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Securities Law Alert

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January 2015

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–Legal 500 2014

Second Circuit Holds That a Failure to Comply With Item 303 of Regulation S-K Is Only Actionable If All Requirements To State a Section 10(b) Claim Are Satisfied

Item 303 of Regulation S-K sets forth the disclosure requirements for the Management's Discussion and Analysis (MD&A) section of a public company's Form 10-Qs and other SEC filings. In relevant part, Item 303 states that a public company must "[d]escribe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations." 17 C.F.R. § 229.303(a)(3)(ii).

On January 12, 2015, the Second Circuit held "as a matter of first impression … that a failure to make a required Item 303 disclosure … is indeed an omission that can serve as the basis for a Section 10(b) securities fraud claim." *Stratte-McClure v. Morgan Stanley*, 2015 WL 136312 (2d Cir. 2015) (Livingston, J.). However, the Second Circuit found that "such an omission is actionable only if it satisfies the materiality requirements outlined in [*Basic Inc. v. Levinson*, 485 U.S. 224 (1988)], and if all of the other requirements to sustain an action under Section 10(b) are fulfilled."

Second Circuit Finds That Failing to Make Required Item 303 Disclosures Could Render Form 10-Qs and Other SEC Filings Misleading Under Section 10(b)

The Second Circuit determined that "Item 303's affirmative duty to disclose in Form 10-Qs can serve as the basis for a securities fraud claim under Section 10(b)" because

"omitting an item required to be disclosed on a 10-Q can render that financial statement misleading." The court explained that "Form 10-Qs are mandatory filings that 'speak … to the entire market.'" Item 303 disclosures are "required elements" of Form 10-Q filings that "give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's financial condition and results of operations." In view of the "obligatory nature" of Item 303 disclosures, the Second Circuit explained that "a reasonable investor would interpret the absence of an Item 303 disclosure to imply the nonexistence of 'known trends or uncertainties … that the registrant reasonably expects will have a material … unfavorable impact on … revenues or income from continuing operations.'" The court therefore concluded that "Item 303 imposes the type of duty to speak that can, in appropriate cases, give rise to liability under Section 10(b)."

In so holding, the Second Circuit noted that it has "already held that failing to comply with Item 303 by omitting known trends or uncertainties from a registration statement or prospectus is actionable under Sections 11 and 12(a)(2) of the Securities Act of 1933" (citing *Panther Partners Inc. v. Ikanos Communications, Inc.*, 681 F.3d 114 (2d Cir. 2012) and *Litwin v. Blackstone Group, L.P.*, 634 F.3d 706 (2d Cir. 2011)). The Second Circuit underscored the similarities between Section 10(b) of the Exchange Act and Section 12(a)(2) of the Securities Act: "Like Section 12(a)(2), Rule 10b-5 requires disclosure of 'material fact[s] necessary in order to make … statements made … not misleading.'"

Second Circuit Clarifies That Omitting a Required Item 303 Disclosure Is Actionable Under Section 10(b) Only If the Disclosure Would Have Been Material Under *Basic*

The Second Circuit underscored that "[t]he failure to make a required disclosure under Item 303 … is not by itself sufficient to state a claim for securities fraud under Section 10(b)." Rather, the court found that "a violation of Item 303's disclosure requirements can only sustain a claim under Section 10(b) and Rule 10b-5 if the allegedly omitted information satisfies *Basic*'s test for materiality." For purposes of "Section 10(b) and Rule 10b-5, the materiality of an allegedly required forward [ ] looking disclosure is determined [under the *Basic* test] by 'a *balancing* of both the *indicated probability* that the event will occur and the *anticipated magnitude* of the event in light of the totality of the company activity.'" *Stratte-McClure*, 2015 WL 136312 (quoting *Basic*, 485 U.S. at 224).

The Second Circuit explained that "[t]he SEC's test for a duty to report under Item 303 … involves a two-part … inquiry" that is "different" from the test for materiality under *Basic*. When determining whether Item 303 mandates disclosure of a "known trend," "management must make two assessments." First, management must consider whether the known trend is "likely to come to fruition." Second, in the event that "management cannot make that determination, it must evaluate objectively the consequences of the known trend … on the assumption that it will come to fruition." Item 303 then requires disclosure of the trend "unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur." The Second Circuit noted that "[a]ccording to the SEC, this disclosure standard is unique to Item 303."

The Second Circuit "conclude[d] that a violation of Item 303's disclosure requirements can only sustain a claim under Section 10(b) and Rule 10b-5 if the allegedly omitted information [also] satisfies *Basic*'s test for materiality." A plaintiff must first establish a duty to disclose by "alleg[ing] that the defendant failed to comply with Item 303 in a 10-Q or other filing." Then, a plaintiff must "allege that the omitted information was material under *Basic*'s probability/magnitude test." In addition, a plaintiff must satisfy the other elements of a Section 10(b) claim, including scienter, reliance, and economic loss caused by plaintiff's reliance.

Second Circuit Disagrees with the Ninth Circuit's Contrary Holding in *In re NVIDIA Corp. Securities Litigation*

The Second Circuit noted that its "conclusion is at odds with the Ninth Circuit's recent opinion in" *In re NVIDIA Corp. Securities Litigation*, 768 F.3d 1046 (9th Cir. 2014)

(O'Connell, J.).[1] There, the Ninth Circuit held that "Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5." *NVIDIA*, 768 F.3d 1046. In reaching its decision, the Ninth Circuit relied on the Third Circuit's decision in *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000). The *Oran* court found that "a violation of the disclosure requirements of Item 303 does not lead inevitably to the conclusion that such disclosure would be required under [Section 10(b) and] Rule 10b-5." *Oran*, 226 F.3d 275.

The Second Circuit determined that the Ninth Circuit had read the Third Circuit's decision in *Oran* too broadly. In the Second Circuit's view, the *Oran* court held that "a violation of Item 303 'does not *automatically* give rise to a *material* omission under Rule 10b-5'" given the differing standards of materiality that govern disclosures under Section 10(b) and Rule 10b-5 as compared with disclosures under Item 303. *Stratte-McClure*, 2015 WL 136312 (quoting *Oran*, 226 F.3d 275) (emphasis added). The Second Circuit found that "*Oran* actually suggested, without deciding, that in certain instances a violation of Item 303 *could* give rise to a material [Rule] 10b-5 omission … as long as the omission is material under *Basic*, and the other elements of Rule 10b-5 have been established."

The Second Circuit further stated that the Ninth Circuit had "misconstrue[d] the relationship between Rule 10b-5 and Section 12(a)(2) of the Securities Act." Like the Second Circuit, the Ninth Circuit has held that "Item 303 creates a duty to disclose for the purposes of liability under Section 12(a)(2)." *Stratte-McClure*, 2015 WL 136312 (citing *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293 (9th Cir. 1998)). The Second Circuit noted that "Section 12(a)(2)'s prohibition on omissions is textually identical to that of Rule 10b-5: both make unlawful omission of 'material fact[s] … necessary in order to make … statements, in light of the circumstances under which they were made, not misleading." The Second Circuit explained that "SEC regulations, like Item 303, dictate the contents of mandatory disclosures—be they Form 10-Qs in the case of Rule 10b-5 or prospectuses in the case of Section 12(a)(2)—and are therefore an essential part of the circumstances under which such disclosures are made.'"

Second Circuit Addresses the Contours of the Duty to Disclose Under Item 303

As to the specific disclosure obligations imposed by Item 303, the Second Circuit found that "'generic cautionary language' does not satisfy Item 303[,]" particularly if these disclosures are "spread out over several different filings" and are "unconnected to the [discussion of] the company's financial position." Rather than a "patchwork commentary on the relevant market trends," the Second Circuit determined that "Item 303 requires [both] disclosure of the known trend and the 'manner in which' it 'might reasonably be expected to materially impact' a company's overall financial position." *Stratte-McClure*, 2015 WL 136312 (quoting *Litwin*, 634 F.3d 706).

The Second Circuit recognized, however, that "[t]he SEC has cautioned that [Item 303] requires 'quantitative information' only when it is 'reasonably available and will provide material information for investors.'" The Second Circuit explained that the SEC "has never gone so far as to require a company to announce its internal business strategies or to identify the particulars of its trading positions."

Second Circuit Finds Plaintiffs Failed to State a Claim Under Section 10(b) and Rule 10b-5 Based on Morgan Stanley's Alleged Failure to Make Required Item 303 Disclosures

Turning to the allegations of the complaint before it, the Second Circuit determined that plaintiffs had adequately alleged that Morgan Stanley and several of its current and former officers had "breached their Item 303 duty to disclose that Morgan Stanley faced a deteriorating subprime mortgage market that, in light of the company's exposure to the market, was likely to cause trading losses that would materially affect the company's financial condition." The court "assume[d], *arguendo*, that this omission was material under *Basic*." However, the Second Circuit affirmed dismissal of plaintiffs' claim for failure to plead scienter adequately.

1. Please click here to read our discussion of the *NVIDIA* decision in the October 2014 edition of the Alert.

Third Circuit Applies the "Irrevocable Liability" Test to Find That *Morrison* Reaches a Foreign Entity's Over-the-Counter Transactions in Domestic Securities

In *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010), the Supreme Court held that "Section 10(b) applies only to transactions in securities listed on domestic exchanges and domestic transactions in other securities." On January 20, 2015, the Third Circuit ruled that "irrevocable liability establishes the location of a securities transaction" for purposes of determining whether a transaction is "domestic" within the meaning of the *Morrison* decision. *United States v. Georgiou*, 2015 WL 241438 (3d Cir. 2015) (Greenaway, Jr., J.). Applying the "irrevocable liability" test, the Third Circuit held "as a matter of first impression" that over-the-counter "purchases and sales of securities issued by U.S. companies through U.S. market makers acting as intermediaries for foreign entities constitute 'domestic transactions' under *Morrison*."

Third Circuit Holds That Securities Listed on Either the OTC Bulletin Board or the Pink OTC Markets Are Not "Securities Listed on an American Stock Exchange" for *Morrison* Purposes

At issue in the case before the Third Circuit was a "stock fraud scheme … centered on manipulating the markets of four stocks" traded by foreign entities on two American over-the-counter stock markets, the OTC Bulletin Board ("OTCBB") and the Pink OTC Markets Inc. ("Pink Sheets"). The Third Circuit noted that "[u]nder the first prong of *Morrison*, Section 10(b) applies to 'the purchase or sale of a security listed on an American stock exchange." The Third Circuit found that "[s]ecurities listed on the OTCBB and the Pink Sheets are not within these parameters" for several reasons.

First, the Third Circuit pointed out that "[a]ccording to the SEC, there are eighteen registered national security exchanges" but "the Pink Sheets and the OTCBB are not among them." Second, the court observed that "the stated purpose of the [Securities Exchange] Act refers to 'securities exchanges' and 'over-the-counter markets' separately, which suggests that one is not inclusive of the other." *Georgiou*, 2015 WL 241438 (citing 15 U.S.C. §78a *et seq*. (described as "[a]n Act [t]o provide for the regulation of securities exchanges and of over-the-counter markets … [and] to prevent inequitable and unfair practices on such exchanges and markets") (emphasis added)). The Third Circuit therefore concluded that the OTCBB and the Pink Sheets "are not national securities exchanges within the scope of *Morrison*."

Third Circuit Applies the "Irrevocable Liability" Test and Determines That the Over-the-Counter Transactions at Issue Were "Domestic Transactions" Under *Morrison*

The Third Circuit next considered whether the foreign entities' over-the-counter transactions in domestic securities constituted "domestic transactions" for purposes of *Morrison*'s second prong. The court found that the case at hand was distinguishable from *Morrison*. While *Morrison* involved a foreign-cubed action in which "all aspects of the trades at issue occurred abroad," the case before the Third Circuit "involve[d] stocks of U.S. companies" and transactions that "were executed through American market makers."

The Third Circuit explained that in order "[t]o determine whether the transactions at issue were 'domestic transactions,' under *Morrison*," it must "consider 'not … the place where the deception originated, but [the place where] purchases and sales of securities' occurred" (quoting *Morrison*, 561 U.S. 247). The court observed that several other circuits, including the Second Circuit, have held that "a securities transaction is domestic when the parties incur irrevocable liability to carry out the transaction within the United States or when title is passed within the United States" (quoting *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60 (2d Cir. 2012)). Agreeing with these circuits, the Third Circuit held "that irrevocable liability establishes the location of a securities transaction" for purposes of *Morrison*'s second prong. The court noted that "[f]acts that demonstrate irrevocable liability' include the 'formation of the contracts, the placement of purchase

orders, the passing of title, or the exchange of money.'"

Applying the "irrevocable liability" test to the case before it, the Third Circuit found that "at least one of the fraudulent transactions in each of [the stocks at issue] was bought and sold through U.S.-based market makers." The court determined that "some of the relevant transactions required the involvement of a purchaser or seller working with a market maker and committing to a transaction in the United States, occurring irrevocable liability in the United States, or passing title in the United States." The Third Circuit therefore held that the transactions at issue constituted "domestic transactions" within the meaning of the *Morrison* test, and affirmed the conviction under Section 10(b) and Rule 10b-5 of a Canadian stockbroker involved in the transactions.

Ninth Circuit Holds That Rule 9(b)'s Particularized Pleading Requirements Apply to Loss Causation Allegations

Under Rule 8(a) of the Federal Rules of Civil Procedure, plaintiffs need only provide "a short and plain statement of the claim showing that the pleader is entitled to relief." Fed. R. Civ. P. 8(a). However, Rule 9(b) requires that a plaintiff "alleging fraud or mistake … state with particularity the circumstances constituting fraud or mistake." Fed. R. Civ. P. 9(b).[2] On December 16, 2014, the Ninth Circuit held that "Rule 9(b) applies to all elements of a securities fraud action, including loss causation." *Oregon Public Employees' Retirement Fund v. Apollo Group Inc.*, 2014 WL 7139634 (9th Cir. 2014) (Smith, Jr., J.).

2. In addition to the federal pleading requirements, securities fraud plaintiffs must also comply with the Private Securities Litigation Reform Act ("PSLRA"). The PSLRA requires that securities fraud complaints "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." The PSLRA further mandates that securities fraud complaints "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."

Ninth Circuit Finds Loss Causation Is Among the "Circumstances Constituting Fraud" Within the Meaning of Rule 9(b)

At the outset, the Ninth Circuit observed that while "it is clear that Rule 9(b) and the [Private Securities Litigation Reform Act ("PSLRA")] apply to almost all elements of a securities fraud action, the law is less clear about the pleading standard that applies to the loss causation element." The court noted that in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), "the Supreme Court suggested that Rule 8's 'short and plain statement' might apply" to loss causation allegations. The Ninth Circuit explained that "[a]fter *Dura*," it had "applied a plausibility standard to loss causation, which avoid[ed] the question of whether the Rule 8(a) or Rule 9(b) pleading standard applie[d]." Under this plausibility standard, courts in the Ninth Circuit considered whether "the complaint allege[d] facts that, if taken as true, plausibly establish[ed] loss causation." *In re Gilead Sciences Sec. Litig*., 536 F.3d 1049 (9th Cir. 2008). On occasion, courts in the Ninth Circuit "applied both Rule 8(a) and 9(b) standards to allegations of loss causation." *Apollo*, 2014 WL 7139634.

In *Apollo*, the Ninth Circuit squarely addressed for the first time the question of which pleading standard applies to loss causation allegations. The Ninth Circuit determined that applying Rule 9(b) to loss causation allegations "is appropriate for at least three reasons." First, the court reasoned that "[s]ince Rule 9(b) applies to all circumstances of common-law fraud, … and since securities fraud is derived from common law fraud, it makes sense to apply the same pleading standard to all circumstances of securities fraud," including loss causation. The court noted that "[t]he requirement of loss causation, in particular, is founded on the common law of fraud and deceit." Second, the Ninth Circuit found that "[l]oss causation is part of the 'circumstances' constituting fraud" within the meaning of Rule 9(b) "because, without it, a claim of securities fraud does not exist." Third, the Ninth Circuit explained that its approach "creates a consistent standard through which to assess pleadings in 10(b) actions, rather than the piecemeal standard adopted by some courts."

Ninth Circuit Recognizes a Circuit Split on Whether Rule 9(b) Applies to Loss Causation Allegations

The Ninth Circuit discussed a circuit split on the applicable pleading standard for loss causation allegations. The Fourth and Seventh Circuits have "suggested that heightened pleading standards apply to loss causation" (citing *Katyle v. Penn Nat'l Gaming, Inc.*, 637 F.3d 462 (4th Cir. 2011); *Tricontinental Indus., Ltd. v. PricewaterhouseCoopers, LLP*, 475 F.3d 824 (7th Cir. 2007)). "The Second Circuit applies a different, but heightened, two-part test for loss causation, requiring that plaintiffs show that the loss was both foreseeable and caused by the materialization of the risk concealed by the fraudulent statement" (citing *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87 (2d Cir. 2007)). "The Fifth Circuit has concluded that Rule 8(a) applies" to loss causation allegations (citing *Lormand v. U.S. Unwired, Inc.*, 565 F.3d 228 (5th Cir. 2009)). Finally, the First Circuit "has only stated that it is unclear whether a plaintiff has to plead loss causation under Rule 8(a) or 9(b) (citing *Mass. Ret. Sys. v. CVS Caremark Corp.*, 716 F.3d 229 (1st Cir. 2013)).

The Ninth Circuit explained that it was "persuaded by the approach adopted in the Fourth Circuit." Courts in the Fourth Circuit "review allegations of loss causation for 'sufficient specificity,' a standard largely consonant with [Rule] 9(b)'s requirement that averments of fraud be pled with particularity." *Penn. Nat'l Gaming*, 637 F.3d 462.

Ninth Circuit Finds Plaintiffs Failed to Plead Loss Causation Under Either Rule 8(a) or Rule 9(b)

Turning to plaintiffs' loss causation allegations in the case before it, the Ninth Circuit found that plaintiffs did "not allege specific statements made by the [d]efendants that were made untrue or called into question by subsequent disclosures." The Ninth Circuit determined that plaintiffs' loss causation allegations did not pass muster under either Rule 8(a) or Rule 9(b), and therefore affirmed dismissal of plaintiffs' complaint.

Tenth Circuit Finds Allegations of GAAP Violations and Claims That Defendants "Must Have Known" of the Fraud Insufficient to Allege Scienter Under the PSLRA's Heightened Pleading Standards

In a January 16, 2015 decision , the Tenth Circuit affirmed dismissal of a securities fraud action against Gold Resource Corporation for failure to meet the heightened scienter pleading standards of the PSLRA. *In re Gold Resource Corp. Sec. Litig.*, 2015 WL 221614 (10th Cir. 2015) (Seymour, J.). The Tenth Circuit held that plaintiffs' allegations of GAAP violations, standing alone, were insufficient to plead scienter. The court further ruled that plaintiffs could not meet the PSLRA's scienter pleading requirements merely by alleging that defendants "must have known" of the alleged fraud or financial discrepancy at issue.

Tenth Circuit Deems Allegations of GAAP Violations Insufficient to Plead Scienter Absent Particularized Facts Showing Fraudulent Intent

The Tenth Circuit first addressed plaintiffs' attempt to plead scienter by pointing to an alleged GAAP violation concerning "the material overstatement of revenues." The Tenth Circuit explained that "allegations of GAAP violations, standing alone, are insufficient to state a securities fraud claim." Rather, such allegations may only "be sufficient to state a claim" where they are "coupled with evidence that the violations or irregularities were the result of the defendant's fraudulent intent to mislead investors."

The Tenth Circuit found that the allegations of GAAP violations against Gold Resource Corporation did not "come on top of … [any] *other* particularized facts showing fraudulent intent" and were therefore inadequate to plead scienter. *Gold Resource*, 2015 WL 221614.

Tenth Circuit Finds Plaintiffs Cannot Meet the PSLRA's Scienter Pleading Requirements Merely by Asserting That Defendants "Must Have Known" of the Alleged Financial Misstatements

The Tenth Circuit rejected plaintiffs' assertion that defendants "'must have known' of the alleged revenue misstatements at the time they occurred" in view of "the small size of the one-product company" and the fact that "the accounting misstatements amounted to more than sixteen percent of net income for the first quarter of 2012." The Tenth Circuit found that plaintiffs' "view of the situation fail[ed] to take account of other plausible inferences" as required under the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).

The alleged revenue misstatements stemmed in large part from a pricing discrepancy involving one of the company's two customers. Applying the *Tellabs* standard, the Tenth Circuit deemed it plausible that lower-level employees at Gold Resource Corporation might have delayed informing senior executives of this pricing discrepancy if they thought the "figures were wrong." *Gold Resource*, 2015 WL 221614. The Tenth Circuit observed that "a prudent executive would want to investigate and confirm a claimed discrepancy before disclosing it publicly."

In reaching this conclusion, the Tenth Circuit found persuasive the Seventh Circuit's reasoning in *Higginbotham v. Baxter International, Inc.*, 495 F.3d 753 (7th Cir. 2007). There, the Seventh Circuit upheld dismissal of a securities fraud action where an executive learned of fraud at one of the company's subsidiaries in May of 2004 but did not publicly disclose the fraud until July 2004. The Seventh Circuit found that "sometime during May 2004, [the executive] learned enough to lead a reasonable person to conduct an investigation." However, the Seventh Circuit emphasized that "[k]nowing enough to launch an investigation … is a very great distance from convincing proof of intent to deceive."

The Tenth Circuit determined that "[t]he same [analysis] is true in this case." *Gold Resource*, 2015 WL 221614. In the case at hand, the Tenth Circuit found that "[d]efendants had every reason not to disclose the [alleged pricing discrepancy] before the dispute was investigated and settled." The Tenth Circuit was "not persuaded [that] a reasonable person would deem an inference of scienter more cogent or compelling than an opposing inference of nonfraudulent intent with respect to the misrepresentations" at issue, and therefore affirmed dismissal of the complaint.

Delaware Supreme Court Reaffirms Passive Market Check May Satisfy Director *Revlon* Duties and Provides Guidance on "Blue Pencil" Injunctions Modifying Merger Agreements

In a December 19, 2014 decision written by Chief Justice Strine in *C&J Energy Services, Inc., et al. v. City of Miami General Employees' & Sanitation Employees' Retirement Trust, et al.*, 2014 WL 7243153 (Del. 2014), the Delaware Supreme Court reaffirmed that enhanced judicial scrutiny under *Revlon* requires that directors of a company make reasonable, but not necessarily perfect, decisions in pursuing a change-of-control transaction; that a passive, post-signing market check period may be sufficient to satisfy directors' *Revlon* duties; and that "blue penciling" of an agreement by courts, to the detriment of the acquiror's rights under the agreement, should be limited to instances where it is clear after trial (or based on undisputed facts) that there was misconduct by the acquiror, such as aiding-and-abetting a breach of a fiduciary duty.

Background

The case arose from the proposed merger, announced on July 25, 2014, between C&J Energy Services and a Bermuda-based division of Nabors Industries, a competitor of C&J. Among other benefits, the merger was expected to produce substantial tax savings from the re-domiciling of C&J from the U.S. to Bermuda, provided that Nabors owned a majority of the combined entity.

The transaction was structured as a merger of C&J with the Nabors subsidiary, with Nabors receiving shares in the merged entity (new C&J) representing approximately 53%

of new C&J as well as approximately $938 million in cash. The existing C&J stockholders would own the remaining minority stake in new C&J. In order to mitigate the public stockholders' loss of corporate control over new C&J, the board of C&J negotiated for several corporate governance related protections, including: (i) a bylaw providing that all of the new C&J stockholders would receive *pro rata* consideration in any sale of new C&J or its major assets, thereby allowing for an equitable sharing of any "future control premium" that Nabors might receive in a sale of its controlling stake in new C&J, (ii) the retention by C&J of management control of new C&J, and the right to nominate four directors, including the chairman, to the seven director board of new C&J, and (iii) a comprehensive, five-year "standstill" agreement from Nabors providing for, among other restrictions, a prohibition on the acquisition of additional shares and limitations on the sale of its new C&J shares to, for example, competitors and any person or group that would own more than 20% of new C&J. The merger agreement also contained a broad fiduciary-out provision that permitted the C&J board to terminate the proposed merger with Nabors if a more favorable deal emerged for the sale of C&J, a "modest" termination fee of 2.27% of the deal value, and a lengthy pre-closing period of approximately five months. The voting agreement that C&J's CEO entered into in support of the merger would also terminate upon a decision by the C&J board to exercise its fiduciary out, leaving the CEO free to vote in favor of a competing deal.

In a bench ruling issued on November 24, 2014, the Court of Chancery, while admitting that its determination was a "very close call," preliminarily enjoined for thirty days a vote by C&J stockholders on the merger, ordered C&J to solicit alternative transactions to the merger, and also provided that such solicitation and any subsequent negotiation by C&J of an alternative proposal would not constitute a breach of the merger agreement. The Court of Chancery based its decision and remedies on its determination of a "plausible" violation by C&J's board of its duty of care under *Revlon*, citing the board's failure to both affirmatively shop C&J and have an "impeccable knowledge" of the value of C&J.

Delaware Supreme Court Analysis

In reversing the judgment of the Court of Chancery, the Delaware Supreme Court assumed for purposes of its analysis that a change-of-control of C&J had occurred, thus invoking enhanced judicial scrutiny of the merger under *Revlon*. In its analysis, the Supreme Court reiterated that *Revlon* does not require a company to conduct an auction or to follow any specific process. The Supreme Court noted with approval Chancellor Allen's reading of *Revlon* and its progeny to permit "a board to pursue the transaction it reasonably views as most valuable to stockholders, so long as the transaction is subject to an effective market check under circumstances in which any bidder interested in paying more has a reasonable opportunity to do so." In its review of the factual record, the Supreme Court noted possible deficiencies in the C&J board sale process, including potential conflicts involving its primary financial advisor; limited direct board oversight and involvement in the merger negotiations; and "aggressive" compensation and severance packages offered by Nabors to the C&J CEO and other executives. On balance, however, the Supreme Court found that C&J's majority-independent and generally well-informed board had met its *Revlon* duties by negotiating "a logical strategic transaction with undisputed business and tax advantages" to its shareholders, a merger agreement that contained a lengthy passive market check and only modest deal protections, and a host of bylaw protections that substantially mitigated the effects of the change-of-control of C&J, while also providing C&J's "stockholders with a fully informed, uncoerced opportunity to vote to accept the deal." The Court also noted that a private equity fund which owned 10% of C&J's stock was supportive of the transaction, and that when a large stockholder receiving the same consideration as the other stockholders is supportive of a transaction, that is normally evidence of its fairness.

The Supreme Court rejected the Court of Chancery's comments that *Revlon* "required impeccable knowledge" by the target's board of the company's value, noting that the C&J board was "well-informed" according to the Court of Chancery decision. The Supreme Court also emphasized several times that *Revlon* and similar decisions arose in situations in which a target board was resisting takeover bids from a higher bidder, whereas in this transaction there were no

other bidders and the C&J stockholders had the right to vote down the proposed merger with Nabors if they so chose.

The Supreme Court also held that the Court of Chancery had misapplied the standard of review when granting a preliminary injunction enjoining the merger. The Court of Chancery erred when finding that the plaintiffs had shown "a plausible likelihood of success on the merits as to a breach of the duty of care" rather than requiring the plaintiffs to show "a reasonable probability of success on the merits." Moreover, the Supreme Court suggested that an especially stringent examination of plaintiffs' claims was warranted as "Delaware courts have emphasized that in cases like this … the showing of a reasonable probability of success must be 'particularly strong' when 'no other bidder has emerged despite relatively mild deal protection devices'."

The Supreme Court was also critical of the Court of Chancery for its issuance of a mandatory injunction requiring C&J to solicit alternative proposals in violation of the merger agreement while expressly providing that such a "go-shop" process would not constitute a breach of the merger agreement. In order to issue the unusual remedy of a mandatory injunction "the Court of Chancery must either hold a trial and make findings of fact or base an injunction solely on undisputed facts." In this case, however, a number of important factual disputes remained unresolved and, accordingly, the Court of Chancery erred in issuing a mandatory injunction. Moreover, the Supreme Court emphasized that even "after a trial, a judicial decision holding a party to its contractual obligations while stripping it of bargained-for benefits should only be undertaken on the basis that the party ordered to perform was fairly required to do so, because it had, for example, aided and abetted a breach of fiduciary duty." For these reasons, the Court of Chancery was not entitled to "blue-pencil" the merger agreement to "strip an innocent third party [Nabors] of its contractual rights while simultaneously binding that party to consummate the transaction."

New York Courts Reject Disclosure-Only Settlements of Merger Litigation

In two recent decisions, New York courts have rejected disclosure-only settlements of merger-related suits based on the immateriality of the additional disclosures. *Gordon v. Verizon Communications, Inc.*, 2014 WL 7250212 (N.Y. Sup. Ct. Dec. 19, 2014) (Schweitzer, J.); *City Trading Fund v. Nye*, 46 Misc. 3d 1206(A) (N.Y. Sup. Ct. 2015) (Kornreich, J.).

On December 19, 2014, in an action arising from Verizon Communication's $130 billion purchase of Vodaphone Group's interest in Verizon Wireless, the court denied approval of a disclosure-only settlement based on its finding that the additional disclosures "individually and collectively fail[ed] to materially enhance the shareholders' knowledge about the merger" and "provide[d] no legally cognizable benefit to the shareholder class." *Verizon Communications*, 2014 WL 7250212. The court explained that "[e]nhanced or corrected disclosure, to be adequate to support a settlement, must be a material improvement over what had previously been disclosed." For example, a material disclosure might "uncover conflicts" or "correct material misstatements." On the other hand, "[m]erely providing additional information—unless the additional information offers a contrary perspective on what has previously been disclosed—does not constitute material disclosure." The court underscored that "divest[ing] [the class] of valuable rights in the form of a broad release of claims … cannot be justified by trivial disclosure adjustments." In so holding, the court observed that "[a] body of law meant to protect shareholder interests from the absence of due care by the corporation's managers has been turned on its head to diminish shareholder value by divesting them of valuable rights and imposing additional gratuitous costs, i.e. attorneys' legal fees on the corporation."

Several weeks later, in an action arising in connection with Martin Marietta Materials' $2.7 billion acquisition of Texas Industries, the court once again rejected a disclosure-only settlement based on its finding that the supplemental disclosures were "grossly immaterial." *City Trading Fund*, 46 Misc. 3d

1206(A). The court explained that it "would have approved the settlement" if "plaintiffs [had] alleged *material* omissions or settled for *material* supplemental disclosures." Given the "utterly immaterial" nature of the supplemental disclosures, however, the court determined that "[a]pproving the settlement would both undermine the public interest and the interests of [Martin Marietta Materials'] shareholders." The court reasoned that allowing the settlement to go forward "would incentivize plaintiffs to file frivolous disclosure lawsuits shortly before a [shareholder vote on a] merger, knowing they will always procure a settlement and attorneys' fees under conditions of duress—that is, where it is rational to settle obviously frivolous claims."

Notably, the court emphasized that "extra scrutiny is warranted when it appears that the incentives of the proposed class representatives diverge from those of the shareholders." In the case before it, the court found that the plaintiff was "essentially a fictitious entity" that held a trivial number of shares of Martin Marietta Materials as part of a strategy pursuant to which a general partnership affiliated with a plaintiffs' firm would "purchase nominal amounts of shares in publicly traded companies" and then bring suit whenever one of those companies announced a merger. Because the plaintiff had "no purposes for existing and no economic interests apart from the generation of attorneys' fees," the court found that plaintiff's counsel had every incentive "to adopt inequitable litigation tactics and to advance meritless claims directed not at vindicating the rights of real shareholders but at maximizing the chance [the] litigation will settle, resulting in awards of attorneys' fees … wholly out of proportion to any real benefit conferred on shareholders." The court observed that "[w]hen a proposed class representative appears to be a fiction, there is the concern that it has no accountability, either to the class or to the court."

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).

New York

Mark G. Cunha
+1-212-455-3475
mcunha@stblaw.com

Paul C. Curnin
+1-212-455-2519
pcurnin@stblaw.com

Michael J. Garvey
+1-212-455-7358
mgarvey@stblaw.com

Paul C. Gluckow
+1-212-455-2653
pgluckow@stblaw.com

Nicholas Goldin
+1-212-455-3685
ngoldin@stblaw.com

David W. Ichel
+1-212-455-2563
dichel@stblaw.com

Peter E. Kazanoff
+1-212-455-3525
pkazanoff@stblaw.com

Joshua A. Levine
+1-212-455-7694
jlevine@stblaw.com

Linda H. Martin
+1-212-455-7722
lmartin@stblaw.com

Joseph M. McLaughlin
+1-212-455-3242
jmclaughlin@stblaw.com

Lynn K. Neuner
+1-212-455-2696
lneuner@stblaw.com

Thomas C. Rice
+1-212-455-3040
trice@stblaw.com

Mark J. Stein
+1-212-455-2310
mstein@stblaw.com

Alan C. Turner
+1-212-455-2472
aturner@stblaw.com

Mary Kay Vyskocil
+1-212-455-3093
mvyskocil@stblaw.com

Craig S. Waldman
+1-212-455-2881
cwaldman@stblaw.com

George S. Wang
+1-212-455-2228
gwang@stblaw.com

David J. Woll
+1-212-455-3136
dwoll@stblaw.com

Jonathan K. Youngwood
+1-212-455-3539
jyoungwood@stblaw.com

Los Angeles

Michael D. Kibler
+1-310-407-7515
mkibler@stblaw.com

Chet A. Kronenberg
+1-310-407-7557
ckronenberg@stblaw.com

Palo Alto

Alexis S. Coll-Very
+1-650-251-5201
acoll-very@stblaw.com

James G. Kreissman
+1-650-251-5080
jkreissman@stblaw.com

Washington, D.C.

Peter H. Bresnan
+1-202-636-5569
pbresnan@stblaw.com

Jeffrey H. Knox
+1-202-636-5532
jeffrey.knox@stblaw.com

Cheryl J. Scarboro
+1-202-636-5529
cscarboro@stblaw.com

Peter C. Thomas
+1-202-636-5535
pthomas@stblaw.com

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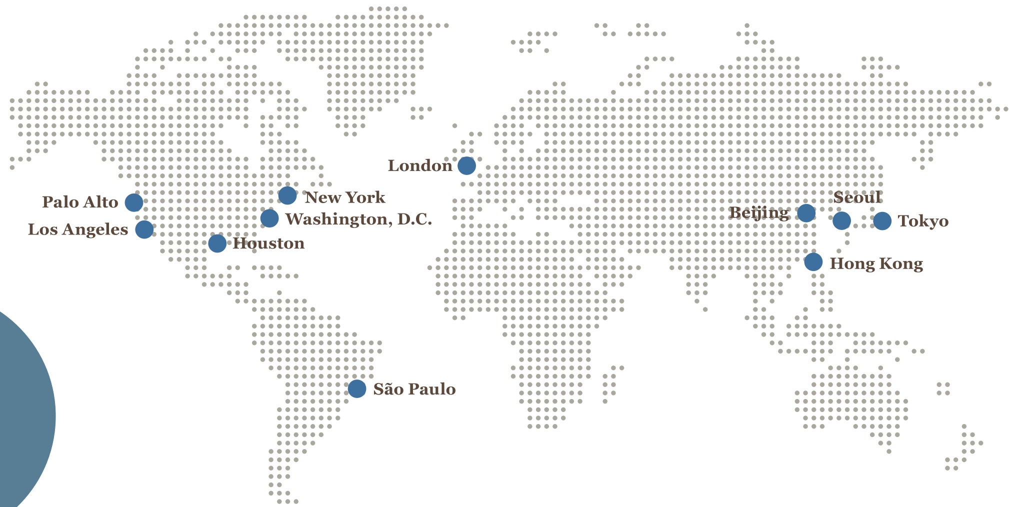

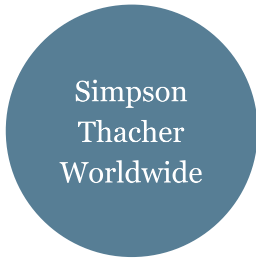

UNITED STATES

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