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# Securities Law Alert

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## Fifth Circuit Holds That Partial Disclosures, Taken Together, May Constitute A Corrective Disclosure for Loss Causation Purposes

On October 2, 2014, the Fifth Circuit reversed dismissal of a securities fraud action against Amedisys, Inc. on loss causation grounds. *Pub. Emps. Ret. Sys. of Mississippi v. Amedisys, Inc.* (*Amedisys II*), 2014 WL 4931411 (5th Cir. 2014) (Gilstrap, J.).[1] The Fifth Circuit found that plaintiffs' alleged partial disclosures of Medicare fraud "collectively constitute[d] and culminate[d] in a corrective disclosure that adequately [pled] loss causation."

1 The Honorable James Rodney Gilstrap of the Eastern District of Texas was sitting by designation on the Fifth Circuit for purposes of this ruling.

### Background

In 2010, plaintiffs brought suit against Amedisys, Inc. and several of its current board members alleging that defendants had "defrauded investors by concealing a Medicare fraud scheme." Plaintiffs claimed that they had "suffered economic loss from declines in Amedisys's stock price in response to a series of five partial disclosures gradually exposing the nature of Amedisys's business practices and the extent of the risks associated with such practices."

The alleged partial disclosures were as follows: (1) an August 12, 2008, Citron Research report "that raised questions about Amedisys's accounting and Medicare billing practices;" (2) the September 2009 announcement of resignations of Amedisys's Chief Operating Officer ("COO"), Larry Graham, and the company's Chief Information Officer ("CIO"), Alice Ann Schwartz; (3) an April 26, 2010 *Wall Street Journal* article offering a "detailed analysis"

by a Yale University professor "indicating that the company might be 'taking advantage of the Medicare reimbursement system;'" (4) the disclosures of investigations by the Senate Finance Committee, the SEC, and the DOJ; and (5) Amedisys's July 12, 2010 announcement of "disappointing second quarter 2010 operating results." Plaintiffs alleged that Amedisys's stock dropped following each of these partial disclosures.

On June 28, 2012, the Middle District of Louisiana dismissed the complaint based on its finding that none of the alleged partial disclosures constituted a corrective disclosure for loss causation purposes. *Bach v. Amedisys, Inc.* (*Amedisys I*), 2012 WL 6947008 (M.D. La. 2012) (Jackson, J.). Plaintiffs appealed.

## Fifth Circuit Addresses the Standard for Pleading a Corrective Disclosure for Loss Causation Purposes

On appeal, the Fifth Circuit considered the question of "what constitutes a corrective disclosure." *Amedisys II*, 2014 WL 4931411. The Fifth Circuit explained that there is "little precedent directly addressing to what extent fraud must become known by the market before it can constitute a corrective disclosure—or revelation of the pertinent truth—for purposes of pleading loss causation in a private securities action." However, the court found "instructive" Fifth Circuit precedent addressing the pleading requirements for proximate causation.

To plead proximate causation in the Fifth Circuit, plaintiffs must "allege the truth that emerged was 'related to' or 'relevant to' the defendants' fraud and earlier misstatements." *Amedisys II*, 2014 WL 4931411 (quoting *Lormand* v. *US Unwired, Inc.*, 565 F.3d 228 (5th Cir. 2009)). The *Amedisys II* court explained that the test for evaluating proximate causation allegations "turns on the meaning of 'relevance'" and considers whether "the truth disclosed ... make[s] the existence of the actionable fraud more probable than it would be without that alleged fact, taken as true." The *Amedisys II* court determined that this test is also "the appropriate standard to measure corrective disclosures as they pertain to the adequacy of alleging loss causation at the initial pleadings stage."

The Fifth Circuit underscored that there is "no requirement that a corrective disclosure take a particular form or be of a particular quality." The court explained that "[a] corrective disclosure can come from any source, and can take any form from which the market can absorb [the information] and react ... so long as it 'reveal[s] to the market the falsity' of the prior misstatements." The Fifth Circuit further stated that a corrective disclosure need not "be a single disclosure" but "rather, the truth can be gradually perceived in the marketplace through a series of partial disclosures." The court noted that "the market may learn of possible fraud from a number of sources," including "from whistleblowers, analysts questioning financial results, resignations of CFOs or auditors, announcements by the company of changes in accounting treatment going forward, [and] newspapers and journals."

## Fifth Circuit Finds Five Alleged Partial Disclosures "Collectively" Constitute a Corrective Disclosure for Loss Causation Purposes

Applying the "test for 'relevant truth'" borrowed from the pleading standard for proximate causation, the Fifth Circuit found that the five alleged partial disclosures at issue "collectively constitute[d] and culminate[d] in a corrective disclosure that adequately pleads loss causation for purposes of a Rule 12(b)(6) analysis." The court explained that its "holding can best be understood by simply observing that the whole is greater than the sum of its parts."

With respect to the Citron Research report, the Fifth Circuit found that "[s]peculation of wrongdoing cannot by itself arise to a corrective disclosure." Similarly, the court determined that the announcement of the resignations of two Amedisys executives did "not in and of itself constitute a corrective disclosure" because "nothing in the resignation announcement alone reveal[ed] the truth behind earlier misstatements." The Fifth Circuit explained that both the Citron Research report and the executive resignations must nevertheless "be considered within the totality of all such partial disclosures."

As to the *Wall Street Journal* article, the Fifth Circuit found it "plausible" that the reported analysis of Amedisys's Medicare billing

practices "was not merely confirmatory." The court acknowledged the possibility that "the efficient market was not aware of the hidden meaning of the Medicare data that required expert analysis, especially where the data itself [was] only available to a narrow segment of the public and not the public at large."

Finally, with respect to the announced government investigations, the Fifth Circuit determined that the "district court [had] erred in imposing an overly rigid rule that government investigations can never constitute a corrective disclosure in the absence of a discovery of actual fraud." The Fifth Circuit "agree[d] with the district court that generally, [the] commencement of government investigations on suspected fraud [does] not, standing alone, amount to a corrective disclosure." However, the Fifth Circuit found that "[t]o require, in all circumstances, a conclusive government finding of fraud merely to plead loss causation would effectively reward defendants who are able to successfully conceal their fraudulent activities by shielding them from civil suit."

The Fifth Circuit held that plaintiffs' "specific allegations of a series of partial corrective disclosures, joined with the subsequent fall in Amedisys['s] stock value" were sufficient to plead loss causation given "the absence of any other contravening negative event." The court explained that the issue of "[w]hether the connection between Amedisys's misleading statements and the alleged corrective disclosures may ultimately be found too attenuated … is a highly fact intensive inquiry that need not be reached at this point." The Fifth Circuit reversed and vacated the district court's dismissal, and remanded the case to the district court for further proceedings consistent with its opinion.

# Sixth Circuit Adopts a "Middle Ground" Formulation for Determining When the Knowledge of a Corporate Officer May be Imputed to the Corporation for Purposes of Alleging Corporate Scienter

On October 10, 2014, the Sixth Circuit adopted a "middle ground" formulation for determining when the knowledge of a corporate officer may be imputed to the corporation for purposes of alleging corporate scienter. *In re Omnicare, Inc. Sec. Litig. (Omnicare II)*, 2014 WL 5066826 (6th Cir. 2014) (Moore, J.). In so holding, the Sixth Circuit "qualifie[d] some of [the] overly broad language" on corporate scienter pleading requirements expressed in its earlier decision in *City of Monroe Emps. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651 (6th Cir. 2005).

## Background

In 2012, plaintiffs brought suit under Section 10(b) and Rule 10b-5 alleging that Omnicare, Inc. and several of its current and former officers (the "Individual Defendants") had made "various material misrepresentations and omissions … in public and SEC filings regarding Omnicare's compliance with Medicare and Medicaid regulations." The allegations focused on three internal audits that allegedly revealed problems with Omnicare's Medicare and Medicaid reimbursement claims practices. These audits were conducted by John Stone, Omnicare's former Vice President of Internal Audit, who eventually brought a *qui tam* action against Omnicare under the False Claims Act in connection with Omnicare's reimbursement practices. Notably, plaintiffs did not name Stone as a defendant in the action.

On March 27, 2013, the Eastern District of Kentucky dismissed plaintiffs' complaint. *In re Omnicare, Inc. Sec. Litig. (Omnicare I)*, 2013 WL 1248243 (E.D. Ky. 2013) (Bunning, J.). The court found that plaintiffs had "failed to plead sufficient facts to establish that any of the Individual Defendants had actual knowledge of the audit results, or that any of the Defendants knew that the legal compliance statements were false

when made." Even if the court "impute[d] to Omnicare the knowledge of non-defendant employees" who were not alleged to be "in any way responsible for the compliance statements," the court determined that plaintiffs had failed to "allege sufficient facts to support a finding that from this knowledge Omnicare knew its legal compliance statements were false." Plaintiffs appealed.

### Sixth Circuit Addresses the Elements of a Misrepresentation Claim Concerning "Soft Information"

The Sixth Circuit began its analysis by addressing the elements of a Section 10(b) and Rule 10b-5 claim based on an alleged misrepresentation of "soft information," such as "predictions and matters of opinion." *Omnicare II*, 2014 WL 5066826. The court explained that "[w]hen an alleged misrepresentation concerns 'hard information'—'typically historical information or other factual information that is objectively verifiable'—it is actionable if a plaintiff pleads facts showing that the statement concerned a material fact and that it was objectively false or misleading." But "[w]hen an alleged misrepresentation concerns 'soft information,' ... a plaintiff must additionally plead facts showing that the statement was 'made with knowledge of its falsity.'" The Sixth Circuit explained that the case at hand concerned "this latter type of alleged misrepresentation."

The Sixth Circuit found that the test for an alleged misrepresentation of "soft information" has historically been problematic "because it adds a subjective inquiry to an otherwise objective element, thus conflating two elements of the six-element cause of action [under Section 10(b) and Rule 10b-5]—an actionable misrepresentation and scienter." The court observed that "[u]ntil now," courts in the Sixth Circuit "have muddled the analytical framework" by assessing "whether a defendant had actual knowledge under both [e]lements."

The Sixth Circuit determined that it "must choose one way or the other to analyze a defendant's actual knowledge" of an alleged misrepresentation of "soft information." The court held that "it makes the most sense to ... conceive of this additional requirement as raising the bar for alleging scienter." The court explained that taking this approach "allow[s] courts to evaluate materiality and whether the statement was misleading or false—two objective inquiries—under the material-misrepresentation prong and then to save all subjective inquiries for the scienter analysis." The Sixth Circuit reasoned that "whether someone made a statement with the knowledge that it was false is, at bottom, a question of someone's state of mind—the general subject of a scienter inquiry."

### Sixth Circuit Adopts a "Middle Ground" Standard for Considering Allegations of Corporate Scienter

The Sixth Circuit next turned to the question of whether plaintiffs had adequately pled scienter in the case before it. The court explained that the scienter analysis "can become much more complicated when the defendant is a corporation because there is the additional question of whose knowledge and state of mind matters." For example, "must the person misrepresenting a material fact in the name of the corporation have also done so with scienter, or is it enough that some person in the corporate structure had the requisite state of mind?" Assuming "the latter conception is correct, how high in the hierarchy of the corporation must the person with scienter be, and what must his relationship be to the statement?" The Sixth Circuit observed that it has "been less than precise in [its] prior pronouncements" on this issue, and therefore attempted to clarify "where [it] stand[s] on the doctrine of collective corporate scienter."

After reviewing decisions from other circuits, the Sixth Circuit adopted what it deemed a "middle ground" approach. The Sixth Circuit held that for purposes of determining whether a corporation made a misrepresentation "with the requisite scienter under Section 10(b)," courts should consider "probative" the "state(s) of mind of any of the following" individuals:

a. The individual who uttered or issued the misrepresentation;

b. Any individual agent who authorized, requested, commanded, furnished information for, prepared (including suggesting or contributing language for inclusion therein or omission therefrom), reviewed, or

approved the statement in which the misrepresentation was made before its utterance or issuance;

c. Any high managerial agent or member of the board of directors who ratified, recklessly disregarded, or tolerated the misrepresentation after its utterance or issuance.

The Sixth Circuit explained that this test "largely prevents corporations from evading liability through tacit encouragement and willful ignorance, as they potentially could under [the] strict *respondeat superior* approach" adopted by the Fifth and Eleventh Circuits in *Southland Sec. Corp. v. Inspire Ins. Sol'ns, Inc.*, 365 F.3d 353 (5th Cir. 2004) and *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015 (11th Cir. 2004) respectively. The Sixth Circuit observed that the Fifth and Eleventh Circuits "'look to the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like) rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment.'" In the Sixth Circuit's view, this approach "risks running counter to the goals and purposes of the 1934 Act—which include fostering 'an attitude of full disclosure by publicly traded corporations.'"

The Sixth Circuit underscored that its formulation for evaluating allegations of corporate scienter is "consistent with" but "qualifies some of [the] … overly broad language" in its earlier decision in *City of Monroe,* 399 F.3d 651. There, the Sixth Circuit stated that "knowledge of a corporate officer or agent acting within the scope of [his] authority is attributable to the corporation." The *City of Monroe* court held that the knowledge of a company's CEO could be imputed to the corporation, even though the CEO did not issue the alleged material misrepresentations at issue in the company's annual report. Notably, the *City of Monroe* court dismissed the suit against the CEO in his personal capacity.

In *Omnicare II*, the Sixth Circuit found that "reading … *City of Monroe* too broadly could expose corporations to liability far beyond what Congress has authorized." The court explained that "[i]f the scienter of any agent can be imputed to the corporation, then it is possible that a company could be liable for a statement made regarding a product, so long as a low-level employee, perhaps in another country, knew something to the contrary." The court determined that "[s]uch a result runs contrary to the PSLRA, which increased the scienter pleading requirements to prevent strike suits."

The Sixth Circuit reasoned that its new "middle ground" "formulation protects corporations from liability—or strike suits—when one individual unknowingly makes a false statement that another individual, unrelated to the preparation or issuance of the statement, knew to be false or misleading." Under the *Omnicare II* test for evaluating allegations of corporate scienter, courts may "examine only the states of mind of lower-level employees connected to the statements" at issue.

## Sixth Circuit Finds Plaintiffs Failed to Allege Omnicare's Scienter

Turning to the allegations in the case before it, the Sixth Circuit "agree[d] with the district court" in finding "that the [c]omplaint does not sufficiently tie … any of the Individual Defendants" to the audits allegedly revealing problems with Omnicare's Medicare and Medicaid reimbursement claims process. The Sixth Circuit found that plaintiffs had therefore "failed to plead sufficient facts showing that … [the] Individual Defendants had actual knowledge that [Omnicare's statements of legal compliance] were false." Since the statements of legal compliance at issue "concerned soft information," the Sixth Circuit held that the Individual Defendants' "lack of knowledge [was] fatal" to plaintiffs' claims "against the Individual Defendants.

The court next considered "whether the [c] omplaint contains sufficient allegations to demonstrate that, collectively, Omnicare possessed actual knowledge that" its statements of legal compliance "were false and that Omnicare, nevertheless, made" those statements "(or failed to correct them) to defraud the public." The Sixth Circuit found that under its "formulation of collective corporate scienter," the knowledge of John Stone, Omnicare's former Vice President of Internal Audit, could "be imputed to Omnicare … because [Stone] was both an 'individual agent who … [allegedly] furnished

information for, … [and] reviewed … the statement in which the misrepresentation was made before its utterance or issuance.'" Stone was also "potentially a 'high managerial agent … who ratified … or tolerated the misrepresentation after its utterance or issuance.'"

Nevertheless, the Sixth Circuit found that plaintiffs had "fail[ed] to plead sufficient facts that would give rise to a strong inference that Omnicare [had] acted to defraud the public." Among other grounds, the court pointed out that plaintiffs had "alleged no facts, other than the Individual Defendants' general interest in being paid, that [led] to an inference that the Individual Defendants or Omnicare [had] fraudulently misled the public to save their jobs or salaries." The Sixth Circuit affirmed dismissal of the complaint and observed that "[i]f a well-pleaded complaint can allege only that a corporation intended to defraud based on a desire to continue earning money, without showing a particular link between the actual statement and a specific payment, then the heightened pleading standard for scienter has no bite."

## Ninth Circuit Holds That Item 303 of Regulation S-K Does Not Create a Duty to Disclose Under Section 10(b) and Rule 10b-5

On October 2, 2014, the Ninth Circuit held that "Item 303 [of Regulation S-K] does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5." *In re NVIDIA Corp. Sec. Litig.*, 2014 WL 4922264 (9th Cir. 2014) (O'Connell, J.).

### Background

NVIDIA Corporation is a publicly traded company that manufactures semiconductors. In the spring of 2008, NVIDIA disclosed certain product defects. Plaintiffs later brought suit under Section 10(b) and Rule 10b-5 alleging that "NVIDIA should have informed investors about the defects as early as November 2007." According to plaintiffs, "NVIDIA's intervening statements regarding its financial condition were misleading to investors."

On October 12, 2011, the Northern District of California dismissed the complaint without leave to amend for failure to plead scienter. Plaintiffs appealed. Among other arguments, plaintiffs asserted that "the district court [had] erred by failing to consider their allegations of scienter in the context of Item 303 of Regulation S-K." Item 303 of Regulation S-K sets forth the disclosure requirements for the Management's Discussion and Analysis (MD&A) section of a public company's SEC filings. In relevant part, Item 303 states that a public company must "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." 17 C.F.R. § 229.303(a)(3)(ii). Plaintiffs contended that a failure to comply with "the disclosure duty under Item 303 of Regulation S-K … is actionable under Section 10(b) and Rule 10b-5."

### Ninth Circuit Finds Item 303's Disclosure Requirement Much Broader Than the Duty to Disclose Under Section 10(b) and Rule 10b-5

On appeal, the Ninth Circuit explained that it has "never directly decided whether Item 303's disclosure duty is actionable under Section 10(b) and Rule 10b-5." Addressing the issue squarely for the first time, the court determined that a failure to comply with the disclosure requirements of Item 303 of Regulation S-K does not give rise to a cause of action under of Section 10(b) and Rule 10b-5.

The Ninth Circuit began its analysis by noting that "neither Section 10(b) nor Rule 10b-5 'create[s] an affirmative duty to disclose any and all material information.'" *NVIDIA*, 2014 WL 4922264 (quoting *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011)). Rather, "[d]isclosure is required under these provisions only when necessary 'to make … statements made, in the … light of the circumstances under which they were made, not misleading.'" *Id.* The court emphasized that "'[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5.'" *NVIDIA*, 2014 WL 4922264 (quoting *Basic Inc. v. Levinson*, 485 U.S. 224 (1988)).

The Ninth Circuit rejected plaintiffs' contention that Item 303 of Regulation S-K "creates a 'duty to disclose'" within the

meaning of the Supreme Court's decision in *Basic*. In so holding, the Ninth Circuit found persuasive the Third Circuit's reasoning in *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000). There, the Third Circuit "explained that Item 303's disclosure requirement 'varies considerably from the general test for securities fraud materiality set out by the Supreme Court in *Basic*.'" *NVIDIA*, 2014 WL 4922264 (quoting *Oran*, 226 F.3d 275). The Third Circuit therefore determined that "'a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under Rule 10b-5.'" *Id.*

Concurring with the Third Circuit, the Ninth Circuit found that "[m]anagement's duty to disclose under Item 303 is much broader than what is required under the standard pronounced in *Basic*." The *Basic* test for the materiality of forward-looking information balances "the indicated probability that the event will occur" against "the anticipated magnitude of the event in light of the totality of the company activity." *Basic*, 485 U.S. 224. In contrast, Item 303 requires disclosure of "known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." 17 C.F.R. § 229.303(a)(3)(ii). Notably, the SEC has explicitly stated that *Basic*'s "probability/magnitude test for materiality ... is inapposite to Item 303 disclosure," which "specifies its own standard for disclosure—*i.e.*, reasonably likely to have a material effect." Exchange Act Release No. 34-26831, 54 Fed. Reg. 22427 (May 24, 1989). The Ninth Circuit determined that "[t]he SEC's effort to distinguish *Basic*'s materiality test from Item 303's disclosure requirement provides further support for the position that ... what must be disclosed under Item 303 is not necessarily required under the standard in *Basic*." *NVIDIA*, 2014 WL 4922264.

The Ninth Circuit found "unavailing" plaintiffs' reliance on *Litwin v. Blackstone Group, L.P.*, 634 F.3d 706 (2d Cir. 2011) and *Panther Partners Inc. v. Ikanos Communications, Inc.*, 681 F.3d 114 (2d Cir. 2012). In both cases, the Second Circuit found that plaintiffs had stated a claim under Sections 11 and 12(a)(2) of the Securities Act of 1933 based on defendants' alleged failure to comply with Item 303's disclosure requirements. The Ninth Circuit explained that "Section 10(b) of the Exchange Act ... differs significantly from Sections 11 and 12(a)(2) of the Securities Act." *NVIDIA*, 2014 WL 4922264. "Liability under Sections 11 and 12(a)(2) of the Securities Act may arise from 'omitt[ing] to state a material fact required to be stated.'" *NVIDIA*, 2014 WL 4922264 (citing 15 U.S.C. §§ 77k(a), 77l(b)). While a claim under Section 11 or 12(a)(2) can stem from "an omission in contravention of an affirmative legal disclosure obligation," the Ninth Circuit emphasized that "[t]here is no such requirement under Section 10(b) or Rule 10b-5." Moreover, "scienter is not an element of either a Section 11 or Section 12(a)(2) claim" and "[s]uch claims are not subject to the [Private Securities Litigation Reform Act's] heightened pleading standards unless based on allegations of fraud."

The Ninth Circuit concluded that "Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5." Rather, "[s]uch a duty to disclose must be separately shown according to the principles set forth by the Supreme Court in *Basic* and *Matrixx Initiatives*." In the case before it, the Ninth Circuit found that the complaint did "not plausibly allege that [defendants] intentionally misled investors, or acted with deliberate recklessness, by not disclosing the [product defects] sooner," and affirmed dismissal of the complaint for failure to allege scienter.

## Delaware Supreme Court Holds That Non-Binding Provisions in a Letter of Intent Do Not Become Binding Even If the Letter of Intent Survives the Final Merger Agreement

In a decision dated September 30, 2014, the Delaware Supreme Court held that a non-binding provision in a letter of intent did not become binding simply "because the letter of intent was not wholly superseded by the [final] merger agreement" between the parties. *ev3, Inc. v. Lesh,* 2014 WL 4914905 (Del. 2014) (Strine, C.J.). The court emphasized that under Delaware law, parties "should not be bound by terms other than those they ultimately assent to in a complete agreement, particularly when express language indicates that a previous understanding [was] preliminary and non-binding."

## Background

Appriva is a California corporation that was created to develop "PLAATO," a medical device designed to prevent strokes by eliminating blood clots in the heart. In 2002, ev3, a medical device company, "made an unsolicited offer to purchase the equity of Appriva for $190 million, with $115 million to be paid upfront and the remainder to be paid upon the completion of certain regulatory milestones on the way to PLAATO's approval for sale to the public."

In the course of their negotiations, Appriva and ev3 entered into a non-binding letter of intent. Several provisions in the letter of intent "were specifically designated as binding." These binding provisions "addressed confidentiality, transferability, and restrictions on the ability of Appriva to engage in discussions with other potential buyers." The remaining provisions of the letter of intent were non-binding, including the following provision (the "Funding Provision"):

> Prior to closing, ev3 shall provide to Appriva a detailed plan describing the operating, funding and strategic plan for the first 12 months after Closing, which will include details about how Appriva and the Appriva employees will be integrated into the ev3 organization. ev3 will commit to funding based on the projections prepared by its management to ensure that there is sufficient capital to achieve the performance milestones detailed above.

Appriva and ev3 later entered into a final merger agreement that differed substantially from the terms of ev3's original offer. The final merger agreement called for ev3 to "pay $50 million at closing," but provided for "the bulk of the potential consideration—$175 million" to be paid "on the timely accomplishment of [certain] milestones."

Section 9.6 of the final merger agreement provided as follows:

> Notwithstanding any other provision in the Agreement to the contrary, from and after the closing, [ev3's] obligation to provide funding for the Surviving Corporation, including without limitation funding to pursue achievement of any of the Milestones, shall be at [ev3's] sole discretion, to be exercised in good faith.

The merger agreement contained an integration clause providing that it "supersede[d] and replace[d] all prior and contemporaneous understandings, oral or written, with regard to such transactions, other than the Letter of Intent."

After the merger was consummated, former Appriva shareholders (collectively, "Appriva") eventually brought suit in Delaware Superior Court alleging that "ev3 had breached its contractual duties to fund and pursue achievement of the milestone payments 'in good faith.'" The case went to trial before a jury.

Over ev3's objection, the Delaware Superior Court permitted Appriva to argue before the jury "that the non-binding Funding Provision in the letter of intent was a binding promise that comprised part of the overall agreement of the parties." The court also allowed Appriva to contend that "the binding 'sole discretion' standard in § 9.6 was subject to the specific promise made in the non-binding Funding Provision." However, the court did not allow ev3 to present "evidence of the negotiating process … demonstrat[ing] that § 9.6's final language was the product of ev3's rejection of Appriva's attempt to turn the non-binding Funding Provision into a binding contractual obligation."

The jury found that "ev3 had breached its contractual obligations and determined that ev3 owed Appriva the full amount of the milestone payments, $175 million." The court denied ev3's motion for a new trial; ev3 appealed.

## Delaware Supreme Court Finds the Trial Court Erred by Allowing Appriva to Argue That the Funding Provision of the Letter of Intent Governed ev3's Funding Obligations

The Delaware Supreme Court found that the "Superior Court [had] erred by permitting Appriva to argue that the non-binding Funding Provision in the letter of intent was in fact binding, either as an independent promise that was part of the parties' overall bargain, or as a limitation on the sole discretion given to ev3 in § 9.6" of the final merger agreement.

Significantly, the Delaware Supreme Court held that "[t]he reference to the letter of intent in the integration clause did not convert the non-binding Funding Provision into a binding contractual obligation." The court found that "the integration clause's provision that allowed the letter of intent to survive simply had the effect of ensuring that the expressly binding provisions contained in the letter of intent … would not be extinguished by the integration clause." The court explained that "[t]he parties would not necessarily have wanted to release each other from" provisions in the letter of intent addressing issues such as confidentiality "just because they signed a merger agreement."

The Delaware Supreme Court determined that "the non-binding provisions of the letter of intent were just that: non-binding." The court found that these non-binding terms "were the framework provisions that outlined the contours of a potential deal that the parties might ultimately strike contractually in a binding form." The court explained that "[t]he fact that the parties designated certain provisions of the letter of intent as binding confirms that the remainder of the letter of intent, including the Funding Provision, was non-binding."

The Delaware Supreme Court further held that "the non-binding Funding Provision" in the letter of intent had "no force or effect" because it was "inconsistent with § 9.6" of the final merger agreement. The court explained that "by its plain terms, § 9.6 overrode any 'other provision in the Agreement to the contrary.'" Since the Funding Provision conflicted with § 9.6, the Delaware Supreme Court found that "[i]t was error for the Superior Court to allow Appriva to argue that the Funding Provision was binding as a promise and that the sole discretion standard in § 9.6 was subject to compliance with or tempered by the Funding Provision." The Delaware Supreme Court determined that the trial court had "compounded" this error by "allow[ing] Appriva to use the Funding Provision as evidence of a binding promise" while "deny[ing] ev3 the opportunity to refute this argument with the broader negotiating history."

The Delaware Supreme Court reversed the Superior Court's final order denying ev3's motion for a new trial, and remanded the case for further proceedings consistent with its opinion.

## Delaware Chancery Court Holds That (1) the Delaware Uniform Contribution Among Tortfeasors Act (DUCATA) Does Not Bar Contribution for All Intentional Torts, and (2) A Credit Under DUCATA Is Not Available for a Director's Settlement If the Director Would Have Been Exculpated Under a Section 102(b)(7) Provision

On October 10, 2014, the Delaware Chancery Court determined damages following a post-trial decision holding RBC Capital Markets, LLC ("RBC") liable to the shareholders of Rural/Metro Corporation ("Rural") for aiding and abetting breaches of fiduciary duty by Rural's board of directors in connection with Rural's June 2011 acquisition by Warburg Pincus LLC. *In re Rural/Metro Corp. S'holdrs. Litig.*, 2014 WL 5280894 (Del. 2014) (Laster, V.C.) (*Rural II*). The court found RBC liable for $75.8 million, "representing 83% of the total damages that the class suffered."

In so holding, the court addressed two significant questions under the Delaware Uniform Contribution Among Tortfeasors Act ("DUCATA"). First, the court found that DUCATA "does not establish a bright-line rule barring contribution for all intentional torts." Second, the court held that in order to claim a settlement credit under DUCATA with respect to a director's liability, a non-settling defendant must establish that the director was not exculpated under a Section 102(b)(7) provision.

### Background

On June 30, 2011, Warburg Pincus acquired Rural at a price of $17.25 per share (the "Merger"). Rural's shareholders brought suit in connection with the acquisition. Plaintiffs contended that Rural's directors, including the company's President and CEO

(collectively, the "individual defendants"), had "breached their fiduciary duties in two ways: first, by making decisions that fell outside the range of reasonableness during the process leading up to the Merger and when approving the Merger (the 'Sale Process Claim'), and second, by failing to disclose material information in the definitive proxy statement ... that [Rural] issued in connection with the Merger (the 'Disclosure Claim')." Plaintiffs also asserted aiding and abetting claims against RBC, Rural's lead financial advisor, as well as Moelis & Company LLC, Rural's secondary financial advisor.

Prior to trial, plaintiffs reached an agreement in principle to settle their claims against the individual defendants and Moelis (collectively, the "Settling Defendants"). The final settlement agreement foreclosed RBC's right to seek contribution against the Settling Defendants but provided that the damages recoverable against RBC would be reduced to the extent of the pro rata liability, if any, of the Settling Defendants. The case proceeded to trial against RBC only. During the trial, RBC did not argue that the individual defendants had breached their fiduciary duties or that Moelis had aided and abetted the directors' breaches. RBC neither attempted to establish that the Settling Defendants were joint tortfeasors, nor contended that its share of potential liability should be reduced under the principles of relative fault. RBC argued only that it should be entitled to a settlement credit based on the pro rata liability of the Settling Defendants if it were found liable.

On March 7, 2014, the Delaware Chancery Court issued a post-trial decision in the *Rural/Metro* case holding RBC liable for aiding and abetting breaches of fiduciary duty by Rural's directors. *In re Rural Metro Corp.*, 88 A.3d 54 (Del. Ch. 2014) (Laster, V.C.) (the "Liability Opinion"). [2] With respect to the Sale Process Claim, the court found that the individual defendants had breached their fiduciary duties, and that RBC had aided and abetted those breaches, in two respects. First, the court held that "the initiation of a sale process in December 2010 fell outside the range of reasonableness." The court found that RBC and Christopher Shackelton, one of Rural's directors, had "put Rural into play without Board authorization." The court further determined that RBC had timed the Rural sale process to run in parallel with the sale of Emergency Medical Services Corporation ("EMS"), Rural's only national competitor in the ambulance business. Significantly, the court found that RBC "did not disclose that proceeding in parallel with the EMS process served RBC's interest in gaining a role on the financing trees of bidders for EMS."

Second, the court determined that the Board had "failed to provide active and direct oversight of RBC" during Rural's final negotiations with Warburg. At the time the Board 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 the meeting to approve the deal, and did not know about RBC's manipulation of its valuation metrics." The court concluded that "[u]nder [these] circumstances, the Board's decision to approve Warburg's bid lacked a reasonable informational basis and fell outside the range of reasonableness." Moreover, the court found that "RBC [had] *created* the unreasonable process and informational gaps that led to the Board's breach of duty."

As to the Disclosure Claim, the court found that the plaintiffs had "proved at trial that the Proxy Statement contained materially misleading disclosures in the form of false [financial] information that RBC [had] presented to the Board." The court underscored that RBC had provided the Board with "false" information "in connection with its precedent transaction analyses," and this "false information was repeated in the Proxy Statement."

Significantly, the Liability Opinion did not "address or attempt to overcome the defendant directors' potential entitlement to exculpation under Section 102(b)(7) of the Delaware General Corporation Law." *Rural II,* 2014 WL 5280894. The court "did not fix an amount of damages" or "address RBC's argument that if it were held liable, then the Delaware Uniform Contribution Among Tortfeasors Act ('DUCATA') ... required that any damages award against RBC be reduced by the aggregate pro rata share of the liability of the defendants who had settled."

2 Please click here to read our complete discussion of the Liability Opinion in the March 2014 edition of the Alert.

## *Rural II* Court Holds RBC Is Entitled to a Settlement Credit Under DUCATA

On October 10, 2014, the Chancery Court in *Rural II* issued an opinion addressing RBC's entitlement to a settlement credit under DUCATA and determining RBC's damages. DUCATA provides in relevant part as follows:

> A release by the injured person of 1 joint tortfeasor … does not discharge the other tortfeasor unless the release so provides; but reduces the claim against the other tortfeasors in the amount of the consideration paid for the release, or in any amount or proportion by which the release provides that the total claim shall be reduced, if greater than the consideration paid.

10 *Del. C.* § 6304(a). "Pending high court guidance" on this issue, the *Rural II* court held that "DUCATA does not establish a bright-line rule barring contribution for all intentional torts." The court found that "[a] defendant in RBC's situation could seek contribution from other joint tortfeasors, so RBC is not barred from claiming DUCATA's settlement credit."

The court first considered the text of the statute, and found that "[t]he plain language of DUCATA does not bar contribution for intentional torts." The court explained that "[t]he literal meaning of the words of DUCATA permits contribution among all tortfeasors." The court also found it significant that the drafting history of the Uniform Act of 1939, on which DUCATA was based, "supports the absence of a bright-line rule against contribution for intentional torts, while contemplating the existence of judicial authority to deny contribution based on the facts of a particular case." Additionally, the court noted that other Delaware statutes "authorize[ ] contribution among intentional tortfeasors … in specific circumstances."

The *Rural II* court then considered cases addressing the availability of contribution for intentional torts under Delaware law. The court determined that the District of Delaware's decision in *McLean v. Alexander (McLean II)*, 449 F. Supp. 1251 (D. Del. 1978), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979) "provides the most persuasive analysis and is closest to the facts of this case." In *McLean II*, the District of Delaware held that an accounting firm found liable for securities fraud and common law fraud in connection with the sale of a closely held company could bring a claim for contribution against defendants who had previously settled their claims with plaintiffs. Finding "no limitation expressed within the terms of" DUCATA, the court held that "all wrongdoers may properly share in the apportionment of damages via claims for contribution." *McLean II*, 449 F. Supp. 1251.

Here, the court found that "the acts in which RBC engaged reflect a level of culpability similar to the conduct in *McLean II*, which supports RBC's ability to claim the settlement credit under DUCATA."

## *Rural II* Court Finds Unclean Hands Precludes RBC From Claiming a Settlement Credit

Plaintiffs contended that "the doctrines of *in pari delicto* and unclean hands should bar RBC from receiving a settlement credit." The *Rural II* court found that the *in pari* delicto doctrine "does not apply here because RBC did not engage in criminal or illegal conduct." However, the court found that "the doctrine of unclean hands bars RBC from claiming the settlement credit to the extent RBC perpetrated what the Delaware Supreme Court has described as a 'fraud upon the board.'"

The court explained that "[t]he doctrine of 'unclean hands' provides that 'a litigant who engages in reprehensible conduct *in relation to the matter in controversy* … forfeits his right to have the court hear his claim, regardless of its merit." Here, the court observed that "[t]he Liability Opinion imposed liability on RBC for both the Sale Process Claim and the Disclosure Claim." Although "[t]he directors [had] breached their duties when approving the disclosures in the Proxy Statement and when approving the Merger …, they did so because RBC misled them." The *Rural II* court reasoned that "[i]f RBC were permitted to seek contribution for these claims from the directors, then RBC would be taking advantage of the targets of its own misconduct."

The court found that RBC could still "claim a settlement credit for the aspect of the Sale Process Claim that did not involve

misrepresentations and omissions by RBC towards its fellow defendants."

## *Rural II* Court Determines That Two Rural Directors Were "Joint Tortfeasors" Under DUCATA

The *Rural II* court next considered "whether RBC [had] met the requirements for the [settlement] credit" under DUCATA. In *Medical Center of Delaware, Inc. v. Mullins*, 637 A.2d 6 (Del. 1994), the Delaware Supreme Court held that "[t]he credit provided for in the Delaware Uniform Contribution Law is applicable exclusively to 'joint tortfeasors.'" *Mullins*, 637 A.2d 6. The *Mullins* court held that a defendant seeking contribution under DUCATA must establish "either judicially or by an admission, that the settling party was liable in tort, i.e., a tort-feasor." Relying on *Mullins*, the *Rural II* court held that "RBC bears the burden of establishing the joint tortfeasor status of each of the Settling Defendants." *Rural II,* 2014 WL 5280894.

The *Rural II* court then considered "the availability of exculpation under Section 102(b)(7)." [3] The court observed that the issue of "[h]ow Section 102(b)(7) affects a right of contribution presents a question of first impression." However, the court emphasized that "Delaware decisions interpreting DUCATA have long held that if a statute or common law doctrine would prevent a party from being held liable for money damages for the underlying harm based on the claim being asserted, then the party is not a joint tortfeasor against whom an action for contribution will be available." Citing the Delaware Supreme Court's decision in *Lutz v. Boltz*, 100 A.2d 647 (Del. Super. 1953), the *Rural II* court held that "if the director defendants would have been entitled to exculpation, then RBC could not obtain contribution from them and" therefore could not "claim the settlement credit."

The *Rural II* court explained that "[u]nder *Mullins*, ... RBC [had] the burden of proving that the director defendants were jointly liable to the Class." "RBC therefore [had] the burden of proving that exculpation was not available because the factual basis for the claim of breach did not '*solely* implicate [ ] a violation of the duty of care.'" In other words, the *Rural II* court found that RBC had to "establish that a disloyal state of mind contributed causally to [each] director's breach of duty."

Based on the trial evidence, the *Rural II* court found that "exculpation would not have been available" to two of the Settling Defendants: Christopher Shackelton, one of Rural's board members, and Michael DiMino, Rural's President and CEO. The court held that RBS therefore was entitled to a settlement credit in light of the participation of Shackelton and DiMino in the settlement.

As to the remaining director defendants, the *Rural II* court deemed the trial evidence insufficient to establish that their actions fell within one of the exceptions to Section 102(b)(7). The court further determined that "RBC and Moelis," Rural's secondary financial advisor, were "not similarly situated" as joint tortfeasors. The court found that it did not "follow from the Liability Opinion's finding [as to RBC's advice] that Moelis's advice was [also] necessarily tortious."

## *Rural II* Court Apportions 83% of the Relative Fault to RBC

The *Rural II* court then turned to apportionment of liability. As an initial matter, the court found that the Disclosure Claim and the Sale Process Claim could "can be weighted equally on the premise that each led to the same injury." Because the court found RBC "solely responsible for the Disclosure Claim," the court allocated RBC "50% of the damages suffered by the [c]lass."

With respect to the 50% remaining liability for the Sale Process Claim, the court noted that "[t]he Liability Opinion identified two sets of breaches of duty ... : the breaches of duty that occurred when Shackelton and RBC initiated the sale process without Board authorization and in conjunction with the EMS sale and the breaches of duty that occurred during the final approval of the Merger." The court found that "the two breaches can be weighted equally." Since the court had determined that the doctrine of unclean hands precluded RBC from claiming "any settlement credit for the breaches of

3 Section 102(b)(7) of the Delaware General Corporation Law provides that a Delaware corporation may include in its certificate of incorporation "[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director," subject to certain exceptions. A Section 102(b)(7) provision may not limit a director's personal liability for "any breach of the director's duty of loyalty to the corporation or its stockholders;" "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law;" or "any transaction from which the director derived an improper personal benefit."

duty that occurred during the final approval of the Merger," the court allocated "an additional 25% of the responsibility for the damages suffered by the [c]lass to account for [these] breaches."

The court explained that "[t]he remaining 25% of the responsibility for the damages suffered by the [c]lass relates to the breaches of duty that occurred when Shackelton and RBC initiated the sale process without Board authorization and in conjunction with the EMS sale." The court determined that this 25% share of damages must be apportioned among RBC and its joint tortfeasors, Shackelton, and DiMino. While the court acknowledged that DUCATA's "basic principle is to divide the damages for which the defendants are responsible equally among all defendants," the court found that "the relative degrees of fault of the joint tortfeasors [must] be considered in determining their pro rata shares" in cases where "there is such a disproportion of fault among joint tortfeasors as to render inequitable an equal distribution among them." With respect to the 25% of the damages in connection with the initiation of the Rural sales process, the court allocated 10% of the responsibility to Shackelton, 8% to RBC, and 7% to DiMino.

The court determined that RBC was therefore entitled to a settlement credit of 17% of the damages suffered by the class. The court explained that "RBC [was] entitled to a reduction in its liability equal to the greater of (i) the share of responsibility attributable to the joint tortfeasors or (ii) the settlement payments made by the joint tortfeasors." Since "the dollar value of the [17%] share of responsibility is greater than the settlement payments," the court determined that "RBC's liability is reduced by the former amount." The court entered judgment against RBC in the amount of $75.799 million (83% of the total damages suffered by the class).

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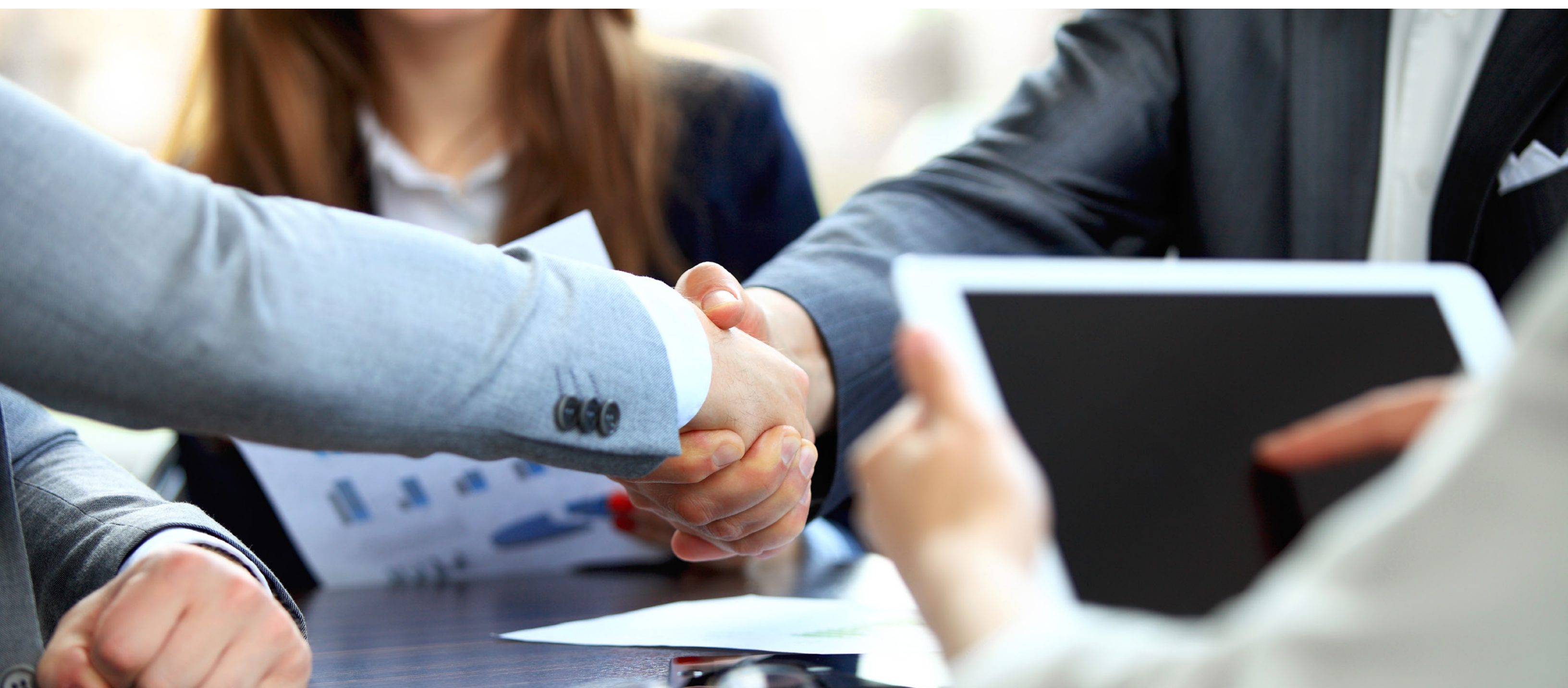

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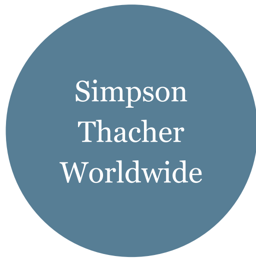


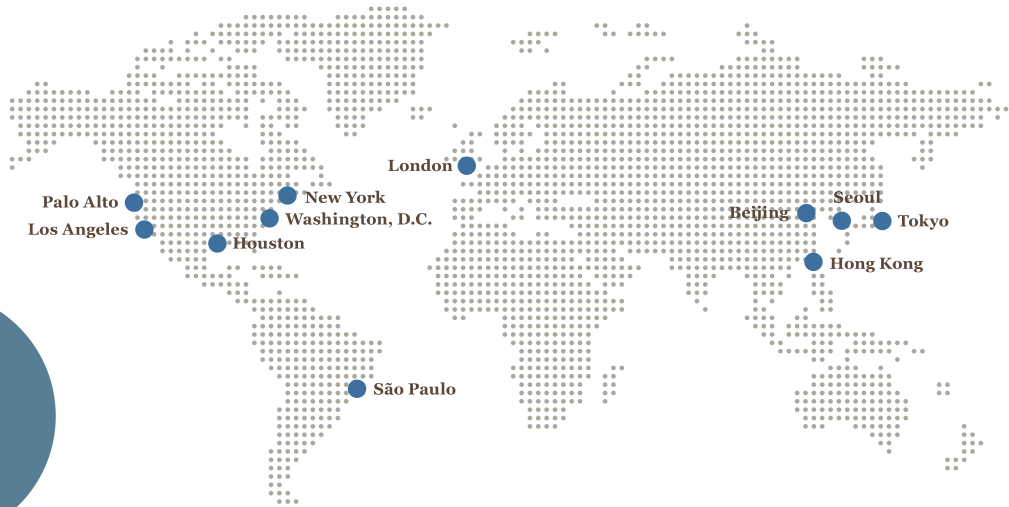


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