SIMPSON THACHER
SECURITIES LAW ALERT
MAY 2014

This month's Alert addresses a First Circuit decision affirming summary judgment for Credit Suisse First Boston on loss causation grounds in a securities fraud class action concerning America Online's 2001 merger with Time-Warner. In addition, we discuss a Fourth Circuit opinion holding that the Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) (Thomas, J.) does not apply to criminal actions brought under Section 10(b).

We also discuss two rulings from the Delaware courts: a Delaware Supreme Court opinion holding that board-adopted litigation fee-shifting bylaws may be permissible under Delaware law; and a Chancery Court decision declining to enjoin Sotheby's annual meeting based on its adoption and enforcement of a shareholder rights plan, or "poison pill." Finally, we address a ruling from the New York Appellate Division, First Department, holding that plaintiffs have no right to discovery in demand-refused derivative actions under either Delaware or New York law.

Earlier this month, in *City of Pontiac Policemen's and Firemen's Ret. Sys. v. UBS AG*, 2014 WL 1778041 (2d Cir. May 6, 2014) (Cabranes, J.), the Second Circuit held that the Supreme Court's decision in *Morrison v. National Australia Bank*, 561 U.S. 247 (2010) (Scalia, J.) precludes Section 10(b) claims involving securities purchased on a foreign exchange even if the securities at issue were cross-listed on a domestic exchange or plaintiffs executed a "buy order" for the securities in the United States. Please click here to read the Firm's memo on the *City of Pontiac* decision.

First Circuit Affirms Summary Judgment for Credit Suisse First Boston in AOL-Time Warner Class Action on Loss Causation Grounds

On May 14, 2014, the First Circuit affirmed the District of Massachusetts' grant of summary judgment in favor of Credit Suisse First Boston ("CSFB") in a shareholder class action arising out of CSFB's analyst coverage of the 2001 merger between America Online ("AOL") and Time-Warner. *Bricklayers and Trowel Trades Int'l Pension Fund v. Credit Suisse Sec. (USA) LLC*, 2014 WL 1910961 (1st Cir. May 14, 2014) (Howard, J.) (*Bricklayers II*). The First Circuit found "no abuse of discretion" in the district court's decision to exclude plaintiffs' expert testimony on loss causation.

The Securities Law Alert is edited by Paul C. Gluckow (pgluckow@stblaw.com/212-455-2653), Peter E. Kazanoff (pkazanoff@stblaw.com/212-455-3525) and Jonathan K. Youngwood (jyoungwood@stblaw.com/212-455-3539).

Background

The case concerns securities fraud claims brought by AOL shareholders alleging that CSFB had "fraudulently withheld relevant information from the market in its reporting on the AOL-Time Warner merger." Plaintiffs alleged that CSFB's analysts had "misrepresented their true opinions … in order to maintain a good relationship with AOL" because it "had the potential to generate significant investment banking revenue for CSFB." Plaintiffs further contended that as a result of these allegedly "purposeful omissions," they "purchased stock in the new company at prices that were artificially inflated."

To establish loss causation, plaintiffs proffered an event study conducted by Dr. Scott D. Hakala. Defendants moved to exclude Dr. Hakala's event study as unreliable under *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579 (1993).[1] In January 2012, the District of Massachusetts ruled that Dr. Hakala's event study was inadmissible in light of "the pervasiveness of Dr. Hakala's methodological errors and the lack of congruity between his theory and the data." *Bricklayers and Trowel Trades Int'l Pension Fund v. Credit Suisse First Boston*, 853 F. Supp. 2d 181 (D. Mass. 2012) (Gorton, J.). Specifically, the court found that Dr. Hakala had "1) studie[d] the wrong days, 2) overuse[d] so-called 'dummy variables,' 3) disregard[ed] prior disclosures and 4) fail[ed] to control for confounding factors."

The district court further determined that even if Dr. Hakala's study was admitted into evidence, it would not raise a triable issue of fact on loss causation. The court observed that "the 'tangle of factors' affecting AOL's stock price during the Class Period was akin to the Gordian knot," in part because "AOL was covered extensively by over 40 investment firms." While "Dr. Hakala's event study purport[ed] to disentangle those factors and pinpoint

1. The *Daubert* Court stated that "the Rules of Evidence … assign to the trial judge the task of ensurng that an expert's testimony both rests on a reliable foundation and is relevant to the task at hand. Pertinent evidence based on scientifically valid principles will satisfy those demands." *Daubert*, 509 U.S. 579.

with precision the effect of defendants' alleged fraud on AOL's stock price," the court found "three infirmities in Dr. Hakala's methodology." "First, Dr. Hakala fail[ed] to link many of the events he label[ed] as corrective disclosures to the defendants' alleged fraud." "Second, … many of the so-called corrective disclosures did not include new information." "Third, … Dr. Hakala failed properly to isolate the extent to which the stock price deflation was caused by the disclosures and not by other confounding factors."

Based on its finding that plaintiffs had failed to establish loss causation, the court granted summary judgment in CSFB's favor. Plaintiffs appealed.

First Circuit Finds District Court Did Not Err in Precluding Dr. Hakala's Event Study

On appeal, the First Circuit found "no abuse of discretion" in the district court's decision to preclude Dr. Hakala's event study for lack of reliability. *Bricklayers II*, 2014 WL 1910961.

Unreliable Selection of Event Dates

The First Circuit agreed with the district court's determination that Dr. Hakala had "selected event dates based on unreliable criteria." The First Circuit

found that "[n]ot only did Dr. Hakala include many dates that bear no relationship to the allegations in the complaint," he also "in some instances … turned the complaint on its head, treating certain events as corrective when the complaint labeled them as inflationary." In the First Circuit's view, the event study seemed "more concerned simply with identifying abnormal market movement than in supporting the shareholders' causation allegations." The court determined that "[t]his complete disconnect between the event study and the complaint nullifie[d] the usefulness of Dr. Hakala's work."

Disregard of Prior Disclosures

The First Circuit concurred with the district court's finding that "several of the relevant events in Dr. Hakala's study [were] based on published references to information previously disclosed that, under an efficient market theory, would have already been incorporated into AOL's share price." Because plaintiffs had "established that AOL stocks traded in an efficient market in order to obtain class certification," the First Circuit agreed with the district court that plaintiffs "could not abandon that factual premise when proving loss causation."

Plaintiffs argued that there were disclosures on the event dates of "new information that was not contained in the original disclosures." However, the First Circuit found that "the disclosures made on the event dates … did no more than … provide [a] gloss on public information and thus permitted the district court to find that [the disclosures] would not have moved AOL's share price in an efficient market."

Failure to Disaggregate Confounding Factors

The First Circuit explained that "when conducting an event study, an expert must address confounding information that entered the market on the same day." In the case at hand, the First Circuit acknowledged that "Dr. Hakala faced a 'herculean task' in sorting through the continuous flow of information about AOL." However, the First Circuit "agree[d] with the district court … that Dr. Hakala did not establish any reliable means of addressing this problem." The First Circuit found that Dr. Hakala did not use the "tools at his disposal, such as intra-day trading analysis, to guide his analysis of confounding information." "Instead, he seemingly made a judgment call as to confounding information without any methodological underpinning." The First Circuit determined that "a subjective analysis without any methodological constraints does not satisfy the requirements of *Daubert*."

Overuse of Dummy Variables

Finally, as to "the district court's conclusion that Dr. Hakala [had] overused dummy variables," the First Circuit found that this "affects only the weight, and not the admissibility, of his event study." The court explained that "Dr. Hakala's event study sought to isolate the effect of the general market conditions on AOL's stock price," and he therefore excluded "material news dates" from his analysis. While "[o]ther market economists may disagree with the efficacy of this step," the First Circuit found that "Dr. Hakala's approach may not be inconsistent with the methodology or goals of a regression analysis."

The First Circuit also distinguished "two previous court opinions that disapproved of Dr. Hakala's use of dummy variables" because in those cases, Dr. Hakala had "dummied out dates on which 'any news' about the company appeared."[2] Here, however, there was no contention "that Dr. Hakala [had] dummied out every day in which AOL appeared in a news story."

2. *See In re Northfield Labs., Inc. Sec. Litig.*, 267 F.R.D. 536 (N.D. Ill. May 18, 2010) (Marovich, J.) (excluding Dr. Hakala's event study where he "excluded all dates on which he could find *any* news about Northfield"); *In re Xcelera.com Sec. Litig.*, 2008 WL 7084626 (D. Mass. Apr. 25, 2008) (Zobel, J.) (excluding Dr. Hakala's event study where he "use[d] 'dummy variables' for every date on which he claims there was any news at all about Xcelera that might have affected the stock price").

The First Circuit found that although "Dr. Hakala's use of dummy variables may … have artificially deflated the baseline volatility of AOL's stock in his regression analysis, it may be a dispute that should be resolved by the jury." Nevertheless, the First Circuit determined that it need not resolve the issue because the district court's other bases for excluding Dr. Hakala's testimony were "sound."

First Circuit Holds District Courts Need Not Parse Through Expert Testimony to Salvage the Admissible Portions

"Even conceding the aforementioned problems with Dr. Hakala's event study," plaintiffs maintained that Dr. Hakala's event study did identify "abnormal market movement, on certain key dates, that did not suffer from any methodological infirmities." Specifically, plaintiffs claimed that "[o]ut of fifty-seven event dates," there were "five 'key disclosures' that should [have] survive[d] the district court's order." Plaintiffs asserted that the district court had "abused its discretion by throwing out the good with the bad" in excluding Dr. Hakala's event study in its entirety.

The First Circuit acknowledged that "some reviewing courts have found abuses of discretion where trial courts rejected mostly salvageable expert testimony for narrow flaws." Here, however, the First Circuit explained that it "confront[ed] the reverse situation—pervasive problems with Dr. Hakala's event study that, allegedly, still leave a few dates unaffected." The First Circuit found that "[t]he district court did not abuse its discretion in treating the entire event study as inadmissible given the overwhelming imbalance between unreliable and reliable event dates."

The First Circuit explained that "[r]equiring judges to sort through all inadmissible testimony in order to save the remaining portions, however small, would effectively shift the burden of proof and reward experts who fill their testimony with as much borderline material as possible."

Fourth Circuit Rules *Janus* Does Not Apply to Criminal Actions under Section 10(b)

On May 7, 2014, the Fourth Circuit determined that the Supreme Court's holding in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) (Thomas, J.)[3] is "inapplicable outside the context of the [Rule] 10b-5 implied private right of action" and "does not extend to … criminal convictions." *Prousalis v. Moore*, 2014 WL 1799803 (4th Cir. May 7, 2014) (Wilkinson, J.) (*Prousalis II*).

Background

The case before the Fourth Circuit concerned a habeas petition brought under 28 U.S.C. § 2241 by a lawyer who had pled guilty to a conspiracy to commit securities fraud and aiding and abetting

3. Please click here to read our discussion of the *Janus* ruling in the June 2011 edition of the Alert.

securities fraud under Section 10(b) in connection with materially false statements in a client's IPO registration materials. The false statements "included the nature of the underwriting agreement between [the client's investment bank] and [the client], the use of proceeds from the IPO, and the fees paid to [defendant] in connection with the IPO." *Prousalis v. Moore*, 2013 WL 1165249 (E.D. Va. Mar. 20, 2013) (Gibney, Jr., J.) (*Prousalis I*).

Defendant argued that "his conduct of conviction [was] no longer criminal" in light of the Supreme Court's decision in *Janus*. *Prousalis I*, 2013 WL 1165249. The *Janus* Court held that "[f]or purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." *Janus*, 131 S. Ct. 2296. The Court emphasized that "[o]ne who prepares or publishes a statement on behalf of another is not its maker" within the meaning of Rule 10b-5.

Defendant contended that "under *Janus*, 'an adviser [such as himself] cannot be held liable under Section 10(b) … for statements made in a prospectus which the adviser participated in drafting, since an adviser is *not* the 'maker' of the statements.'" *Prousalis I*, 2013 WL 1165249. According to defendant, his client "exercised ultimate authority and control over its IPO, including its Registration Materials, the distribution of its prospectuses and its closing." Defendant argued that "only" his client and the client's officers and directors could be "liable for the statements made in the Registration Materials" under Section 10(b).

The Eastern District of Virginia denied defendant's § 2241 motion, finding that the *Janus* Court "had no intention of limiting criminal liability for securities fraud violations." The court explained that *Janus* "stemmed from a line of decisions limiting judicially created private causes of action" and "involved no discussion of criminal liability for securities fraud." Moreover, the court found that "aiding and abetting in the making of false statements in registration materials remains a crime" after *Janus*. Defendant appealed.

Fourth Circuit Finds *Janus* Applies Only to Private Actions under Section 10(b)

On appeal, the Fourth Circuit found that the *Janus* holding is "confined to cases invoking the implied private right of action" under Section 10(b) and Rule 10b-5. The Fourth Circuit observed that "[t]he *Janus* opinion itself makes clear the limits of its reach," insofar as it "established at the outset" that the Court had granted certiorari to determine whether an adviser could be "held liable *in a private action* under Rule 10b-5 for false statements included in [its client's] prospectuses." *Prousalis II*, 2014 WL 1799803 (quoting *Janus*, 131 S. Ct. 2296). The Fourth Circuit deemed it significant that the *Janus* Court had "relied heavily" on the Supreme Court's decisions in *Stonebridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148 (2008) (Kennedy, J.) and *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S.

164 (1994) (Kennedy, J.), both of which addressed the scope of private actions under Section 10(b) and Rule 10b-5.

In the Fourth Circuit's view, the *Janus* opinion "evinces a general desire to circumscribe implied causes of action" under Section 10(b) and Rule 10b-5. The *Janus* Court emphasized the need to "give 'narrow dimensions … to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.'" *Janus*, 131 S. Ct. 2296. The Fourth Circuit explained that these concerns are "absent when Congress has in fact acted." *Prousalis II*, 2014 WL 1799803. "Nowhere" in the *Janus* ruling "is there the suggestion that criminal sanctions for security fraud violations would be similarly imperiled," because "[e]xplicit congressional prohibitions simply operate in a different universe than the one inhabited by *Janus*."

The Fourth Circuit determined that applying *Janus* to the criminal convictions at issue in the case before it "would render the Supreme Court's discussion of private rights of action largely superfluous." Based on its determination that the *Janus* Court "gave not the slightest indication that its holding applied beyond the implied civil context," the Fourth Circuit affirmed dismissal of defendant's § 2241 motion.

Delaware Supreme Court Holds Board-Adopted Litigation Fee-Shifting Bylaws May Be Permissible under Delaware Law

On May 8, 2014, the Delaware Supreme Court responded to certified questions from the District of Delaware "concerning the validity of a [board-adopted] fee-shifting provision in a Delaware non-stock corporation's bylaws" pursuant to which unsuccessful plaintiffs in intra-corporate litigation would be held responsible for all attorneys' fees and costs incurred by the corporation. *ATP Tour, Inc. v. Deutscher Tennis Bund*, 2014 WL 1847446 (Del. May 8, 2014) (Berger, J.). The Delaware Supreme Court held that a board-adopted fee-shifting bylaw is "facially valid" under Delaware law. However, the court cautioned that the enforceability of a fee-shifting bylaw "depends on the manner in which it was adopted and the circumstances under which it was invoked."

Delaware Supreme Court Finds Board-Adopted Litigation Fee-Shifting Bylaws Facially Valid

The District of Delaware's "first certified question ask[ed] whether the board of a Delaware non-stock corporation may lawfully adopt a bylaw that shifts all litigation expenses to a plaintiff in intra-corporate litigation who 'does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought.'" The Delaware Supreme Court explained in order for a bylaw to be "facially valid," it "must be authorized by the Delaware General Corporation Law (DGCL), consistent with the corporation's certificate of incorporation, and its enactment must not be

otherwise prohibited."

The Delaware Supreme Court determined that "[n]either the DGCL nor any other Delaware statute forbids the enactment of fee-shifting bylaws." Moreover, the court found that a fee-shifting bylaw "appear[s] to satisfy the DGCL's requirement that bylaws must 'relat[e] to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.'" (quoting *8 Del. C.* § 109(b)). The court also noted that a "corporate charter could permit fee-shifting provisions, either explicitly or implicitly by silence."

Turning to Delaware common law, the court explained that "Delaware follows the American Rule, under which parties to litigation generally must pay their own attorneys' fees and costs." However, "contracting parties may agree to modify the American Rule and obligate the losing party to pay the prevailing party's fees." The Delaware Supreme Court found that a fee-shifting bylaw "would fall within the contractual exception to the American Rule" because "[c]orporate bylaws are 'contracts among a corporation's shareholders.'"

Delaware Supreme Court Cautions That the Enforceability of a Litigation Fee-Shifting Bylaw Depends on "the Circumstances Surrounding Its Adoption and Use"

Having determined that board-adopted fee-shifting bylaws are "facially valid," the Delaware Supreme Court then clarified that the enforceability of any particular fee-shifting bylaw "depends on the manner in which it was adopted and the circumstances under which it was invoked." The court stated that "[b]ylaws that may otherwise be facially valid will not be enforced if adopted or used for an inequitable purpose." Notably, the Delaware Supreme Court found that an "intent to deter litigation … is not invariably an improper purpose" and "would not necessarily render the bylaw unenforceable in equity."

Delaware Supreme Court Holds Bylaw Amendments Are Enforceable Against Members Who Joined the Corporation Prior to Its Enactment

The District of Delaware also certified to the Delaware Supreme Court the question of "whether a fee-shifting bylaw provision is enforceable against members who joined the corporation before the provision's enactment and who agreed to be bound by rules 'that may be adopted and/or amended from time to time.'" The Delaware Supreme Court answered in the affirmative, finding that "the fact that [a fee-shifting bylaw] was adopted after entities became members will not affect its enforceability."

The Delaware Supreme Court explained that "[t]he DGCL permits a corporation to, 'in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors.'" (quoting *8 Del. C.* § 109(a). "If directors are so authorized, 'stockholders will be bound by bylaws adopted unilaterally by their boards.'"

Delaware Chancery Court Declines To Enjoin Sotheby's Annual Meeting Based on Its Adoption and Enforcement of a Poison Pill

On May 2, 2014, the Delaware Chancery Court denied an activist hedge fund's motion to enjoin Sotheby's annual shareholder meeting based on the Board's adoption of a two-tiered rights plan (or "poison pill"), and the Board's subsequent denial of the hedge fund's request for a waiver of the plan's terms. *Third Point LLC v. Ruprecht*, 2014 WL 1922029 (Del. Ch. May 2, 2014) (Parsons, V.C.). The court found that the fund had not established "a reasonable probability of success on the merits of [its] claims."

Background

In late 2013, several hedge funds, including Third Point LLC, began simultaneously accumulating Sotheby's stock. Sotheby's financial advisors informed the Board that "it was not uncommon for activist hedge funds to form a group or 'wolfpack,' for the purpose of jointly acquiring large blocks of a target company's stock." At the suggestion of its advisors, Sotheby's adopted a two-tiered Shareholder Rights Plan in October 2013 pursuant to which passive investors eligible to file a Schedule 13G may acquire up to a 20% interest in Sotheby's.[4] All other stockholders, including Third Point and other activist hedge funds, may only acquire a 10% stake before triggering the Rights Plan.

In March 2014, Third Point requested that Sotheby's grant a waiver under the Rights Plan permitting Third Point to purchase up to a 20% stake in the company. At the time, Third Point owned nearly 10% of Sotheby's stock. When Sotheby's denied Third Point's waiver request, Third Point and its CEO ("plaintiffs") brought suit and moved to enjoin Sotheby's annual shareholder meeting. Among other claims, plaintiffs contended that the Sotheby's Board had "adopted and enforced the Rights Plan against Third Point for the primary purpose of inhibiting its ability to wage a successful proxy contest without any compelling justification for doing so."

Chancery Court Finds the *Unocal* Standard Applies

The Delaware Chancery Court found it "settled law that the Board's compliance with [its] fiduciary duties in adopting and refusing to amend or redeem the Rights Plan in this case must be assessed under" *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (Moore, J.). To satisfy the first prong of the *Unocal* test, a board must establish "reasonable grounds for believing that a danger to corporate policy and effectiveness existed" in the form of "a legally cognizable threat." "The second prong of *Unocal* is a 'proportionality test,'" pursuant to which a board must demonstrate that its "defensive response was reasonable in relation to the threat posed."

Court Finds Sotheby's Adoption of the Rights Plan Would Likely Pass Muster Under *Unocal*

The Chancery Court first considered plaintiffs' challenge to the October 2013 adoption of Sotheby's Rights Plan. Applying the first prong of the *Unocal* test, the Chancery Court found "sufficient support for the Board's assertion that its good faith investigation led it to determine that Third Point posed a legally cognizable threat." The court focused specifically on

4. Investors may only file a Schedule 13G if they have "not acquired the securities with any purpose, or with the effect of, changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having that purpose or effect." 17 C.F.R. § 240.13d-1(c).

the threat of "creeping control." At the time the Board adopted the Rights Plan, Third Point and several other hedge funds were simultaneously accumulating Sotheby's stock. Under the circumstances, the court explained that it was not objectively unreasonable for the Board to conclude that "Third Point posed a threat of forming a control block for Sotheby's with other hedge funds without paying a control premium."

The Chancery Court found no support for plaintiffs' argument that the Board had adopted the Rights Plan "for the *primary purpose* of interfering with the franchise of any stockholder, including Third Point." Moreover, the court determined that the Rights Plan itself is neither "coercive" nor "preclusive," since it "does not contain any features that would outright force a stockholder to vote in favor of the Board or allow the Board to induce votes in its favor through more subtle means." The Chancery Court therefore concluded that there was no basis for it to apply the heightened "compelling justification" standard articulated in *Blasius Industries, Inc. v. Atlas Corp*, 564 A.2d 651 (Del. Ch. 1988) (Allen, C.).[5]

Turning to the second prong of the *Unocal* test, the Chancery Court found "the Board has a reasonable probability of being able to show that the Rights Plan was a proportionate response to the control threat posed by Third Point." The court determined that the Board would "likely … be able to show that the Rights Plan's 10% trigger for activist stockholders is reasonable and proportionate" given that "the entire Board, collectively, owns less than 1% of Sotheby's stock" and Third Point, with its holding of just under 10%, is Sotheby's largest single stockholder. The court explained that "[a] trigger level much higher than 10% could make it easier for a relatively small group of activist investors to achieve control, without paying a premium, through conscious parallelism."

Plaintiffs argued that the Rights Plan was "disproportionate" insofar as it permitted "passive" investors to purchase 20% of the company's shares while allowing "activist" investors to purchase no more than 10%. The court found that "while the Rights Plan is 'discriminatory' in that sense, it is also arguably a 'closer fit' to addressing [Sotheby's] needs to prevent an activist … from gaining control than a 'garden variety' rights plan that would restrict the ownership levels for every stockholder, even those with no interest in obtaining control or asserting influence."

The court concluded that plaintiffs "have not demonstrated a likelihood of success on their claim that the Board breached its fiduciary duties in adopting the Rights Plan in October 2013."

Court Determines the Sotheby's Board's Refusal to Waive the 10% Trigger Is a "Closer Call," But Would Also Likely Meet the *Unocal* Standard

The Chancery Court next considered the Sotheby's Board's denial of Third Point's request for a waiver of the 10% trigger in the Rights Plan. For purposes of *Unocal*'s first prong, the court found that

5. The Chancery Court found that the *Blasius* standard only applies where "'the primary purpose of the board's action is to interfere with or impede exercise of the shareholder franchise and the shareholders are not given a full and fair opportunity to vote' effectively." *Third Point*, 2014 WL 1922029 (quoting *MM Cos. v. Liquid Audio, Inc.* 813 A.2d 1118 (Del. 2002)). Moreover, the court noted that neither the Delaware Supreme Court nor the Chancery Court has applied the *Blasius* standard in the context of a shareholder rights plan.

"the key inquiry" is "whether the Board determined there was an objectively reasonable and legally cognizable threat to the Company in March 2014 when Third Point made its waiver request." The court explained that "[t]his presents a much closer question than the Board's original decision to adopt the Rights Plan."

The court determined that "Sotheby's ha[d] made a sufficient showing as to at least one objectively reasonable and legally cognizable threat: negative control." Based on the available evidence, the court found that "Sotheby's may have had legitimate real-world concerns that enabling" entities such as Third Point "to obtain 20% as opposed to 10% ownership interests in [Sotheby's] could effectively allow those persons to exercise disproportionate control and influence over major corporate decisions, even if they do not have explicit veto power."

The court cautioned that "[t]he notion of effective, rather than explicit, negative control obviously raises some significant concerns, chief among them being where does one draw the line to ensure that 'effective negative control' does not become a license for corporations to deploy defensive measures unreasonably." Here, however, the court determined that Sotheby's had "an adequate basis for legitimate concern" because allowing Third Point to achieve 20% ownership would render it "Sotheby's largest single stockholder" by a large margin.

The court then turned to *Unocal*'s second prong, pursuant to which "the relevant inquiry is whether the Board's refusal to grant Third Point a waiver from the 10% trigger falls within the range of reasonableness." The court found that "[t]he refusal to waive the Rights Plan's 10% trigger level is consistent with the Board's stated purposes, and the operation of the Rights Plan at the 10% level would help the Board achieve that end." Although the court found it "conceivable that there is some level of ownership between 10% and 20% that the Board could have allowed Third Point to increase its stake in the Company to without allowing it to obtain negative control," the court emphasized that "the 10% cap must be reasonable, not perfect."

The court concluded that plaintiffs had "not established a likelihood of success on the merits of their claim that the Board [had] breached its fiduciary duties by refusing to allow Third Point in March 2014 to acquire up to 20% of the Company's stock."

Court Finds Third Point Made a "Marginal Showing of Imminent, Irreparable Harm"

Among other claims, Third Point contended that it would "suffer irreparable harm because its odds of winning the proxy contest [would] be reduced, if the Rights Plan remains in place as is." The Chancery Court found that this was a "close question," but determined that "Third Point's reduced odds of winning the proxy contest due to the Rights Plan likely would have qualified as a threat of irreparable harm, if Third Point had established a likelihood of success on the merits." The court explained that the proxy contest was "a 'dead heat,'" and thus "likely to be determined by a relatively thin margin." Therefore, the court found that "the threatened harm to Third Point is [not] so insubstantial as to render it speculative."

The court also explained that it "would have found that the balancing of the equities weighs slightly in favor of [Third Point's] request for injunctive relief." The court stated that "[p]rotection of the stockholder franchise is important in every instance, but it is of particular importance here, where Third Point is engaged in a hotly contested proxy fight with the Company and certain of the Company's directorships are at stake."

Nevertheless, because plaintiffs could not "satisfy their burden of showing a likelihood of success on the merits," the court denied their motion for a preliminary injunction.

First Department Holds Plaintiffs Have No Right to Discovery in Demand-Refused Derivative Actions under Either Delaware or New York Law

On May 22, 2014, the New York Appellate Division, First Department held that Delaware law governs a plaintiff's right to discovery in a demand-refused derivative action brought on behalf of a Delaware corporation. *Lerner v. Prince*, 2014 WL 2118253 (N.Y. App. Div. May 22, 2014) (Moskowitz, J.). The court further determined that plaintiffs are not entitled to discovery in such suits under either Delaware or New York law.

Background

Citigroup is a Delaware corporation. In late 2007, a Citigroup shareholder made a formal pre-suit demand asking Citigroup's Board to bring suit against the company's senior management for alleged mismanagement of Citigroup's subprime assets. The Board established a demand committee and hired independent counsel to investigate the allegations. In July 2009, prior to the Board's response to the demand, plaintiff brought the instant derivative action in New York state court against certain current and former directors of Citigroup, as well as several of the company's officers and employees. On June 25, 2010, the Board formally rejected plaintiff's demand. Defendants later moved to dismiss the complaint.

Before the trial court ruled on the motion to dismiss, plaintiff served document requests on defendants. Defendants refused to produce the requested documents on the ground that plaintiffs in demand-refused derivative suits are "not entitled to

discovery under either Delaware or New York law on a pre-answer motion to dismiss."

In January 2011, plaintiff filed a motion to compel discovery, which the trial court denied. In a separate order, the trial court found that plaintiff had "failed to allege particularized facts creating a reasonable doubt about the Board's reasonableness and good faith in investigating plaintiff's demand" and dismissed the complaint. Plaintiff appealed both decisions.

First Department Holds Delaware Law Governs a Plaintiff's Right to Discovery in a Demand-Refused Derivative Action Brought on Behalf of a Delaware Corporation

The First Department began its analysis by resolving the parties' choice-of-law dispute. The court determined that a "plaintiff's right to discovery in this demand-refused case is a substantive question, rather than a procedural one, and therefore is governed by Delaware law." While "New York courts have applied the law of the forum when deciding matters, such as discovery, affecting the conduct of the litigation," the First Department explained that the derivative nature of the case at hand "places it into a different context."

The First Department found that "Delaware law on discovery is an integral part of the legal framework governing derivative proceedings; indeed, it is inextricably intertwined with the decision to act or decline to act on a shareholder demand." Moreover, the court observed that "allowing discovery under New York law … would almost certainly lead future plaintiffs to forum shop in an effort to circumvent the Delaware prohibition against discovery."

First Department Finds Delaware Law Does Not Permit Discovery in Demand-Refused Derivative Suits

The First Department determined that "[u]nder Delaware law, 'plaintiffs in a derivative suit are not entitled to discovery to assist their compliance with the particularized pleading requirement of [Delaware Chancery Court] Rule 23.1 in a case of demand refusal.'" The court found it to be "of no moment" that "Delaware has not codified its discovery rule in demand-refused cases." The First Department explained that "allowing plaintiff to proceed with discovery would thwart the purposes underlying Delaware's law on demand refusal—specifically, its recognition that deciding whether to pursue litigation is a decision entitled to deference under the business judgment rule."

Notably, the First Department found that "plaintiff would not be entitled to discovery in this demand-refused case" even if New York law applied. "Courts applying New York law in demand-refused cases presume that a board of directors' decision was the exercise of valid business judgment." "[W]here, as here, a complaint fails to set forth allegations overcoming the presumption that the board's decision resulted from that valid judgment, courts will properly deny a plaintiff's discovery request."

First Department Finds Plaintiff Failed to Rebut the Business Judgment Presumption

Having determined "that plaintiff is not entitled to discovery," the First Department then considered the merits of plaintiff's complaint. The court held that "the allegations … are insufficient to support plaintiff's contention that defendants' investigation was unreasonable, uninformed or conducted in bad faith." Finding "defendants' investigation … sufficient" under Delaware law, the First Department affirmed dismissal of plaintiff's complaint.

NEW YORK

Bruce D. Angiolillo
212-455-3735
bangiolillo@stblaw.com

Mark G. Cunha
212-455-3475
mcunha@stblaw.com

Paul C. Curnin
212-455-2519
pcurnin@stblaw.com

Michael J. Garvey
212-455-7358
mgarvey@stblaw.com

Paul C. Gluckow
212-455-2653
pgluckow@stblaw.com

Nicholas Goldin
212-455-3685
ngoldin@stblaw.com

David W. Ichel
212-455-2563
dichel@stblaw.com

Peter E. Kazanoff
212-455-3525
pkazanoff@stblaw.com

Joshua A. Levine
212-455-7694
jlevine@stblaw.com

Linda H. Martin
212-455-7722
lmartin@stblaw.com

Joseph M. McLaughlin
212-455-3242
jmclaughlin@stblaw.com

Lynn K. Neuner
212-455-2696
lneuner@stblaw.com

Barry R. Ostrager
212-455-2655
bostrager@stblaw.com

Thomas C. Rice
212-455-3040
trice@stblaw.com

Mark J. Stein
212-455-2310
mstein@stblaw.com

Alan C. Turner
212-455-2472
aturner@stblaw.com

Mary Kay Vyskocil
212-455-3093
mvyskocil@stblaw.com

Craig S. Waldman
212-455-2881
cwaldman@stblaw.com

George S. Wang
212-455-2228
gwang@stblaw.com

David J. Woll
212-455-3136
dwoll@stblaw.com

Jonathan K. Youngwood
212-455-3539
jyoungwood@stblaw.com

LOS ANGELES

Michael D. Kibler
310-407-7515
mkibler@stblaw.com

Chet A. Kronenberg
310-407-7557
ckronenberg@stblaw.com

PALO ALTO

Alexis S. Coll-Very
650-251-5201
acoll-very@stblaw.com

James G. Kreissman
650-251-5080
jkreissman@stblaw.com

WASHINGTON, D.C.

Peter H. Bresnan
202-636-5569
pbresnan@stblaw.com

Cheryl J. Scarboro
202-636-5529
cscarboro@stblaw.com

Peter C. Thomas
202-636-5535
pthomas@stblaw.com

Simpson Thacher is "one of the handful of firms you can go to with confidence."

—THE LEGAL 500 2013

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000