SIMPSON THACHER

SECURITIES LAW ALERT

APRIL 2014

This month's Alert addresses the oral arguments before the Supreme Court in two cases: *Fifth Third Bancorp v. Dudenhoeffer* (No. 12-751), in which the Court is considering the presumption of prudence for employee stock ownership plan (ESOP) fiduciaries under the Employee Retirement Income Security Act of 1974 (ERISA); and *Loughrin v. United States* (No. 13-316), in which the Court is reviewing the elements of a claim under 18 U.S.C. § 1344(2), the federal bank fraud statute.

We also discuss the Supreme Court's grant of certiorari in *Dart Cherokee Basin Operating Company, LLC v. Owens* (No. 13-719), in which the Court will consider what a defendant must establish in order to remove a state court action to federal court. The Court will address whether a defendant must include evidence supporting federal jurisdiction in the notice of removal, or whether it is sufficient for the defendant simply to set forth a "short and plain statement of the grounds for removal" as specified in the federal removal statute, codified at 28 U.S.C. § 1446(a).

Finally, we discuss two Delaware Chancery Court opinions addressing the standard for alleging bad faith-based breach of fiduciary duty claims. In *Chen v. Howard-Anderson*, 2014 WL 1366551 (Del. Ch. Apr. 8, 2014) (Laster, V.C.), the Chancery Court denied defendants' motion for summary judgment with respect to breach of fiduciary duty claims, holding that the "utterly failed to attempt" standard set forth in the Delaware Supreme Court's decision in *Lyondell Chemical Company v. Ryan*, 970 A.2d 235 (Del. 2009) (Berger, J.) does not govern all bad faith claims against Delaware directors. In *Houseman v. Sagerman*, 2014 WL 1478511 (Del. Ch. Apr. 16, 2014) (Glasscock, V.C.), the Chancery Court applied the *Lyondell* standard and granted defendants' motion to dismiss breach of fiduciary duty and aiding and abetting claims.

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Supreme Court Hears Oral Argument on the Presumption of Prudence for Employee Stock Ownership Plan (ESOP) Fiduciaries

On April 2, 2014, the Supreme Court heard oral argument in *Fifth Third Bancorp v. Dudenhoeffer* (No. 12-751),[1] a case in which the Court is considering the presumption of prudence for employee stock ownership plan[2] (ESOP) fiduciaries under the Employee Retirement Income Security Act of 1974 (ERISA).

Although the Court granted certiorari to address whether the presumption of prudence applies at the pleading stage, the Justices focused most of their questions on the rationale for the presumption of prudence and whether an ESOP fiduciary has any obligation to investigate or rely on inside information in managing plan assets. The Justices also queried whether there is any inherent conflict of interest in having corporate insiders serve as ESOP fiduciaries.

Fiduciary Duties Under ERISA

ERISA requires fiduciaries of employee benefit plans, including ESOPs, to manage the plans "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." 29 U.S.C. § 1104(a)(1)(B). ERISA fiduciaries must "discharge [their] duties with respect to a plan solely in the interest of the participants and beneficiaries." 29 U.S.C. § 1104(a)(1).

ERISA provides special exemptions for fiduciaries of eligible individual account plans, including ESOPs. For example, ESOP fiduciaries do not have to "diversify[ ] the investments of the plan so as to minimize the risk of large losses." 29 U.S.C. § 1104(a)(1), (2). Moreover, ESOP fiduciaries may invest more than 10% of the plan assets in employer securities and employer real property. 29 U.S.C. § 1104(a)(2); 29 U.S.C. § 1107(a), (b).

The Presumption of Prudence for ESOP Fiduciaries

In the seminal case of *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995) (Greenberg, J.), the Third Circuit considered the "difficult question" of when ESOP fiduciaries may "be held liable under [ERISA] for investing solely in employer common stock." The *Moench* court held that "an ESOP fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision." The court further ruled that a "plaintiff may overcome that presumption by

1. For a complete discussion of the case background and the lower court decisions in *Fifth Third Bancorp*, please click here to read our coverage of the Court's grant of certiorari in the January 2014 edition of the Alert.

2. An employee stock ownership plan is "an individual account plan … designed to invest primarily in qualifying employer securities." 29 U.S.C. § 1107(d)(6).

establishing that the fiduciary abused its discretion by investing in employer securities."

The Second, Fifth, Sixth, Seventh, Ninth and Eleventh Circuits have all adopted the *Moench* presumption of prudence. *In re Citigroup ERISA Litig.*, 662 F.3d 128 (2d Cir. 2011); *Kirschbaum v. Reliant Energy Inc.*, 526 F.3d 243 (5th Cir. 2008); *Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995); *White v. Marshall & Isley Corp.*, 714 F.3d 980 (7th Cir. 2013); *Quan v. Computer Scis. Corp.*, 623 F.3d 870 (9th Cir. 2010); *Lanfear v. Home Depot, Inc.*, 679 F.3d 1267 (11th Cir. 2012).

Five circuits—the Second, Third, Fifth, Seventh and Eleventh Circuits—have applied the presumption of prudence at the pleading stage. *Citigroup*, 662 F.3d 128; *Edgar v. Avaya Inc.*, 503 F.3d 340 (3d Cir. 2007); *Kopp v. Klein*, 722 F.3d 327 (5th Cir. 2013); *White*, 714 F.3d 980; *Lanfear*, 679 F.3d 1267. However, the Sixth Circuit has held that the presumption of prudence "does not apply at the motion to dismiss stage." *Pfeil v. State St. Bank and Trust Co.*, 671 F.3d 585 (6th Cir. 2012) (Anderson, J.). In the Sixth Circuit, "[p]laintiffs need only allege a fiduciary breach and a causal connection to losses suffered by the Plan" in order to state an ERISA claim against ESOP fiduciaries. *Dudenhoefer v. Fifth Third Bancorp*, 692 F.3d 410 (6th Cir. 2012) (Stranch, J.).

Oral Argument Highlights

Justices Question the Rationale for the Presumption of Prudence

As soon as Petitioners' counsel mentioned the presumption of prudence, Justice Kennedy immediately questioned the basis for the presumption. "You … want us to say that we have sort of a coach class trustee. We're all traveling in coach class when we have an ESOP."

Later, Justice Scalia queried: "why do you need a special rule [governing the duty of prudence] for ESOPs?" If ESOP fiduciaries can't be "expect[ed] … to outsmart the market" or "use [their] inside knowledge," then Justice Scalia questioned why the Court should "adopt a special law" for ESOP fiduciaries.

Petitioners' counsel defended the presumption by explaining that "the duty of prudence must take into account the character and aims of the enterprise," and "the purpose of an ESOP is to own company stock, to give the employees a piece of the rock."

Justice Ginsburg noted that "there is no presumption [of prudence] written into" ERISA. She observed that apart from the "exception from the diversification requirements" for ESOPS, "the statutory requirement on loyalty and prudence is undiluted." Justice Ginsburg stated: "I don't know where this presumption comes from. It's not in the statute itself." Petitioners' counsel responded that the presumption of prudence "comes from the duty of prudence itself which looks to the character and aims of the plan," and "an ESOP is defined in ERISA to be a plan that's designed to invest primarily in the employer's own stock."

Justice Alito asked whether ESOP fiduciaries must "take into account the interests of the participants as employees as opposed to their interests as investors." He noted that "there may be situations in which something that would be potentially good for the participants as investors would be quite bad for them as employees" because employees "want to keep their jobs" and "want the company to stay afloat."

Petitioners' counsel agreed that Justice Alito's point gets to "the bottom line that we think is correct here, which is that an ESOP is a special kind of pension plan, and the whole nature of it is to own company stock."

Justice Kennedy asked Petitioners' counsel to define the standard applicable to ESOP fiduciaries. He posited: "Let's assume that trustees in a non-ESOP[ ] plan have a duty to maximize returns and provide stable investments. Is it somehow different when it's an ESOP?" Petitioners' counsel responded that "the courts of appeals have had a fairly uniform approach to this for now almost 20 years." Under this approach, "when the plan requires that all the funds be invested in the ESOP … that's what the fiduciary must do, and that is presumptively prudent."

Petitioners' counsel underscored that "the special purpose of an ESOP is to give the employees a piece of the rock, ownership in the company" even "if the company is going through temporary hard times." Unless the Court "give[s] the ESOP fiduciary some leeway," ESOP fiduciaries will be caught between a "rock and [a] hard place." "[I]f the stock goes down under [an] open-ended duty of prudence, they're going to be sued for not having anticipated that and done something, sold, stopped trading, put out information." But on the other hand, "if they don't do it and the stock goes up, they're going to be sued for that" as well.

Chief Justice Roberts appeared to agree with the presumption of prudence: "[W]hat every Court of Appeals has recognized is that [purchasing company stock] is by definition prudent, because that is the settlor's objective." If, however, "the company's collapsing, well, then [the fiduciary] does have the obligation to do something. So I don't understand how you … can say that [the fiduciary] has breached a fiduciary duty of prudence when the people investing in [an ESOP] ought to know what they're going to get is the company's stock."

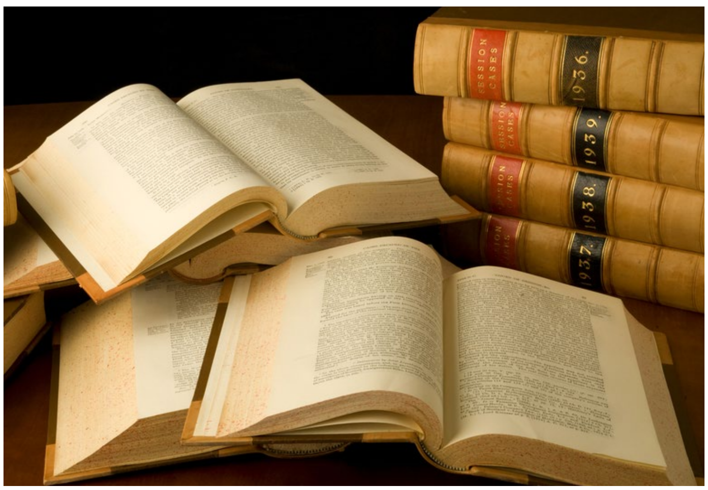
Justices Probe the Scope of an ESOP's Fiduciary's Duties When the Fiduciary Has Access to Adverse Nonpublic Information

Justice Kagan observed that "there are occasions" when the company is not in 'serious peril' but the stock is nonetheless "way, way, way overvalued relative to what the fiduciaries know is the company's actual value." She offered the example of a situation in which "the market price is four times more than the actual value, and the fiduciaries know that because of inside information that they have."

Petitioners' counsel responded that "when you get to that point of the analysis, … you have to bring in securities law, and you have to recognize [that] to trade on that inside information would violate securities laws." One of the "other options" would be to "halt trading," which "would not itself violate securities law." However, Petitioners' counsel stated that this "could do great damage to the participants … if the company's own ESOP said, well, we think something is so wrong that we're shutting down" further purchases.

Justice Kagan seemed unconvinced. She noted that "a prudent manager might say that it would do greater damage to … keep putting more and more of [participants'] retirement investments into something that is really overvalued."

Justice Kennedy asked whether ESOP fiduciaries are "allowed to take into account the impact of a decision to stop buying on the beneficiaries." Chief Justice Roberts similarly questioned "what exactly, [in] concrete terms" a trustee should do with "inside information that says that the stock is overvalued." Should a trustee sell, "[i]n which case the beneficiaries' holdings go way down and they sue [the trustee]"? Or should the trustee not sell, "[i]n which case when the information comes out, the beneficiaries sue [the trustee] because their value goes down."



Justice Sotomayor asked why ESOP fiduciaries should not simply "follow[ ] the law and disclos[e] that material information to the public and stop[ ] … the employees from losing more money in worthless stock." Petitioners' counsel answered that the Court must "consider this in connection with securities law" and stated that imposing a disclosure requirement on ESOP fiduciaries "would be quite a big change in ERISA." Such a disclosure requirement "would create [a] new sort of general ERISA duty to provide information when it's not spelled out in ERISA."

Justice Sotomayor asked what would be "wrong with a rule that simply says a fiduciary has to do whatever … possible to protect beneficiaries within the bounds of the law?" Under such a rule, "if the law required you to disclose it, and you didn't, you've breached your duty of prudence and of loyalty, because you've protected the company." Petitioners' counsel responded that this "would create serious problems" because you would then have "two sources of information about the company, the ESOP fiduciary … and the company, which could create great confusion."

Justice Breyer questioned whether the Court could simply hold that an ESOP fiduciary "has an obligation to act prudently in respect to … the beneficiaries" but "he cannot, irrespective of that, have an obligation to use inside information." He pointed out that "[t]here is no rule of trust or ERISA law that [says] you can breach a duty to a beneficiary by failing to use inside information, period."

Justice Alito questioned Respondents' counsel whether "the trustee has a duty to acquire inside information." Respondents' counsel answered that "the duty of the trustee is to behave as a prudent fiduciary would behave, and if the trustee is unable to do that because the trustee has conflicting interests to serve, then the trustee is violating the duty of loyalty and should arrange the situation differently." Respondents' counsel further stated that "if the trustee does not undertake the investigation that a prudent fiduciary would take, because of their concern about acquiring insider information of the employer, then they would violate the ordinary standard of prudence."

Justice Kennedy queried whether the Court has been asked to "decide what the fiduciary standard is … without regard to inside information" or whether the "key issue in the case" is the fiduciary's obligation to act on inside information. Counsel for the United States, as Amicus Curiae, answered that "in this case" the question of an ESOP fiduciary's use of inside information "is the key issue." He stated that "[w]e are focused here on inside information that materially enhances the value of the stock, overvalues it, and in that situation, we think that a fiduciary of an ESOP, just like the fiduciary of any other plan, … has a duty of prudence not to remain invested in or to purchase materially overvalued stock."

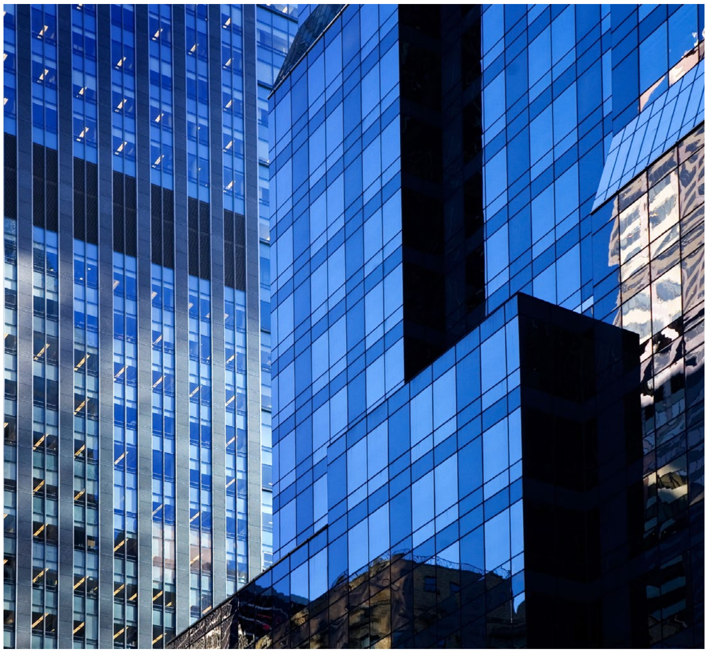
Justices Consider Whether Corporate Insiders Should Serve as ESOP Fiduciaries

Justice Kennedy asked whether it is "a very common practice for the directors and officers of the company themselves to be the trustees." He stated that he "had just assumed that that didn't happen much anymore." Justice Kennedy observed that "a lot of these problems would be taken care of, insider information and so forth, if there was an outside trustee."

Petitioners' counsel responded that "it is common to have the officers of the company" serve as ESOP fiduciaries, and explained that the reason is "not just to save money." Rather, "it's a very important part of what the company does, and they want to have their top people running it."

Respondents' counsel emphasized the potential conflicts that may arise when a corporate insider also serves as an ESOP fiduciary, and claimed that "the trustees in this case undertook to represent conflicting interests." "[E]ssentially, what the petitioners are saying is, if I decide to put myself in a position where I owe duties to two different people, my employer on the one hand and the beneficiaries of the plan, because I've put myself in a conflicted situation, it's perfectly right for me to just do nothing." Respondents' counsel argued "[t]hat's not the way it works."

Justice Alito asked Respondents' counsel whether it was Respondents' position that "you never should have insiders serving as trustees; you always have to have an outside[r] running these ESOPS?" Respondents' counsel said that in other corporate contexts, when directors' "interests patently diverge from the interests of the shareholders, they don't simply decide to represent both interests … They instead step aside and appoint … independent people to represent the shareholders." Justice Alito stated that what Respondents' counsel was "basically saying [is] that if it's not flatly prohibited, it is very unwise. … You're putting yourself in an impossible situation if you're an insider and you're going to serve as trustee of an ESOP." Respondents' counsel stated that "[t]here is nothing in the statute" nor any other "reason that these funds need to be managed by insiders."



Justice Sotomayor appeared to agree with Respondents' position. She stated: "If you're going to place someone" as an ESOP fiduciary "who comes to inside knowledge, you're going to create potentially a problem." A company that chooses to appoint an insider as an ESOP fiduciary creates "a self-induced problem, not one that the law should excuse [the company] from following whatever the law is."

Petitioners' counsel cautioned the Court against "interpreting these [fiduciary] duties in ways that will make ESOPs unworkable, and … that would basically cause many companies to say we can't put fiduciaries in that situation, so we're not going to have ESOPs at all."

* * *

The Court is expected to issue a decision in the *Fifth Third* case later this term.

Supreme Court Hears Oral Argument on the Elements of a Bank Fraud Claim under 18 U.S.C. § 1344(2)

On April 1, 2014, the Supreme Court heard oral argument in *Loughrin v. United States* (No. 13-316),[3] a case in which the Court is considering what the Government must prove in order to establish a claim under subsection (2) of 18 U.S.C. § 1344, the federal bank fraud statute. The question presented is "[w]hether the Government must prove that the defendant intended to defraud a bank and expose it to risk of loss in every prosecution under 18 U.S.C. § 1344."

Petitioner argued that "a scheme to defraud someone is not converted into bank fraud" under 18 U.S.C. § 1344(2) "simply because the defendant obtains the victim's funds from a bank account or otherwise uses a bank in a way that poses no risk to the bank's own financial or property interests." Brief for the Petitioner, *Loughrin v. United States of America* (No. 13-316), 2014 WL 333882 (Jan. 27, 2014). However, the Government contended that 18 U.S.C. § 1344(2) requires neither an "intent to defraud a bank" nor "proof of a 'risk of financial or other property loss to a bank.'" Brief for the United States, *Loughrin v. United States of America* (No. 13-316), 2014 WL 828053 (Feb. 26, 2014).

Based on the Justices' questions during oral argument, the Justices seemed unconvinced by either side's position. The Justices indicated that the Government's interpretation of § 1344(2) would allow the statute to reach virtually every "bad check" case, while Petitioner's position would render § 1344(1) mere surplusage.

3. For a complete discussion of the case background and the lower court decisions in Loughrin, please click here to read our coverage of the Court's grant of certiorari in the January 2014 edition of the Alert.

The Federal Bank Fraud Statute

The federal bank fraud statute provides as follows:

> Whoever knowingly executes, or attempts to execute, a scheme or artifice—
>
> (1) to defraud a financial institution; or
>
> (2) to obtain any of the moneys, funds, credits, assets, securities, or other property owned by, or under the custody or control of, a financial institution, by means of false or fraudulent pretenses, representations, or promises;
>
> shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.

18 U.S.C. § 1344 (2012).

Oral Argument Highlights

Justices Suggest Petitioner's Interpretation Renders Section 1344(1) "Surplusage"

Petitioner's counsel began by arguing that the Government's "broad interpretation of the Federal bank fraud statute threatens to sweep in a garden variety State law crime." Petitioner offered as an example the Government's reliance on Section 1344(2)

to "prosecute[ ] people whose only relationship to a bank is that they tricked a third party into issuing them a perfectly valid check, which the defendant then cashed at a bank."

Petitioner's counsel contended that "there is an ambiguity in [Section 1344(2)] about to whom the false representation must be directed," and argued that the Court should resolve that ambiguity by requiring that the representation must be directed to a bank. Justice Alito agreed that Petitioner's counsel had presented "a credible textual argument" but found that Petitioner's suggested "interpretation makes … [Section 1344(1)] surplusage." Justice Alito stated that if Section 1344(2) "requires that the representation be made to the bank, there is no point in having two subsections. You might as well just have one." Justice Ginsburg raised the same concern with Petitioner's position: "[Y]ou are essentially asking us to read the word 'or,' '(1) or (2)' to mean (1) including (2)."

Justices Indicate Government's Interpretation of Section 1344(2) Is Overbroad

At the outset of the Government's argument, Justice Kagan presented the following hypothetical:

> [I]f I sell a painting to somebody and I represent it to be by a famous artist and in fact I've just made it in my kitchen, and that person pays me with a check and it's a perfectly valid check, it's a good check, the fraud is obviously as to the person who's just bought the painting. It has nothing to do with the bank. But your interpretation would cover that case as well.

Counsel for the Government agreed, explaining that "Congress specified in clause (2) that the scheme to obtain money or property from the bank has to be by means of a false or fraudulent pretense, but it doesn't specify to whom that false or fraudulent pretense must be made."

Justice Kagan found the Government's position "a little bit peculiar" because in the hypothetical she presented, "the [G]overnment can't prosecute the person" if "somebody pays … in cash" but "[i]f somebody pulls out a check, the [G]overnment can." She observed that this difference in outcome "doesn't seem to make a whole lot of sense in terms of what the statute is about." Justice Sotomayor appeared to agree, noting that "here the bank is not the victim … In these con-artist cases, the bank is incidental."

Justice Kennedy stated that the Government's interpretation would "federalize[ ] every fraudulent transaction in the economy whenever a check is involved." Similarly, Justice Scalia noted that the Government's interpretation would "extend Federal law enormously into the kind of stuff that we've usually left to the States."

Justices Consider the Government's Fallback Position

The Justices then turned to the Government's fallback position, pursuant to which Section 1344(2) would only reach "false or fraudulent statements [that] would foreseeably or inherently be directed to the bank and have the potential to influence its actions." Brief for the United States, 2014 WL 828053.

Justice Kennedy agreed that the Government's fallback position "substantially narrows the statute" because "it takes out of the equation schemes to defraud where the bank is not going to be liable." However, Justice Kennedy asked the Government's counsel to provide the Court with some basis or authority for adopting its proposed fallback position. "[I]s there a case you can cite to us that says we have a duty to save poorly drawn statutes by a sensible amendment?" Counsel for the Government answered that "the hook" for the Court to adopt its fallback position is that Section 1344(2) "leaves open [the question of] to whom [the] false or fraudulent communication must be directed." Counsel for the Government suggested that "in light of the history and in light of what Congress's main intent was here," the Court could "read the statute as saying, ah, Congress actually in clause 2 was concerned with … the means that are directed to the bank."

Justice Scalia asked whether Section 1344(2) does "anything that (1) doesn't do" under the Government's fallback position. Counsel for the Government answered that "[b]oth clauses … cover things that the others will not." Counsel for the Government further argued that Section 1344(2) "covers schemes like [the present case], where you can argue maybe you didn't intend to defraud the bank itself, but you used false or fraudulent means that would inherently go to the bank because of the nature of the means themselves."

Justice Alito asked what the Government would "have to prove in an altered check case" under Section 1344(2) if the Court adopted the Government's fallback position. "[W]ould this require delving into the defendant's knowledge of the legal relationship between the merchant … and the bank?" Counsel for the Government agreed that it was "inevitabl[y] … going to come to that."

Justice Kagan seemed unconvinced by either side's interpretation of the statute: "[I]f we go with [Petitioner's interpretation], we read a statute in a way we wouldn't normally." However, "if we go with [the Government's interpretation], we have to read [differently] … two statutes that say the same thing" (the bank fraud statute and the mail fraud statute) even though "we know Congress meant to say the same thing" in both statutes. Counsel for the Government agreed that the bank fraud statute was "modeled on the mail fraud statute," but emphasized that "Congress modified the text [of the mail fraud statute] itself" when enacting the bank fraud statute.

* * *

The Court is expected to issue a decision in the *Loughrin* case later this term.

Supreme Court Grants Certiorari to Consider What a Defendant Must Establish in Order to Remove an Action to Federal Court under 28 U.S.C. § 1446(A)

28 U.S.C. § 1446(a) provides in relevant part that a defendant "desiring to remove any civil action from a State court shall file in the district court of the United States for the district and division within which such action is pending a notice of removal … containing a short and plain statement of the grounds for removal, together with a copy of all process, pleadings, and orders served."

On April 7, 2014, the Supreme Court granted certiorari to determine "[w]hether a defendant seeking removal to federal court" under 28 U.S.C. § 1446(a) "is required to include evidence supporting federal jurisdiction in the notice of removal," or whether it is enough for the defendant simply to allege a "short and plain statement of the grounds for removal" as set forth in the statute. *Dart Cherokee Basin Operating Company, LLC v. Owens* (No. 13-719).

Background

In October 2012, plaintiff Brandon W. Owens filed a putative class action in Kansas state court against Dart Cherokee Basin Operating Co., LLC ("DCBO") and Cherokee Basin Pipeline, LLC ("CBPL") alleging underpaid royalties. Plaintiff did not specify the amount of damages sought.

On December 5, 2012, defendants removed the suit to the District of Kansas under the Class Action Fairness Act of 2005 ("CAFA"), codified at 28 U.S.C. § 1332(d). CAFA provides that the federal courts "shall have original jurisdiction" over class actions where (1) there is diversity of citizenship between the parties;

(2) the proposed class consists of at least a hundred members; and (3) the amount in controversy exceeds $5 million, exclusive of interests and costs. 28 U.S.C. § 1332(d).

In their Notice of Removal, defendants explained that they had "undertaken to quantify the amount of additional royalties that would be owed if all or substantially all of the adjustments to royalties advanced by [p]laintiff were found to be required to be made." *Owens v. Dart Cherokee Basin Operating Co. LLC*, 2013 WL 2237740 (D. Kan. May 21, 2013) (Robinson, J.) "Based upon this calculation of [p]laintiff's putative class claims," defendants asserted that "the amount of additional royalty sought is in excess of $8.2 million." However, defendants did "not offer any documentation or affidavits explaining how they reached this calculation."

Plaintiff moved to remand the action. In response, defendants submitted a declaration from Charles E. Henderson, Vice President of Legal Affairs and General Counsel for DCBO, and Manager of CBPL. Henderson's declaration "further outline[d] the calculations initially conducted" in substantial detail, and included a spreadsheet setting forth the damages analysis. Plaintiff did not contest defendants' calculation, but claimed that the Notice of Removal was "deficient as a matter of law" because

it contained "no evidence" but "only a bare allegation that the amount in controversy exceeds the statutory requirement." According to plaintiff, this alleged defect could not "be cured" by the submission of evidence in response to the motion to remand.

District of Kansas Remands Action to State Court, Finding Defendants' Notice of Removal Inadequate

On May 21, 2013, the District of Kansas granted plaintiff's motion to remand. The court found that under Tenth Circuit precedent, "the amount in controversy must be affirmatively established on the face of either the [P]etition or [N]otice of [R]emoval." If "the jurisdictional amount is not shown by the allegations of the complaint," the "burden is on the party requesting removal to set forth, in the [N]otice of [R]emoval itself, the 'underlying facts supporting [the] assertion that the amount in controversy exceeds'" the jurisdictional minimum. The court noted that it "narrowly construes removal statutes, and all doubts must be resolved in favor of remand."

Here, the court found it significant that defendants had "fail[ed] to incorporate any evidence supporting [their] calculation [of damages] in the Notice of Removal, such as an economic analysis of the amount in controversy or settlement estimates." The court held that "in the absence of such evidence, the general and conclusory allegations of the Petition and Notice of Removal do not establish by a preponderance of the evidence that the amount in controversy exceeds $5 million."

The court next considered whether defendants could "rely on factual allegations not contained in the Notice of Removal, subsequently submitted with their response as 'additional support' in an attempt to meet their jurisdictional burden." The court found that "reference to factual allegations or evidence outside of the [P]etition and [N]otice of

[R]emoval is not permitted to determine the amount in controversy."

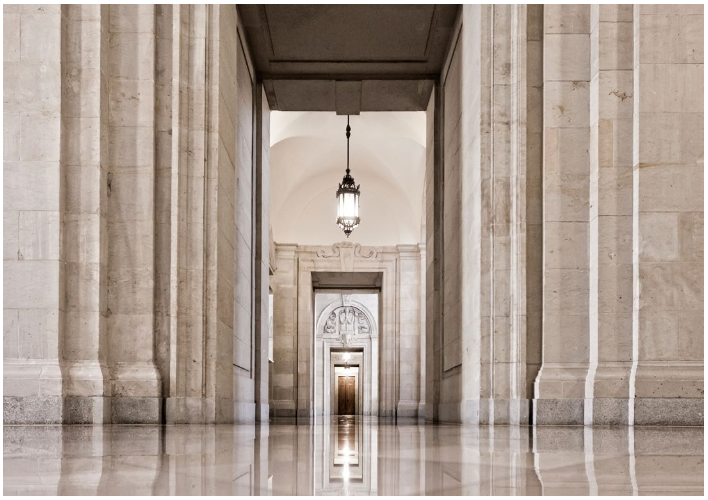
Tenth Circuit Denies Leave to Appeal; Four Dissenting Tenth Circuit Judges Express Their View That 28 U.S.C. § 1446(a) Requires Only a "Short and Plain Statement of the Grounds for Removal"

Defendants attempted to appeal the district court's ruling. However, the Tenth Circuit denied defendants' request for permission to appeal, and also rejected defendants' petition for en banc review of the Tenth Circuit's denial of leave to appeal. *Dart Cherokee Basin Operating Co., LLC v. Owens*, 730 F.3d 1234 (10th Cir. 2013).

Circuit Judge Hartz, joined by Circuit Judges Kelly, Tymkovich, and Phillips, dissented from the Tenth Circuit's decision to deny defendants' petition for en banc review. The dissent found that "[t]he burden imposed by the district court on [defendants] was excessive and unprecedented." In the dissent's view, "a defendant seeking removal under CAFA need only allege the jurisdictional amount in its [N]otice of [R]emoval and must prove that amount only if the plaintiff challenges the allegation."

Citing a Circuit Split on the Requirements for Removal, Defendants Petition the Supreme Court for Certiorari

On December 13, 2013, defendants-petitioners ("Petitioners") petitioned the Supreme Court for certiorari to resolve the question of what a defendant must establish in order to remove a state court action to federal court under 28 U.S.C. § 1446(a). Petition for



Writ of Certiorari, *Dart Cherokee Basin Operating Co., LLC v. Owens* (No. 13-719), 2013 WL 6665192 (Dec. 13, 2013). Petitioners argued that their "removal petition would have turned out differently in the First, Fourth, Fifth, Seventh, Eighth, Ninth and Eleventh Circuits."

Petitioners emphasized that "[t]he plain language of Section 1446(a) establishes a notice-pleading standard for defendants' notices of removal." According to Petitioners, "Congress eliminated any evidentiary requirement [for removal petitions] in 1988," when it "repealed the requirement that defendants file a verified petition for removal."

Petitioners further argued that the Tenth Circuit's standard does not comport with the Supreme Court's holding in *Hertz Corp. v. Friend*, 559 U.S. 77 (2010). In *Hertz*, the Court held that "[t]he burden of persuasion for establishing diversity jurisdiction … remains on the party asserting it." 559 U.S. 77. The Court further stated that "[w]hen challenged on allegations of jurisdictional facts, the parties must support their allegations by competent proof."

Finally, Petitioners contended that the Tenth Circuit's holding undermines CAFA, which was designed to "broaden[ ] … federal court jurisdiction for class actions." Petition for Writ of Certiorari, 2013 WL 6665192. Petitioners emphasized that "there is no dispute that this case satisfies each of the substantive jurisdictional requirements under CAFA, including the $5 million amount in controversy threshold, and, therefore, is precisely the type of case Congress intended to qualify for federal jurisdiction."

Respondent Relies on 28 U.S.C. § 1446(c)'s "Preponderance of the Evidence" Requirement to Defend the Tenth Circuit's Approach

In opposition to the Petition for Writ of Certiorari, plaintiff-respondent ("Respondent") disputed the existence of a circuit split on the requirements under 28 U.S.C. § 1446(a), but contended that the key issue here was defendants' evidentiary burden under 28 U.S.C. § 1446(c). Brief in Opposition to Petition for Writ of Certiorari, *Dart Cherokee Basin Operating Co., LLC v. Owens* (No. 13-719), 2014 WL 709701 (Feb. 21, 2014). Respondent argued that the problem with Petitioners' Notice of Removal "was not the allegation under [28 U.S.C] § 1446(a), but the total lack of 'evidence' submitted with the [N]otice of [R]emoval to satisfy [28 U.S.C.] § 1446(c)."

28 U.S.C. § 1446(c)(2) provides as follows:

> If removal of a civil action is sought on the basis of the jurisdiction conferred by [S]ection 1332(a), the sum demanded in good faith in the initial pleading shall be deemed to be the amount in controversy, except that—
>
> (A) the notice of removal may assert the amount in controversy if the initial pleading seeks—
>
> > (i) nonmonetary relief; or
> >
> > (ii) a money judgment, but the State practice either does not permit demand for a specific sum or permits recovery of damages in excess of the amount demanded; and
>
> (B) removal of the action is proper on the basis of an amount in controversy asserted under subparagraph (A) if the district court finds, by the preponderance of the evidence, that the amount in controversy exceeds the amount specified in [S]ection 1332(a).

Respondent contended that if a plaintiff seeks "an unspecified money judgment," then 28 U.S.C. § 1446(c) requires that "the [N]otice of [R]emoval state the amount in controversy … *and* attach evidence from which the district court can find, by preponderance of the evidence, that the amount in controversy exceeds the jurisdictional minimum." According to Respondent, this requirement "ensures that the defendant, who, in class actions, is often the party with the evidence of the amount in controversy, presents that evidence at the earliest opportunity." An alternative approach would disadvantage the plaintiff, who would otherwise have "no evidence as to how defendant calculated the [jurisdictional] amount such that he can challenge it" in the motion to remand.

Respondent argued that "the submission of evidence to establish jurisdictional facts alleged in the notice of removal is 'proper removal practice' in the Tenth Circuit and elsewhere." For example, Respondent pointed out that in *Hertz*, 559 U.S. 77, the removing defendant had in fact "filed [a] detailed declaration with its [N]otice of [R]emoval to establish the amount in controversy necessary for federal court jurisdiction." Respondent noted that in cases where "the defendant does not have [jurisdictional] evidence, the defendant can seek discovery in the state court and then remove to federal court when it has the evidence, because, for class actions, there is no one (1) year limitation on removal."

* * *

The Court will hear oral argument in the *Dart Cherokee* case in October Term 2014.

Delaware Chancery Court Denies in Part Defendants' Motion for Summary Judgment in a Shareholder Class Action Arising out of the Occam Networks-Calix Merger

On April 8, 2014, the Delaware Chancery Court denied in part defendants' motion for summary judgment in a class action brought by shareholders of Occam Networks in connection with its acquisition by Calix. *Chen v. Howard-Anderson*, 2014 WL 1366551 (Del. Ch. Apr. 8, 2014) (Laster, V.C.). Notably, the court declined to apply the "utterly failed to attempt" standard set forth in the Delaware Supreme Court's decision in *Lyondell Chemical Company v. Ryan*, 970 A.2d 235 (Del. 2009) (Berger, J.). The Chancery Court found that the *Lyondell* standard does not govern all bad faith claims against Delaware directors, but only applies in cases where plaintiffs allege that the directors had consciously disregarded their known duties.

Background

In September 2010, Occam Networks announced its agreement and plan of merger with Calix, pursuant to which "each share of Occam common stock would be converted into the right to receive 0.2925 shares of Calix common stock and $3.83 in cash." Shareholders sought to enjoin the transaction. On January 24, 2011, the Chancery Court issued a preliminary injunction pending corrective disclosures. On February 22, 2011, after Occam made the required disclosures, Occam's shareholders voted in favor of the merger.

Plaintiffs pressed on with their suit against Occam's directors, alleging that defendants had "breached their fiduciary duties by (i) making decisions during Occam's sale process that fell outside the range of reasonableness and (ii) issuing a proxy statement for Occam's stockholder vote on the Merger (the 'Proxy Statement') that contained materially misleading disclosures and material omissions." On January 6, 2012, the Chancery Court granted class certification.

Following fact discovery, defendants moved for summary judgment. With respect to the sale process claims, defendants argued "as a matter of law that they did not breach their fiduciary duties by deciding to sell Occam to Calix." Alternatively, defendants "contend[ed] that they at most breached their duty of care and are therefore protected by the Exculpatory Provision." As to the disclosure claim, defendants claimed "as a matter of law that the disclosures in the Proxy Statement were accurate and the allegedly omitted information was either disclosed or immaterial."

Chancery Court Applies Enhanced Scrutiny Standard of Review

At the outset of its analysis, the court explained that "Delaware has three tiers of review for evaluating director decision-making: the business judgment rule, enhanced scrutiny, and entire fairness." The business judgment rule applies where the directors "were disinterested and independent." The enhanced scrutiny standard applies if the directors "faced potential conflicts of interest because of the decisional dynamics present." Finally, the entire fairness standard applies if there were "actual conflicts of interest such that the directors making the decision did not comprise a disinterested and independent board majority."

At the preliminary injunction phase, the Chancery Court had applied the enhanced scrutiny standard because of the "divergent interests" created by the fact that Occam shareholders were to be compensated partially in cash and partially in Calix stock. (At the time the merger was announced, "the relative value of the two components was approximately 49.6% cash and 50.4% stock.") The Chancery Court determined that the closing of the transaction did not "cause the standard of review to relax from enhanced scrutiny to the business judgment rule." The court explained that "[t]he specter that potential context-dependent or situationally specific conflicts may have undermined a board's decision does not dissipate just because a transaction has closed."

Chancery Court Finds the Record Supports an Inference That a Number of the Board's Sale-Related Decisions "Fell Outside the Range of Reasonableness"

Under the enhanced scrutiny test, "the metric for measuring fiduciary duties … is reasonableness." Applying this standard, the Chancery Court found that "the record supports an inference that certain [of the directors' decisions during the sales process] fell outside the range of reasonableness." Specifically, the court pointed to evidence that the Board had relied on a 24-hour market check right before the July 4th holiday, and had delivered an ultimatum to a potential competing bidder to make an offer within 24 hours. "When evaluated as a whole," the court determined that "the record supports a reasonable inference that the Board favored Calix at the expense of generating greater value through a competitive bidding process or by remaining a stand-alone company and pursuing acquisitions."

Defendants argued that the court should nevertheless grant summary judgment in their favor based on the Delaware Supreme Court's decision in *Lyondell*. There the Delaware Supreme Court considered breach of fiduciary duty claims in connection with a transaction governed under the enhanced scrutiny standard. The court held that the directors could be found liable for a breach of the duty of loyalty "[o]nly if they knowingly and completely failed to undertake their responsibilities." *Lyondell*, 970 A.2d 235. Rather than "questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sales price," the Delaware Supreme Court stated that "the inquiry should [be] whether those directors utterly failed to obtained the best sale price."

The Chancery Court found that *Lyondell* would have been dispositive had "plaintiffs in this case made the same legal argument that the *Lyondell* plaintiffs made, namely that the directors [had] consciously disregarded [their] known obligations." *Chen*, 2014 WL 1366551. Here, however, plaintiffs argued that "certain directors had interests that diverged from those of the common stockholders, that other directors faced the types of situational conflicts inherent in an enhanced scrutiny setting, and that there is evidence that the directors gave into those conflicts by steering Occam into a deal with Calix through a course of actions falling outside the range of reasonableness." Plaintiffs contended that

the court could therefore "draw the inference that the directors acted for reasons unrelated to the pursuit of the highest value reasonably available." The Chancery Court determined that "*Lyondell* does not speak to this theory" of liability.

The Chancery Court emphasized that *Lyondell* did not "establish[ ] a new standard that supplanted all the other means by which a plaintiff can attempt to show bad faith." While the *Lyondell* court "addressed the theory of consciously disregarding known duties," the *Lyondell* court "recognized that there [are] other theories of bad faith." The Chancery Court explained that "[t]he 'utterly failed to attempt' standard does not govern the question of whether the evidence supports a permissible inference that the directors acted with a purpose other than that of advancing the best interests of the corporation." Moreover, the court found that such a standard would not "fit well with Delaware's established standards of review" because it is "a linguistically extreme formulation." The court observed that "[i]f an attempt is all that matters, as the 'utter failure' tests suggest[s], then one can well wonder how a board ever could 'utterly fail' in the change of control setting."

In the case at hand, the Chancery Court held that plaintiffs could defeat defendants' motion for summary judgment "by citing evidence which … supports an inference that the directors made decisions that fell outside the range of reasonableness for reasons other than pursuit of the best value reasonably available, which could be no transaction at all." Applying this standard, the court found that "the factual record [does] not support a reasonable inference that any of the outside directors were motivated by a non-stockholder-related influence." The court determined that the outside directors had at most "exclusively breached their duty of care," and therefore "the Exculpatory Provision bars any monetary damages award." The court granted the outside directors' motion for summary judgment on the sale process claims.

As to the two officer defendants, however, the court found that plaintiffs had "cited evidence … that could support a reasonable inference of favoritism towards Calix consistent with their personal financial interests rather than the pursuit of maximal value for the stockholders." Because the exculpatory provision does not protect actions these directors took in their capacities as Occam officers, the court denied the officer directors' motion for summary judgment on the sale process claims.

Chancery Court Denies Defendants' Motion for Summary Judgment on the Disclosure Claims

Turning next to plaintiffs' disclosure claims, the court explained that the directors of a Delaware corporation must "disclose fully and fairly all material information within the board's control" when seeking stockholder approval of a merger transaction. Here, plaintiffs argued that defendants should have disclosed Occam's 2012 revenue projections in the Proxy Statement. Plaintiffs also contended that the Proxy Statement's description of management's 2011 projections was "inaccurate and misleading," and that the Proxy Statement "falsely described" the information provided to Occam's financial advisor for use in its fairness opinion. Finally, plaintiffs argued that "the Proxy Statement offered a misleading description of the sale process," particularly with respect to the discussion of "(i) Occam's early contacts with Calix; (ii) Occam's negotiations with [a potential competing acquirer]; and (iii) the 24-hour market check."

The Chancery Court denied defendants' motion for summary judgment as to all of plaintiffs' disclosures claims. The court found that it was "not clear at this stage whether the disclosure violations in the Proxy Statement resulted from a breach of the duty of loyalty or the duty of care," and therefore the court could not determine "whether and to what degree the Exculpatory Provision applies."

Delaware Chancery Court Dismisses Breach of Fiduciary Duty and Aiding and Abetting Claims in Connection with Healthport Technologies' Acquisition of Universata

On April 16, 2014, the Delaware Chancery Court granted defendants' motions to dismiss breach of fiduciary duty and aiding and abetting claims arising out of HealthPort Technologies' acquisition of Universata.[4] *Houseman v. Sagerman*, 2014 WL 1478511 (Del. Ch. Apr. 16, 2014) (Glasscock, V.C.). Although Universata's directors did not obtain a fairness opinion prior to the transaction, the court found no allegation that the directors had "utterly fail[ed] to undertake *any* action to obtain the best price for stockholders" as required under the Delaware Supreme Court's holding in *Lyondell Chemical Company v. Ryan*, 970 A.2d 235 (Del. 2009) (Berger, J.). The court further determined that KeyBanc Capital Markets' "agree[ment] to provide limited services in connection with the transaction, rather than the panoply of financial services—including a fairness opinion—it could have provided … [was] not sufficient to support the inference that KeyBanc knew the Universata Board was breaching its fiduciary duties in selling the [c]ompany and aided and abetted that breach."

4. The court did permit plaintiffs to proceed with their claims of improper diversion of merger consideration.

Background

In late 2010, HealthPort Technologies approached Universata concerning a possible acquisition. In March 2011, Universata's directors hired KeyBanc Capital Markets to advise the company with respect to the transaction. Because of expense concerns, Universata's Board "limited KeyBanc's engagement to assisting in due diligence and 'identifying additional parties that could have an interest in acquiring the [c]ompany." Universata's Board "considered obtaining a fairness opinion," but decided against requesting one from KeyBanc in view of "the exigencies of time and expense" involved. The Board also "decided not to employ independent financial consultants or other appraisers to determine the price to be offered in connection with the Merger or to consider the fairness of such price" based on cost concerns.

KeyBanc did not prepare a written presentation in connection with the merger, nor did it issue a formal fairness opinion. However, a KeyBanc investment banker did provide the Board with "his informal opinion that the merger price was within a range of reasonableness." On May 10, 2011, KeyBanc's directors approved a merger agreement with HealthPort Technologies. Since Universata's directors collectively owned approximately 55% of the company's voting shares, the Board did not conduct a shareholder vote prior to approving the transaction.

In September 2013, Universata shareholders brought a class action suit asserting breach of fiduciary duty claims against Universata's directors, and aiding and abetting claims against KeyBanc, among other claims. Defendants moved to dismiss.

Chancery Court Dismisses Breach of Fiduciary Duty Claims, Finding No Allegation That Universata's Directors "Utterly Failed" to Undertake Any Action to Obtain the Best Price for Shareholders

In view of Universata's exculpation provision and the fact that a majority of Universata's directors were disinterested in the merger, the Chancery Court explained that any breach of fiduciary duty claim against Universata's directors "must be premised on a breach of the duty of good faith." The court observed that "in the context of the sale of a company, a breach of the duty of good faith may be implicated *either* by a board's utter failure to attempt to satisfy its fiduciary duties … or by its 'intentionally act[ing] with a purpose other than that of advancing the best interests of the corporation,' for example by acting out of greed, hatred, lust, envy, revenge, shame, pride, or some other 'human motivation.'" *Id.* (quoting *Chen v. Howard-Anderson*, 2014 WL 1366551 (Del. Ch. Apr. 8, 2014) (Laster, V.C.)).[5] Here, plaintiffs did "not allege[ ]—or even argue[ ]—that in negotiating a sale of the [c]ompany the Universata Board [had] acted out of any interest other than maximizing stockholder value." Rather, plaintiffs advanced "as the sole basis for a finding of a breach of the duty of good faith" defendants' alleged knowing and complete failure to undertake their responsibilities in good faith.

The Chancery Court explained that under

the Delaware Supreme Court's decision in *Lyondell*, an "'extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties.'" *Id.* (quoting *Lyondell*, 970 A.2d 235). In the case before it, the court acknowledged that plaintiffs had "allege[d] several flaws in the sales process that might amount to a breach of the duty of care," including the Board's failure to obtain a formal fairness opinion from KeyBanc. While the allegations made it "clear that the Universata Board did not conduct a perfect sales process," the court found that Universata's directors did not "utterly fail to undertake *any* action to obtain the best price for stockholders." The court explained that "the Board contacted legal counsel; reached out to KeyBanc regarding its ability to issue a fairness opinion; determined that, due to the relative expense, it was not in the [c]ompany's best interest to obtain a fairness opinion; decided instead to hire KeyBanc to assist in shopping the [c]ompany and provide a more informal recommendation that HealthPort's offer was within a range of reasonableness; [and] received and considered bids from multiple interested bidders." The court determined that "[t]he facts alleged fall short of demonstrating bad faith."

The court also found it noteworthy that "the directors who approved the transaction had a significant economic stake in the transaction: together, they owned more than fifty percent of the [c]ompany."

5. Please see pages 13 through 16 for a discussion of the *Chen v. Howard-Anderson* decision.

Quoting its recent decision in *In re Answers Corp. Shareholders Litig.*, 2014 WL 463163 (Del. Ch. Feb. 3, 2014) (Noble, V.C.),[6] the court observed that "'a plaintiff's inability to explain a Board's motivation to act in bad faith may … be relevant to analyzing bad faith claims,' at least at the summary judgment stage." Here, plaintiffs did not even "attempt[ ] to suggest what could have caused these directors with substantial economic interests in the [c]ompany to utterly abandon their responsibilities to maximize value in selling the company." The Chancery Court concluded that plaintiffs' allegations "do not state a claim for breach of the duty of good faith."

Chancery Court Dismisses Aiding and Abetting Claims Against KeyBanc

The Chancery Court next considered plaintiffs' aiding and abetting claims against KeyBanc. The court explained that in order "[t]o state a claim for aiding and abetting breach of fiduciary duty, a plaintiff must demonstrate '(1) the existence of a fiduciary relationship; (2) a breach of the fiduciary's duty and (3) knowing participation in that breach by the nonfiduciary.'" Quoting its recent ruling in *In re Rural Metro Corp. Stockholders Litig.*, 2014 WL 971718 (Del. Ch. Mar. 7, 2014) (Laster, V.C.),[7] the court stated that "a third party knowingly participates in a breach of the duty of care if it 'knows that the board is breaching its duty of care and participates in the breach by misleading the board or creating the informational vacuum,' or otherwise 'purposely induce[s] the breach of the duty of care.'"

Here, the court found that there were no "allegations that KeyBanc [had] actively concealed information to which it knew the Board lacked access, or promoted the failure of a required disclosure by the Board." As to the fact that "KeyBanc agreed to participate in a transaction wherein it would not issue a fairness opinion," the court determined that this did "not demonstrate that KeyBanc knew the failure to obtain additional services would constitute a breach of the Board's duties." The court also pointed out that "KeyBanc's incentive to encourage such a breach [was] utterly lacking" because "[t]he more services KeyBanc provided to the [c]ompany, the more fees it would earn." Finally, the court emphasized that "there is no single way to sell a company" and "no single financial service is *required*." The court therefore held that plaintiffs had failed to state an aiding and abetting claim against KeyBanc.

6. Please click here to read our discussion of the *Answers Corp.* decision in the February 2014 edition of the Alert.

7. Please click here to read our discussion of the *Rural Metro* decision in the March 2014 edition of the Alert.

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