Rule 14e-3 liability important in deciding whether to vote for proposals advocated by [d]efendants, which [were] part of [d]efendants' plan for Valeant to acquire Allergan." The court determined that "the potential threat of an uninformed vote … presents an irreparable harm," and therefore granted plaintiffs' motion for a preliminary injunction to enjoin defendants from voting any proxies solicited by them pending corrective disclosures.

However, the court denied plaintiffs' motion to enjoin PS Fund 1 from voting its shares at the special shareholder meeting. The court emphasized that "no jury has made a final determination as to whether substantial steps were taken toward a tender offer by the time PS Fund 1 began trading on confidential information." Moreover, the court noted that "[t]his case also involves the novel legal issue of whether an entity that is a 'co-bidder' for disclosure purposes is necessarily a 'co-offering person' exempt from Rule 14e-3's 'disclose or abstain' rule." Finally, the court explained that there were "too many 'ifs' between PS Fund's ability to vote and the ultimately threatened harm to characterize the harm as certain or imminent."

Delaware Chancery Court Holds That (1) a Minority Stockholder Can Only Be a "Controlling Stockholder" If It Had Actual Control Over Board Decisions; and (2) Entire Fairness Applies Only If a "Controlling Stockholder" Engaged in a "Conflicted Transaction"

In a decision dated October 24, 2014, the Delaware Chancery Court addressed "two different contested issues related to the law of controlling stockholders: (1) when is a stockholder a controlling stockholder?; and (2) which transactions involving a controlling stockholder implicate entire fairness?" *In re: Crimson Exploration Inc. Stockholder Litig.*, 2014 WL 5449419 (Del. Ch. 2014) (Parsons, V.C.). The Chancery Court determined that a minority stockholder can only be considered a "controlling stockholder" if it "actually control[led] the board's decisions about the challenged transaction." The court further ruled that the controlling stockholder "must engage in a conflicted transaction" in order for entire fairness review to apply.

Background

Plaintiffs brought suit challenging the now-completed stock-for-stock merger of Crimson Exploration, Inc., and Contango Oil & Gas Company. Plaintiffs contended that Oaktree Capital Management, L.P., which held 33.7% of Crimson's outstanding shares at the time of the merger, was a controlling stockholder of Crimson. Among other claims, plaintiffs asserted that Oaktree had breached its fiduciary duties to Crimson's shareholders "by selling the company below market value for self-serving reasons." Plaintiffs claimed that the Crimson-Contango merger must therefore be reviewed under the entire fairness standard.

Chancery Court Holds That a Minority Stockholder Is a Controlling Stockholder Only If It Actually Controlled the Board's Decisions with Respect to the Challenged Transaction

The Chancery Court first addressed the question of when a stockholder may be deemed a controlling stockholder with fiduciary duty obligations to other stockholders of the corporation. The court noted that "Delaware law treats a majority stockholder as a controlling stockholder." The Chancery Court conducted a review of cases in which "the parties disputed whether a non-majority stockholder satisfied this actual control test." Based on these cases, the court found that "a large blockholder will not be considered a controlling stockholder unless [it] actually control[led] the board's decisions about the challenged transaction." The Chancery Court observed that there is no "linear, sliding-scale … whereby a larger share percentage makes it substantially more likely that the court will find the stockholder was a controlling stockholder." Rather, courts have conducted "fact-intensive" assessments of "the actual control factor." For example, in *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110 (Del. 1994), the Delaware Supreme Court found that a minority stockholder "who literally dominated the boardroom and threatened a hostile takeover" was a controlling stockholder. In the instant case, the Chancery Court observed that "[a] bsent a significant showing" of the minority stockholder's "actual control" over the board, "courts have been reluctant to apply the label of controlling stockholder -- potentially triggering fiduciary duties -- to large, but minority, blockholders."

Chancery Court Holds Entire Fairness Review Applies Only If the Controlling Stockholder Engaged in a Conflicted Transaction

The Chancery Court next considered the question of "[w]hich transactions involving a controlling stockholder trigger entire fairness review?" The court explained that "[e]ntire fairness is not triggered solely because a company has a controlling stockholder." Rather, entire fairness applies only if the controller "engage[d] in a conflicted transaction."

The Chancery Court found that courts have applied entire fairness review to two categories of transactions: "(a) transactions where the controller stands on both sides," such "as when a controller buys out the minority," and "(b) transactions where the controller competes with the common stockholders for consideration."

The court explained that there are "three types of cases" that fall into the second category, in which the controlling stockholder "receives different consideration or derives some unique benefit from the transaction not shared with the common stockholders." First, there are cases in which "the controller receives disparate consideration, which the board approves." This "disparate consideration" sometimes includes "a separate class of high-vote stock" in exchange for the controller's shares. Second, there are cases in which "the controller receives a continuing stake in the surviving entity, whereas the minority is cashed out."

Finally, in the third subset of cases, "the controller receives a unique benefit" of some kind, "despite nominal pro rata treatment of all stockholders." The court noted that "[t]he case law has recognized only a few situations" that fall into this category "where, despite the stockholders receiving the same consideration, the controller nonetheless receives a unique benefit and the court applies entire fairness." Courts have found the entire fairness standard of review applicable in "unique benefit" cases where "(a) the controller eliminates something bad for it and good for the minority, … or (b) all parties suffer a sub-optimal sale price, but the controller still benefits because it receives cash to satisfy an idiosyncratic liquidity problem."

Chancery Court Finds Entire Fairness Does Not Apply to the Crimson-Contango Merger

The Chancery Court then considered whether entire fairness review applied to the Crimson-Contango merger based on Oaktree's alleged status as a "controlling stockholder." The court emphasized that "the focus in a control analysis is on domination of the board with regard to the transaction at issue." Here, the court found "no specific allegations from which a court reasonably could infer that Oaktree, alone or in combination with others,

actually exercised control over Crimson or the negotiation of the [m]erger."

The court further determined that plaintiffs had "failed to allege facts sufficient to support a reasonable inference that Oaktree was … conflicted in the Contango transaction, or that it received some benefit not shared with the common stockholders." The court explained that here, "[e]very stockholder received the same exchange ratio." All Oaktree received by way of an alleged "unique benefit" was a Registration Rights Agreement ("RRA") that allowed Oaktree to sell its stock in the combined entity in a private placement. Because the RRA "appears to have had relatively minimal cash value to Oaktree … and no cash value to the minority[,]" the court found that the RRA was "not a sufficiently unique benefit to trigger entire fairness." The court concluded that "none of [the] theories advanced by [p]laintiffs provide a basis for applying entire fairness review in this case."

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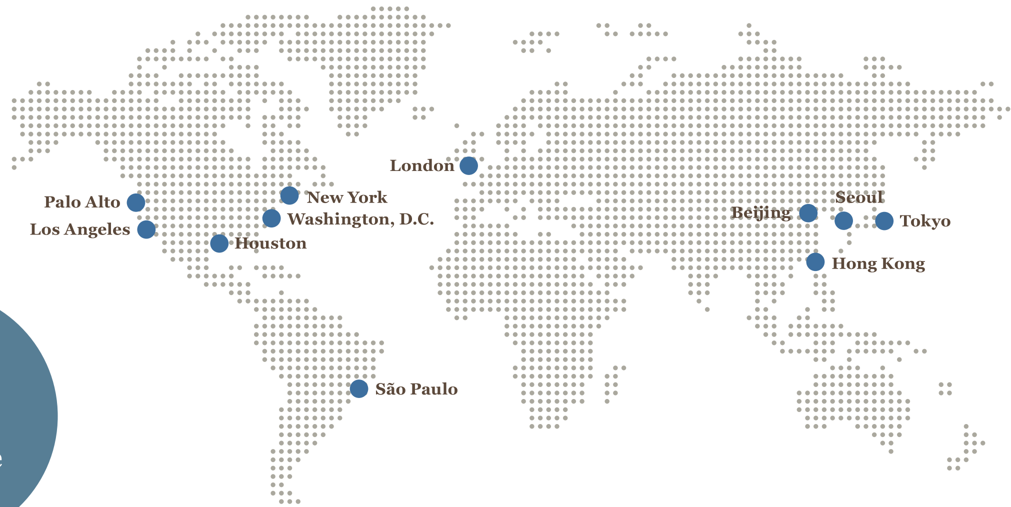

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