Simpson Thacher

Securities Law Alert

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Simpson Thacher litigators "are very experienced in handling complex, multi-faceted litigation involving novel issues."

–*Benchmark Litigation* (quoting a client)

Second Circuit: SLUSA Bars Certain Class Action Claims Asserting Breach of the Duty of Best Execution

On July 31, 2018, the Second Circuit affirmed dismissal of a class action complaint alleging breach of the duty of best execution claims against a brokerage house based on the court's determination that the Securities Litigation Uniform Standards Act ("SLUSA") precludes such claims.[1] *Rayner v. E*Trade Fin. Corp.*, 2018 WL 3625378 (2d Cir. 2018) (Livingston, J.). The Second Circuit joined the Eighth and Ninth Circuits "in concluding that best execution claims alleging misrepresentations or omissions relating to: (1) a broker's receipt of 'kickbacks' from trading venues; and (2) the execution of trades so as to take advantage of such arrangements, satisfy the third element of SLUSA, by alleging securities claims based on fraudulent conduct."[2] The court further held that such "alleged fraudulent conduct" is "'in connection with' the purchase or sale of covered securities" within the meaning of SLUSA.

The Second Circuit explained that it "emphasize[s] substance over form" when determining whether "allegations fall within the ambit of SLUSA." The court stated that "plaintiffs cannot avoid SLUSA merely by consciously omitting references to securities or to the federal securities law," nor can they "escape SLUSA by artfully characterizing a claim as dependent on a theory other than falsity when falsity nonetheless is essential to the claim." Here, plaintiffs alleged that the brokerage house falsely represented that it would "do everything possible" to achieve

1. SLUSA bars certain state law-based class action claims alleging either that the defendant made "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security" or "that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1).

2. *See Zola v. TD Ameritrade*, 889 F.3d 920 (8th Cir. 2018); *Lewis v. Scottrade*, 879 F.3d 850 (8th Cir. 2018); *Fleming v. Charles Schwab Corp.*, 878 F.3d 1146 (9th Cir. 2017).

the "best execution" for clients' trades, when in fact, the company allegedly "rout[ed] clients' trades to the trading venues that paid the highest 'kickbacks.'" The Second Circuit found the "substance" of plaintiffs' complaint "plainly allege[d] fraudulent conduct."

The Second Circuit further held that the alleged fraud "arose 'in connection with' the purchase or sale of covered securities." The court explained that in order "[t]o satisfy this element, the fraud perpetrated . . . must be material to a decision by one or more individuals (other than the fraudster) to buy or sell a covered security." The court found the company's purported "fraudulent failure to provide best execution allegedly caused . . . clients to purchase and sell securities at unfavorable prices and at lower volumes than expected."

Ninth Circuit: Limits the Extent to Which Courts Can Rely on Judicial Notice and the Incorporation-by-Reference Doctrine to Consider Extrinsic Documents at the Pleading Stage

On August 13, 2018, the Ninth Circuit held that the district court "abused its discretion by improperly considering materials outside the [c]omplaint" in dismissing a securities fraud action. *Khoja v. Orexigen Therapeutics*, 2018 WL 3826298 (9th Cir. 2018) (Tashima, J.). The Ninth Circuit "note[d] a concerning pattern in securities cases" in which defendants "improperly" utilize judicial notice and the incorporation-by-reference doctrine "to defeat what would otherwise constitute adequately stated claims at the pleading stage." The court cautioned that "the unscrupulous use of extrinsic documents to resolve competing theories against the complaint risks premature dismissals of plausible claims that may turn out to be valid after discovery." To address these concerns, the Ninth Circuit "clarif[ied] when and how the district court[s] should consider materials extraneous to the pleadings at the motion to dismiss stage."

Courts May Not Judicially Notice Disputed Facts

The Ninth Circuit explained that "a court may take judicial notice of matters of public record without converting a motion to dismiss into a motion for summary judgment." However, "a court cannot take judicial notice of disputed facts contained in such public records." The Ninth Circuit explained that "[j]ust because [a] document itself is susceptible to judicial notice does not mean that every assertion of fact within that document is judicially noticeable for its truth."

The Ninth Circuit found the district court erred to the extent it took judicial notice of the transcript of an investor call for the purpose of determining what investors knew at the time. The Ninth Circuit explained that "[i]t is improper to judicially notice a transcript when the substance of the transcript is subject to varying interpretations, and there is a reasonable dispute as to what the transcript establishes."

Courts May Not Incorporate by Reference Unmentioned Documents That Dispute the Complaint's Factual Allegations

The Ninth Circuit reaffirmed that "a defendant may seek to incorporate a document into the complaint 'if the plaintiff refers extensively to the document or the document forms the basis of the plaintiff's claim.'" *Id.* (quoting *United States v. Ritchie*, 342 F.3d 903 (9th Cir. 2003)). The court stated that a complaint must usually refer to a document "more than once" to satisfy the "extensively" standard. However, the court noted that a single reference "may be sufficiently 'extensive' if [it] is relatively lengthy."

The Ninth Circuit found that the "more difficult question is whether a document can ever form the basis of the plaintiff's claim if the complaint does not mention the document at all." The court stated that there are "rare

instances when assessing the sufficiency of a claim requires that [a] document [not mentioned in the complaint] be reviewed, even at the pleading stage." But the Ninth Circuit made it clear that "if the document merely creates a defense to the well-pled allegations in the complaint, then that document did not necessarily form the basis of the complaint." The court reasoned that "[s]ubmitting documents not mentioned in the complaint to create a defense is nothing more than another way of disputing the factual allegations in the complaint," but with the "added benefit" that "the plaintiff receives no opportunity to respond to the defendant's new version of the facts" "unless the district court converts the defendant's motion to dismiss into a motion for summary judgment."

The Ninth Circuit further noted that the issue of "what inferences a court may draw from an incorporated document should also be approached with caution." The court stated that "it is improper to assume the truth of an incorporated document if such assumptions only serve to dispute facts stated in a well-pleaded complaint."

The Ninth Circuit found the district court abused its discretion by considering certain documents that were neither extensively referenced in the complaint, nor formed the basis of plaintiffs' claims.

District of Minnesota: Denies Leave to Amend Complaint to Plead Alleged Misstatements From a Press Release Protected by the PSLRA's Safe Harbor

On July 11, 2018, Magistrate Judge Franklin Noel of the District of Minnesota denied plaintiffs' request to file an amended class action complaint in a long-pending securities fraud action against a major electronics retailer.[3] *IBEW Local 98 Pension Fund v. Best Buy Co.*, 2018 WL 3377175 (D. Minn. 2018) (*Best Buy IV*). Plaintiffs sought the court's leave to plead additional alleged misstatements from a press release that the court had previously deemed protected by appropriate cautionary language under the safe harbor provision of the Private Securities Litigation Reform Act ("PSLRA.") The *Best Buy IV* court held that plaintiffs' "attempt to present a different portion of the [same] press release countervail[ed] the law of the case doctrine." The court explained that "[t]he cautionary language was issued in tandem with the entire press release, not merely excerpts of it."

The *Best Buy IV* court also found meritless plaintiffs' contention that the proposed amended complaint would be sufficient to merit class certification with respect to alleged misstatements made during a September 14, 2010 conference call, which were the only statements that the court had found actionable under the securities laws. The court explained that "the issue of class certification" as to these alleged misstatements had already "been exhaustively litigated." The Eighth Circuit had previously reversed the court's order granting class certification based on its determination that the statements made during the September 14, 2010 conference call had no price impact; the district court subsequently denied plaintiffs' request to file a new motion for class certification.[4] The *Best Buy IV* court found no "clear error or manifest injustice in these holdings," and explained that it would be inappropriate "to permit amendment based on an issue competently decided by the Eighth Circuit and District Court." The *Best Buy IV* court held that "[a]fter seven years of litigation . . . this case must now proceed as an individual action based" solely on the statements made during the September 14, 2010 conference call. Plaintiffs have filed an objection to the decision with the district court judge presiding over the case.

3. Simpson Thacher represents Best Buy and several of its executives in this matter.

4. Please click here to read our discussion of the Eighth Circuit's decision in *IBEW Local 98 Pension Fund v. Best Buy Co.*, 818 F.3d 775 (8th Cir. 2016).

Delaware Chancery Court: Business Judgment Standard of Review May Apply Under *MFW* Even if Discussions Take Place Before *MFW*'s Procedural Safeguards Are Announced

On July 20, 2018, the Delaware Chancery Court held that the business judgment rule applied to an alleged controlling stockholder transaction even though discussions about the possibility of the transaction had taken place before the alleged controller conditioned the transaction in compliance with *MFW*'s requirements.[5] *Olenik v. Lodzinski*, 2018 WL 3493092 (Del. Ch. 2018) (Slights, V.C.). The court reasoned that the discussions, "while extensive, never rose to the level of bargaining" but were instead "entirely exploratory in nature."

MFW's Conditions Must Be in Place at the Time a "Definitive Proposal" Is Made

MFW holds that the business judgment standard of review applies to a controlling stockholder transaction if the transaction "is conditioned *ab initio* upon the approval of both an independent, adequately-empowered [s]pecial [c]ommittee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders." 88 A.3d 635. The *Olenik* court explained that in order "to mimic arms-length dealing, and to neutralize the controller's influence, these two conditions must be [in] place . . . before any negotiations take place." 2018 WL 3493092.

The *Olenik* court stated that "for purposes of the *MFW* analysis, in most instances, 'negotiations' begin when a proposal is made by one party which, if accepted by the counter-party, would constitute an agreement between the parties regarding the contemplated transaction." Applying this standard, the court found that the receipt of a definitive proposal (in the form of an Offer Letter) "marked the appropriate time at which to announce the *MFW ab initio* conditions." The court rejected plaintiffs' contention that negotiations began for *MFW* purposes when the CEO engaged in "substantial preliminary discussions" with the alleged controller. The court found "[t]his argument . . . ignores the important distinction between 'discussions' about the possibility of a deal and 'negotiations' of a proposed transaction after the 'discussions' lead to a definitive proposal."

The Transaction Structure Satisfied *MFW*'s Requirements

The court held that the transaction structure at issue met *MFW*'s conditions because the special committee was "well-functioning," and the stockholder vote was adequately informed and uncoerced.

The court explained that in order to question a director's independence, plaintiffs must "show[ ] that a specific director's independence is compromised by factors material to" that director. Here, plaintiffs claimed, *inter alia*, that there were financial ties between two of the directors and the alleged controller. The court found these allegations insufficient because plaintiffs failed to "even attempt" to plead that these factors were material to those directors.

The court further found that the special committee had appropriate authority and acted with due care in negotiating the deal price. The court stated that "the [s]pecial [c]ommittee did not rubber-stamp a fully-baked deal that [the CEO] had negotiated." Rather, "[i]t was actively engaged in the process, called its own shots and interfaced directly with management and its legal and financial advisors throughout the negotiations."

5. The parties disputed whether the stockholder at issue was a controlling stockholder. The court found it unnecessary to resolve the question because it found the business judgment rule applicable under *MFW*. Please click here to read our discussion of the Delaware Supreme Court's decision in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) *(MFW)*.

Delaware Chancery Court: Two Recent Decisions Provide Guidance on When Courts Will Rely on the Merger Price as Presumptive Evidence of Fair Value

Last year, the Delaware Supreme Court issued two decisions emphasizing the significance of the deal price in appraisal litigation. *See DFC Glob. Corp. v. Muirfield Value Partners*, 172 A.3d 346 (Del. 2017); *Dell v. Magnetar Glob. Event Driven Master Fund*, 177 A.3d 1 (Del. 2017).[6] Two recent appraisal rulings suggest that the weight a court places on the deal price will depend on the court's assessment of the sales process. *Compare* [*Blueblade Capital Opportunities v. Norcraft Cos.*, 2018 WL 3602940 (Del. Ch. July 27, 2018) (Slights, V.C.)] (no weight on the merger price where the court found the sales process defective) *with* [*In re Appraisal of Solera Holdings*, 2018 WL 3625644 (Del. Ch. July 30, 2018) (Bouchard, C.)] (dispositive weight on the merger price where the court found the sales process thorough and effective).

Blueblade Court Places No Weight on the Merger Price Because of Deficiencies in the Sales Process

In *Blueblade*, the Delaware Chancery Court determined the deal price did not reflect the fair value of petitioners' shares as of the merger date in view of what the court found to be "significant flaws in the process leading to the [m]erger." 2018 WL 3602940. The court stated that it was "cognizant of the Delaware Supreme Court's embrace of 'deal price' as a strong indicator of fair value in *Dell* and *DFC*." But the court noted that in both cases, the Delaware Supreme Court "declined to adopt a rule that the deal price is presumptively reflective of fair value."

The *Blueblade* court stated that "[i]n an appraisal action under the Delaware General Corporation Law, the trial court's 'fair value' determination must 'take into account all relevant factors." *Id.* (quoting 8 *Del. C.* § 262(h)). The court explained that the Delaware Supreme Court has "reiterated the 'flexible' nature of the trial court's fair value calculus, while also noting its lack of 'confidence in its ability to craft, on a general basis, the precise pre-conditions that would be necessary to invoke a presumption' in favor of the deal price." *Id.* (quoting *DFC*, 172 A.3d 346).

In the case before it, the *Blueblade* court found the "deal process did not include a meaningful market check and, consequently, the [m]erger [p]rice was not arrived upon by the collective views of many sophisticated parties with a real stake in the matter." With respect to the company's decision to negotiate with a single bidder during the pre-signing phase, the court recognized that such an approach "can, in certain instances, lead to significant value." Here, however, "the [b]oard's focus on only one bidder was tainted" because the board member who served as the company's "lead negotiator from start to finish" was "conflicted." The court found the post-signing go-shop process "equally ineffective as a price discovery tool" because of the restrictions placed on the process by the acquiror.

The court also deemed the company's unaffected trading price unreliable as an indicator of fair value because "at the time of the [m]erger, [the company] was fresh off an initial public offering of its stock, [the stock] was relatively thinly traded given the niche market in which it operated and [the company] was also thinly covered by analysts."

The court opted to place no weight on either the merger price or the unaffected trading price, and instead employed a discounted cash flow analysis. The court did then use the merger price as a "'reality check'" on its fair value determination. The court determined that each share was worth $26.16, an additional 66 cents over the deal price of $25.50 per share.

Solera Court Relies on the Merger Price Where the Company Was Sold in an Open Process With Objective Indicia of Reliability

In contrast with the *Blueblade* court, the *Solera* court gave the deal price, as adjusted for merger synergies, "sole and dispositive weight in determining the fair value of petitioners' shares as of the date of the merger." 2018 WL 3625644. The court

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*.

found "the [m]erger price resulted from an open process, informed by robust public information, and easy access to deeper, non-public information, in which many parties with an incentive to make a profit had a chance to bid." The court also found it significant that there was "an efficient and well-functioning market for [the company's] stock" at the time of the merger.

The *Solera* court stated that the Delaware Supreme Court's recent decisions in *DFC* and *Dell* "teach that deal price is the best evidence of fair value" in cases where the sales process "is characterized by objective indicia of reliability." The *Solera* court also noted that both rulings "emphasized" that "the price of a widely dispersed stock traded in an efficient market may provide an informative lower bound in negotiations between parties in a potential sale of control."

The *Solera* court found unpersuasive petitioners' contention that the deal price was not reliable because the sale "took place against the backdrop of extraordinary market volatility, such that it was not the product of a well-functioning market." The court explained that petitioners "are only entitled to the fair value of [the company's] stock at the time of the [m]erger, not the best price theoretically attainable had market conditions been the most seller-friendly."

The court also rejected petitioners' argument that a management buyout transaction ("MBO") "should be subject to heightened scrutiny." The court stated that "even though there may be theoretical characteristics of an MBO that could detract from the reliability of the deal price, the deal price that results from an MBO is not inherently suspect or unreliable *per se*."

In addition, the court found no basis for petitioners' request that the merger fees should be added to fair value as part of what the acquiror was willing to pay for the company. The court observed that "[i]f stockholders received payment for transaction fees in appraisal proceedings, then it would compel rational stockholders in even the most pristine deal processes to seek appraisal to capture their share of the transaction costs (plus interest) that would otherwise be unavailable to them in any non-litigated arm's-length merger."

Finally, the court rejected defendants' contention that the deal price should be downwardly adjusted for the value of control. The court found that a number of recent appraisal decisions "suggest that the value of control is properly part of the going concern and not an element of value that must be excised under Section 262(h)." Moreover, the court stated that it did not read *DFC* and *Dell* "to suggest that agency costs represent an element of value attributable to a merger separate from synergies that must be excluded under Section 262(h)." If that had been the Delaware Supreme Court's intention in either case, the *Solera* court reasoned that "it would have said so explicitly."

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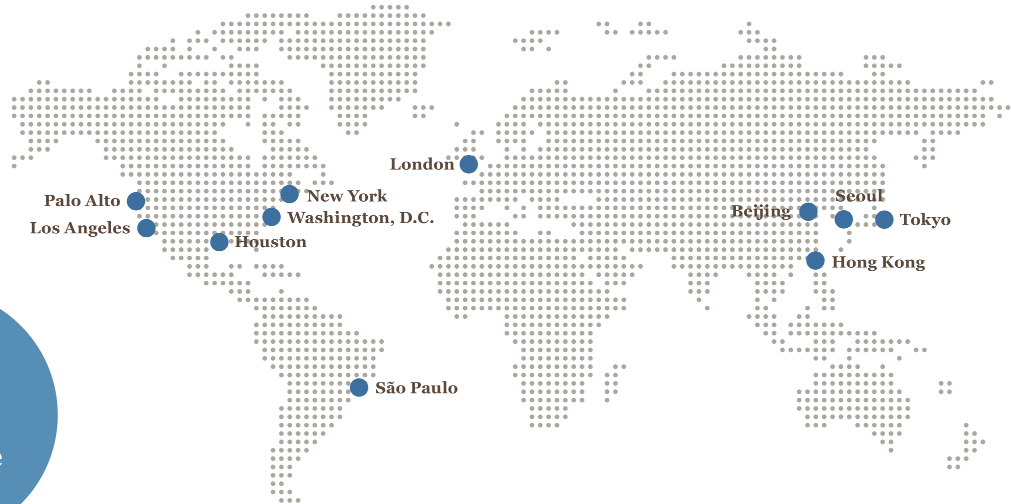

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