Simpson Thacher

Securities Law Alert

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Simpson Thacher's "deep bench of trial and appellate lawyers" are "regularly retained to act on multibillion-dollar securities class actions and derivative suits."

–Chambers USA 2018

Third Circuit: A Company Has No Stand-Alone Obligation to Disclose Alleged Regulatory Violations by an Affiliated Entity

On November 14, 2018, the Third Circuit affirmed dismissal of a securities fraud action alleging that a company failed to disclose regulatory violations by an affiliated entity. *City of Cambridge Ret. Sys. v. Altisource Asset Mgmt. Corp.*, 2018 WL 5931509 (3d Cir. 2018) (Fisher, J.). The Third Circuit found "no authority to support the conclusion that [the defendant company] was obligated to disclose the flaws of a separate entity in its own filings." The court also observed that "[w]hen a stock experiences the rapid rise and fall that occurred here, it will not usually prove difficult to mine from the economic wreckage a few discrepancies in the now-deflated company's records." The court underscored that "[h]indsight . . . is not a cause of action."

As a preliminary matter, the Third Circuit declined to consider alleged misstatements made by any entities affiliated with the defendant company. The defendant company and other entities had been spun off from the affiliated entity at issue, and the companies worked together to capitalize on opportunities in the real estate market. The court explained that under the Supreme Court's decision in *Janus Capital Grp. v. First Derivative Traders,* 564 U.S. 135 (2011), the "maker" of a statement for Rule 10b-5 purposes is "the person or entity with ultimate authority over the statement."[1] The court therefore determined that "statements made by companies other than" the defendant company had no "legal significance" with respect to plaintiffs' Rule 10b-5 claims.

The Third Circuit then considered the defendant company's statements concerning the manner in which it benefited from its affiliate's mortgage servicing expertise. The defendant company stated that it depended on the affiliate for mortgage servicing and would face financial risks if the affiliate could no longer provide these services. Plaintiffs contended that these statements were misleading because the defendant company was allegedly aware of but did not disclose the affiliate's alleged regulatory violations. But the Third Circuit found that the defendant company's statements did "not imply anything about the *quality* of [the affiliate's]

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

loan servicing." The court determined that there was no basis for holding that the defendant company's "reference to [the affiliate] carried some form of implied warranty" as to the quality of the affiliate's services. The court stated that "[e]ven assuming that such an obligation could arise in some cases, it would make no sense to impose such a requirement where, as here, the allegedly 'concealed' information—[the affiliate's] regulatory failures—was not only well-known, but typical of most mortgage servicers at the time."

Plaintiffs also claimed that the defendant company misrepresented its recusal policy, pursuant to which the chairman of the defendant company's board was required to recuse himself from transactions involving affiliated entities because the chairman founded these entities. Plaintiffs did not allege that the chairman failed to recuse himself from any transactions between the defendant company and the affiliated mortgage servicing entity. Instead, plaintiffs "speculate[d] that [the chairman] must have violated the . . . recusal policy because he is suspected to have done so with other companies." The Third Circuit found plaintiffs' allegations constituted "the very sort of speculative fraud by hindsight that the [Private Securities Litigation Reform Act] was intended to eliminate."

Delaware Chancery Court: An Activist Investor Aided and Abetted Directors' Breaches of Fiduciary Duty

On October 16, 2018, the Delaware Chancery Court held that an activist investor aided and abetted a board's breaches of fiduciary duty in connection with the sale of the company. *In re PLX Tech. Stockholders Litig.*, 2018 WL 5018535 (Del. Ch. 2018) (Laster, V.C.).[2] The trial took place solely against the activist investor; the other parties were either dismissed or settled. At issue were the actions of the activist investor's board designee, who the court found did not disclose significant information concerning the acquisition to his fellow board members. The court further found that the conduct of the activist investor's board designee could be attributed to the activist investor because the board designee was a co-managing member of the activist investor and played an important "role in directing and implementing [the activist investor's] strategy" with respect to the sale of the company. Significantly, the court stated that its holding did "not stand for the proposition that the actions of the director-representative of a stockholder can always be attributed to . . . the stockholder that nominated or appointed him, simply by virtue of the fact of the nomination or appointment."

The court found that the activist investor had purchased a stake in the company for the specific purpose of engineering a sale of the company. Following a proxy contest, the activist investor placed its co-managing member on the board. The activist investor's board designee subsequently learned that an acquiror intended to purchase the company and was informed of the price the acquiror was willing to pay. The activist investor's board designee did not disclose this information to his fellow board members. The acquiror ultimately bid for the company, and the company's directors quickly recommended that stockholders approve the sale of the company to the acquiror. A majority of the company's stockholders tendered their shares in the first step of the merger.

The court found that there was a predicate breach of fiduciary duty by the directors by (a) engaging in a sales process without

2 Simpson Thacher represented Avago Technologies Limited in this matter, and PLX Technology, Inc. after the closing. Simpson Thacher also represented Avago Technologies Limited in its acquisition of PLX Technology, Inc.

knowing critical information about the tip (though Vice Chancellor Laster noted this information was withheld from them), and (b) issuing the Recommendation Statement without disclosing (i) the information concerning the acquiror's interest in purchasing the company, (ii) the role of the activist investor's designee in the sales process, or (iii) a discounted cash flow analysis commissioned by the Special

Committee. The court further found that the Recommendation Statement mischaracterized projections that were prepared specifically for the purpose of the acquisition as projections made in the ordinary course of business.

Because the court determined that the stockholders' approval was not fully informed, the court held that the business judgment rule did not apply to the sales process under *Corwin v. KKR Fin. Holdings,* 125 A.3d 304 (Del. 2015).[3] The court instead applied enhanced scrutiny, the default standard of review when a company is sold for cash. Under this standard, plaintiffs suing a third party for aiding and abetting a breach of fiduciary duty "bear the burden of proving that the directors' conduct fell outside the range of reasonableness." The court explained that "evidence of self-interest" can lead to a finding of unreasonableness.

The court observed that an investor's large stock holding would normally "undermine any concern about divergent interest." The court explained that "[w]hen directors or their affiliates own material amounts of common stock, it aligns their interests with other stockholders by giving them a motivation to seek the highest price." However, the court stated that "particular types of investors may espouse short-term investment strategies and structure their affairs to benefit economically from those strategies, thereby creating a divergent interest in pursuing short-term performance at the expense of long-term wealth." The court noted that "[i]n particular, activist hedge funds are impatient shareholders, who look for value and want it realized in the near or intermediate term." Here, the court found that the activist investor and its board designee "had a divergent interest in achieving quick profits by orchestrating a near-term sale" of the company. The court also found that "the incumbent directors deferred to [the activist investor's board designee] when he sought to position himself to best achieve a sale," and "permitted [him] to take control of the sale process when it mattered most." The court concluded that the directors breached their fiduciary duties in connection with the sales process and further held that the activist investor's board designee knowingly aided and abetted those breaches by "creat[ing] a critical informational gap."

The court nevertheless ruled in favor of the activist investor because the court found plaintiffs failed to prove damages. While the court determined that the transaction was "flawed from a fiduciary standpoint," the court concluded that "the sale process was sufficiently reliable" to show that "the plaintiffs received consideration that exceeded the value of the Company on a stand-alone basis" because the board "combined a narrow, pre-signing canvass with a post-signing market check." The court relied on the Delaware Supreme Court's decision in *Dell v. Magnetar Glob. Event Driven Master Fund,* 177 A.3d 1 (Del. 2017), to find that the deal price was a "persuasive source of valuation evidence."[4] The court determined that the deal price likely exceeded the standalone value of the company because the transaction "involved a combination between two companies operating in the same industry."

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

4 Please click here to read our prior discussion of the Delaware Supreme Court's decision in *Dell*.

Delaware Chancery Court: More Detailed Disclosures May Be Required When Directors Propose a Transaction While the Company Is Facing Challenging Circumstances

On November 20, 2018, the Delaware Chancery Court held that stockholder approval of a take-private acquisition that took place while the company was under duress did not warrant application of the business judgment rule standard of review at the pleading stage because plaintiffs adequately alleged that stockholders were not fully informed. *In re Tangoe Stockholders Litig.*, 2018 WL 6074435 (Del. Ch. 2018) (Slights, V.C). The court also found plaintiffs adequately alleged non-exculpated breaches of the duty of loyalty.

The court explained that in order to merit business judgment deference for transactions made during a "regulatory storm," "the directors must demonstrate that they carefully and thoroughly explained all material aspects of the storm to stockholders—how the company sailed into the storm, how the company has been affected by the storm, what alternative courses the company can take to sail out of the storm and the bases for the board's recommendation that a sale of the company is the best course." The court stated that "[e]xtraordinary transactions proposed to stockholders in the midst of extraordinary times must be explained with commensurate care." The court also underscored that "in trying times, the directors must remain focused on the best interests of stockholders, not their own interests."

Plaintiffs Alleged Material Disclosure Deficiencies Sufficient to Defeat Application of the *Corwin* Doctrine at the Pleading Stage

Under *Corwin v. KKR Fin. Holdings,* 125 A.3d 304 (Del. 2015), the business judgment rule applies to transactions approved by "a fully informed, uncoerced majority of the disinterested stockholders." *In Tangoe*, the Delaware Chancery Court explained that in order to defeat application of the *Corwin* doctrine at the pleading stage, plaintiffs must allege that the disclosures provided by the board in connection with the transaction did not include all material information.

The transaction at issue in *Tangoe* took place after the company failed to complete a restatement in a timely manner; NASDAQ had delisted the company, and the SEC had threatened the company with deregistration. The *Tangoe* court found that plaintiffs adequately alleged that shareholder approval of the transaction was not fully informed because defendants failed to provide stockholders with (i) audited financials, and (ii) information concerning the status of the restatement. The court recognized that Delaware law "by no means deems audited financial statements material *per se*." However, the court found it "reasonably

conceivable that a reasonable stockholder would have deemed audited financials important when deciding whether to approve the [t]ransaction" in view of the allegedly "sporadic and heavily qualified" financial information provided by the board. The court noted that the board allegedly commissioned a quality of earnings report for the acquiror, yet "elected not to disclose that report to the public stockholders." The company also failed to file several quarterly reports, and did not hold annual stockholders meetings for three years. Given this "information vacuum," the court found plaintiffs sufficiently alleged that stockholder approval "was not fully informed" because stockholders lacked access to "adequate financial information about the [c]ompany and its value."

With respect to the status of the restatement, the court rejected defendants' contention that they had "no duty to make a prediction" as to when the restatement would be finalized. The court found that defendants allegedly

knew the restatement was nearing completion, yet "chose not to share this information with the stockholders and, thus, deprived them of the opportunity to consider whether to stay the course and allow the [r]estatement to proceed or whether to sell as the consequences of the unfinished [r]estatement were still unfolding." The court therefore concluded that the *Corwin* doctrine did not apply because plaintiffs "adequately pled that the [company's] stockholders were not fully informed when they approved the [t]ransaction."

Plaintiffs Adequately Alleged Non-Exculpated Breaches of the Duty of Loyalty

Because of the Section 102(b)(7) exculpatory clause in the company's certificate of incorporation, plaintiffs could survive a motion to dismiss only by alleging breaches of the duty of loyalty. The court explained that pleading a breach of the duty of loyalty requires allegations of "sufficient facts to support a rational inference that the corporate fiduciary acted out of *material self-interest* that diverged from the interests of the shareholders."

Here, SEC rules prohibited defendants from obtaining equity awards under the company's existing incentive plan while the restatement was pending. Plaintiffs alleged that in order to secure their own compensation, defendants established new incentive awards that would vest in the event of a change in control. Plaintiffs alleged that this new incentive plan motivated defendants to expedite the sale of the company. The court found that the new incentive plan "provided reasonably conceivable material benefits" to the defendants, whose "compensation was comprised primarily of equity awards." The court recognized that the existing equity awards were "increasingly chimerical as the unfinished [r]estatement wore on." The court found that the alleged "temporal connection" between defendants' adoption of the new incentive plan and their "decision to shift course toward an allegedly ill-advised sale of the [c]ompany" suggested defendants were motivated by personal financial interests. The court also found it significant that the board faced the threat of a proxy contest, even though the possibility of a proxy contest, standing alone, does not defeat application of the business judgment rule. The court concluded that plaintiffs adequately pled a claim for breach of the fiduciary duty of loyalty as to each of the defendants and allowed the case to proceed to discovery.

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