Simpson Thacher

Securities Law Alert

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Supreme Court: Grants Certiorari to Determine Whether the SEC May Seek and Obtain Disgorgement in Civil Enforcement Proceedings

On November 1, 2019, the Supreme Court granted certiorari to consider whether the SEC may seek and obtain disgorgement in civil enforcement proceedings. *Liu v. SEC*, No. 18-501. The SEC is statutorily authorized to seek and obtain injunctive relief, equitable relief and civil monetary penalties in civil enforcement proceedings. *See* 15 U.S.C. §§ 77t(b), (d), 78u(d)(1), (3), (5). The statutory scheme does not specifically empower the SEC to seek and obtain disgorgement in civil enforcement proceedings.[1]

All of the circuit courts have either explicitly held, or simply assumed, that courts may order disgorgement in SEC enforcement proceedings as part of their broad authority to award equitable relief. *See SEC v. Cavanagh*, 445 F.3d 105 (2d Cir. 2006) (holding that "contemporary federal courts are vested with the . . . authority by the Constitution and the Judiciary Act" to order disgorgement in SEC enforcement proceedings); *SEC v.*

1. The SEC is, however, statutorily authorized to seek and obtain disgorgement, among other remedies, in SEC administrative proceedings. *See* 15 U.S.C. § 78u-2(e) (permitting the SEC to "enter an order requiring accounting and disgorgement, including reasonable interest").

Maxxon, 465 F.3d 1174 (10th Cir. 2006) ("Disgorgement is by nature an equitable remedy as to which a trial court is vested with broad discretionary powers."); *SEC v. Blavin*, 760 F.2d 706 (6th Cir. 1985) ("Once the [SEC] has established that a defendant has violated the securities laws, the district court possesses the equitable power to grant disgorgement . . . .").[2]

But in *Kokesh v. SEC*, 137 S. Ct. 1635 (2017), the Supreme Court held that "[d]isgorgement in the securities-enforcement context is a 'penalty'" subject to the 5-year statute of limitations set forth in 28 U.S.C. § 2462.[3] The Court rejected the SEC's contention that disgorgement is remedial rather than punitive in nature. The Court observed that "SEC disgorgement sometimes exceeds the profits gained as a result of the violation" and "sometimes is ordered without consideration of a defendant's expenses that reduced the amount of illegal profit." The Court noted that, "[i]n such cases, disgorgement does not simply restore the status quo; it leaves the defendant worse off." Notably, the *Kokesh* Court stated that "[n]othing in [its] opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context."

2. *See also SEC v. Happ*, 392 F.3d 12 (1st Cir. 2004); *SEC v. Hughes Capital Corp.*, 124 F.3d 449 (3d Cir. 1997); *SEC v. Gotchey*, 1992 WL 385284 (4th Cir. 1992); *SEC v. Huffman*, 996 F.2d 800 (5th Cir. 1983); *SEC v. Lipson*, 278 F.3d 656 (7th Cir. 2002); *SEC v. Ridenour*, 913 F.2d 515 (8th Cir. 1990); *SEC v. Rind*, 991 F.2d 1486 (9th Cir. 1993); *SEC v. Calvo*, 378 F.3d 1211 (11th Cir. 2004); *SEC v. First City Fin. Corp.*, 890 F.2d 1215 (D.C. Cir. 1989).

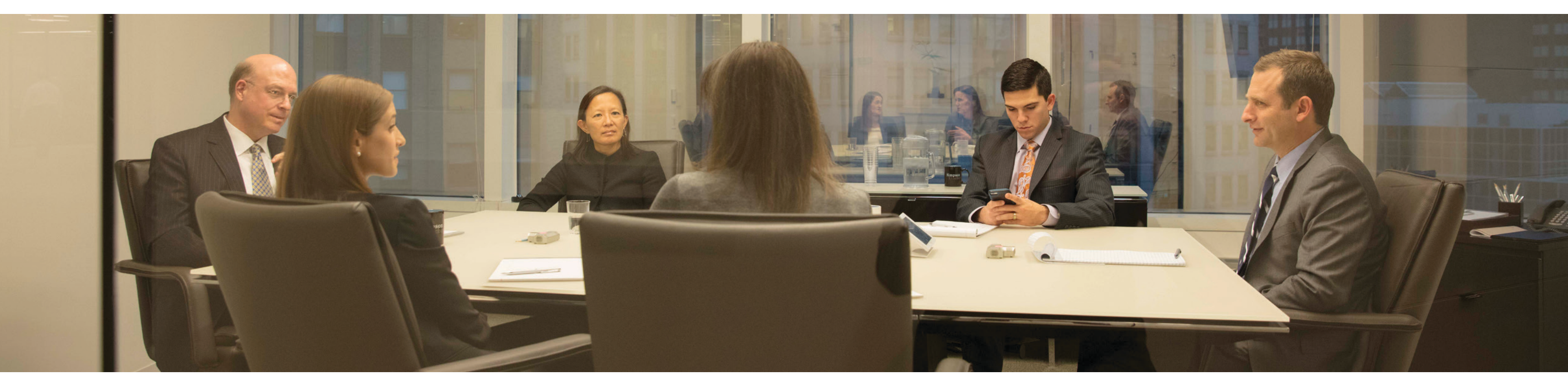
3. 28 U.S.C. § 2462 establishes a five-year statute of limitations for "an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise." Please click here to read our discussion of the Supreme Court's decision in *Kokesh*.

Ninth Circuit Rejects the Argument That *Kokesh* Precludes Courts From Ordering Disgorgement in Excess of Net Profits in SEC Enforcement Proceedings

In *SEC v. Liu*, 754 F. App'x 505 (9th Cir. 2018), the Ninth Circuit affirmed a district court decision ordering disgorgement of the full amount of the funds defendants raised from investors (over $26 million) for a project that violated federal securities laws, with no deduction for expenses (approximately $16 million). The district court ordered disgorgement in addition to millions of dollars in civil penalties.

The Ninth Circuit rejected the argument that under *Kokesh*, the district court was not permitted to order disgorgement in an amount that exceeded defendants' net profits. The Ninth Circuit reasoned that "*Kokesh* expressly refused to reach this issue . . . so that case is not 'clearly irreconcilable' with [its] longstanding precedent" on disgorgement orders in SEC enforcement proceedings. Defendants successfully petitioned the Supreme Court for certiorari.

On November 5, 2019, several days after the Supreme Court granted certiorari to address the question of whether district courts may order disgorgement in SEC enforcement proceedings, the Fifth Circuit rejected the argument that *Kokesh* "necessarily decided that disgorgement is no longer an equitable remedy." *SEC v. Team Res.*, 2019 WL 5704525 (5th Cir. 2019) (Duncan, J.). The Fifth Circuit stated that it was "not convinced that *Kokesh* quietly revolutionized SEC enforcement proceedings while at the same time explicitly stating it was not doing so."



Potential Implications

Should the Supreme Court rule against the SEC in *Liu*, we expect some measure of short-term disruption to the SEC's enforcement program. But we anticipate that Congress would act to provide express statutory authority for disgorgement—and there are in fact two draft bills advancing in Congress—in a manner that may actually extend the statutory limitations period for disgorgement to as long as ten years. And in the interim, the SEC could be expected to pursue more cases in an administrative forum, where it has express statutory authority to pursue disgorgement.

The Supreme Court will hear and rule on *Liu v. SEC* later this Term; a date for oral argument has not yet been set.

Supreme Court: Hears Oral Arguments on Whether Plaintiffs Can Satisfy *Fifth Third*'s "More Harm Than Good" Pleading Standard by Alleging That Delaying the Inevitable Disclosure of an Alleged Fraud Results in Greater Stock Price Harm

On November 6, 2019, the Supreme Court heard oral arguments in *Retirement Plans Committee of IBM v. Jander*, No. 18-1165. At issue is whether plaintiffs can satisfy *Fifth Third*'s "more harm than good" pleading standard for inside information-based ERISA claims against the fiduciaries of an employee stock ownership plan ("ESOP") by alleging that delaying an inevitable disclosure of an alleged fraud results in greater stock price harm.

Background

In *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409 (2014), the Supreme Court held that in order "[t]o state a claim for breach of the duty of prudence" against ESOP fiduciaries "on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it."[4]

In *Jander v. Retirement Plans Committee of IBM*, 910 F.3d 620 (2d Cir. 2018), the Second Circuit held that *Fifth Third*'s "more harm than good" pleading standard was met where plaintiffs alleged that the disclosure of the overvaluation of one of the company's business divisions was "inevitable, because [the company] was likely to sell the business and would be unable to hide its overvaluation from the public at that point." The court found plaintiffs adequately alleged that "the eventual disclosure of a prolonged fraud causes 'reputational damage' that 'increases the longer the fraud goes on.'" The court determined that "when 'a drop in the value of the stock already held by the fund is inevitable' . . . it is far more plausible that a prudent fiduciary would prefer to limit the effects of the stock's artificial inflation on the ESOP's beneficiaries through prompt disclosure." Defendants petitioned the Supreme Court for a writ of certiorari to review the Second Circuit's decision. The Court granted defendants' petition on June 3, 2019.

Justices Grapple with the Question of Whether Claims Against ESOP Fiduciaries for Failure to Disclose Inside Information Should Be Brought Under the Securities Laws

During oral argument, petitioners' counsel argued that "ESOP fiduciaries do not have a fiduciary obligation to use information gained in a corporate capacity or to use the regular corporate channels of disclosure for the benefit of plan participants." Petitioners' counsel further contended that in every case, plaintiffs could plead "generic allegations" that "it is prudent to disclose early" because "no fraud lasts forever, disclosure's

4. Please click here to read our discussion of the Supreme Court's decision in *Fifth Third*.

inevitable, and the harms of concealment only grow over time." He asserted that permitting such allegations to satisfy *Fifth Third* is "fundamentally inconsistent" with the "objective reality that if you disclose negative inside information to the market, it's going to have a negative impact on the value of the stock, which is all an ESOP holds." Petitioners' counsel argued that *Fifth Third* therefore requires something "very specific" and "very different" that would cause a prudent fiduciary to determine that "committing this immediate harm is nonetheless prudent."

Justice Sotomayor stated that "[t]he economic principle" that the harm of an inevitable disclosure increases over time "is both logical and supported by the literature." She questioned what was "missing from the specifics" of the complaint, other than the theory that this "economic principle shouldn't exist at all." Justice Sotomayor asked whether petitioners' counsel could "really be saying that it's a fiduciary duty to help sellers promote fraudulent conduct by avoiding losses for people." Petitioners' counsel responded that such disclosure-based claims against ESOP fiduciaries who are also company insiders should be brought under the securities laws, rather than ERISA. Justice Sotomayor stated that this was "not what you asked for cert on." Justice Breyer raised the same concern, and suggested that the Court should "just stick to the question on which we granted cert." He stated that plaintiffs' allegations concerning the increased stock price harm resulting from a delayed disclosure were "fairly specific" and "seem[] adequate." Justice Breyer questioned, "What's wrong with [the complaint]?"

Counsel for the United States, as amicus curiae supporting neither party, posited that the securities laws should exclusively govern a company's disclosure obligations. He asserted that "it would undermine the objectives of the securities laws to impose an additional disclosure regime based on the ad hoc balancing of a single ERISA fiduciary." Justice Ginsburg observed that this "theory" was "nowhere aired below." Counsel for the United States explained that he was trying to "be useful to the Court by discussing the objectives of the securities laws" and highlighting the quandary faced by ESOP fiduciaries, who are prohibited under the securities laws from making a selective disclosure only to plan participants. Justice Alito seemed persuaded, and noted that the "more harm than good" standard asks the "fiduciary . . . to make a very complicated calculation" about whether and when to disclose adverse inside information, by trying to anticipate what the situation would be "at some point in the future when the information will inevitably come out." Justice Kagan noted that "it does sound like you want us to scrap [*Fifth Third*] and start all over again." Counsel for the United States responded that *Fifth Third* requires courts to consider "whether a[n] ERISA-based obligation to disclose . . . would be inconsistent with the objectives of . . . the securities laws." He asserted that "in almost every case it would be."

Justice Gorsuch questioned respondents' counsel why the securities laws would not "be a really good place to start and maybe finish in assessing what [the] long-term overall health of the corporate interests might be?" He stated, "I mean, isn't that what the securities laws are all about? It's . . . ensuring the markets function on a net basis with as much transparency and efficiency as we can muster, subject to . . . imposing reasonable costs and duties on people?" Justice Gorsuch observed that if the fiduciary is supposed to consider "the general interests . . . of the plan as a whole," he "would have thought the securities laws would have been a really good proxy for the duties we'd expect a fiduciary to abide."

Respondents' counsel argued that the case before the Court was among the "rare exception[s]" in which ESOP fiduciaries were required to make a disclosure because of the unique circumstances at issue. He explained that the case involved "fiduciaries who happen to be insiders . . . who happen to be involved in the thing that is alleged to have inflated the stock price, who happen to have direct knowledge of that, and who happen to have responsibility for the accounting of that, and, therefore, are in a position to know about it." Justice Kavanaugh observed, "That doesn't seem rare at all. That seems fairly commonplace." During rebuttal, petitioners' counsel reiterated that "[t]he allegations here are generic allegations that could be made in every stock drop case."

The Court will issue a decision in *Retirement Plans Committee of IBM v. Jander* later this Term.

District of New Jersey: *American Pipe* Tolling Does Not Apply to Untimely Opt-Out Individual Actions Brought Prior to a Decision on Class Certification

On September 10, 2019, the District of New Jersey held that plaintiffs who file opt-out actions after the statute of limitations has expired, but before a decision on class certification has been issued, are not entitled to the benefit of *American Pipe* tolling. *Northwestern Mut. Life. Ins. Co. v. Valeant Pharm. Int'l*, 2019 WL 4278929 (D.N.J. 2019) (Shipp, J.).[5] The court explained that holding otherwise would "encourage future plaintiffs to sit back, await developments in the case as the strength of the parties' positions are tested through Rule 12 motion practice, and if there are favorable determinations, file an otherwise untimely action that is saved by the *American Pipe* doctrine." The court determined that "[s]uch a result does not support the efficiency and economy of litigation" that underpins the *American Pipe* doctrine.

Background

In *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974), the Supreme Court held that "the commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class who would have been parties had the suit been permitted to continue as a class action." The Supreme Court subsequently "clarified" that "[t]he rule is not dependent on intervening in or joining an existing suit; it applies as well to putative class members who, after denial of class certification, 'prefer to bring an individual suit rather than intervene . . . once the economies of a class action [are] no longer available.'" *China Agritech v. Resh*, 138 S. Ct. 1800 (2018) (quoting *Crown, Cork & Seal Co. v. Parker*, 462 U.S. 345 (1983)).

In *China Agritech*, the Supreme Court held that "*American Pipe* does not permit the maintenance of a follow-on class action past expiration of the statute of limitations." Prior to the *China Agritech* decision, "the Second[,] Tenth, and Ninth Circuits each held that a putative class member who brings an individual action prior to class certification would receive the benefit of *American Pipe* tolling," while the Sixth Circuit reached the opposite conclusion.[6] *Northwestern Mut. Life. Ins. Co.*, 2019 WL 4278929. The Third Circuit has not ruled on this issue, nor has any circuit court addressed this question since the Supreme Court's decision in *China Agritech*.

Applying *American Pipe* Tolling to Untimely Opt-Out Actions Filed Prior to a Decision on Class Certification Would Not Promote Efficiency and Economy of Litigation

"To resolve th[e] issue" of whether a plaintiff who brings untimely opt-out claims prior to a decision on class certification is entitled to the benefit of the *American Pipe* tolling doctrine, the *Northwestern Mutual* court "consider[ed] the history and purpose of the *American Pipe* doctrine." The court explained that "the *American Pipe* doctrine encourages efficiency and economy of litigation because without the doctrine potential class members would be induced to file protective motions to intervene or join." The court also noted that it "protect[s] the interests of putative unnamed class members who ha[ve] not received notice and were unaware of the pending class action."

The court found that "the expansion of the *American Pipe* doctrine here would not promote efficiency and economy of litigation," as it would "encourage additional individual actions to be brought prior to class-certification" and could require the court to "deal with dispositive motions rehashing legal and factual issues [it] previously addressed." The court also found it significant that the plaintiff in the case before it was "not a putative unnamed class member who never received notice of this action and must rely on the protection of the *American Pipe* doctrine." Moreover, the court observed that the plaintiff could "hardly qualify as diligent in asserting claims and pursuing relief" given that the plaintiff "wait[ed] more than two years after the filing of the" class action complaint to bring suit. The court

5. Simpson Thacher represents Valeant Pharmaceuticals International Inc. in this matter.

6. *Compare In re WorldCom Sec. Litig.*, 496 F.3d 245 (2d Cir. 2007); *State Farm Mut. Auto. Ins. Co. v. Boellstorff*, 540 F.3d 1223 (10th Cir. 2008); *and In re Hanford Nuclear Reservation Litig.*, 534 F.3d 986 (9th Cir. 2008); *with Wyser-Pratte Mgmt. Co. v. Telxon Corp.*, 413 F.3d 553 (6th Cir. 2005).

"conclude[d] that application of the *American Pipe* doctrine to [the plaintiff's] federal law claims would not further the purposes of the doctrine," and dismissed the plaintiff's claims as untimely.

Western District of Kentucky: Financial Projections That Assumed No Future Acquisitions Were Not Misleading, Where the Proxy Statement Included a Disclaimer and Adequately Disclosed the Company's Growth Plans

On September 24, 2019, the Western District of Kentucky dismissed a securities fraud action alleging that financial projections that assumed no future acquisitions by the company rendered a proxy statement misleading, in violation of Section 14(a) of the Securities Exchange Act of 1934 and SEC Rule 14a-9 promulgated thereunder. [*Laborers' Local #231 Pension Fund v. PharMerica Corp.*, 2019 WL 4645583 (W.D. Ky. 2019) (Jennings, J.)](). [7] The court rejected plaintiffs' contention that the financial projections and other statements in the proxy statement "would cause an investor to believe that the [c]ompany's future business plan only included organic growth" and not growth through acquisitions. The court emphasized that the proxy statement "contains an express disclaimer that warns stockholders not to make assumptions . . . based on the [p]rojections," as well as "statements explicitly stating that future acquisition remains part of the [c]ompany's growth plans." The court determined that "no reasonable stockholder would construe" the statements at issue concerning the financial projections "to imply that [the company's] growth plan only contemplated organic growth," because the proxy statement "all but explicitly told the stockholder not to make such an inference."

The court found *Laborers' Local #231 Pension Fund v. Cowan*, 300 F. Supp. 3d 597 (D. Del. 2018), instructive. There, plaintiff "claimed that financial forecasts in the proxy statement . . . were misleading because those forecasts failed to accurately portray [the company's] acquisition strategy." *PharMerica*, 2019 WL 4645583 (discussing *Cowan*). But the proxy statement specifically "cautioned" stockholders "not to place undue, if any, reliance on the forecasts. The *Cowan* court found that the proxy's disclaimer effectively prevented the financial forecasts from affirmatively misleading stockholders about [the company's] future actions, including potential future acquisitions."

As in *Cowan*, the financial projections at issue in the proxy statement in *PharMerica* did not account for future acquisitions. The proxy statement included a disclaimer specifically warning that "the projections are not to be relied on as indicative of future events," and the company's "SEC filings and other public statements explicitly state[ed] that the [c]ompany's plans included future acquisition." Given this "context," the court found that it would be "unreasonable" for stockholders to conclude, based on the financial projections, that the company's "growth plan at the time of the merger only included organic growth."

The court also found that the financial projections could not be "materially false" for assuming no future acquisitions, because the projections "on their face unambiguously disclose that assumption to stockholders." The court further found that the financial projections could not be rendered misleading because they relied on what plaintiffs characterized as an "incorrect" assumption. The court explained that "assumptions and inputs in financial forecasts are immaterial, and therefore not misstatements under Section 14(a), when disclosed, because once disclosed the stockholder[s] [are] free to determine for themselves whether such assumptions and inputs are appropriate." The

7. Simpson Thacher represents PharMerica Corporation and Kohlberg Kravis Roberts & Co. in this matter.

court concluded that plaintiffs failed to state a claim under Section 14(a) and Rule 14a-9.

Delaware Supreme Court: Generalized Allegations of a Controller's Need for Liquidity Do Not, Standing Alone, Warrant Application of the Entire Fairness Standard of Review

On November 1, 2019, the Delaware Supreme Court affirmed the dismissal of a shareholder class action alleging that a company's controlling stockholder "orchestrated a sale of the company [to a third party] for less than fair value to address a personal need for liquidity prompted by his retirement as the company's CEO." *English v. Narang*, 2019 WL 1300855 (Del. Ch. Mar. 20, 2019), *aff'd*, 2019 WL 5681416 (Del. Nov. 1, 2019) (Vaughn, Jr., J.). The Chancery Court found plaintiffs alleged "no concrete facts from which it can reasonably be inferred that [the CEO] had an exigent or immediate need for liquidity" that created a disabling conflict of interest with respect to the transaction. Because the court found the transaction was approved by a majority of the company's uncoerced and fully-informed stockholders, the court determined that "the [t]ransaction is governed by the business judgment rule under *Corwin* and its progeny" rather than the entire fairness standard of review.[8]

Plaintiffs alleged that when the CEO "decided to retire in mid-2015 at seventy-three years of age, he needed to liquidate his position as part of his estate planning and wealth management strategy because his [company stock] holdings accounted for nearly all of his net worth." *English*, 2019 WL 1300855. Plaintiffs relied on *N.J. Carpenters Pension Fund v. infoGROUP*, 2011 WL 4825888 (Del. Ch. Sept. 30, 2011, revised Oct. 6, 2011). There, the Chancery Court found plaintiffs adequately alleged that a controlling stockholder "forced" the sale of a company "at an inopportune time and utilizing a flawed and inadequate sales process," so that the controller "could obtain desperately needed liquidity." *infoGROUP*, 2011 WL 4825888. The *infoGROUP* plaintiffs alleged that the controller had over $25 million in debts at the time the complaint was filed, and had not received a salary since the controller was pushed out of his role as the company's CEO.

Defendants in *English* argued that the Chancery Court's decision in *In re Synthes Shareholder Litigation*, 50 A.3d 1022 (Del. Ch. 2012), provided a closer analogy. There, the court declined to apply the entire fairness standard of review to a transaction that was allegedly motivated by a controlling stockholder's need for liquidity. The *Synthes* court found that "a controlling stockholder's immediate need for liquidity" might "constitute a disabling conflict of interest" only in "very narrow circumstances." *Synthes*, 50 A.3d 1022. The court stated that "[t]hose circumstances would have to involve a crisis, fire sale where the controller, in order to satisfy an exigent need (such as a margin call or default in a larger investment) agreed to a sale of the corporation without any effort" to provide "logical buyers" with the opportunity to "make a bid that would reflect the genuine fair market value of the corporation." The *Synthes* court dismissed the complaint because there were "no well-pled facts to suggest that [the CEO] forced a crisis sale of [the company] . . . to satisfy some urgent need for cash."

In *English*, the Chancery Court found the allegations "similar to those pled in *Synthes*" and "dramatically different than the situation in *infoGROUP*." 2019 WL 1300855. The court noted that plaintiffs had "not identified any *allegations of fact* . . . about [the CEO's] estate planning or wealth management strategy to support the inference that he was seeking to liquidate his shares quickly." Moreover, the court found the complaint "devoid of any facts suggesting" that the CEO had "debt obligations, needed to exit his position [at the company] in order to pursue a new business venture, or had admitted to others a need for liquidity." The court also deemed it significant that the company engaged in a lengthy sales process that included outreach to "numerous

8. In *Corwin v. KKR Financial Holdings*, 125 A.3d 304 (Del. 2015), the Delaware Supreme Court held that "when a transaction not subject to the entire fairness standard is approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies." The *Corwin* rule also applies when a majority of disinterested stockholders tender their shares in the first step of a two-step merger under 8 *Del. C.* § 251(h). *See In re Volcano Corporation Stockholder Litig.*, 143 A.3d 727 (Del. 2016). Please click here to read our discussion of the Delaware Supreme Court's decision in *Corwin*, and here to read our discussion of the Chancery Court's decision in *Volcano*.

potential buyers." The court concluded that plaintiffs "failed to plead facts to support a reasonable inference that [the CEO's] retirement . . . posed some sort of exigency or emergency where he needed liquidity fast so as to create a disabling conflict of interest with respect to the [t]ransaction." The court therefore found that "no basis exists to subject the [b]oard's consideration of the [t]ransaction to entire fairness review," and dismissed the complaint based on application of the business judgment rule.

The Delaware Supreme Court affirmed the dismissal of the complaint "on the basis of and for the reasons assigned by" the Chancery Court. *English*, 2019 WL 5681416.

Delaware Supreme Court: Plaintiffs Failed to Allege That Venture Capital Investors Who Collectively Controlled 60% of a Company's Shares Constituted a "Control Group"

On October 4, 2019, the Delaware Supreme Court affirmed the dismissal of a shareholder action premised on the legal theory that several venture capital firms constituted a "control group" that breached its fiduciary duties in connection with allegedly dilutive financing transactions and a subsequent acquisition. *Sheldon v. Pinto Tech. Ventures*, 2019 WL 4892348 (Del. 2019) (Valihura, J.).[9] Plaintiffs alleged, *inter alia*, that the venture capital firms (1) collectively controlled over 60% of the company's shares, (2) were parties to a voting agreement that provided them with the right to appoint three directors, who in turn chose two additional directors; and (3) had a history of investing together. The Delaware Supreme Court found these allegations insufficient to demonstrate that the venture capital firms "were connected in a legally significant way, either before or during the allegedly dilutive actions."

The court explained that Delaware law "recognizes that multiple stockholders together can constitute a control group exercising majority or effective control, with each member subject to the fiduciary duties of a controller." The stockholders must be "connected in some legally significant way—such as by contract, common ownership, agreement, or other arrangement—to work together toward a shared goal." The "mere concurrence of self-interest among certain stockholders" is not sufficient to establish the existence of a control group. "Rather, there must be some indication of an actual agreement, although it need not be formal or written."

Plaintiffs argued that their allegations were similar to those in *In re Hansen Medical Stockholders Litigation*, 2018 WL 3025525 (Del. Ch. June 18, 2018). There, the Chancery Court held that plaintiffs adequately pled the existence of a "control group" by alleging, *inter alia*, that the stockholders had (1) coordinated their investments for twenty-one years, (2) declared themselves as a "group of stockholders" to the SEC; and (3) were "the only participants in a private placement that made them the largest stockholders of" the company at issue. But the Chancery Court in *Sheldon* found that plaintiffs' allegations more closely paralleled those at issue in *van der Fluitt v. Yates*, 2017 WL 5953514 (Del. Ch. Nov. 30, 2017). In *van der Fluitt*, the court held plaintiffs failed to plead the existence of a "control group" where the defendant stockholders were not the only signatories of the relevant investor rights agreement, and that agreement did not concern the challenged transaction.

In *Sheldon*, the Delaware Supreme Court "agree[d] with the Court of Chancery that it is

9. Plaintiffs argued that their failure to make a demand or plead demand futility did not mandate the dismissal of their claims because their claims were partially direct under *Gentile v. Rosette*, 906 A. 2d 91 (Del. 2006). In *Gentile*, the Delaware Supreme Court recognized that a claim may be "both derivative and direct in character" if "(1) a stockholder having majority or effective control causes the corporation to issue 'excessive' shares of its stock in exchange for assets of the controlling stockholder that have a lesser value; and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling stockholder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders."

not reasonably conceivable that the [v]enture [c]apital [f]irms functioned as a control group." 2019 WL 4892348. The Delaware Supreme Court noted that the voting agreement "bound all of [the company's stockholders]" and "was unrelated" to the allegedly dilutive transactions. Moreover, the court observed that the agreement "only governs the election of certain directors to [the company's board]" and "does not require [the stockholders] to vote together on any transaction." The Delaware Supreme Court found similarly "unavailing" plaintiffs' allegations concerning the venture capital firms' prior investments. Plaintiffs pointed to four companies in which "two or more" of the venture capital firms "invested in the same financings." The court observed that plaintiffs did "not identify any instance in which all three [v]enture [c]apital [f]irms participated in any investment," or "allege that they held themselves out as a group of investors or that they reported as such to the SEC." Instead, the "allegations merely indicate that venture capital firms in the same sector crossed paths in a few investments."

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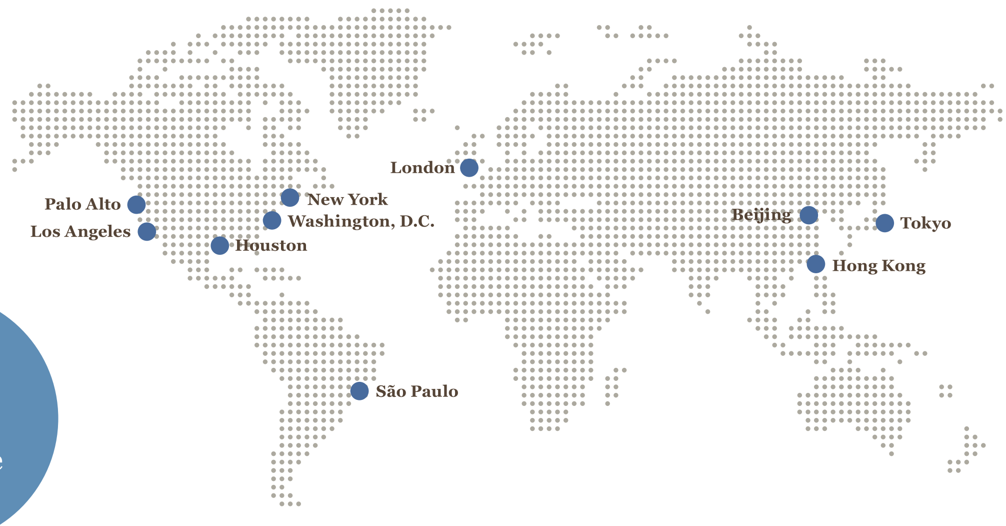

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