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Securities Law Alert

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Supreme Court: Hears Oral Argument on Whether the SEC May Seek and Obtain Disgorgement in Civil Enforcement Proceedings

On March 3, 2020, the Supreme Court heard oral arguments in *Liu v. SEC*, No. 18-1501. At issue is whether existing legislation authorizes the SEC to seek disgorgement of profits as "equitable relief" in district court proceedings to enforce the Securities Act of 1933 and the Securities Exchange Act of 1934.

Background

In the case before the Court, defendants-petitioners ("Petitioners") raised approximately $27 million for a project, but misappropriated the bulk of the investment. The district court imposed penalties of $8 million (the amount of the salaries defendants received) and ordered disgorgement of the remaining $19 million defendants took from investors. The district court declined to offset the disgorgement amount by Petitioners' legitimate business expenses (approximately $4.5 million). The Ninth Circuit affirmed the district court's decision.

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–The Legal 500

The SEC often seeks disgorgement in cases where it believes defendants have defrauded or deliberately deceived investors. In 2019, the SEC obtained $3.2 billion in disgorgement, compared with $1.1 billion in civil penalties; the SEC returned 37% of disgorged profits to harmed investors, with the remainder of disgorged funds dispensed to the U.S. Treasury.

Congress has authorized the SEC to seek disgorgement in its own administrative proceedings, *see* 15 U.S.C. § 78u-2(e), but has not expressly authorized disgorgement when the SEC seeks such relief in federal court.

Instead, Congress has authorized the SEC to seek a range of remedies in district court proceedings, including "any equitable relief that may be appropriate or necessary for the benefit of investors." 15 U.S.C. § 78(u)(d)(5). The Court recently held in *Kokesh v. SEC*, 137 S. Ct. 1635 (2017), that disgorgement of profits is a penalty, and not an equitable remedy, for purposes of the statute of limitations set forth in 28 U.S.C. § 2462.[1] The unanimous *Kokesh* Court did not reach the question of whether the SEC can seek disgorgement in district court proceedings.

Several Justices Express Concern Regarding the Punitive Nature of the Disgorgement Sought by the SEC in the Case Before It

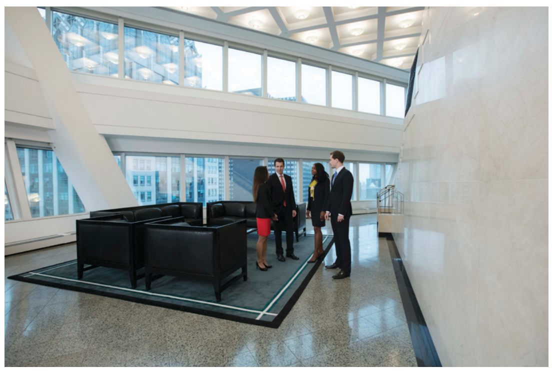
During oral argument, the Justices focused on the seemingly punitive nature of the disgorgement the SEC sought in the case before it. The Justices asked whether disgorged funds should be returned to investors and appeared concerned that here, the SEC sought to disgorge all of the investments Petitioners raised, not just their profits.

Justice Alito asked Petitioners' counsel if the remedy would be equitable if it were limited to net profits instead of the entire amount Petitioners took in from investors. Petitioners' counsel responded that a similar remedy in equity would be based on profits, but that such a remedy would normally only be available for breaches of fiduciary duty, which the SEC did not plead or prove in this case. When Justice Kavanaugh followed up on the relevance of the disgorgement's calculation as revenues or profits, Petitioners' counsel noted that there is not even agreement among the circuit courts as to what disgorgement is and how it should be calculated and urged that Congress, not the Court, should be responsible for crafting the scope of disgorgement and determining how it should be calculated.

Justice Kavanaugh asked if the analysis would be different if disgorged funds were dispersed to investors (instead of the Treasury). Petitioners' counsel acknowledged that this would address one of the main inconsistencies between the disgorgement obtained by the SEC and traditional equitable remedies.

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

Nonetheless, Petitioner's counsel insisted that the disgorgement sought by the SEC "was clearly a penalty and clearly inconsistent with *Kokesh*." Justice Ginsburg observed that the context of *Kokesh*, which concerned the statute of limitations set forth in 28 U.S.C. § 2462, was vastly different from the equitable remedy question at issue in *Liu*. She noted the equitable principle that wrongdoers should not profit from their wrongs. Counsel for the SEC downplayed the significance of *Kokesh* and instead pointed the Court to *Kansas v. Nebraska*, 135 S. Ct. 1042 (2015), a case where disgorgement was ordered as an equitable remedy.



Justices Sotomayor and Gorsuch asked how the SEC decides whether to return money to investors or distribute it to the Treasury. Counsel for the SEC explained that while the SEC attempts to return disgorged funds to investors, there are some cases, such as those arising under the Foreign Corrupt Practices Act, in which there may not be an individual victim who should receive the disgorgement proceeds. Justice Kavanaugh questioned whether the Supreme Court should announce a rule on how disgorgement is calculated or leave it to district courts to decide.

Justice Ginsburg probed the SEC's position that administrative proceedings (in which the SEC is statutorily authorized to seek disgorgement) are an inadequate substitute for district court proceedings. She noted that the SEC could take an administrative order to a district court for enforcement if needed. Counsel for the SEC responded that the SEC often proceeds in district court when it has doubts about a defendant's compliance, allowing for a more streamlined enforcement action.

The Supreme Court will rule on *Liu v. SEC* later this Term.

Supreme Court: "Actual Knowledge" Requirement for the Three-Year Statute of Limitations for ERISA Breach of Fiduciary Duty Claims Is Not Satisfied Merely by the Plaintiff's Receipt of the Relevant Disclosures

ERISA breach of fiduciary duty claims are subject to a six-year statute of limitations unless the plaintiff "had actual knowledge of the breach or violation," in which case a three-year statute of limitations applies. 29 U.S.C. § 1113(2). On February 26, 2020, the Supreme Court held that an ERISA plaintiff does not necessarily have "actual knowledge" of information contained in disclosures that he received but did not read or recall reading. *Intel Corp. Inv. Policy Comm. v. Sulyma, 2020 WL 908881 (2020) (Alito, J.)*. The Court found that in order to satisfy Section 1113(2)'s "actual knowledge" requirement, "the plaintiff must in fact have become aware of that information."

Background

In the case before the Court, plaintiff alleged that an investment plan committee and other plan administrators "breached their fiduciary duties by overinvesting in alternative assets." Plaintiff brought suit "within six years of the alleged breaches," but "more than three years after [defendants] had disclosed their investment decisions to him." Plaintiff "testified in his deposition that he did not 'remember reviewing'" the relevant disclosures.

The district court granted summary judgment to defendants because plaintiff failed to bring suit within three years of the receipt of the disclosures. The district court reasoned that "[i]t would be improper to allow [plaintiff's] claims to survive merely because he did not look further into the disclosures made to him." 2017 WL 1217185 (N.D. Cal. Mar. 31, 2017). The Ninth Circuit reversed the district court's decision. 909 F.3d 1069 (9th Cir. 2018). The court held that Section 1113(2)'s "actual knowledge" requirement demands "knowledge that is actual, not merely a possible inference from ambiguous circumstances." The Ninth Circuit's interpretation was in accord with prior rulings from the Second, Third, Fifth, Seventh and Eleventh Circuits. Only the Sixth Circuit has held that "[a]ctual knowledge does not require proof that the individual [p]laintiffs actually saw or read the documents that disclosed the allegedly harmful investments." *Brown v. Owens Corning Inv. Review Comm.*, 622 F.3d 564 (6th Cir. 2010).

Defendants petitioned the Court for certiorari to consider whether Section 1113(2) "bars suit where all of the relevant information was disclosed to the plaintiff by the defendants more than three years before the plaintiff filed the complaint, but the plaintiff chose not to read or could not recall having read the information." The Court granted the petition on June 10, 2019.

Court Interprets the Phrase "Actual Knowledge" to Require Awareness of the Relevant Information

In a unanimous decision authored by Justice Alito, the Court held that Section 1113(2)'s "actual knowledge" requirement demands "more than evidence of disclosure alone." The Court determined that "§ 1113(2) begins only when a plaintiff actually is aware of the relevant facts, not when he should be" based on the receipt of the relevant disclosures. The Court explained that "a given plaintiff will not necessarily be aware of all facts disclosed to him; even a reasonably diligent plaintiff would not know those facts immediately upon receiving the disclosure."

The Court rested its decision on the plain meaning of the phrase "actual knowledge." The Court found that the phrase "actual knowledge" refers to "[r]eal knowledge as distinguished from presumed knowledge or knowledge imputed to one." The Court explained that in order "to have 'actual knowledge' of a piece of information, one must in fact be aware of it." The Court found that "if a plaintiff is not aware of a fact, he does not have 'actual knowledge' of that fact however close at hand the fact might be."

In interpreting Section 1113(2), the Court found it significant that "Congress has repeatedly drawn a linguistic distinction between what an ERISA plaintiff actually knows and what he should actually know." The Court noted that "when Congress has included both forms of knowledge in a provision limiting ERISA actions, it has done so explicitly." The Court explained that it could not "assume that [Congress] meant to do so by implication in § 1113(2)," particularly since the 1987 Congress repealed the constructive knowledge clause included in the original version of Section 1113(2). The Court determined that "Section 1113(2)'s history thus more readily suggests that the current version does in fact require actual knowledge."

Court Leaves Open the Possibility That Defendants Can Show "Actual Knowledge" Through Willful Blindness

The Court clarified that "[n]othing in [its] opinion forecloses any of the usual ways to prove actual knowledge at any stage in the litigation." The Court explained that in addition to relying on direct evidence, defendants may prove "actual knowledge" "through inference from circumstantial evidence." The Court noted that "[e]vidence of disclosure would no doubt be relevant, as would electronic records showing that a plaintiff viewed the relevant disclosures and evidence suggesting that the plaintiff took action in response to the information contained in them." Significantly, the Court stated that its "opinion also does not preclude defendants from contending that evidence of 'willful blindness' supports a finding of 'actual knowledge.'"

Tenth Circuit: Affirms the Dismissal of a Securities Fraud Action for Failure to Allege That Any Individual Defendant or the Corporation Itself Acted with Scienter

On February 25, 2020, the Tenth Circuit affirmed the dismissal of a securities fraud action alleging misstatements concerning a money transfer company's anti-money laundering ("AML") and anti-fraud compliance systems. [*Smallen v. The Western Union Co.*, 2020 WL 893826 (10th Cir. 2020) (Baldock, C.J.)](). The Tenth Circuit recognized that "the complaint may give rise to some plausible inference of culpability on the part of [d]efendants," but determined that plaintiff did not plead particularized facts raising a strong inference of scienter as to any of the individual defendants. The court further found that that plaintiff did not plead that the corporation itself acted with scienter. Addressing a question of first impression, the court held that for purposes of pleading a corporation's scienter with respect to alleged misstatements, the knowledge of non-defendant corporate agents who played no role in those statements cannot be imputed to the corporation.

Plaintiffs Failed to Plead Scienter as to Any of the Individual Defendants

The Tenth Circuit rejected plaintiff's contention that the individual defendants "must have known the company's compliance programs were ineffective" because the company received complaints regarding hundreds of millions of dollars in fraudulent transactions. The court explained that the transactions at issue represented less than 1% of the total dollars transferred by the company and therefore did not impact "an overwhelming percentage of the company's business."

The Tenth Circuit also declined to infer the individual defendants' scienter based on "materials from [the company's] board and committee meetings, which the individual defendants allegedly attended." The court explained that "mere attendance at meetings does not contribute to an inference of scienter." The Tenth Circuit further determined that it could not infer the individual defendants' scienter based on reports and records concerning compliance issues that were produced to government investigators. The court explained that there were no "particularized allegations showing the [i]ndividual [d]efendants themselves dealt with the government regulators, reviewed the underlying documents submitted as part of the investigations, or were otherwise informed legal noncompliance existed within the company during the [c]lass [p]eriod." While the court found plaintiffs' theory of scienter "strongest against" the company's CEO, who was allegedly "regularly briefed" on compliance issues, the court concluded that it could not "infer scienter based only a defendant's position in a company or involvement with a particular project."

The Tenth Circuit also held that findings in a joint settlement agreement with federal regulators and admissions in a deferred prosecution agreement did not demonstrate that the individual defendants knew of compliance violations. The court found plaintiff's reliance on these documents was "simply another variation of fraud by hindsight" because "neither document provide[d] particularized facts tying the [i]ndividual [d]efendants to these violations or otherwise showing they were aware of ongoing illegality and widespread disciplinary failures during the [c]lass [p]eriod." The Tenth Circuit also found that plaintiffs could not demonstrate a motive to defraud based on the individual defendants' stock sales, as two of the defendants "increased their aggregate holdings" while one of the defendants sold no company stock during the class period.

The Scienter of Non-Defendant Corporate Agents Who Played No Role in the Alleged Misstatements Cannot Be Attributed to the Corporation

The Tenth Circuit acknowledged that "[a]lthough [p]laintiff fail[ed] to adequately plead scienter for any of the [i]ndividual [d]efendants, the complaint could, in theory, still give rise to a strong inference [that the company] acted with the requisite state of mind." The court explained that "[c]orporations, of course, do not have the their own state of mind. Rather, the scienter of a corporation's agents must be imputed to it."

The court noted that "[t]he appropriate standard for evaluating whether a non-defendant corporate agent's state of mind can be imputed to a corporate defendant under the [Private Securities Litigation Reform Act ("PSLRA")] appears to be an open question" in the Tenth Circuit. The court held that "[b]ecause the allegations here concern allegedly fraudulent public statements," it would "look to the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like)."

The court expressly rejected plaintiffs' argument that "the scienter of *any* [company] agent, including lower-level corporate officers who played no role in the misstatement, can be imputed to the company for purposes of liability under the PSLRA." The court explained that "[i]f the scienter of any agent is imputable to a corporation, 'then it is possible that a company could be liable for a statement made [] so long as a low-level employee, perhaps in another country, knew something to the contrary.'" The court found that "[s]uch a result runs afoul of the PSLRA's heightened standard for pleading scienter."

The court determined that plaintiff's allegations did not "give rise to a strong inference of scienter as to any identifiable [corporate] officer," and further held that the company was not "subject to § 10(b) liability under the doctrine of 'corporate scienter,'" which "allows a plaintiff to plead scienter against a corporate defendant without doing so for a particular individual." The court noted that the Tenth Circuit has "neither accepted nor rejected this theory of corporate scienter," but found that it need not resolve the question as "the facts pleaded are a far cry" from the frequently-cited hypothetical situation "as to when the doctrine would apply": the example of a car company that claimed to have sold millions of vehicles but in fact sold none.

Southern District of New York: Plaintiffs Cannot Satisfy the PSLRA's Pleading Requirements With Uncorroborated Allegations Attributed to Anonymous Sources Referenced in Short-Seller Reports

On March 2, 2020, the Southern District of New York dismissed a securities fraud action that relied on allegations attributed to anonymous sources referenced in a short-seller report. *Miao v. Fanhua*, 2020 WL 996602 (S.D.N.Y. 2020) (Engelmayer, J.). The court explained that "[w]hen properly utilized and suitably corroborated or particularized, factual representations by [confidential witnesses] and in short-seller reports may enable a securities fraud complaint to clear the bar set by the PSLRA." The court found the complaint did not meet this standard, as it "relie[d] exclusively on general statements" that were "credited to anonymous interviewees in a secondhand short-seller report" and were "uncorroborated by an independent investigation by counsel."

The court recognized that "[s]hort sellers operate by speculating that the price of a security will decrease" and thus "have an obvious motive to exaggerate the infirmities of the securities in which they speculate." *Id.* Notwithstanding this potential bias, the court held that a complaint's reliance on a short-seller report does not necessarily require dismissal. The court found "[t]he developing body of case law involving factual attributions to short-seller reports to satisfy pleading requirements in a securities fraud complaint instead reflects the need for similar caution and care as with respect to attributions to [confidential witnesses]."

The court observed that the case law indicates "a particular need for close scrutiny where a short-seller report relied upon by a securities plaintiff itself relies on 'confidential' or anonymous sources, without corroboration."

The court explained that in such cases, "the risk of motivated reporting by the author of the short-seller report is twinned with the reliability concerns presented by anonymous sourcing." Conversely, "where courts have found that well-pled independent and particularized facts corroborate those attributed to anonymous sources in short-seller reports, courts have sustained such complaints."

In the case before it, the court found the complaint did "no more than recapitulate the [short-seller report's] characterization of purported interviews with anonymous sources" and did "not allege any independent corroborative facts, any independent investigation by counsel, or any contact by plaintiff's counsel with the interviewees." The court found it "concerning" that the complaint reproduced "significant factual errors" contained in the short-seller report that "[a]n alert reader of [the company's SEC filings] would have caught." The court found these factual errors "raise[d] doubt as to whether the other factual representations in the same short-seller's report . . . can be credited as a reliable basis to establish the factual falsity of [the company's] representations to the market."

The court held the complaint failed to state a claim with respect to the alleged misstatements for which the anonymous sources referenced in the short-seller report were cited. The court gave plaintiff the opportunity to replead these allegations, reasoning that "an independent investigation could [potentially] substantiate [plaintiff's] theory that . . . an actionable fraud occurred."

Southern District of New York: Dismisses Securities Fraud Complaint That Mischaracterized Defendants' Opinions and Emphasizes That Companies Have No Duty to Disclose All Facts Cutting Against Statements of Opinion

On February 27, 2020, the Southern District of New York dismissed a securities fraud action alleging that a mining company misleadingly expressed continued confidence in its plan for developing and operating a mine (the "mine plan"), while failing to disclose that the quantity of unusable "waste rock" excavated at the mine was higher than expected. *In re Pretium Resources Sec. Litig.*, 2020 WL 953609 (S.D.N.Y. 2020) (Preska, J.). The court found that contrary to "[p]laintiffs' mischaracterizations, [the company's] statements were not affirmations of categorical confidence in all aspects of the mine plan or of specific confidence in the plan's waste rock projections."

The court held that the statements at issue were opinions. The court explained that in order to allege that a statement of opinion was misleading by omission under the test set forth in *Omnicare v. Laborers District Council Construction Industry Pension Fund*, 575 U.S. 175 (2015), "the plaintiff must identify particular (and material) facts going to the basis for the speaker's opinion whose omission makes the opinion statement . . . misleading to a reasonable person reading the statement fairly and in context."[2] The court underscored that "a reasonable investor does not expect that every fact known to a speaker supports its opinion." The court noted that "[a]n opinion therefore is not necessarily misleading when a speaker knows, but fails to disclose, some fact cutting the other way."

The court determined that "[d]efendants' disclosures about the mine plan could not have been fairly construed by reasonable investors as expressing confidence in the plan's waste rock projections or the plan as a whole." The court held that "[d]efendants' failure to disclose the waste rock excavation

2. Please click here to read our discussion of the Supreme Court's decision in *Omnicare*.

numbers therefore did not render the statements misleading." The court further found that even if the company's "statements could be interpreted as broad expressions of confidence in the mine plan's viability, [d]efendants' failure to disclose the waste rock figures would still not be actionable." The court explained that "[s]ecurities fraud plaintiffs must do more than show that the speaker knew or had access to countervailing information; they must show that the speaker's opinion did not fairly align with all the information that was then available." The court held that plaintiffs did "not satisfy that standard." To the extent that "increased tunneling and waste rock excavation weighed against a cheerful view of the mine plan's overall viability," the court found plaintiffs had "not plausibly alleged that [this] pushed the scale's needle so far as to render continued faith in the plan unreasonable."

The court also found plaintiffs failed to allege scienter because the waste rock data was publicly available in the company's reports to Canadian regulators. The court held that the public accessibility of this data "kick[ed] the legs out from any inference of scienter."

Central District of California: Plaintiffs Adequately Alleged That (1) Purchases of Unsponsored ADRs Constituted "Domestic Transactions," and (2) the Foreign Issuer's Alleged Fraud Was "in Connection With" Those ADR Transactions

On January 28, 2020, the Central District of California declined to dismiss a securities fraud action arising out of purchases of unsponsored American Depositary Receipts and Shares (ADRs) on over-the-counter markets.[3] [*Stoyas v. Toshiba Corp.*, 2020 WL 466629 (C.D. Cal. 2020) (Pregerson, J.)](). The court held plaintiffs adequately alleged that the purchases were "domestic transactions" for purposes of the test set forth in *Morrison v. National Australia Bank*, 561 U.S. 247 (2010), and that alleged misstatements by the foreign issuer of the underlying securities were made "in connection with" those ADR transactions.[4]

Background

The Central District of California had previously held that Section 10(b) does not reach securities fraud transactions in unsponsored ADRs. *Stoyas v. Toshiba Corp.*, 191 F. Supp. 3d 1080 (C.D. Cal. 2016). Based on this determination, the court granted defendants' motion to dismiss and denied plaintiffs leave to amend.

On July 17, 2018, the Ninth Circuit reversed the Central District of California's decision. *Stoyas v. Toshiba Corp.*, 896 F.3d 933 (9th Cir. 2018). The Ninth Circuit held that *Morrison* does not preclude Section 10(b) claims in connection with unsponsored ADRs, provided that the ADRs were purchased or sold in a "domestic transaction."[5] The Ninth Circuit reasoned that *Morrison* instructs courts "to examine the location of the transaction[;] it does not matter that a foreign entity was not engaged in the transaction." The Ninth Circuit adopted the test set forth in *Absolute Activist Value Master Fund v. Ficeto*, 677 F.3d 60 (2d Cir. 2012), for determining whether the securities were purchased or sold in a "domestic transaction." To plead a "domestic transaction" under the *Absolute Activist* test, "a plaintiff must allege facts suggesting that irrevocable liability was incurred or title was transferred within the United States." *Absolute Activist*, 677 F.3d 60.[6]

The Ninth Circuit agreed with the district court that plaintiffs failed to allege the existence of a "domestic transaction." The Ninth Circuit further found that plaintiffs failed to plead that the foreign issuer's alleged fraud was "in connection with" a "domestic transaction." The court explained that in order "for fraud to be in connection with the purchase or sale of any security, it must touch the sale—i.e., it must be done to induce the

3. "An ADR is a receipt that is issued by a depositary bank that represents a specified amount of a foreign security that has been deposited with a foreign branch or agent of the depositary, known as the custodian." *Stoyas v. Toshiba Corp.*, 191 F. Supp. 3d 1080 (C.D. Cal. 2016).

4. In *Morrison*, the Supreme Court held that Section 10(b) applies only to (1) "transactions in securities listed on domestic exchanges," and (2) "domestic transactions in other securities." 561 U.S. 247.

5. Please click here to read our discussion of the Ninth Circuit's decision in *Stoyas*.

6. Please click here to read our discussion of the Second Circuit's decision in *Absolute Activist*.

purchase at issue." The court suggested that plaintiffs may need to allege facts concerning the foreign issuer's involvement in the ADRs to satisfy this requirement.

The Ninth Circuit reversed the district court's decision and remanded to permit the plaintiffs an opportunity to amend their complaint. After plaintiffs amended their complaint, defendants again moved to dismiss.

Central District of California Finds Plaintiffs Adequately Alleged a "Domestic Transaction" and Satisfied the "in Connection with" Requirement

The Central District of California held that the amended complaint adequately alleged that plaintiffs incurred irrevocable liability for the ADRs in the United States by pleading, *inter alia*, that the buy order, purchase price payment, and transfer of title took place in the United States. The court therefore determined that plaintiffs adequately alleged a "domestic transaction" for *Morrison* purposes. The court rejected defendants' contention that "[p]laintiffs purchased the underlying securities in a foreign transaction before converting the foreign stock into ADRs" because there were no allegations of a two-step transaction. Rather, "[p]laintiffs allege[d] that a single transaction occurred"—the purchase of ADRs on an over-the-counter market in the United States.

The court also found that plaintiffs "sufficiently alleged [the foreign issuer's] plausible participation in the establishment of the ADR program." Plaintiffs alleged that one of the banks that offered the unsponsored ADRs was among the foreign issuer's ten largest shareholders and further alleged that it was unlikely the bank could have acquired so many shares "without the consent, assistance or participation of" the foreign issuer. The court held these allegations satisfied the "in connection with" requirement.

Delaware Supreme Court: Federal Forum Selection Provisions for Securities Act Claims Are Facially Valid

On March 18, 2020, the Delaware Supreme Court held that forum selection provisions in certificates of incorporation requiring actions arising under the Securities Act of 1933 (the "Securities Act") to be filed in federal court are facially valid under Section 102(b)(1) of the Delaware General Corporation Law ("DGCL").[7] Salzberg v. Sciabacucchi, 2020 WL 1280785 (Del. 2020) (Valihura, J.). The court recognized that federal forum provisions ("FFPs") "can provide a corporation with certain efficiencies in managing the procedural aspects of securities litigation following the United States Supreme Court's decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund*," 138 S. Ct. 1061 (2018), which held that state courts have concurrent jurisdiction over actions asserting Securities Act claims.[8]

Background

The Delaware Supreme Court reversed a Chancery Court decision holding that FFPs are "ineffective and invalid." *Sciabacucchi v. Salzberg*, 2018 WL 6719718 (Del. Ch. Dec. 19, 2018).[9] The Chancery Court based its decision on *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013), which held that companies may adopt forum selection bylaws requiring "internal affairs" litigation to be brought in Delaware Chancery Court.[10] The *Boilermakers* court indicated that it would have reached a different conclusion if the forum selection bylaws at issue "regulat[ed] external matters" by, for

7. Section 102(b)(1) sets forth certain categories of provisions that may be included in a certificate of incorporation.

8. Please click here to read our discussion of the Supreme Court's decision in *Cyan*.

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

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

example, reaching tort claims or commercial contract claims. The *Sciabacucchi* court held that a forum-selection provision cannot govern Securities Act claims because such claims are "external to the corporation." 2018 WL 6719718. The court reasoned that such a claim "does not turn on the rights, powers, or preferences of the shares, language in the corporation's charter or bylaws, a provision in the DGCL, or the equitable relationships that flow from the internal structure of the corporation."

Section 102(b)(1) Is Not Limited to "Internal Affairs" Matters

The Delaware Supreme Court found that "*Boilermakers* did not establish the outer limit of what is permissible under . . . Section 102(b)(1)." The Court explained that "[t]here is a category of matters that is situated on a continuum between the *Boilermakers* definition of 'internal affairs' and its description of purely 'external' claims," and held that this category falls within "the universe of matters encompassed by Section 102(b)(1)." The Court found that claims under Section 11 of the Securities Act "are 'internal' in the sense that they arise from internal corporate conduct on the part of the Board and, therefore, fall within Section 102(b)(1)."

The Court found that its earlier decision in *ATP Tour v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014), supports this conclusion. The *ATP* Court held that a litigation fee-shifting bylaw is facially valid.[11] The *Sciabacucchi* Court found that "*ATP* suggests that certificate of incorporation provisions governing certain types of 'intracorporate' claims that are not strictly within *Boilermakers*' 'internal affairs,' can be within the boundaries of . . . Section 102(b)(1)."

The Delaware Supreme Court further held that Section 115 of the DGCL, which was enacted in 2015 to codify the *Boilermakers* holding, does not limit the scope of Section 102(b)(1).[12] Section 115 governs forum selection provisions concerning "internal corporate claims." The Court found that "Section 102(b)(1) is unquestionably broader than, and is not circumscribed by, Section 115's definition of 'internal corporate claims.'"

FFPs Fall Within the Broad Scope of Section 102(b)(1)

Section 102(b)(1) provides that a company's certificate of incorporation may include:

> Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders . . . if such provisions are not contrary to the laws of this State.

8 *Del. C.* § 102(b)(1). The Court found that an FFP "could easily fall within either of these broad categories." The Court explained that "FFPs involve a type of securities claim related to the management of litigation arising out of the Board's disclosures to current and prospective stockholders in connection with an IPO or secondary offering." The Court further noted that "[t]he drafting, reviewing, and filing of registration statements by a corporation and its directors is an important aspect of a corporation's management of its business and affairs and its relationship with its stockholders." The Court also found that "FFPs do not violate the policies or laws of this State" as "the DGCL allows immense freedom for businesses to adopt the most appropriate terms for the organization, finance, and governance of their enterprise."

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

12. Section 115 provides that "[t]he certificate of incorporation or the bylaws may require, consistent with applicable jurisdictional requirements, that any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State, and no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State." 8 *Del. C.* § 115. Section 115 defines "internal corporate claims" to include "claims . . . that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity." *Id.*

The Court observed that since the United States Supreme Court's decision in *Cyan*, there has been a sizable increase in Securities Act actions brought in state courts. The Court recognized that defending against parallel suits in federal and state courts involves "costs and inefficiencies," as well as "[t]he possibility of inconsistent judgments and rulings on other matters, such as stays of discovery." The Court explained that "[b]y directing [Securities Act] claims to federal courts when coordination and consolidation are possible, FFPs classically fit the definition of a provision 'for the management of the business and for the conduct of the affairs of the corporation'" under Section 102(b)(1). The court further determined that "[a]n FFP would also be a provision 'defining, limiting and regulating the powers of the corporation, the directors and the stockholders' since FFPs prescribe where current and former stockholders can bring Section 11 claims against the corporation and its directors and officers."

The Court concluded that "a bylaw that seeks to regulate the forum in which such 'intra-corporate' litigation can occur is . . . facially valid under Section 102(b)(1)."

FFPs Do Not Violate Federal Laws or Policies

The Delaware Supreme Court determined that "FFPs do not violate federal law or policy." The court explained that "nothing in *Cyan* prohibits a forum-selection provision from designating federal court as the venue for litigating Securities Act claims." The court found it significant that in *Rodriguez de Quijas v. Shearson/American Express*, 490 U.S. 477 (1989), the United States Supreme Court enforced an arbitration provision that precluded the litigation of Securities Act claims in state court. The Delaware Supreme Court also noted that in *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972), the United States Supreme Court directed "courts to give as much effect as possible to forum-selection clauses." Because *Cyan* did not address or limit either *Bremen* or *Rodriguez*, the Delaware Supreme Court found that those rulings "still govern the enforcement of [forum selection] provisions."

FFPs Do Not Violate Inter-State Policy

The Delaware Supreme Court acknowledged that potentially "the most difficult aspect" of the question before it was "the 'down the road' question of whether [FFPs] will be respected and enforced by our sister states." The Court recognized that other "states might react negatively" to its decision. Nevertheless, the Court concluded that there were "persuasive arguments" to be made that "a provision in a Delaware corporation's certificate of incorporation requiring Section 11 claims to be brought in a federal court does not offend principles of horizontal sovereignty—just as it does not offend federal policy." The Court reasoned that "many Section 11 claims closely parallel state law breach of fiduciary duty claims" and thus, "many of the same reasons requiring application of the internal affairs doctrine would support the enforcement of FFPs." The Court stated that "[t]he need for uniformity and predictability that FFPs address suggest that they fall closer to the 'internal affairs' side of the spectrum, which would argue in favor of deference being given to them." The Court emphasized that "forum-selection provisions are process-oriented," and only "regulate *where* stockholders may file suit, not *whether* the stockholder may file suit or the kind of remedy that the stockholder may obtain on behalf of herself or the corporation." Finally, the Court explained that other states have respected the types of "forum provisions sanctioned by *Boilermakers*," which "are arguably more restrictive than FFPs . . . because they may require non-resident stockholders to litigate their internal affairs claims exclusively in Delaware—potentially far from their geographic home-base." The court noted that "FFPs [merely] require that non-residents bring Section 11 claims in federal court (which could be in their home state)."

The Delaware Supreme Court emphasized that its ruling was limited to the facial challenge at issue. The Court explained that its sister courts could consider the enforcement of a particular FFP in an as-applied challenge and noted that "[s]uch 'as applied' challenges are an important safety valve in the enforcement context."

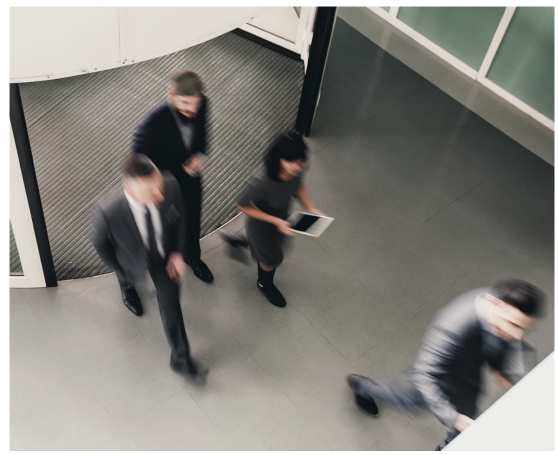
Delaware Chancery Court: *MFW*'s Procedural Safeguards Were Not Satisfied Where a Majority of the Special Committee Members Allegedly Had a Material Self-Interest in the Transaction

On February 26, 2020, the Delaware Chancery Court held that the business judgment standard of review did not apply to a controlling stockholder transaction that was conditioned on *MFW's* procedural safeguards because plaintiffs alleged that "three of the four members of the special committee had a material self-interest in the transaction."[13] *In re AmTrust Fin. Servs. Stockholder Litig.*, 2020 WL 914563 (Del. Ch. 2020) (Bouchard, C.). The court found that *MFW*'s requirement of special committee independence "was intended to ensure not only that members of a special committee must be *independent* in the sense of not being beholden to a controlling stockholder, but also that the committee members must have no disabling personal *interest* in the transaction at issue."

The court explained that "directors are interested in a transaction if they expect to derive any personal financial benefit from the transaction as opposed to a benefit which devolves upon the corporation or all stockholders generally." Moreover, "[i]n the absence of self-dealing, for the interest of a director to be disabling, the benefit must be alleged to be *material* to that director."

13. In *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (*MFW*), the Delaware Supreme Court held 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." Please click here to read our discussion of the *MFW* decision.

In the case before it, plaintiffs alleged that the transaction "was expected to extinguish viable derivative claims exposing [three of the four members of the special committee] to significant personal liability." Plaintiffs argued that the court should follow the analysis in *In re Riverstone Shareholder Litig.*, 2016 WL 4045411 (Del. Ch. July 28, 2016), which involved a similar situation. The *Riverstone* court found that "the [d]irector [d]efendants [allegedly] obtained a special benefit for themselves" "by orchestrating a merger that extinguished a possible derivative action." The court found it significant plaintiffs had alleged that (1) the directors were aware of the derivative claim, (2) the claim was viable, and (3) the potential liability was material to each of the directors.



The *AmTrust* court found "*Riverstone* sets forth an appropriate framework" for evaluating plaintiffs' contention that a majority of the special committee members had a material self-interest in the transaction. The court noted that defendants did not dispute that (1) these special committee members were aware of a potential derivative claim, (2) the claim was viable, and (3) "the potential liability they faced was material to each of them personally," as the estimated net settlement value was between $15 million and $25 million. Moreover, the court found plaintiffs adequately alleged that the transaction had the practical effect of extinguishing the committee members' liability. The court therefore "conclude[d] that [p]laintiffs have pled a reasonably conceivable set of facts showing that each of the conditions necessary to apply the *MFW* framework to subject the [t]ransaction to business judgment review have not been satisfied."

Delaware Chancery Court: Involvement of a Special Committee Can Cleanse a Transaction Involving a Conflicted Board Only If the Special Committee Is Engaged Before the Commencement of Substantive Economic Negotiations

On February 27, 2020, the Delaware Chancery Court held that the entire fairness standard of review applied to a conflicted board transaction despite the engagement of a special committee because substantive economic negotiations took place prior to the special committee's involvement. *Salladay v. Lev*, 2020 WL 954032 (Del. Ch. 2020) (Glasscock, V.C.).

The court stated that "a fully-empowered, independent special committee can potentially cleanse [a] transaction" involving a conflicted board. However, the court found that the cleansing effect applies only if the special committee is "sufficiently constituted and authorized *ab initio*." The court held that "this requires the committee's empowerment prior to substantive economic negotiations, which include valuation and price discussions if such discussions set the field of play for the economic negotiations to come." The court reasoned that "[i]nsiders in particular, standing on both sides of the transaction, may [otherwise] be tempted to exercise the opportunity and influence their positions afford them to move the transaction favorably toward their own interests" prior to the special committee's involvement.

Here, plaintiffs alleged that by the time the special committee became involved, the parties had already established "a price collar that set the field of play for the economic negotiations to come." The court held the complaint "raises a pleading-stage inference that these discussions deprived the [special] [c]ommittee of the full negotiating power sufficient to invoke the business judgment rule."

Delaware Chancery Court: Allegations That Directors Made Misrepresentations Concerning FDA Approval Prospects Were Insufficient to Plead Demand Futility Absent Plausible Allegations of Scienter

On February 13, 2020, the Delaware Chancery Court dismissed a derivative action alleging that a pre-suit demand on the board of a biopharmaceutical company would have been futile because the directors faced a substantial likelihood of liability for either authorizing or failing to prevent alleged misstatements in a press release concerning FDA approval prospects for one of the company's products. *Owens v. Mayleben*, 2020 WL 748023 (Del. Ch. 2020) (Slights, V.C.). The court found plaintiff failed to meet his "burden to plead particularized facts that those board members knew the statements were false, but directed that they be disclosed to the market nevertheless."

The press release at issue reported that the FDA had informed the company during a recent meeting that it would permit a "fast tracked" regulatory approval process for the company's cholesterol drug. Several weeks after the issuance of that press release, the FDA released a summary of the same meeting. The FDA's summary "expressed doubt that [the company's cholesterol drug] had a 'clear regulatory path forward.'" Plaintiff alleged that the press release was materially misleading, and further alleged that the company's directors "contributed to and approved the allegedly misleading statements [in the press release] knowing they were false."

The court stated that "[w]henever directors communicate publicly or directly with shareholders about a corporation's affairs, with or without a request for shareholder action, directors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty." The court explained that "[i]f the board of directors intentionally misleads stockholders about the business of the corporation it serves, then its members will be held liable for breach of fiduciary duty." The court specifically recognized that "directors who knowingly make materially misleading statements to stockholders may be considered to be interested for the purposes of demand."

The court found "the [c]omplaint pleads no facts that would allow a reasonable inference the [o]utside [d]irectors, individually or collectively, knew that anything included in the press release was false." The court noted that plaintiff did "not allege the [o]utside [d]irectors attended the FDA meeting or that any one of them knew what occurred at that meeting."

The court observed that it was "not surprising [p]laintiff has not pled particularized facts to support an inference of bad faith" given that there was no "conceivable explanation of *why* any of the [d]efendants, let alone the [o]utside [d]irectors, would intentionally lie to the market knowing full well the official FDA minutes would contradict their statements in a matter of weeks." The court pointed out that there were "no allegations that any of the [d]efendants engaged in insider trading or otherwise derived some benefit from having misled the market." The court determined that it was therefore "not reasonable to infer bad faith" absent some rational "explanation for why [d]efendants would lie so openly, especially when they were virtually certain to be caught in the lie."

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