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Securities Law Alert

In This Edition:

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–The Legal 500 2019

Supreme Court: Upholds Liability Under Rules 10b-5(a) and (c) for an Individual Who Disseminated but Was Not the "Maker" of a Fraudulent Statement

On March 27, 2019, the Supreme Court held that an individual who disseminates false or misleading statements with an intent to defraud can be found to have violated the "fraudulent scheme" provisions of Rules 10b-5(a) and (c) even if such an individual did not "make" the statements and is therefore outside the scope of subsection (b) of Rule 10b-5. *Lorenzo v. SEC*, 139 S. Ct. 1094 (2019) (Breyer, J.). A 6-2 Justice majority affirmed the D.C. Circuit's conclusion that petitioner-defendant is liable for knowingly conveying his boss's false statements to potential investors. Justice Kavanaugh was recused from the case, as he dissented from the D.C. Circuit's ruling.

Background

SEC Rule 10b-5 proscribes three types of securities fraud: subsection (a) makes it unlawful "[t]o employ any device, scheme or artifice to defraud"; subsection (b) prohibits making a false statement or omitting information that would be misleading to an investor; and subsection (c) prohibits engaging in fraudulent or deceitful conduct.

In 2013, the SEC initiated an administrative enforcement action against a representative of a registered broker-dealer, alleging that he intended to defraud potential investors when he sent two emails to potential investors, "at the request" of his boss, making misrepresentations and omitting material information. An SEC administrative law judge found that defendant's conduct amounted to offenses under all three provisions of Rule 10b-5. The SEC affirmed this ruling in 2015, issuing a lifetime bar prohibiting defendant from working in the securities industry; and imposing a $15,000 monetary penalty.

Defendant appealed to the D.C. Circuit, and in 2017 the court reversed the SEC, finding that although defendant had the requisite intent to defraud, defendant was not the "maker" of the statements under the test set forth in *Janus Capital Group v. First Derivative Traders*, 564 U.S. 135 (2011).[1]

Defendants Can Face Primary Liability Under Rules 10b-5(a) and (c) for Disseminating False or Misleading Information

In an opinion delivered by Justice Breyer, the Court concluded that the language of subsections (a) and (c) of Rule 10b-5 is "sufficiently broad to include within their scope the dissemination of false or misleading information with the intent to defraud." The Court emphasized that defendant knew the emails he sent to potential investors contained materially false information, he sent them in his capacity as vice president of an investment banking company, and he invited follow-up questions. While acknowledging that borderline cases could involve difficult questions concerning the scope of these provisions, which should be read narrowly to avoid liability for tangential actors (for example, a mailroom clerk), the Court determined that there was "nothing borderline" about defendant's actions in this case.

The Court further addressed three primary arguments advanced by defendant and articulated in a dissenting opinion penned by Justice Thomas and joined by Justice Gorsuch. First, both defendant and the dissent posited that subsections (a) and (c) of Rule 10b-5 address only "scheme liability claims," not liability for false statements, and that to hold otherwise would render subsection (b) "superfluous." Citing dictionary definitions and historical precedent, the dissent reasoned that subsection (a) cannot impose liability for a mere misstatement that does not involve "some form of planning, designing, devising, or strategizing." The dissent further opined that while subsection (c) appears to proscribe broader conduct, it must not be construed to encompass primary liability solely for misstatements because that conduct is specifically covered by the language in subsection (b) of Rule 10b-5.

The majority, however, held that the subsections of Rule 10b-5 are not mutually exclusive; to the contrary, the Court and the SEC have always understood that these subsections, as well as related provisions of the securities laws, overlap and may prohibit the same conduct in certain circumstances.

Second, defendant and the dissent both raised a concern that the Court's decision in *Janus* would be a "dead letter" if the Court were to apply subsections (a) and (c) to fraudulent misstatements. The majority dismissed this concern, noting that *Janus* did not address the application of Rule 10b-5 to *dissemination* of false or misleading information, and further noted that *Janus* would still have force and preclude liability where an individual neither makes nor disseminates with fraudulent intent the false or misleading information—"provided, of course, that the individual is not involved in some other form of fraud."

Finally, the majority addressed the dissent's concern that imposing liability in this case would improperly result in an individual who disseminates but does not "make" a misstatement being held both primarily liable under subsections (a) and (c), as well as secondarily liable under subsection (b) of Rule 10b-5. The Court noted, "[I]t is hardly unusual for the same conduct to be a primary violation with respect to one offense and aiding and abetting with respect to another." Further, the Court explained that a construction of Rule 10b-5 that would impose only secondary liability on an individual who fraudulently disseminates false statements would risk allowing such an individual to "escape liability" altogether (for example, where the "maker" of the statement is found not to have held the requisite intent, and there is therefore no primary violation for the disseminator to have aided and abetted). The Court stated: "That is not what Congress intended. Rather, Congress intended to root out all manner of fraud in the securities industry. And it gave to the [SEC] the tools to accomplish that job."

1. Please click here to read our prior discussion of the Supreme Court's decision in *Janus*.

Southern District of New York: Plaintiffs' Pleadings May Rely on Allegations in an Unadjudicated Complaint

On March 29, 2019, the Southern District of New York held that plaintiffs had adequately pled scienter based on allegations that were borrowed from an unadjudicated complaint in a suit filed by a group of state attorneys general (the "State AG action"). *In re Mylan Sec. Litig.*, 2019 WL 1427430 (S.D.N.Y. 2019) (Oetken, J.). The court rejected defendants' contention that these allegations "must be disregarded" because they were "taken from the State AG action." The court found that "it makes little sense to say that information . . . which a complaint could unquestionably rely on if it were mentioned in a news clipping or public testimony is immaterial simply because it is conveyed in an unadjudicated complaint." *Id.* (quoting *In re Bear Stearns Mortg. Pass-Through Certificates Litig.*, 851 F. Supp. 2d 746 (S.D.N.Y. 2012)).

Defendants pointed to several decisions in which courts in the Southern District of New York "have held that unproven allegations taken from a complaint in another matter do not constitute factual allegations and are thus immaterial under Rule 12(f)."[2] But the court found that "the weight of authority holds that plaintiffs may base factual allegations on complaints from other proceedings because 'neither Circuit precedent nor logic supports . . . an absolute rule' against doing so." *Id.* (quoting *Youngers v. Virtus Inv. Partners*, 195 F. Supp. 3d 499 (S.D.N.Y. 2016)). The court explained that "[t]o the extent the cases on which [defendants rely] suggest that Second Circuit precedent requires a different result, other cases in this District have cogently explained that those decisions emanate from a misconstruction of Circuit precedent."

2. *See In re CRM Holdings Sec. Litig.*, 2012 WL 1646888 (S.D.N.Y. 2012) ("Plaintiffs' citation to unproven allegations made in [other] complaints do not constitute factual allegations. Second Circuit case law is clear that paragraphs in a complaint that are either based on, or rely on, complaints in other actions that have been dismissed, settled, or otherwise not resolved, are, as a matter of law, immaterial within the meaning of [Rule] 12(f)."); *Janbay v. Canadian Solar*, 2012 WL 1080306 (S.D.N.Y. 2012) ("Allegations contained in the complaint of an unrelated matter . . . cannot establish the particularized facts necessary to support this securities fraud claim."); *Low v. Robb*, 2012 WL 173472 (S.D.N.Y. 2012) (finding it "well settled under Second Circuit law" that plaintiffs cannot rely on allegations in unadjudicated complaints).

The court noted that the Southern District of New York's decision in *Strougo v. Barclays*, 105 F. Supp. 3d 330 (S.D.N.Y. 2015), was "particularly relevant." There, the court "permitt[ed] plaintiffs to borrow allegations from . . . a credible complaint" brought by the New York Attorney General ("NYAG"). The *Strougo* court found it significant that the NYAG complaint was "based on facts obtained after an investigation" and plaintiffs' counsel "ha[d] reached out to attorneys at the NYAG to verify the allegations" before filing suit. The *Mylan* court found that the case before it involved "[t]he same circumstances" as in *Strougo* because the allegations at issue "originate[d] from the State AG action, were the result of a government investigation, and were verified by [p]laintiffs' counsel." The *Mylan* court therefore "treat[ed] allegations borrowed from the State AG complaint as a proper basis for the pleadings."

Southern District of New York: Digital Coins Sold in an Initial Coin Offering to Finance a Blockchain Are Securities Under the *Howey* Test

On March 31, 2019, the Southern District of New York held that digital coins sold in an initial coin offering ("ICO") to finance a new blockchain were "securities" pursuant to the test set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). *Balestra v. ATBCOIN*, 2019 WL 1437160 (S.D.N.Y. 2019) (Broderick, J.). The court explained that "[u]nder *Howey*, an offering is an investment contract security where there is (i) an investment of money; (ii) in a common enterprise; (iii) with the expectation of profits to be derived solely from the efforts of others." The court rejected defendants' contention that the second and third prongs of the *Howey* test were not met. The court explained that "[i]n analyzing whether an investment satisfies the *Howey* test, form should be disregarded for substance," and "the emphasis should be on the economic realities underlying a transaction."

Howey's "Common Enterprise" Prong Does Not Require Pro Rata Profit Sharing

The court noted that plaintiffs can satisfy the "common enterprise" requirement "by pleading the existence of horizontal commonality," which exists when "the fortunes of each investor in a pool of investors are tied to one another and to the success of the overall venture." The court recognized that "a finding of horizontal commonality requires a sharing or pooling of funds." Here, the court found that the "common enterprise" requirement was met because plaintiffs alleged that "the funds raised through the ICO were pooled together to facilitate the launch of the [blockchain], the success of which, in turn, would increase the value of" the digital coins sold in the ICO.

Defendants argued that there was no horizontal commonality because the digital coins "did not entitle purchasers to a pro rata share of the profits derived from any [company]-managed transaction." But the court found that "a formalized profit-sharing mechanism is not required for a finding of horizontal commonality." The court noted that the SEC had recently concluded that digital assets offered in an ICO to fund an iPhone application constituted securities "even though the terms of the offer did not provide for a pro rata distribution of profits." The SEC determined that "investors were led to believe that as more individuals began using [the iPhone application], the value of investors' [digital assets] would increase." The court found that the digital coins at issue in the case before it were also securities because the value of the digital coins "was dictated by the success of [the company's] enterprise as a whole, thereby establishing horizontal commonality."

Howey's Third Prong Was Met Because Defendants Alone Controlled the Success of the Blockchain, Which in Turn Determined the Value of the Digital Coins

The court explained that "[t]he third prong of the *Howey* test is satisfied where investors have been led to expect profits solely from the efforts of the promoter." The court noted that in *U.S. v. Leonard*, 529 F.3d 83 (2d Cir. 2008), the Second Circuit cautioned that "the word 'solely' should not be construed as a literal limitation." The Second Circuit further instructed that courts must "consider whether under all the circumstances, the scheme was being promoted primarily as an investment." Here, the court found that plaintiffs adequately alleged that purchasers of the digital coins "reasonably believed that those coins would increase in value based primarily on [d]efendants' entrepreneurial and managerial efforts" with respect to the blockchain.

Delaware Supreme Court: Business Judgment Rule Did Not Apply to a Controlling Stockholder Transaction Where the Parties Allegedly "Set the Field of Play for the Economic Negotiations" Before the Transaction Was Conditioned on *MFW*'s Procedural Protections

On April 11, 2019, the Delaware Supreme Court reversed the dismissal of a shareholder derivative suit alleging that the directors breached their fiduciary duties in approving a controlling stockholder transaction. [*Olenik v. Lodzinski*, 2019 WL 1497167 (Del. 2019) (Seitz, J.) (*Olenik II*)]. The Delaware Supreme Court held that the Chancery Court erred in applying the business judgment standard of review because plaintiffs alleged that the company and its controlling stockholder "substantially negotiated the financial state of play" before the transaction was conditioned on the procedural protections set forth in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (*MFW*).[3]

3. Please click here to read our discussion of the Delaware Supreme Court's decision in *MFW*.

Background

Over the course of more than eight months in late 2015 and 2016, the company engaged in discussions with its controlling shareholder concerning the possibility of acquiring an entity controlled by the same shareholder. These discussions included a "joint exercise" by the acquiring company and its controlling shareholder to value the target company. This "joint exercise" yielded a valuation of $305 million in the acquiring company's first presentation to its controlling shareholder, and $335 million in the second presentation. On August 19, 2016, the acquiring company's CEO submitted a letter to the target company (the "Offer Letter") proposing the acquisition and conditioning the transaction on *MFW*'s procedural protections, namely, approval by the acquiring company's special committee and approval by a majority of the acquiring company's minority stockholders. The "first formal offer" submitted in the Offer Letter "reflected an equity valuation for [the target company] of about $300 million, and the final deal reflected an equity valuation for [the target company] of around $333 million."

One of the acquiring company's minority stockholders subsequently filed a shareholder derivative suit; defendants moved to dismiss. In a decision dated July 20, 2018, the Delaware Chancery Court held that the submission of the Offer Letter "marked the appropriate time at which to announce the *MFW ab initio* conditions." *Olenik v. Lodzinski*, 2018 WL 3493092 (Del. Ch. July 20, 2018). The court reasoned that although the discussions preceding the Offer Letter were "extensive," they "never rose to the level of bargaining" but were instead "entirely exploratory in nature."[4] The court applied the business judgment rule and dismissed plaintiffs' complaint; plaintiffs appealed.

4. Please click here to read our discussion of the Delaware Chancery Court's decision in *Olenik*.

While the appeal was pending, the Delaware Supreme Court issued its decision in *Flood v. Synutra Int'l*, 195 A.3d 754 (Del. 2018), in which it held that *MFW*'s *ab initio* requirement is satisfied "so long as the controller conditions its offer on the key protections" before the commencement of "substantive economic negotiations with the controller."[5]

The Business Judgment Rule Did Not Apply Because the Purchase Price Parameters Were Allegedly Set Before the Transaction Was Conditioned on *MFW*'s Procedural Protections

The Delaware Supreme Court relied on *Synutra* to hold that the Chancery Court "erred when it found that *MFW*'s dual protections had been agreed to from the deal's inception." The court determined that the Chancery Court "failed to credit reasonable inferences from well-pled facts that the *MFW* procedural protections were not put in place until after almost eight months of substantive economic dealings among the parties." The Delaware Supreme Court acknowledged that "some of the early interactions between [the acquiring company and its controlling shareholder] could fairly be described as preliminary discussions outside of *MFW*'s 'from the beginning' requirement." However, the court found plaintiffs adequately alleged that "the preliminary discussions transitioned to substantive economic negotiations when the parties engaged in a joint exercise to value" the target company. The Delaware Supreme Court found that "these valuations set the field of play for the economic negotiations to come by fixing the range in which offers and counteroffers might be made." The court observed that the final deal reflected an equity valuation for the target company of $333 million—just shy of the $335 million valuation presented in the acquiring company's second presentation to the controlling stockholder.

The Delaware Supreme Court rejected defendants' contention that the Chancery Court's decision should nevertheless be

5. Please click here to read our discussion of the Delaware Supreme Court's decision in *Synutra*.

affirmed because the alleged controlling stockholder "shed its controller status" through a reduction in stock ownership before the submission of the Offer Letter. The Delaware Supreme Court found that *MFW* still governed the transaction because the stockholder "controlled [the company] . . . and also held a majority of [the company's] stock while substantive economic negotiations took place that fixed the field of play for the eventual transaction price."

The court reversed the Chancery Court's decision, and remanded for further proceedings consistent with its opinion.

Delaware Supreme Court: Holds the Chancery Court Erred in Appraising Shares Using the Unaffected Market Price, Rather Than the Merger Price Less Synergies, in an Arm's Length Transaction Following a Fair Sales Process

On April 16, 2019, the Delaware Supreme Court held that the Chancery Court abused its discretion in appraising a company's shares using the unaffected market price, rather than the merger price less synergies, in an arm's length transaction following a fair sales process. [*Verition Partners Master Fund v. Aruba Networks*, 2019 WL 1614026 (Del. 2019) (per curiam)]. The Chancery Court found the deal price less synergies valuation unreliable because "it needed to make an additional deduction . . . for unspecified 'reduced agency costs.'" But the Delaware Supreme Court determined that there was no evidence of any agency cost reductions that "were not already captured by [the acquirer's] synergies estimate."

The Delaware Supreme Court noted that a stock's market price "is an important indicator of its economic value." However, the court underscored that when a company is sold in an arm's length transaction that is preceded by extensive due diligence, "the price that results . . . is even more likely to be indicative of so-called fundamental value" than the unaffected market price.

Background

The company at issue (Aruba) was acquired for $24.67 per share in 2015. Before accepting the acquirer's (HP's) offer, the company conducted a pre-signing market check with five other potential bidders, none of which showed any interest. The company's stock price rose twice between its acceptance of the acquirer's offer and the signing of the final merger agreement. First, the share price increased from $18.37 to $22.24 when news of the transaction was leaked to the press. Second, the stock price rose to $24.81 upon the company's release of its quarterly earnings, which exceeded analyst expectations. The final merger agreement permitted consideration of a superior inbound offer, but no competing bidder emerged.

Following the merger, certain shareholders sought appraisal. The appraisal petitioners argued that the fair value of their shares at the time of the merger was $32.57 per share, based on a discounted cash flow (DCF) analysis. The company contended that the fair value was $19.10 per share using a deal price less synergies valuation.

Chancery Court Relies on the Unaffected Stock Price Because of Difficulties Estimating Synergies in the Form of Reduced Agency Costs

The Chancery Court found that the fair value of the company's shares at the time of the merger was $17.13 per share, based on the company's average share price during the thirty days prior to the market leak. *Verition Partners Master Fund v. Aruba Networks*, 2018 WL 922139 (Del. Ch. 2018). The court recognized that the Delaware Supreme Court's decisions in *DFC Global Corp. v. Muirfield Value Partners*, 172 A.3d 346 (Del. 2017), and *Dell v. Magnetar Global Event*

Driven Master Fund, 177 A.3d 1 (Del. 2017), "teach that the deal price is . . . entitled to substantial weight."[6] The Chancery Court noted that the deal was "an arm's-length transaction" in which the merger price "contained synergies," and "petitioners failed to identify a bidder who would pay more than" the acquirer. The Chancery Court therefore determined that "the deal price in this case operates as a ceiling for fair value."

The Chancery Court then acknowledged challenges in calculating the amount of synergies to deduct from the deal price, and particularly in how to account for (a) academic literature suggesting that a deduction for "reduced agency costs" should be made, and (b) *Dell*'s emphasis on real world indicators of value. Rather than accepting the company's $19.10 valuation (which was generally consistent with DCF valuations conducted by the company's

financial advisors), the court estimated the company's merger price minus synergies valuation at $18.20 per share by applying certain academic literature. The court then disregarded this estimate because it "continues to incorporate an element of value resulting from the merger" in the form of "reduced agency costs that result from unitary (or controlling) ownership," again relying on academic literature. In the absence of a precise way to calculate reduced agency costs, the Chancery Court looked to the unaffected stock price of $17.13 per share, as a "direct route" to valuation and entitled to substantial weight under *DFC* and *Dell*. The court found that both *DFC* and *Dell* "endorse using the market price of a widely traded firm as evidence of fair value."

6. Please click here to read our discussion of the Delaware Supreme Court's decision in *DFC* and here to read our discussion of the Delaware Supreme Court's decision in *Dell*.

Delaware Supreme Court Holds That the Fair Value Is Merger Price Less Synergies

The Delaware Supreme Court reversed the Chancery Court's decision and held that the fair value was $19.10 per share—the merger price less synergies, as calculated by the company. It found this value "corroborated by abundant record evidence."

In reviewing the Chancery Court's analysis, the Delaware Supreme Court first reaffirmed that "fair value" under the Delaware appraisal statute is the "going concern" value—*i.e.*, excluding any value from potential acquisition synergies. The Delaware Supreme Court then opined that the Chancery Court abused its discretion by attempting to deduct reduced agency costs under the facts of the case. The Delaware Supreme Court did not outright reject academic literature which has argued that "replacing a dispersed group of owners with a concentrated group of owners can be expected to add value because the new owners are more capable of making sure management isn't shirking or diverting the company's profits." However, the Delaware Supreme Court found that "unlike a private equity deal, the merger at issue in this case would not replace [the company's] public stockholders with a concentrated group of owners; rather, it would swap out one set of public stockholders for another." The Delaware Supreme Court stated that "the Court of Chancery's belief that it had to deduct for agency costs ignores the reality that [the acquirer's] synergies case likely already priced any agency cost reductions it may have expected."

The Delaware Supreme Court next rejected the Chancery Court's view that *Dell* required deference to the unaffected stock price as "not supported by any reasonable reading" of precedent. It clarified that *Dell* "did not imply that the market price of a stock was necessarily the best estimate of the stock's so-called fundamental value at any particular time," but rather that when a market was "informationally efficient," the market price was "informative" of—not equivalent to—fair value under the Delaware appraisal statute. Here, the Delaware Supreme Court determined that the deal price "could be seen as reflecting a better assessment of [the company's] going-concern value" than the unaffected market price because the acquirer "had more incentive to study [the company] closely than ordinary traders in small blocks of [the company's] shares, and also had material, nonpublic information that, by definition, could not have been baked into the public trading price." The Delaware Supreme Court finally criticized the Chancery Court's decision to unilaterally render a fair value award based on an unaffected market price that was lower than the company's litigation position, which the Court found "injected due process and fairness problems into the proceedings" by raising the prospect of relying on the unaffected market price "late in the proceedings." The Delaware Supreme Court found it troublesome that "the extent to which the market price approximated fair value was never subjected to the crucible of pretrial discovery, expert depositions, cross-expert rebuttal, expert testimony at trial, and cross examination at trial." The Delaware Supreme Court stated that this was "antithetical to the traditional hallmarks of a Court of Chancery appraisal proceeding."

This edition of the
Securities Law Alert was edited by
Susannah S. Geltman
sgeltman@stblaw.com / +1-212-455-2762,
Paul C. Gluckow
pgluckow@stblaw.com / +1-212-455-2653,
Linton Mann III
lmann@stblaw.com / +1-212-455-2654,
and Jonathan K. Youngwood
jyoungwood@stblaw.com / +1-212-455-3539.

Simpson
Thacher

New York

Brooke E. Cucinella
+1-212-455-3070
brooke.cucinella@stblaw.com

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

Stephen M. Cutler
+1-212-455-2773
stephen.cutler@stblaw.com

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

Susannah S. Geltman
+1-212-455-2762
sgeltman@stblaw.com

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

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

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

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

Linton Mann III
+1-212-455-2654
lmann@stblaw.com

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

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

Michael J. Osnato, Jr.
+1-212-455-3252
michael.osnato@stblaw.com

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

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

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

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

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

David Elbaum
Senior Counsel
+1-212-455-2861
david.elbaum@stblaw.com

Janet A. Gochman
Senior Counsel
+1-212-455-2815
jgochman@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

Stephen P. Blake
+1-650-251-5153
sblake@stblaw.com

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

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

Simona G. Strauss
Senior Counsel
+1-650-251-5203
sstrauss@stblaw.com

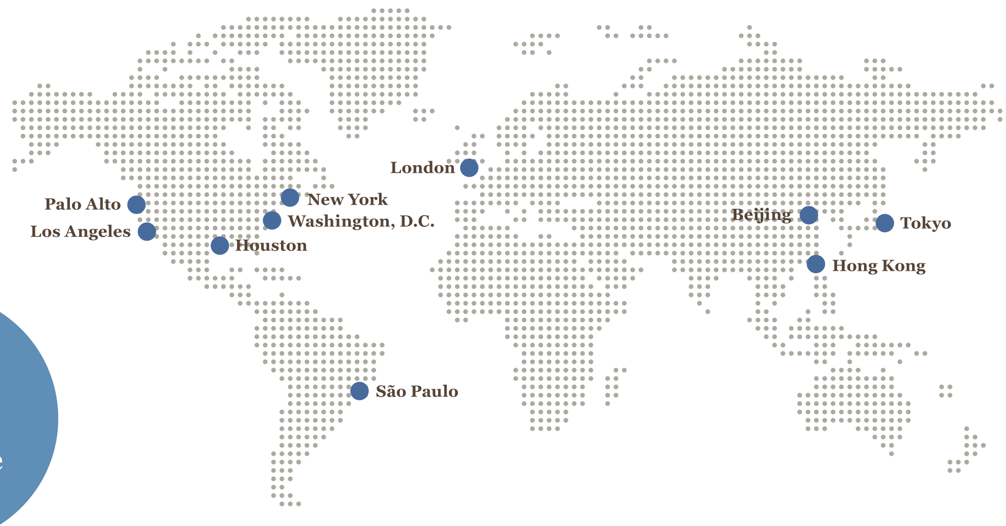
Washington, D.C.

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

Simpson Thacher



Simpson Thacher Worldwide

UNITED STATES

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

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+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.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

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

ASIA

Beijing
3901 China World Tower A
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

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