Simpson Thacher
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This month's Alert addresses three Second Circuit decisions: one applying the Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010), to limit the extraterritorial reach of private rights of action under the Commodity Exchange Act; another holding that forum selection clauses may supersede the arbitration rules of the Financial Industry Regulatory Authority ("FINRA"); and a third addressing corporate disclosure obligations in affirming dismissal of a securities fraud class action against Xerox Corporation.

We also discuss two Delaware Chancery Court decisions: one upholding a forum selection bylaw providing that intra-corporate disputes may be heard only in North Carolina courts; and another addressing the pleading standard for breach of fiduciary duty claims against disinterested directors in connection with controlling stockholder transactions subject to entire fairness review.

Second Circuit Applies *Morrison* to Limit the Extraterritorial Reach of Private Rights of Action Under the Commodity Exchange Act

On September 4, 2014, the Second Circuit applied the Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010), to hold that § 22 of the Commodity Exchange Act ("CEA"), which provides a private right of action for CEA violations, "is limited to claims alleging a commodity transaction within the United States." *Loginovskaya v. Batratchenko* (*Loginovskaya II*), 2014 WL 4358439 (2d Cir. 2014) (Jacobs, J.). Significantly, the Second Circuit found it unnecessary "to decide how the presumption against extraterritorial effect defines the reach of § 4*o*," one of the CEA's antifraud provisions.

Sections 4*o* and 22 of the CEA

In relevant part, § 4*o* of the CEA prohibits a "commodity trading advisor" or "commodity pool operator" from "employ[ing] any device, scheme, or artifice to defraud any client or . . . prospective client." 7 U.S.C. § 6*o*(1)(A). Section 4*o* of the CEA further prohibits a "commodity trading advisor" or "commodity pool operator" from "engag[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client . . . or prospective client." 7 U.S.C. § 6*o*(1)(B).

Section 22 of the CEA establishes a private right of action for violations of the CEA's provisions, including § 4*o*. A private plaintiff has standing to sue for a CEA violation only if he or she alleges

> (A) the receipt of "trading advice . . . for a fee;" (B) the making of a "contract of sale of any commodity for future delivery" or the deposit or payment of "money, securities, or property

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> . . . *in connection with any* order to make such contract or swap;" (C) the purchase or sale or placing of an order for purchase or sale of a commodity; or (D) market manipulation "*in connection with* a swap, or a contract of sale of a commodity."

Loginovskaya v. Batratchenko (*Loginovskaya I*), 936 F. Supp. 2d 357 (S.D.N.Y. 2013) (Oetken, J.) (emphasis added by the court) (quoting 7 U.S.C. § 25(a)(1)(A)-(D)).

Background

The Thor Group is a New York-based international financial services organization that "manages investment programs, chiefly in commodities futures and real estate." *Loginovskaya II*, 2014 WL 4358439. Thor United, one of the Thor Group entities, "maintains 'integrated accounts'" for the Thor Group companies. The Thor Group's CEO, Oleg Batratchenko, is a U.S. citizen residing in Moscow.

In January 2006, Batratchenko solicited Ludmila Loginovskaya, a Russian citizen, to invest with the Thor Group. He provided her with investment memoranda and other materials written in Russian that described the proposed investment. In 2006 and 2007, Loginovskaya "entered into two investment contracts with Batratchenko and Thor United" that "expressly incorporated" the memoranda that Batratchenko had provided earlier. To fund the investment, Loginovskaya transferred more than $700,000 to Thor United's bank accounts in New York.

Sometime after 2010, Loginovskaya "learned that the Thor programs [had] used investors' funds in a manner inconsistent with the investment contracts." After she unsuccessfully attempted to recover her investments from the Thor entities, Loginovskaya brought suit in the Southern District of New York, alleging violations of § 4*o* of the CEA, as well as state law claims. Defendants moved to dismiss Loginovskaya's complaint based, *inter alia*, on the Supreme Court's decision in *Morrison*.

Applying *Morrison*'s Transactional Test to CEA § 22, Southern District of New York Dismisses Plaintiff's Complaint

In *Morrison*, the Supreme Court stated that, "[w]hen a statute gives no clear indication of an extraterritorial application, it has none." *Morrison*, 561 U.S. 247. Examining the Securities Exchange Act of 1934, the *Morrison* Court held that § 10(b) of that act only applies to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities."

On March 29, 2013, the Southern District of New York relied on *Morrison* to dismiss Loginovskaya's CEA claims. *Loginovskaya I*, 936 F. Supp. 2d 357. Because "[t]he CEA is silent as to its extraterritorial reach," the court found that "the *Morrison* presumption against extraterritoriality applies" to the CEA "in full force."

Notably, the court determined that "*Morrison*'s transaction test is not immediately applicable to § 4*o*" of the CEA since "[t]he terms of § 4*o* are broader than the 'purchase or sale' language of § 10(b)" of the Securities Exchange Act of 1934. However, the court concluded that *Morrison*'s transaction-based test "does govern analysis of" § 22 of the CEA, "which specifically delimits actionable conduct to four, specific types of transactions." The court emphasized that "§ 4*o* must

be read *in pari materia* with the other provisions of the [CEA], including, most importantly, that which confers a private right of action, § 22."

The court then considered whether Loginovskaya had alleged a "domestic transaction" under "*Morrison*'s transactional analysis, as further defined by" the Second Circuit's decision in *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60 (2d Cir. 2012).[1] The *Absolute Activist* court held that, in order "to sufficiently allege the existence of a 'domestic transaction in other securities'" for purposes of the *Morrison* transaction test, "plaintiffs must allege facts indicating that irrevocable liability was incurred or that title was transferred within the United States."

The Southern District of New York found that Loginovskaya had not "incur[red] irrevocable liability in the United States within the reasoning of *Absolute Activist*" because "[t]he contracts [with Thor United] were negotiated in Russia, signed in Russia, and the meeting of the minds occurred in Russia." *Loginovskaya I*, 936 F. Supp. 2d 357. Although Loginovskaya had wired funds to Thor United in New York to fund her investment, the court determined that it was Loginovskaya's "signature that bound [her]" to the transaction, "not the wiring of money." The court explained that, under *Absolute Activist*, neither the "exchange of money" nor "the location of [the] broker-dealer" is dispositive for purposes of determining whether or not a transaction is domestic.

The court emphasized that "[i]t is the contract that gives rise to [p]laintiff's irrevocable liability" and found that "the contract at issue here was not domestic in nature." Based on its determination that Loginovskaya's transaction "occurred in Russia," the court held that Loginovskaya had "fail[ed] to state a claim under the CEA." The court dismissed Loginovskaya's CEA claims and declined to exercise supplemental jurisdiction over her state law claims. Loginovskaya appealed.

1. Please click here to read our discussion of the *Absolute Activist* decision in the March 2012 edition of the Alert.

Second Circuit Finds that CEA § 22 Requires a "Domestic Transaction" Under *Morrison*

The Second Circuit first found that, "[g]iven the absence of any 'affirmative intention' by Congress to give the CEA extraterritorial effect, [it] must 'presume [the CEA] is primarily concerned with domestic conditions.'" *Loginovskaya II*, 2014 WL 4358439 (quoting *Morrison*, 561 U.S. 247).

The Second Circuit next explained that "Loginovskaya's suit [had to] satisfy the threshold requirement of CEA § 22" before the court could "reach[ ] the merits of her § 4*o* fraud claim." Observing that "courts have [traditionally] looked to the securities laws when called upon to interpret similar provisions of the CEA," the Second Circuit determined that "*Morrison*'s domestic transaction test in effect decides the territorial reach of CEA § 22." The Second Circuit therefore held that "[a] private right of action [under the CEA] exists only when a plaintiff shows that one of the four transactions listed in § 22 occurred within the United States."

Significantly, the Second Circuit rejected Loginovskaya's contention that *Morrison* only "governs substantive (conduct-regulating) provisions rather than procedural provisions such as § 22." The court explained that "*Morrison* . . . draws no such distinction, and holds that the presumption applies generally to 'statutes.'" The Second Circuit further ruled that Loginovskaya's argument was "foreclosed by" *Kiobel v. Royal Dutch Petroleum Co.*, 133 S. Ct. 1659 (2013). There, the Supreme Court "applied the presumption against extraterritoriality to the Alien Tort Statute, which 'provides district courts with jurisdiction to hear certain claims, but does not expressly provide any causes of action.'" *Loginovskaya II*, 2014 WL 4358439 (quoting *Kiobel*, 133 S. Ct. 1659).

Second Circuit Applies *Absolute Activist* Test to Determine Whether a "Domestic Transaction" Took Place for Purposes of CEA § 22

In view of its "holding that *Morrison* applies to a private right of action under CEA § 22," the Second Circuit found "no reason why *Absolute Activist*'s formulation" for pleading a domestic transaction "should not apply" to CEA § 22. As noted, *Absolute Activist* requires a plaintiff to allege either that title was transferred within the United States or that irrevocable liability was incurred in the United States.

Here, the Second Circuit found no allegations that Loginovskaya had incurred irrevocable liability in the United States for the commodities contracts at issue. The court emphasized that "[t]he investment contracts with Thor United were negotiated and signed in Russia." As to the fact that "Thor United is incorporated in New York," the court explained that "'a party's residency or citizenship is irrelevant to the location of a given transaction'" under the *Absolute Activist* test. *Loginovskaya II*, 2014 WL 4358439 (quoting *Absolute Activist*, 677 F.3d 60).

The Second Circuit also determined that Loginovskaya had failed to allege that transfer of title took place in the United States. While Loginovskaya alleged "that she was required to wire transfer her funds to Thor's bank account in New York," the court found that the wire transfer "merely implemented an aspect of a transaction that was executed in Russia." The Second Circuit stated that "[t]he direction to wire transfer money to the United States is insufficient to demonstrate a domestic transaction."

The Second Circuit concluded that Loginovskaya had "not alleged a domestic commodities transaction" under CEA § 22 and affirmed dismissal of her CEA claims.

Second Circuit Does Not Reach the Question of Whether *Morrison* Applies to CEA § 4*o*

Notably, the Second Circuit did "not reach Loginovskaya's argument regarding the territorial reach of the antifraud provision in CEA § 4*o*." The court did, however, observe that "[t]he contention that *Morrison*'s transaction test is inapplicable to § 4*o*'s antifraud protection is not without merit."

The Second Circuit pointed out that, "if § 4*o* regulates the conduct of domestic commodities market participants in other countries, it would seem Congress has allowed a remedy through" 7 U.S.C. § 18(a)(1), which allows a plaintiff alleging violations of the CEA to apply to the Commodity Futures Trading Commission ("CFTC") for an order awarding damages. The Second Circuit clarified that "[n]othing in this opinion precludes relief for a private party in these circumstances; the inability to bring a cause of action in federal court does not restrict the ability to bring a claim before the CFTC."

Judge Lohier Dissents Based on His View that the Presumption Against Extraterritoriality Does Not Apply to CEA § 22

Judge Lohier issued a lengthy dissent. He expressed his view that "the presumption [against extraterritoriality] has nothing to do with statutory provisions, like § 22, that merely define *who* may assert a private right of action." He emphasized that "§ 22 does not purport to regulate conduct, impose liability for particular actions, or define a plaintiff's claims under the CEA."

Judge Lohier explained that he would have "start[ed] and end[ed] the *Morrison* inquiry" by considering whether Loginovskaya had adequately pled a violation of § 4*o* of the CEA. He would have based his decision on allegations that the "deceptive scheme was executed in part in the United States because the defendants issued memoranda and correspondence regarding the Thor programs from New York, Loginovskaya wired her investment funds to New York bank accounts, account statements were generated in New York, and the unauthorized investments occurred in the United States." Judge Lohier determined that "[t]hese allegations, taken together, satisfy the territoriality requirement under § 4*o*."

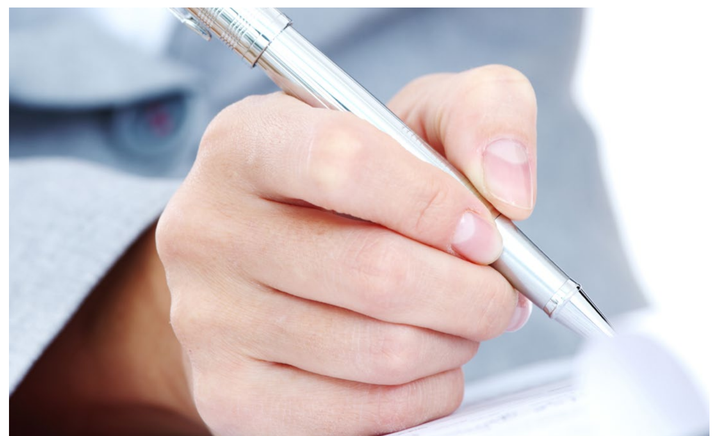
Judge Lohier criticized the majority opinion for "creat[ing] two sets of rules that depend solely on the identity of the party seeking to enforce § 4*o*: one for private parties located outside the United States and another for private parties located inside the United States." Moreover, Judge Lohier found erroneous the majority's requirement that "private victims of commodities fraud . . . allege a separate domestic commodities transaction even if they adequately plead a violation of § 4*o*, which does not require such a transaction." Judge Lohier underscored that "*Morrison*'s transaction test does not apply to § 4*o*" because "§ 4*o* does not *demand* that a transaction occur."

Second Circuit Holds Forum Selection Clauses May Supersede FINRA's Arbitration Rules

On August 21, 2014, the Second Circuit held that the arbitration rules of the Financial Industry Regulatory Authority ("FINRA") were "superseded by forum selection clauses requiring 'all actions and proceedings' related to the transactions between the parties to be brought in court." *Goldman, Sachs & Co. v. Golden Empire Sch. Fin. Auth.* (*Golden Empire II*), 2014 WL 4099289 (2d Cir. 2014) (Walker, Jr., J.). In so holding, the Second Circuit deepened a circuit split on the issue of whether forum selection clauses may supersede FINRA's arbitration rules.

Background

Golden Empire Schools Financing Authority and Kern High School District (collectively, "Golden Empire") retained Goldman, Sachs & Co. ("Goldman") as an underwriter and broker-dealer with respect to auction rate securities ("ARS") issuances in 2004, 2006 and 2007. The governing broker-dealer agreements for the 2004 and 2006 issuances provided that "all actions and proceedings arising out of" the broker-dealer agreement "or any of the transactions



contemplated hereby shall be brought in the United States District Court in the County of New York." The broker-dealer agreement for the 2007 issuance included a forum selection clause that "was the same in all material respects." All three broker-dealer agreements included a merger clause specifying that each agreement and "any other agreements executed in connection with that ARS issuance 'contain the entire agreement between the parties relating to the subject matter hereof.'"

In February 2012, Golden Empire commenced arbitration proceedings against Goldman, and contended that Goldman was required to arbitrate the dispute pursuant to FINRA Rule 12200. Rule 12200 provides that FINRA "members 'must arbitrate a dispute' if arbitration is '[r]equested by the customer' and '[t]he dispute arises in connection with the business activities of the member.'" *Golden Empire II*, 2014 WL 4099289 (quoting FINRA Rule 12200). Goldman responded by bringing suit in the Southern District of New York to enjoin the FINRA arbitration based on the forum selection clauses in the broker-dealer agreements. On February 8, 2013, the district court found that Goldman had "demonstrated the applicability of the [f]orum [s]election [c]lauses to the instant dispute" and thus granted an injunction. *Goldman, Sachs & Co. v. Golden Empire Sch. Fin. Auth.* (*Golden Empire I*), 922 F. Supp. 2d 435 (S.D.N.Y. 2013) (Sullivan, J.). Golden Empire appealed.

In a similar dispute in a separate action, the Southern District of New York enjoined an ARS-related FINRA arbitration commenced by North Carolina Eastern Municipal Power Agency ("NCEMPA") against Citigroup Global Markets Inc. ("Citigroup"). The governing broker-dealer agreement in the *NCEMPA* case "contained a forum selection clause and a merger clause identical to those in" the *Golden Empire I* case. NCEMPA appealed; the Second Circuit heard argument in both appeals on April 4, 2014.

On appeal, Golden Empire and NCEMPA contended that, because Goldman and Citigroup are FINRA members, the disputes at issue "are subject to mandatory arbitration before FINRA" pursuant to FINRA Rule 12200. *Golden Empire II*, 2014 WL 4099289. Goldman and Citigroup argued that the forum selection clauses in the governing broker-dealer agreements "superseded" FINRA Rule 12200.

Second Circuit Finds the "All-Inclusive and Mandatory" Forum Selection Clauses Preclude Arbitration Under FINRA Rule 12200

At the outset of its analysis, the Second Circuit noted that the circuit courts have reached different conclusions on the question of whether a forum selection clause takes precedence over FINRA's arbitration rules. While the Ninth Circuit has held that a forum selection clause in a broker-dealer agreement "supersedes Rule 12200," the Fourth Circuit has ruled that "a nearly identical forum selection clause" to the one at issue in the *Golden Empire I* and *NCEMPA* cases "does not supersede Rule 12200." *Compare Goldman, Sachs & Co. v. City of Reno*, 747 F.3d 733 (9th Cir. 2014), *with UBS Fin. Servs., Inc. v. Carilion Clinic*, 706 F.3d 319 (4th Cir. 2013). The Second Circuit expressly disagreed with the Fourth Circuit and held that "a forum selection clause requiring 'all actions and proceedings' to be brought in federal court supersedes an earlier agreement to arbitrate." *Golden Empire II*, 2014 WL 4099289.

The Second Circuit first found that a presumption in favor of arbitrability under the Federal Arbitration Act "does not apply" "[b]ecause the question presented here concerns whether an arbitration agreement remains in force in light of a later-executed agreement." The court explained that the presumption of arbitrability is applicable "only if an 'enforceable arbitration agreement is ambiguous about whether it covers the dispute at hand.'" The presumption of arbitrability does not govern "'disputes concerning

whether an agreement to arbitrate has been made.'"

The Second Circuit then considered its earlier decision in *Applied Energetics, Inc. v. NewOak Capital Mkts., LLC*, 645 F.3d 522 (2d Cir. 2011). There, the Second Circuit determined that "an arbitration agreement was superseded by an agreement stating that '[a]ny dispute arising out of this Agreement shall be adjudicated in' New York courts." *Golden Empire II*, 2014 WL 4099289 (quoting *Applied Energetics*, 645 F.3d 522). Like the agreements at issue in the *Golden Empire I* and *NCEMPA* cases, the governing agreement in *Applied Energetics* included a merger clause.

The Second Circuit determined that "[t]he forum selection clause at issue in the present appeals is indistinguishable from that in *Applied Energetics* because it states that 'all actions and proceedings . . . shall be brought' in the Southern District of New York." Like the forum selection clause in *Applied Energetics*, "the clause here is all-inclusive and mandatory." The Second Circuit concluded that "the forum selection clause at issue in [the *Golden Empire I* and *NCEMPA*] cases is plainly sufficient to supersede FINRA Rule 12200."

The Second Circuit therefore affirmed the district court decisions enjoining FINRA arbitrations in both the *Golden Empire I* and *NCEMPA* cases. However, the Second Circuit has since issued a stay of its decision to allow the parties to petition the Supreme Court for certiorari on the question of whether forum selection clauses may supersede FINRA's arbitration rules.

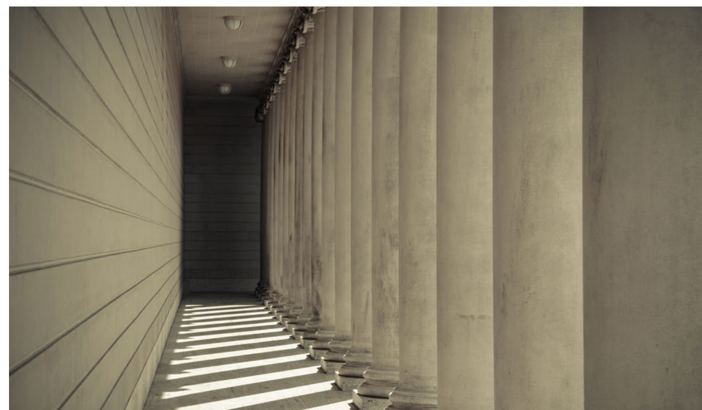
Second Circuit Addresses Corporate Disclosure Obligations in Affirming Dismissal of Xerox Class Action

On September 8, 2014, the Second Circuit affirmed the district court's grant of summary judgment to defendants in a securities fraud class action alleging that Xerox Corporation ("Xerox") and three of its executive officers had failed to adequately disclose to the market challenges arising from Xerox's worldwide restructuring initiative in 1998 and 1999. *Dalberth v. Xerox Corp.* (*Xerox II*), 2014 WL 4390695 (2d Cir. 2014) (Pooler, J.). The Second Circuit found that, although plaintiffs "may have desired more detailed or nuanced language" in Xerox's public disclosures concerning the severity of certain restructuring-related problems, "that is not what the law requires." The court underscored that it has "never required a corporation to frame its public information with specific adjectives" or "phrase disclosures in pejorative terms."

Background

In 1998 and 1999, Xerox embarked on a "large-scale, worldwide restructuring initiative." One of the plan's sub-initiatives, the 1998 Customer Business Organization Reorganization ("CBO Reorganization"), entailed closing one of Xerox's four Customer Administrative Centers ("CACs"), reorganizing the three remaining CACs into Customer Business Centers ("CBCs") and eliminating approximately 500 positions. The CBO Reorganization caused "various challenges" for the company.

Internal Xerox memoranda described the issues with the CBO Reorganization. For example, a July 1999 internal presentation on the CBO Reorganization stated that the initiative had led to a "massive backlog"



on accounts receivable and that the company had gone "[t]oo far too fast" with the initiative. The presentation went on to state that Xerox had "a five alarm fire" on its hands.

Xerox made a number of public statements disclosing problems with the implementation of the CBO Reorganization. For example, at an investor conference on May 14, 1999, Xerox's CFO stated that one of the principal causes of the company's "clearly unsatisfactory" cash generation in 1998 was "a deterioration in receivables." Xerox's CFO acknowledged that the growth in receivables "was primarily the result of" the CBO Reorganization. He stated that "frankly, we reduced the headcount . . . at too fast a rate. And it was too much change, too fast."

In the fall of 1999, Xerox shareholders brought suit in the District of Connecticut, alleging violations of §§ 10(b) and 20(a) of the Exchange Act and Rule 10b-5. Specifically, plaintiffs contended that "the problems that arose from the CBO Reorganization . . . were insufficiently disclosed to the market." Plaintiffs succeeded in obtaining class certification, and several years of litigation ensued. On March 29, 2013, the district court granted defendants' motion for summary judgment in its entirety. *In re Xerox Corp. Sec. Litig.* (*Xerox I*), 935 F. Supp. 2d 448 (D. Conn. 2013) (Thompson, J.). The court determined that there was "no genuine issue as to the fact that" defendants had adequately "disclosed to the market" the problems involving the CBO Reorganization. Plaintiffs appealed.

Second Circuit Affirms, Finding Immaterial Discrepancies Between Xerox's Internal and Public Descriptions of CBO Reorganization-Related Problems

On appeal, plaintiffs contended that the district court had "incorrectly" deemed "immaterial" "the distinctions between Xerox's carefully phrased public disclosures" concerning challenges with the CBO Reorganization and "the more colorful language in the corporation's internal documents. *Xerox II*, 2014 WL 4390695." The Second Circuit found plaintiffs' argument meritless. "While [p]laintiffs may have desired more detailed or nuanced language" in Xerox's disclosures, the Second Circuit explained that it has "never required a corporation to frame its public information with specific adjectives." The court underscored that "'[d]isclosure is not a rite of confession'" and "'[c]orporations are not required to phrase disclosures in pejorative terms.'" All that "'is required is the disclosure of material objective factual matters.'"

Here, the Second Circuit found the fact that plaintiffs' "wish[ed] that *more* was said, perhaps in more evocative language . . . simply insufficient to establish a genuine dispute as to whether the market was adequately informed about the impact of the CBO Reorganization on Xerox during the class period." The court held that "whether one referred to a problem

as a 'five alarm fire' internally or as just causing a 'deterioration' as the result of 'too much change, too fast' publicly, the bottom line was the same: the public information reflected that the CBO Reorganization was causing problems for Xerox's bill collection and sales force operations." The court concluded that "no reasonable juror could find, based on the disclosures made by Xerox over the course of the class period, that material information was omitted or falsely reported" concerning the CBO Reorganization.

The Second Circuit therefore affirmed the district court's grant of summary judgment in favor of defendants.

Delaware Chancery Court Upholds Forum Selection Bylaw Providing that Intra-Corporate Disputes May Be Heard Only in North Carolina Courts

On September 8, 2014, the Delaware Chancery Court addressed "an issue of first impression: whether the board of a Delaware corporation may adopt a bylaw that designates an exclusive forum other than Delaware for intra-corporate disputes." *City of Providence v. First Citizens BancShares, Inc.*, 2014 WL 4409816 (Del. Ch. 2014) (Bouchard, C.). In the case before it, the board of a Delaware corporation headquartered in North Carolina had adopted a forum selection bylaw providing that intra-corporate disputes may be brought only in the federal and state courts of North Carolina. The Chancery Court found the bylaw "facially valid as a matter of law." Notably, the court determined that "nothing in the text or reasoning" of its recent decision in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.* (*Chevron*), 73 A.3d 934 (Del. Ch. 2013), "can be said to prohibit directors of a Delaware corporation from designating an exclusive forum other than Delaware in its bylaws."[2]

The *Chevron* Decision

In *Chevron*, the Chancery Court rejected shareholder challenges to forum selection bylaws adopted by the boards of Chevron Corporation and FedEx Corporation requiring that litigation relating to each company's "internal affairs" be conducted in Delaware courts. The court found that the bylaws were both "statutorily valid under Delaware law" and "contractually valid and enforceable." *Chevron*, 73 A.3d 934.

The Chancery Court noted that, under 8 *Del. C.* § 109(b), board-adopted bylaws "may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the . . . rights

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

or powers of its stockholders." *Chevron*, 73 A.3d 934 (quoting 8 *Del. C.* § 109(b)). The court determined that the forum selection bylaws at issue plainly "address the 'rights' of the stockholders" within the meaning of 8 *Del. C.* § 109(b) "because they regulate where stockholders can exercise their right to bring certain internal affairs claims against the corporation and its directors and officers."

The Chancery Court further explained that "an essential part of the contract stockholders assent to when they buy stock in Chevron and FedEx is one that presupposes the board's authority to adopt binding bylaws consistent with 8 *Del. C.* § 109." Pursuant to this "clear contractual framework," the court found that "the stockholders assent to not having to assent to board-adopted bylaws."

Case Background

First Citizens BancShares, Inc. ("FC North") is a Delaware corporation headquartered in North Carolina. On June 10, 2014, the FC North board adopted a forum selection bylaw providing that intra-corporate disputes may be brought only in North Carolina federal and state courts. On the same day, FC North announced a merger agreement to acquire First Citizens Bancorporation, Inc. ("FC South"), a South Carolina corporation. Both companies "are allegedly controlled by the members and affiliates of the Holding family (the 'Holding Group')." *First Citizens BancShares*, 2014 WL 4409816. However, "the Holding Group's economic interests are allegedly greater in FC South than FC North."

On June 19, 2014, the city of Providence, an FC North shareholder, brought suit against FC North and the twelve members of its board of directors in the Delaware Chancery Court, challenging the forum selection bylaw as "invalid as a matter of Delaware law or public policy." Plaintiff also asserted breach of fiduciary duty and *ultra vires* claims in connection with the FC North board's adoption of the bylaw. On August 1, 2014, plaintiff filed a second Chancery Court complaint, asserting numerous breach of fiduciary duty claims arising out of the merger (the "Merger Complaint"). "In essence, [plaintiff] contend[ed] that the Holding Group, through its controlling interest, unfairly forced FC North to overpay for FC South to its own benefit and to the dilution of FC North's minority stockholders." Defendants moved to dismiss both suits.

Relying on *Chevron*, Chancery Court Finds FC North's Forum Selection Bylaw Facially Valid

The Chancery Court determined that "the same analysis of Delaware law outlined in *Chevron* validates the [f]orum [s]election [b]ylaw" adopted by FC North's board. The court explained that FC North's forum selection bylaw is "functionally identical" to the bylaws at issue in *Chevron* "[i]n all but two respects." First, while "the boards of Chevron and

FedEx selected Delaware courts as their exclusive forums, the Board of FC North selected North Carolina courts." Second, unlike the forum selection bylaws adopted by Chevron and FedEx, FC North's forum selection bylaw "is applicable only 'to the fullest extent permitted by law.'" The Chancery Court found "the fact that the Board selected the federal

and state courts of North Carolina—the second most obviously reasonable forum given that FC North is headquartered and has most of its operations there—rather than those of Delaware as the exclusive forums for intra-corporate disputes [did] not . . . call into question the facial validity of" FC North's forum selection bylaw.

The Chancery Court declined to address plaintiff's claims concerning Delaware courts' "exclusive jurisdiction" over intra-corporate disputes and plaintiff's "substantive right" to assert its claims in Delaware courts. The court determined that these contentions were "purely hypothetical." Moreover, the court emphasized that FC North's bylaw "is only enforceable 'to the fullest extent permitted by law'" and thus "appears to carve out . . . a claim for relief, if any, that may be asserted only in the Court of Chancery."

Chancery Court Rejects Plaintiff's As-Applied Challenge to FC North's Forum Selection Bylaw and Dismisses the Merger Complaint for Improper Venue

The court next considered whether FC North's forum selection bylaw required dismissal of the Merger Complaint. The court determined that it was not "unreasonable or unjust . . . or inequitable . . . to enforce" the bylaw given that "FC North and the majority of its operations are based in North Carolina" and "no legitimate contention can be made that complete relief cannot be afforded there."

The court found it "immaterial" that FC North had adopted the forum selection bylaw on the same day that it had entered into a merger agreement with FC South. Notably, the court rejected plaintiff's argument that the adoption of the forum selection bylaw was beyond plaintiff's "reasonable expectations" because it occurred concurrently with the announcement of the merger,. The court explained that FC North stockholders, at the time they purchased FC North stock, were on notice that FC North's board of directors could unilaterally amend the company's bylaws at any time. "Thus," the court found that "the reasonable expectation a stockholder of FC North should have is that its Board may adopt a forum selection bylaw that . . . designates a court outside Delaware as the exclusive forum for intra-corporate disputes."

The Chancery Court also found irrelevant the FC North stockholders' alleged inability to repeal the forum selection bylaw given the Holding Group's controlling stake in the company. The court explained that neither Delaware law nor *Chevron* "mandate[s] that a board-adopted forum selection bylaw can be applied only if it is realistically possible that stockholders may repeal it." The court reasoned that holding otherwise would "'be tantamount to rendering questionable all board-adopted bylaws of controlled corporations.'"

Finally, the court stated that it had considered "important interests of judicial comity" in reaching its decision. The court explained that, "[i]f Delaware corporations are to expect, after *Chevron*, that foreign courts will enforce valid bylaws that designate Delaware as the exclusive forum for intra-corporate disputes, then, as a matter of comity, so too should this [c]ourt enforce a Delaware corporation's bylaw that does not designate Delaware as the exclusive forum."

The Chancery Court therefore granted defendants' motion to dismiss the Merger Complaint for improper venue.

Delaware Chancery Court Addresses the Pleading Standard for Breach of Fiduciary Duty Claims Against Disinterested Directors in Connection with Transactions Subject to Entire Fairness Review

On September 9, 2014, the Delaware Chancery Court declined to dismiss breach of fiduciary duty claims against any of the disinterested directors of Cornerstone Therapeutics Inc. ("Cornerstone") in connection with a controlling stockholder transaction subject to the entire fairness standard of review, even though there were no allegations that any of the disinterested directors had breached a non-exculpated fiduciary duty. *In re Cornerstone Therapeutics Inc. Stockholder Litig.*, 2014 WL 4418169 (Del. Ch. 2014) (Glasscock, V.C.). The court held that "where, as here, entire fairness is the standard of review *ab initio*, controlling case precedent directs that negotiating and facilitating directors must await a developed record, post-trial, before their liability is determined."

Background

Cornerstone is a Delaware corporation focused on commercializing specialty health care products. In May 2009, Chiesi Farmaceutici S.p.A. ("Chiesi"), a privately-held Italian pharmaceutical company, purchased a controlling interest in Cornerstone. Chiesi purchased additional Cornerstone shares in the years that followed. By June 2012, Chiesi had become the beneficial owner of more than 65% of Cornerstone stock.

In February 2013, Chiesi offered to acquire all outstanding Cornerstone shares that it did not already own at a price range of $6.40 to $6.70 per share. Chiesi did not condition its offer on approval by a majority of the minority stockholders.

Cornerstone established a special committee of disinterested directors to evaluate the offer and negotiate with Chiesi. The special committee retained its own counsel and an independent financial advisor. On September 15, 2013, after several rounds of negotiations, Cornerstone's special committee unanimously approved a merger agreement with Chiesi at a price of $9.50 per share. The merger agreement was conditioned on the approval of a majority of the minority stockholders. On February 3, 2014, more than 80% of the minority stockholders approved the merger agreement.

Cornerstone's shareholders brought suit, asserting breach of fiduciary duty claims against Cornerstone's directors, among other claims. Cornerstone's disinterested directors moved to dismiss plaintiffs' claims based on Cornerstone's Section 102(b)(7) exculpation provision. Defendants contended that dismissal was required because there was no allegation that the disinterested directors had breached a non-exculpated fiduciary duty.

Chancery Court Finds the Entire Fairness Standard of Review Applies

As an initial matter, the Chancery Court found that the Chiesi-Cornerstone transaction was "subject *ab initio* to entire fairness review" because "a controlling stockholder [stood] on both sides of [the] transaction." The court explained that, in *Kahn v. Lynch*, 638 A.2d 1110 (Del. 1994), the Delaware Supreme Court held that "entire fairness . . . is the only proper standard of judicial review" of a controlling stockholder transaction, "even when an interested cash-out merger transaction receives the informed approval of a majority of minority stockholders or an independent

committee of disinterested directors." *Cornerstone Therapeutics*, 2014 WL 4418169 (quoting *Lynch*, 638 A.2d 1110).

The Chancery Court noted that, in *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014), the Delaware Supreme Court "refined its view" in *Lynch* and held that "a transaction structured *ab initio* on approval both by an empowered independent, disinterested committee of directors *and* by a fully informed majority of the minority stockholders is . . . entitled to deference under the business judgment rule."[3] The *M & F Worldwide* court determined that, when both of these protections are in place, a controlling stockholder "transaction becomes, in effect, an unconflicted, arm's-length transaction."

Here, the transaction at issue "involve[d] the acquisition of [Cornerstone] by a controlling stockholder, negotiated by a special committee and recommended to the minority by the board of directors, but not at the outset of negotiations made contingent on a non-waivable condition requiring the approval of a majority of the minority stockholders." Finding that the complaint "adequately alleges that the [m]erger was not entirely fair to the minority," the Chancery Court determined that "the transaction is subject *ab initio* to entire fairness review."

Chancery Court Denies Disinterested Directors' Motion to Dismiss, Finding No Obligation for Plaintiffs to Plead a Breach of a Non-Exculpated Fiduciary Duty

The Chancery Court then turned to the central issue in dispute: the applicable "pleading standard for *disinterested directors* charged with a breach of fiduciary duty in connection with" a controlling stockholder transaction subject to the entire fairness standard of review. The court framed the question as follows: "must specific facts raising an inference of a non-exculpated breach be pled with respect to each director defendant, or is it enough at the motion-to-dismiss stage to have pled that a disinterested director facilitated a transaction with a controller that was not entirely fair"?

Plaintiffs contended that, "where the applicable standard of review is entire fairness," courts should not dismiss breach of fiduciary duty claims against disinterested directors "based on a plaintiff's failure to plead a non-exculpated breach of duty . . . because entire fairness review exists, in part, to allow for thorough discovery and fact-finding in order to uncover possible violations of the duty of loyalty by facially independent directors who may be unduly influenced by a controller." *In re Cornerstone Therapeutics Inc. Stockholder Litig.*, 2014 WL 4418169 (internal quotation marks omitted). Defendants, on the other hand, "argue[d] that the pleading standard for an interested fiduciary in a case subject to entire fairness cannot logically be applied to disinterested directors alleged to have breached a duty." Defendants contended "that particularized pleadings are required that, if true, raise an inference that such director[s] breached a non-exculpated duty."

The Chancery Court explained that it was

3. Please click here to read our discussion of the *M & F Worldwide* decision in the March 2014 edition of the Alert.

constrained by the Delaware Supreme Court's ruling in *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001). There, the court held that, "'when entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only *after the basis* for their liability has been decided,' that is, upon a fully-developed factual record and a determination of whether the transaction was entirely fair." *In re Cornerstone Therapeutics Inc. Stockholder Litig.*, 2014 WL 4418169 (quoting *Emerald Partners*, 787 A.2d 85).

Applying *Emerald Partners*, the Chancery Court found that plaintiffs had "made a sufficient pleading that a stockholder controlled the corporate machinery; that it used that machinery to facilitate a transaction of which it thus stood on both sides; that the transaction was not entirely fair to the minority; and that the [disinterested directors had] negotiated or facilitated the unfair transaction." The court held that "[s]uch a pleading is sufficient, under controlling precedent, to withstand a motion to dismiss" by the disinterested directors. The court explained that, "[o]nce the question of entire fairness is resolved after trial, and if [the court] find[s] the transaction not entirely fair, then the issue of whether the [disinterested directors] breached a non-exculpated duty may be addressed."

Chancery Court Expresses Concerns About the Policy Implications of Its Decision

Notably, the Chancery Court found defendants' argument was "by no means without persuasive force." The court observed that "doctrinally it seems insufficient to simply plead that [ ] a director has participated in a transaction with a controller and thus an inference of disloyalty arises sufficient to sustain a complaint against her." The court reasoned that this type of "automatic inference . . . makes service on a special committee risky, and thus unattractive to qualified and disinterested directors." Such an inference "creates an incentive [for disinterested directors] to reject entering negotiations with controllers," which could ultimately "cost minority stockholders value."

Nevertheless, the Chancery Court expressed its view that "[t]he rule advocated by the [p]laintiffs"—and adopted by the court—"also has advantages." The court explained that "[c]ontroller transactions are the corporate transactions where the possibility of divided director loyalties, often cryptic and unknowable at the pleading stage, is of greatest concern." The court found that "[h]olding directors who negotiated or facilitated the transaction as defendants until a post-trial determination of entire fairness has been made, for purposes of determining at that point whether those defendants have breached non-exculpated fiduciary

duties, will undoubtedly result in justice being done in cases" involving "faithless directors."

The court found that it was not "free to make a policy determination" in the case before it because "controlling precedent require[d] [the court] to deny" the disinterested directors' motion to dismiss.

Chancery Court Grants Defendants' Motion for an Interlocutory Appeal

In a letter opinion dated September 26, 2014, the Chancery Court granted defendants' motion for an interlocutory appeal pursuant to Delaware Supreme Court Rule 42. The court explained that "[a] Rule 42 interlocutory appeal may be certified by this [c]ourt only when the appealed decision (1) 'determines a substantial issue,' (2) 'establishes a legal right,' and (3) meets one or more criteria further enumerated in the Rule, including that the decision falls under any of the criteria for certification of questions of law set forth in Rule 41" (quoting Del. Supr. Ct. R. 42(b)). The court found that all three requirements were met here.

First, the Chancery Court determined that its decision "constitutes a substantial issue in the course of this litigation" because its "determination, if reversed, could lead to the dismissal of the [disinterested director defendants] from this litigation." Second, the court found that its decision "establishes a legal right in that it necessitates [that the disinterested director defendants] be held as parties to the litigation, unable to assert their Section 102(b)(7) defense, at least until a determination of entire fairness at trial."

"Finally," the court concluded that its "ruling satisfies the criteria enumerated in Rule 42(b)(i) by meeting the '[c]onflicting decisions' qualification for certification of questions of law set forth in Rule 41(b)(ii). The court noted that there are "conflicting" Chancery Court decisions "on the determinative question of law" at issue here.[4]

The Chancery Court declined to stay the proceedings pending the Delaware Supreme Court's consideration of the appeal.

4. The court compared *DiRienzo v. Lichtenstein*, 2013 WL 5503034 (Del. Ch. Sept. 30, 2013) ("To burden the Special Committee with proving entire fairness, [plaintiff] must allege sufficiently that the committee members breached a non-exculpated fiduciary duty. This inquiry necessarily requires consideration of the Company's 102(b)(7) provision."), and *In re S. Peru Copper Corp. S'holder Derivative Litig.*, 52 A.3d 761 (Del Ch. 2011) (dismissing disinterested directors on summary judgment based on a Section 102(b)(7) provision because "[t]he entire fairness standard ill suits the inquiry whether *disinterested* directors who approve a self-dealing transaction and are protected by an exculpatory charter provision authorized by *8 Del. C.* § 102(b)(7) can be held liable for breach of fiduciary duties"), with *In re Orchard Enterprises, Inc. S'holder Litig.*, 88 A.3d 1 (Del. Ch. 2014) ("[W]hen a case involves a controlling stockholder with entire fairness as the standard of review, and when there is evidence of procedural and substantive unfairness, a court cannot summarily apply Section 102(b)(7) on a motion for summary judgment to dismiss facially independent and disinterested directors.").

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