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# Securities Law Alert

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–*Benchmark Litigation* 2017

## Supreme Court: Grants Certiorari to Determine Whether SEC Administrative Law Judges Are "Officers of the United States" Within the Meaning of the Appointments Clause

On January 12, 2018, the Supreme Court granted certiorari to resolve a circuit split on the question of whether the administrative law judges ("ALJs") for the SEC's in-house courts are "Officers of the United States" within the meaning of the Appointments Clause of the United States Constitution. *Lucia v. SEC*, No. 17-130. The Appointments Clause states that the President "shall nominate, and by and with the Advice and Consent of the Senate, shall appoint … Officers of the United States." U.S. Const. art. II, § 2, cl. 2. The Appointments Clause further provides that "Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments."

In *Raymond J. Lucia Cos. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016) (Rogers, J.), the D.C. Circuit concluded that the SEC's ALJs are not "Officers of the United States" within the meaning of the Appointments Clause. The court held that the key inquiry for determining the applicability of the Appointments Clause is whether the SEC ALJs "issue final decisions" of the SEC. The D.C. Circuit found it significant that the SEC has a discretionary right to review the action of any ALJ as it sees fit, either on its own initiative or upon a petition for review filed by a party or aggrieved person. *Id.* (citing 15 U.S.C. § 78d-1(a)-(b)). The SEC has the authority to "review[ ] an ALJ's decision de novo" and "may make any findings or conclusions that in its judgment are proper and on the basis of the record." *Id.* (citing 17 C.F.R. § 201.411(a)). In the event that "no review of the initial decision is sought or ordered," the SEC will issue an order stating that it has declined review and specifying the date that the ALJ's sanctions, if any, will take effect. The ALJ's initial decision becomes final only upon issuance of the SEC's order.

The D.C. Circuit noted that the SEC "retain[s] full decision-making powers" over cases heard by the ALJs. The court observed that the SEC's ALJs "neither have been delegated sovereign authority to act independently of the [SEC] nor, by other means established by Congress, do they have the power to bind third parties, or the government itself, for the public benefit."

In *Bandimere v. SEC*, 844 F.3d 1168 (10th Cir. 2016) (Matheson, J.), the Tenth Circuit rejected final decision-making power as the key criterion for assessing whether the Appointments Clause applies. The Tenth Circuit relied on the Supreme Court's decision in *Freytag v. Commissioner of Internal Revenue*, 501 U.S. 868 (1991) to hold that the SEC's ALJs are "inferior officers" who must be appointed in conformity with the Appointments Clause.

The *Freytag* Court found that the special trial judges ("STJs") of the federal Tax Court were "inferior officers" within the meaning of the Appointments Clause because (1) the position of STJ was "established by Law"; (2) "the duties, salary, and means of appointment" of STJs were "specified by statute"; and (3) STJs "perform more than ministerial tasks" and "exercise significant discretion" in "carrying out [their] important functions." *Bandimere,* 844 F.3d 1168 (quoting *Freytag*, 501 U.S. 868).

The Tenth Circuit found that these three *Freytag* factors apply equally to SEC ALJs. The court determined that "SEC ALJs exercise significant discretion in performing important functions commensurate with the STJs' functions described in *Freytag*." The court noted, for example, that SEC ALJs have the "authority to shape the administrative record by taking testimony, regulating document production and depositions, ruling on the admissibility of evidence, … and presiding over trial-like hearings," among other responsibilities.

In so holding, the Tenth Circuit expressly disagreed with the D.C. Circuit's decision in *Lucia*. While the Tenth Circuit acknowledged that "[f]inal decision-making authority is relevant in determining whether a public servant exercises significant authority," the court found that not "*every* inferior officer *must* possess final decision-making power."

The Supreme Court will hear the case later this year. A date for oral argument has not yet been set.

## Second Circuit: (1) Defendants Do Not Have to Conclusively Prove a Complete Absence of Price Impact to Rebut the *Basic* Presumption, and (2) Courts Must Consider Price Impact Evidence at the Class Certification Stage

On January 12, 2018, the Second Circuit vacated class certification in a securities fraud action in which defendants attempted to rebut the *Basic* presumption with price impact evidence.[1] *Arkansas Teachers Ret. Sys. v. Goldman Sachs Grp.*, 2018 WL 385215 (2d Cir. 2018) (Wesley, J.) (*Arkansas Teachers II*). The Second Circuit found the district court may have imposed a higher burden than the "preponderance of the evidence" standard it recently adopted in *Waggoner v. Barclays*, 875 F.3d 79 (2d Cir. 2017).[2] The Second Circuit further ruled that the district court "erred in declining to consider" defendants' price impact evidence at the class certification stage.

1. The Supreme Court has stated that "[a]ny showing that severs the link between the alleged misrepresentation and … the price received (or paid) by the plaintiff … will be sufficient to rebut the presumption of reliance." *Basic v. Levinson*, 485 U.S. 224 (1988).

2. Please click here to read our prior discussion of the Second Circuit's decision in *Waggoner*.

### To Rebut the *Basic* Presumption at the Class Certification Stage, Defendants Must Only Demonstrate a Lack of Price Impact by a Preponderance of the Evidence

In the decision below, the district court found defendants' proffered evidence of price impact insufficient to rebut the *Basic* presumption because defendants did "not provide conclusive evidence that no link exists between the price decline and the misrepresentation." *In re Goldman Sachs Grp. Sec. Litig.*, 2015 WL 5613150 (S.D.N.Y. 2015) (*Arkansas Teachers I*). Defendants argued on appeal that the district court "imposed an impermissibly high evidentiary burden by requiring them to rebut the *Basic* presumption with conclusive proof of a lack of price impact." *Arkansas Teachers II*, 2018 WL 385215.

After the district court issued its decision, the Second Circuit in *Waggoner* held that defendants must "do more than merely produce evidence that *might* result in a favorable outcome." *Waggoner*, 875 F.3d 79. The *Waggoner* court ruled that "defendants seeking to rebut the *Basic* presumption must demonstrate a lack of price impact by a preponderance of the evidence at the class certification stage rather than merely meet a burden of production."

In *Arkansas Teachers II*, the Second Circuit found it "unclear ...whether the [district] court required more of defendants than a preponderance of the evidence." 2018 WL 385215. The Second Circuit therefore vacated the district court's decision and remanded for the court "to reconsider defendants' evidence in light of the [*Waggoner*] standard."

### Courts Must Consider Price Impact Evidence at the Class Certification Stage

During the class certification proceedings, defendants produced evidence that there was no decline in the price of the company's stock on more than thirty dates when news sources reported the company's alleged conflicts of interest in the transactions at issue. The Second Circuit found the district court erroneously "construed this evidence as 'an inappropriate truth on the market defense' or as evidence of the statements' lack of materiality, neither of which the court thought it could consider at the class certification stage." *Id.* (quoting *Arkansas Teachers I*, 2015 WL 5613150). The district court did not hold an evidentiary hearing or an oral argument to address defendants' price impact evidence.

On appeal, the Second Circuit explained that "[t]he 'truth on the market' defense attacks the timing of the plaintiffs' purchase of shares" on the theory that "the market was already aware of the truth regarding defendants' misrepresentations at the time the class members purchased their shares." Here, it was "undisputed that plaintiffs purchased their shares after the misstatements were made but before the truth was revealed." The Second Circuit found that "defendants did not present a 'truth on the market' defense" but instead presented evidence that alleged "conflicts of interest 'did not actually affect the stock's market price.'" *Id.* (quoting *Halliburton Co. v. Erica P. John Fund*, 134 S. Ct. 2398 (2014)).

The Second Circuit also distinguished price impact from materiality. The court observed that while "price impact touches on materiality, which is not an appropriate consideration at the class certification stage, it 'differs from materiality in a crucial respect.'" *Id.* (quoting *Halliburton*, 134 S. Ct. 2398). The court explained that "[w]hether a misrepresentation was reflected in the market price at the time of the transaction—whether it had price impact—'is *Basic*'s fundamental premise. It ... has everything to do with the issue of predominance at the class certification stage.'" *Id.* (quoting *Halliburton*, 134 S. Ct. 2398). The Second Circuit emphasized that if an alleged misrepresentation did not affect the stock price, there would be no basis for plaintiffs to assert that they indirectly relied on that misrepresentation through the market price.

The Second Circuit instructed the district court to consider defendants' price impact evidence on remand, and "encourage[d] the court to hold any evidentiary hearing or oral argument it deems appropriate under the circumstances."

## Sixth Circuit: Allegations in a Third-Party Complaint, Coupled with an Admission of One of Those Allegations, May Constitute Corrective Disclosures for Loss Causation Purposes

On December 13, 2017, the Sixth Circuit rejected a "categorical" rule that allegations in a third-party complaint cannot constitute corrective disclosures for loss causation purposes. *Norfolk Community Ret. Sys. v. Community Health Sys.*, 877 F.3d 687 (6th Cir. 2017) (Kethledge, J.). Reversing the district court's decision, the Sixth Circuit held that plaintiffs adequately pled loss causation based on the allegations in a third-party complaint, coupled with the CFO's admission of one of the central allegations in the complaint. The court found that "these disclosures—and the speed at which [the company's] share price fell after them—make it at least plausible that the disclosures had something to do with [plaintiffs'] losses."

The Sixth Circuit explained that the requirement for pleading loss causation is "'not meant to impose a great burden upon a plaintiff.'" *Id.* (*quoting Dura Pharm. v. Broudo*, 544 U.S. 336 (2005)). "Rather it is meant to prevent disappointed shareholders from filing suit merely because their shares have lost value and then using discovery to determine whether the loss was due to fraud." That "at the pleading stage, a plaintiff need only 'provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind.'" *Id.* (quoting *Dura*, 544 U.S. 336).

The court observed that while "[s]ometimes defendants reveal their own fraud via a 'corrective disclosure,' … such admissions can be hard to come by." And corrective "revelations can come from many sources, including whistleblowers, analysts, and newspaper reports." Moreover, "such revelations need not come all at once, but can come in a series of partial disclosures."

In the case before it, defendants contended that the third-party complaint "could not reveal the truth behind their prior alleged misrepresentations because complaints can reveal only allegations rather than truth." The Sixth Circuit recognized that this "proposition might have merit as a general rule," but "reject[ed] it as a categorical one." The court reasoned that "every representation of fact is in a sense an allegation, whether made in a complaint, newspaper report, press release, or under oath in a courtroom." The court acknowledged that certain types of representations "are more credible than others," and "[m]ere allegations in a complaint tend to be less credible." However, "these are differences of degree, not kind, and even within each type of representation some are more credible than others." The court stated that it must therefore "evaluate each putative disclosure individually (and in the context of any other disclosures) to determine whether the market could have perceived it as true."

The Sixth Circuit found the third-party complaint at issue was particularly credible because the company's CEO "promptly admitted the truth of one of the complaint's core allegations." The court noted that the allegations of loss causation were similar to those in *Lloyd v. CVB Financial Corp.*, 811 F.3d 1200 (9th Cir. 2016).[3] There, the Ninth Circuit found plaintiffs had adequately pled loss causation based on the announcement of an SEC investigation, together with the

3. Please click here to read our prior discussion of the Ninth Circuit's decision in *Lloyd*.

company's subsequent disclosure that it was charging off the loans that were the subject of that investigation.

The Sixth Circuit also noted that the third-party complaint included expert analyses describing the extent to which the company allegedly inflated its revenues. The court found that the experts' conclusion concerning the hospital's inpatient admission practices "was beyond the ken of most investors, and thus revealed new information to them."

The court concluded that plaintiffs "plausibly alleged corrective disclosures that revealed the defendants' antecedent fraud to the market and that thereby caused the plaintiffs' economic loss."

## Central District of California: Allegations That a Company Revised a Statement of Opinion, Standing Alone, Are Insufficient to Plead a Securities Fraud Claim

On January 8, 2018, the Central District of California held that plaintiffs could not assert a securities fraud claim concerning a preliminary purchase price allocation ("PPA") for an acquisition merely through hindsight pleading that the company had subsequently revised the PPA. *M&M Hart Living Trust v. Global Eagle Entertainment*, 2018 WL _____ (C.D. Cal. 2018) (Anderson, J.).[4]

Following the acquisition in question, the company announced a delay to its annual report and disclosed material weaknesses in its internal controls. Plaintiffs' initial allegations were dismissed without leave to amend. After the company filed its annual report, plaintiffs moved to amend the judgment, and obtain leave to file an amended complaint, on the grounds that the company's annual report disclosed, for the first time, a revised PPA for the acquisition.

Although plaintiffs conceded that the preliminary PPA "constituted an opinion," plaintiffs argued that the preliminary PPA "was false because it was later revised" and claimed that the extent of the revisions demonstrated that the opinion was false when made. The court rejected this contention, and held that "later adjustments do not inherently make the earlier statement false under Rule 10(b)."

The court explained that in order to state a securities fraud claim based on an alleged misstatement of opinion, plaintiffs must satisfy one of the three prongs of the test the Ninth Circuit adopted in *City of Dearborn Heights Act 345 Police & Fire Retirement System v. Align Technology*, 856 F.3d 605 (9th Cir. 2017).[5] If a plaintiff "relies on a theory of material misrepresentation" under the first prong, "the plaintiff must allege both that the speaker did not hold the belief she professed and that the belief is objectively untrue." *City of Dearborn Heights*, 856 F.3d 605. If the "plaintiff relies on a theory that a statement of fact contained within an opinion statement is materially misleading" under the second prong of the test, the plaintiff "must allege that the supporting fact the speaker supplied is untrue." Finally, if the "plaintiff relies on a theory of omission" under the third prong, "the plaintiff must allege facts going to the basis for the issuer's opinion whose omission makes the statement at issue misleading to a reasonable person reading the statement fairly and in context."

Here, the court found plaintiffs "offer[ed] only a post hoc assessment" that the preliminary PPA was "'grossly incorrect.'" The court held these allegations "insufficient to allege falsity under the Ninth Circuit's standard." *M&M Hart Living Trust*, 2018 WL _____. The court found plaintiffs did not "allege that the preliminary PPA was not actually believed by [d]efendants or that [d]efendants were aware of undisclosed facts that tended to seriously undermine the preliminary PPA's accuracy at the time the statement was made" as required under the first prong of the *City of Dearborn Heights* test.

The court further determined that plaintiffs did not "identify facts going to the basis of the preliminary PPA that rendered it misleading to a reasonable person" under the second prong of the *City of Dearborn Heights* test. The court found it significant that the company had expressly cautioned investors that the final PPA could be materially different from the preliminary PPA based on

4. Simpson Thacher represents Global Eagle Entertainment, Inc. and the individual defendants in this matter.

5. Please click here to read our prior discussion of the Ninth Circuit's decision in *City of Dearborn Heights*.

several factors, some of which could not be "predicted with certainty."

The court concluded that "[o]n these facts, [p]laintiffs cannot adequately allege that the preliminary PPA was false." Based on its finding that plaintiffs' proffered new evidence would not have "changed the outcome of the case," the court denied plaintiffs' motion to amend the judgment and for leave to file an amended complaint.

## Delaware Supreme Court: Chancery Court Abused Its Discretion in Placing No Weight on the Deal Price in a Transaction Resulting From a Robust Sales Process

On December 14, 2017, the Delaware Supreme Court reversed and remanded a widely-covered appraisal decision in which the Chancery Court placed no weight on the $13.75 per share deal price, but instead relied on its own discounted cash flow ("DCF") analysis to arrive at a fair value of $17.62 for Dell (approximately 30% higher than the deal price and 75% higher than the unaffected stock price). Based on the record before it, the Delaware Supreme Court found "the deal price deserved heavy, if not dispositive, weight." *Dell v. Magnetar Global Event Driven Master Fund Ltd.*, 2017 WL 6375829 (Del. 2017) (*Dell II*) (Valihura, J.).

In the decision below, the Chancery Court acknowledged that the sales process (both pre- and post-signing) was "praiseworthy." *In re Appraisal of Dell*, 2016 WL 3186538 (Del. Ch. May 31, 2016). However, it identified multiple concerns which led it to disregard both the stock price and deal price in calculating fair value. The Chancery Court concluded that investor short-sightedness led the company to be chronically undervalued in the market despite Michael Dell's long-term strategy to transform and reinvigorate the company. The Chancery Court was also critical of a pre-signing process of exclusively private equity firms, and questioned whether private equity buyers ever pay "fair value" under the appraisal statute due to their use of leveraged buyout ("LBO") models targeting high internal rates of return ("IRR"). The Chancery Court was finally skeptical that the post-signing go-shop process helped establish that Michael Dell and Silver Lake Partner's bid was at a market clearing price due to structural concerns inherent in management buyout ("MBO") transactions.

The Delaware Supreme Court found the Chancery Court's "decision to rely 'exclusively' on its own DCF analysis [was] based on several assumptions that [were] not grounded in relevant, accepted financial principles." *Dell II*, 2017 WL 6375829. First, the Delaware Supreme Court determined that the record reflected that the market for the company's securities was efficient (e.g., significant analyst coverage, robust trading volume, rapid price reactions to significant company news).

Second, the Delaware Supreme Court again reaffirmed (as it had in *DFC Global Corp. v. Muirfield Value Partners*, 172 A.3d 346 (Del. 2017)[6]) that there is no "private equity carve out" in appraisal. Where there is an appropriate sales process, the Chancery Court can defer to the merger price as the best evidence of fair value, even if that process included only private equity bidders.

Third, the Delaware Supreme Court concluded that the Chancery Court's elevation of "theoretical" concerns about MBO go-shops over the facts of the transaction, which suggested a fair and relatively open post-signing market check, was an error.

The Delaware Supreme Court was also critical of the Chancery Court's reasoning that its own DCF analysis was superior to the stock market consensus on Dell's value and the agreed deal price. The Delaware Supreme Court observed that the $17.62 per share value derived from

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

the Chancery Court's DCF analysis was a price that, as reflected in the record, no real world party (private equity bidder, strategic bidder or public market investor) was willing to pay for Dell. The Delaware Supreme Court found that the "Court of Chancery's DCF value was the antithesis of any economist's definition of fair market value" and wrote that the facts suggested "strong reliance upon the deal price and far less weight, if any, on the DCF analyses."

The Delaware Supreme Court determined that there was "compelling" "evidence of market efficiency, fair play, low barriers to entry, outreach to all logical buyers, and the chance for any topping bidder to have the support of [the CEO's] own votes." Under these circumstances, the Delaware Supreme Court found the Chancery Court's decision to place no weight on the market price "abuse[d] even the wide discretion afforded the Court of Chancery in these difficult cases."

Although the Delaware Supreme Court did not hold "that the market is always the best indicator of value, or that it should always be granted some weight," its opinion—particularly when read in conjunction with its earlier guidance in *DFC Global*—signals that the Delaware Supreme Court believes that greater deference should be given to the deal price resulting from an appropriate sale process.

The Delaware Supreme Court instructed that on remand, the Chancery Court may "enter judgment at the deal price … with no further proceedings." If the Chancery Court instead "chooses to weigh a variety of factors in arriving at fair value," the court must "explain that weighting based on reasoning that is consistent with the record and with relevant, accepted financial principles."

# Delaware Supreme Court: Reaffirms the High Standard for Pleading Demand Futility Based on an Alleged *Caremark* Violation

On December 15, 2017, the Delaware Supreme Court affirmed dismissal of a derivative suit against the directors of an energy company for failure to plead demand futility based on an alleged *Caremark* violation. *City of Birmingham Ret. & Relief Sys. v. Good*, 2017 WL 6397490 (Del. 2017) (Seitz, J.). Plaintiffs alleged that demand was excused because the directors faced a substantial likelihood of personal liability for failing to ensure the company's compliance with environmental regulations.[7] The company ultimately faced criminal consequences, along with hefty fines and sizable remediation costs. The Delaware Supreme Court reaffirmed that plaintiffs cannot plead the bad faith necessary to state a *Caremark* violation merely by pointing to a "bad outcome."

In *In re Caremark International Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), the Delaware Chancery Court recognized that directors may face personal liability for failure to ensure corporate compliance with the law. Plaintiffs asserting a *Caremark* claim "must allege that the directors intentionally disregarded their oversight responsibilities such that their dereliction of fiduciary duty rose to the level of bad faith." *City of Birmingham,* 2017 WL 6397490. Given "the difficulties in proving bad faith director action," the Delaware Supreme Court reiterated that "a *Caremark* claim is 'possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.'" *Id.* (quoting *Caremark,* 698 A.2d 959).

## Plaintiffs Cannot Rely on a Bad Outcome to Allege Bad Faith

In the case before the court, plaintiffs alleged that certain board presentations and minutes demonstrated that the board knew the company was flouting environmental

7. Plaintiffs may plead demand futility by alleging particularized facts that "create a reasonable doubt of the board's independence and disinterestedness when the demand would reveal board inaction of a nature that would expose the board to 'a substantial likelihood' of personal liability." *Horman v. Abney*, 2017 WL 242571 (Del. Ch. 2017) (quoting *Rales v. Blasband*, 634 A.2d 927 (Del. 1993)).

regulations, yet failed to take steps to ensure compliance. The Delaware Supreme Court determined that these presentations and minutes instead confirmed that "the board was not only informed of environmental problems, but also the steps being taken to address them." The court held these materials did "not lead to the inference that the board consciously disregarded its oversight responsibility by ignoring environmental concerns."

The Delaware Supreme Court found plaintiffs' allegations similar to those at issue in *Stone v. Ritter*, 911 A.2d 362 (Del. 2006). There, plaintiffs asserted a *Caremark* violation where the company had paid large fines for legal violations, even though the board had monitored the company's operations through periodic reports from the company's officers. The *Stone* court held that plaintiffs could not state a *Caremark* claim by "equat[ing] a bad outcome with bad faith." *Stone*, 911 A.2d 362. "As in *Stone*," the Delaware Supreme Court in *City of Birmingham* found that plaintiffs were attempting to "conflate the bad outcome of the criminal proceedings with the actions of the board."

## Allegations of Business-Friendliness Are Not Sufficient to Allege Regulator Corruption

Plaintiffs further claimed that the directors had "improperly colluded with regulators to avoid remediating environmental problems." The Delaware Supreme Court found plaintiffs merely "alleged that [the regulator] in general did not aggressively enforce environmental laws." The court explained that "general allegations regarding a regulator's business-friendly policies are insufficient to lead to an inference that the board knew [the company] was colluding with a corrupt regulator." Rather, plaintiffs must "allege in sufficient detail that [the company] illegally colluded with a corrupt regulator," and then "tie the improper conduct to an intentional oversight failure by the board," to allege a *Caremark* violation on this basis.

## Chief Justice Strine, Dissenting, States That "Conclusive Proof" Is Not Necessary to Allege a *Caremark* Claim

Chief Justice Strine, dissenting, expressed his view that plaintiffs need not "have conclusive proof of all their contentions" to meet the particularized pleading requirement for demand futility. He observed that "[r]arely will [the] evidence involve admissions by experienced managers and board advisors that the strategy they are undertaking involves a conscious decision to violate the laws." Chief Justice Strine opined that plaintiffs do not "have to prove at this stage that there was collusion between a weak local regulator" and the company to state a *Caremark* violation. Rather, plaintiffs only have to "plead facts supporting an inference that [the company] consciously was violating the law, taking steps that it knew were not sufficient to come into good faith compliance, but which it believed would be given a blessing by a [business-friendly] regulatory agency."

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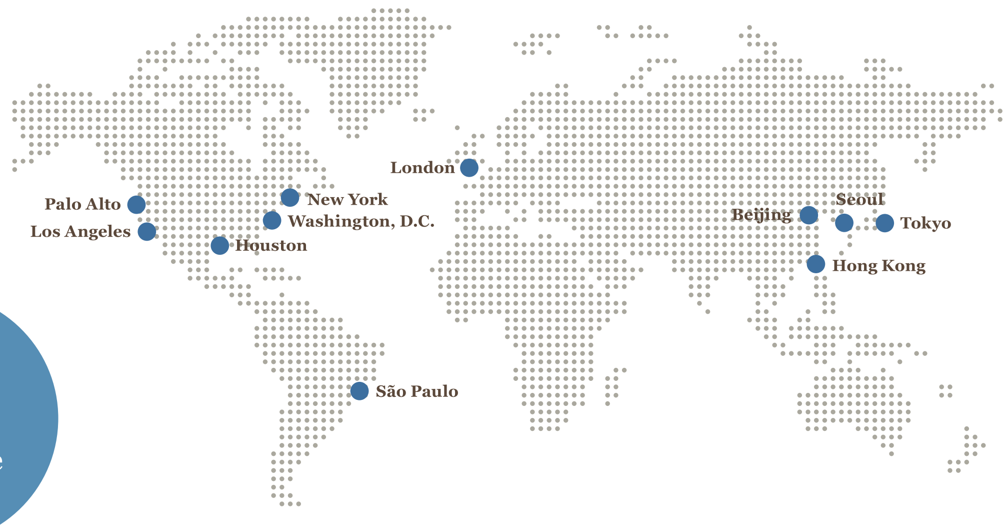


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