Simpson Thacher

Securities Law Alert

Year in Review:

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2019

Simpson Thacher's "[s]ophisticated group of securities litigators expertly handl[es] the representation of major financial institutions and private equity clients."

–Chambers USA

Supreme Court Decisions

Defendants Can Face Primary Liability Under Rules 10b-5(a) and (c) for Disseminating False or Misleading Information With Intent to Defraud

On March 27, 2019, the Supreme Court held that "dissemination of false or misleading statements with intent to defraud can fall within the scope of subsections (a) and (c) of Rule 10b-5, . . . even if the disseminator did not 'make' the statements" within the meaning of the Supreme Court's decision in *Janus Capital Group v. First Derivative Traders*, 564 U.S. 135 (2011), "and consequently falls outside subsection (b) of" Rule 10b-5. *Lorenzo v. SEC*, 139 S. Ct. 1094 (2019) (Breyer, J.).[1]

SEC Rule 10b-5 proscribes three types of securities fraud: subsection (a) makes it unlawful "[t]o employ any device, scheme or artifice to defraud"; subsection (b) prohibits "mak[ing] any untrue statement of a material fact"; and subsection (c) prohibits "engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit." The Court rejected the argument that the three subsections of Rule 10b-5 "should be read as governing different, mutually exclusive, spheres of conduct." The Court explained that both the Supreme Court and the SEC "have long recognized considerable overlap among the subsections of the Rule and related provisions of the securities laws."

The Court also found meritless the contention that subsection (b) "*exclusively* regulates conduct involving false or misleading statements." The Court reasoned that adopting this interpretation "would mean those who disseminate false statements with the intent to cheat investors might escape liability under the Rule altogether." The Court observed that "using false representations to

1. The *Janus* Court held that for purposes of Rule 10b-5, "the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." Please click here to read our discussion of the Supreme Court's decision in *Janus*.

induce the purchase of securities would seem a paradigmatic example of securities fraud."

The Court explained that *Janus* did not require a different result as it concerned only subsection (b) of Rule 10b-5, and did not address Rule 10b-5's "application to the dissemination of false or misleading information." The Court stated that "*Janus* would remain relevant (and preclude liability) where an individual neither *makes* nor *disseminates* false information—provided, of course, that the individual is not involved in some other form of fraud."

Circuit Court Decisions Addressing Section 10(b) Claims

Second Circuit: Plaintiffs Cannot Assert a Securities Fraud Claim Based on "Tentative and Generic" Compliance-Related Statements

On March 5, 2019, the Second Circuit affirmed the dismissal of a securities fraud action alleging that a health services company made misstatements concerning its regulatory compliance. [*Singh v. Cigna Corp.*, 918 F.3d 57 (2d Cir. 2019) (Cabranes, C. J.)](). The court cautioned that plaintiffs cannot assert "a prima facie case of securities fraud" merely by "point[ing] to banal and vague corporate statements affirming the importance of regulatory compliance" coupled with "significant regulatory violations." The court emphasized that "such generic statements do not invite reasonable reliance."

The Second Circuit found that compliance-related statements in the company's Code of Ethics were "textbook example[s] of puffery" because they were simply "general declarations about the importance of acting lawfully and with integrity." The court further held that a reasonable investor would not rely upon the "tentative and generic" compliance-related statements in the company's SEC filings, particularly because those statements were "framed by acknowledgements of the complexity and numerosity of applicable regulations." The court observed that "[s]uch framing suggests caution (rather than confidence) regarding the extent of [the company's] compliance."

Third Circuit: Company's Comprehensive Disclosures Defeated an Inference of Scienter

On June 20, 2019, the Third Circuit affirmed the dismissal of a securities fraud action alleging that a company "fraudulently lauded its financial health and misrepresented that its distributions were funded from the performance of the business." *Fan v. StoneMor Partners*, 927 F.3d 710 (3d Cir. 2019) (Restrepo, C. J.). The Third Circuit found that "for each category of alleged misstatements, [the company] disclosed sufficient information to render them immaterial." The court determined that these disclosures "alert[ed] reasonable investors" to the company's downside potential.

The Third Circuit further held that the company's comprehensive disclosures belied any inference of scienter. The court noted that the company's disclosures "accurately show how [the company] leveraged its assets in order to maximize its distributions despite the state trust requirements" that limited its ability to recognize proceeds as revenue under GAAP. The court explained that although the company "may have been caught by the risk inherent in its business strategy, . . . those risks were disclosed" to investors and thus

"the pleadings do not demonstrate scienter as the [Private Securities Litigation Reform Act ("PSLRA")] requires."

Fifth Circuit: Plaintiffs Can Rely on Post-Statement Events to Demonstrate That a Statement Was False When Made

On May 15, 2019, the Fifth Circuit found plaintiffs adequately pled that a company made misrepresentations concerning its algorithm for predicting and collecting insurance reimbursements, by alleging that the company "was ultimately unable to collect on the overwhelming majority of claims it billed." *Masel v. Villareal*, 924 F.3d 734 (5th Cir. 2019) (King, C. J.).The court determined that "evidence of later events can provide useful circumstantial evidence that a given representation was false when made."

The Fifth Circuit rejected defendants' contention that plaintiffs were "attempting to prove fraud by hindsight by pointing to later events in order to shed light on the truth or falsehood of earlier statements." The court noted that "fraud–by–hindsight issues arise in the context of the scienter factor, not the misrepresentation factor." The court explained that "[w]here, as here, the representation in question concerned an asset or skill possessed by the defendant (here, an algorithm), the defendant's failure to perform as promised casts doubt on whether he possessed that skill in the first place."

Fifth Circuit: Plaintiffs Cannot Impute One Corporation's Knowledge to Another Through Unsubstantiated Allegations of a Joint Venture

On May 24, 2019, the Fifth Circuit affirmed the dismissal of an Enron-related securities fraud action brought against the independently–incorporated retail brokerage and investment banking arms of a major bank. *Lampkin v. UBS Fin. Servs.*, 925 F.3d 727 (5th Cir. 2019) (Higginbotham, C. J.). The Fifth Circuit rejected plaintiffs' contention that "any material, nonpublic information known to [the investment bank] had to be disclosed by [the brokerage]" because the bank "operated as a single, fully integrated entity." The court found that "'vague corporate platitudes about integration as a firm' are insufficient to support a finding of joint venture liability" (quoting *Giancarlo v. UBS Financial Services*, 725 F. App'x. 278 (5th Cir. 2018)). The court emphasized that plaintiffs did not allege "that defendants shared profits or losses" or "that defendants had joint control or right of control over the joint venture," as required to establish the existence of a joint venture under governing Delaware law.

Fifth Circuit: Defendants' Alleged Awareness of Excess Inventory Levels Was Insufficient to Raise a Strong Inference of Scienter Concerning a Significant Markdown Risk

On August 19, 2019, the Fifth Circuit affirmed the dismissal of a securities fraud action alleging that a home furnishings company and its executives failed to disclose "the risk that [the company] had so much inventory that it could get rid of it only by lowering prices dramatically." *Municipal Emps. Ret. Sys. of Mich. v. Pier 1 Imports*, 935 F.3d 424 (5th Cir. 2019) (Elrod, C.J.). Plaintiffs did not claim that defendants "misrepresented [the company's] inventory" but instead asserted that defendants "misled the public about [the company's] ability to offload that excessive inventory without significant markdown risk." The court held plaintiffs failed to allege scienter because "[k]nowledge of high inventory does not necessarily equate to knowledge of significant markdown risk."

The court rejected plaintiffs' contention that the company's "products are particularly subject to markdown risk" because the company "is a trend-based [home] fashion retailer that is subject to the whims of consumer trends." The court found the company "operates largely in the sturdier business of style" rather than the ever-changing business of fashion. The court also noted that plaintiffs offered no explanation for why defendants "kept ordering more inventory when they supposedly knew deep down that they would not be able to sell it." Rather than raising a strong inference of scienter as to a significant markdown risk, the court found it "equally plausible . . . that [defendants] reasonably believed they could fix the excessive inventory problem without resorting to markdowns."

Eleventh Circuit: (1) The Puffery Defense Applies in the Securities Fraud Context, and (2) Statements Conveying Future Plans Are Entitled to Safe Harbor Protection Even If They "Implicitly Communicate Information About the Present"

On August 15, 2019, the Eleventh Circuit issued its first published decision applying the puffery defense in the securities fraud context. *Carvelli v. Ocwen Fin. Corp.*, 934 F.3d 1307 (11th Cir. 2019) (Newsom, C.J.). The court found that "the defense seems a particularly good fit in the securities context" because Rule 10b-5 prohibits only "untrue statements of a *material* fact, with 'material' defined to mean something that a reasonable investor would view as having significantly altered the total mix of information made available." The court explained that "[e]xcessively vague, generalized, and optimistic comments—the sorts of statements that constitute puffery—aren't those that a 'reasonable investor,' exercising due care, would view as moving the investment decision needle—that is, they're not material."

The Eleventh Circuit cautioned that "[a] conclusion that a statement constitutes puffery doesn't absolve the reviewing court of the duty to consider the possibility—however remote—that in context and in light of the 'total mix' of available information, a reasonable investor might nonetheless attach importance to the statement." The court found that many of the compliance-related statements at issue in the case before it—such as assertions that the company "was taking a 'leading role' and making 'progress' toward compliance"—were "quintessential puffery" and "immaterial as a matter of law." The court rejected plaintiffs' contention that the statements "can't be nonactionable puffery because [the company] did not genuinely or reasonably believe them." The court explained that "[w]hether a statement was made in bad faith or without a reasonable basis is irrelevant to the question [of] whether the statement is nonetheless so airy as to be insignificant."

The Eleventh Circuit also held that the company's forward-looking statements were entitled to safe harbor protection even though they included "statements about the [c]ompany's present condition and intentions." The court held that "when a forward-looking statement is of the sort that, by its nature, rolls in present circumstances—that is, when a statement forecasts in a tentative way a future state of affairs in which a present commitment unfolds into action—the statement isn't barred from safe harbor protection solely on that ground."

Circuit Court Decisions Addressing Section 11 Claims

Second Circuit: Duty to Disclose Under Item 303 of Regulation S-K Is Limited to Known Trends or Uncertainties That Have Had, or Are Reasonably Expected to Have, a Material Impact on a Company's Overall Revenue

On December 16, 2019, the Second Circuit affirmed the dismissal of a securities fraud action against an online hotel search platform operator and the underwriters of its IPO. *Shetty v. Trivago*, 2019 WL 6834250 (2d Cir. 2019) (per curiam).[2] The Second Circuit found that defendants had no obligation under Section 11 of the Securities Act of 1933 (the "Securities Act") to disclose (i) violations of the company's landing page standards by the company's largest advertiser, or (ii) a modification to the company's market algorithm known as the "relevance assessment" that imposed financial penalties on advertisers that failed to adhere to the company's landing page standards.

The Second Circuit rejected plaintiffs' contention that defendants had a duty to disclose pursuant to Item 303 of Regulation S-K, which requires the disclosure of "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues." 17 C.F.R. § 229.303(a)(3)(ii). With respect to the landing page violations by the company's largest advertiser, the Second Circuit noted that the complaint was "silent as to the extent of the financial impact" of these violations. The Second Circuit determined that a court could not "plausibly and reasonably infer" that these violations "had any negative

2. Simpson Thacher represents the underwriters of Trivago's initial public offering in this matter.

financial impact at all, let alone a material impact on [the company's] overall revenue such that Item 303 would require disclosure."

The Second Circuit further found that the complaint did not "permit the inference" that "it was reasonably foreseeable . . . that implementing the [r]elevance [a]ssessment would have a material impact [on the company's] revenue." The court found the allegations "suggest that [d]efendants expected advertisers to conform their landing pages to the stated standards to avoid paying the penalty" and thus anticipated that the "impact on revenue, if any, would be minimal." Although several advertisers ultimately "ended up paying significant penalty fees for several months," the Second Circuit found that this "merely highlights the benefits of hindsight." The court explained that this "does not mean that outcome was reasonably foreseeable when the [r]elevance [a]ssessment was implemented."

Third Circuit: Nonvoting Board Observers Affiliated With an Issuer's Placement Agent Are Not Subject to Liability Under Section 11

On July 23, 2019, the Third Circuit held that "a nonvoting board observer affiliated with an issuer's placement agent" is not subject to liability under Section 11 of the Securities Act as a person who "'perform[s] similar functions'" to a "'director.'" *Obasi Inv. Ltd. v. Tibet Pharm.*, 931 F.3d 179 (3d Cir. 2019) (Hardiman, C. J.) (quoting 15 U.S.C. § 77k(a)(3)).

15 U.S.C. § 77k(a)(3) provides that Section 11 claims may be brought against "every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner." The Third Circuit held that "deciding whether a person is a proper § 77k(a)(3) defendant . . . is a question of law for the court, not a question of fact for the jury." The court further held that the inquiry is limited to a review of "the description provided" in the registration statement of the person's role, and does not extend to extrinsic evidence concerning the person's actual functions.

In the case before it, the Third Circuit determined that "[t]hree features differentiate [the nonvoting board members] from directors" based on the description of their roles in the registration statement. First, the nonvoting board members "cannot vote for board action" and thus have no "ability to manage the company's affairs," which is the "directors' most basic power." Second, the nonvoting board members are "aligned with the placement agent" rather than the company. The court explained that the nonvoting board members' "loyalties aren't with [the company's] shareholders—and loyalty to the shareholders is as vital to directorship as the power to manage." Finally, the nonvoting board members' "tenures are set to end automatically, with no opportunity [for shareholders] to vote them out." The Third Circuit therefore concluded that the nonvoting board members could not face Section 11 liability pursuant to § 77k(a)(3).

Fifth Circuit: Grant of Stock Options Pursuant to an Employee Stock Option Plan Is Not a "Sale" of Securities

On May 24, 2019, the Fifth Circuit held that a grant of stock options pursuant to an employee stock option plan was not a "sale" of securities, as required to state a claim under Sections 11 and 12 of the Securities Act. *Lampkin v. UBS Fin. Servs.*, 925 F.3d 727 (5th Cir. 2019) (Higginbotham, C. J.). The court reasoned that "participation in the [plan] was compulsory and employees furnished no value, or tangible and definable consideration in exchange for the option grants."

The Fifth Circuit noted that in *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979), the Supreme Court held that "'participation in a noncontributory, compulsory pension plan' is not the equivalent of purchasing a security" because "the 'purported investment is a relatively insignificant part' of the employee's total compensation, and the decision to accept and retain employment likely had only an attenuated relationship to the investment." *Lampkin*, 925 F.3d 727 (quoting *Daniel*, 439 U.S. 551). The Fifth Circuit found that the key inquiry under *Daniel* is "whether employees made an investment decision that could be influenced by fraud or manipulation."

Applying *Daniel*, the Fifth Circuit held that plaintiffs "failed to demonstrate that the grant of" the options at issue "amounted to the sale of a security." The court found that it was "of no consequence" that plaintiffs "would eventually make an affirmative investment decision—whether to exercise the option or let it expire," since plaintiffs' claims were "based explicitly on the grant of the option, not the exercise of that option."

Circuit Court Decisions Addressing SLUSA

Third Circuit: SLUSA Does Not Preclude Opt-Out Actions That Were Never Actually Combined With a "Covered Class Action"

On September 12, 2019, the Third Circuit held that SLUSA does not preclude plaintiffs from bringing individual suits under state law after opting out from a securities-related class action unless the opt-out suit and the class action were "somehow combined, in whole or in part, for case management or for resolution of at least one common issue." *North Sound Capital v. Merck & Co.*, 938 F.3d 482 (3d Cir. 2019) (Krause, C. J.). The court found that SLUSA generally does not preclude opt-out suits that did not "coincide for some period" with a class action because "[i]f two cases never overlap, a court cannot combine them."

SLUSA's "mass action provision" defines a "covered class action" to include "any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which . . . (I) damages are sought on behalf of more than 50 persons; and (II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose." 15 U.S.C. § 78bb(f)(5)(B)(ii). The Third Circuit "consider[ed] what Congress meant by the broader phrase 'otherwise proceed as a single action for any purpose.'" The court explained that it was "hard-pressed to imagine any scenario in which two cases that never overlap [in time] could function as a single lawsuit on any dimension, as the mass action provision requires."

Seventh Circuit: SLUSA Precludes State-Law-Based Securities Fraud Class Actions Even If the Proposed Class Consists of Fifty or Fewer Members

On January 24, 2019, the Seventh Circuit held that the Securities Litigation Uniform Standards Act ("SLUSA") precluded a state law-based securities fraud class action brought on behalf of a class consisting of fewer than fifty proposed members. *Nielen-Thomas v. Concorde Inv. Servs.*, 914 F.3d 524 (7th Cir. 2019) (Flaum, C. J.).

The court found that Subparagraph (II) of "SLUSA's 'covered class action' definition includes any class action brought by a named plaintiff on a representative basis, regardless of the proposed class size."[3] The court stated that an "obvious implication" of its "interpretation is that no putative securities class actions that are based on state law and otherwise meet SLUSA's requirements (they involve a covered security, allege a misrepresentation in connection with that security, etc.) can proceed in either federal or state court under SLUSA."

The Seventh Circuit noted that SLUSA was enacted "to combat a specific problem—litigants were attempting to circumvent the PSLRA's barriers to federal securities class actions by filing their class actions under state law instead." The court explained that "[t]his purpose could be easily frustrated if plaintiffs bringing a state-law securities class action could simply allege that they represented a class of no more than fifty people." Absent SLUSA preclusion, "such suits could proceed through the courts until discovery identified the entire class of plaintiffs." If it turned out that "the actual class could include more than fifty persons, . . . by that time the abuses that the PLSRA sought to prevent would have already taken place."

3. SLUSA provides that a "single lawsuit" constitutes a "covered class action" if, *inter alia*, "(I) damages are sought on behalf of more than 50 persons or prospective class members," or "(II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated." 15 U.S.C. § 78bb(f)(5)(B)(i).

Other Significant Circuit Court Decisions

Second Circuit: Creates a Circuit Split by Holding That Section 47(b) of the Investment Company Act Provides a Private Right of Action

On August 5, 2019, the Second Circuit held that Section 47(b) of the Investment Company Act ("ICA") "creates an implied private right of action for a party to a contract that violates the ICA to seek rescission of that violative contract." *Oxford University Bank v. Lansuppe Feeder*, 933 F.3d 99 (2d Cir. 2019) (Leval, C. J.). The Second Circuit expressly disagreed with the Third Circuit's decision in *Santomenno ex rel. John Hancock Trust v. John Hancock Life Ins. Co.*, 677 F.3d 178 (3d Cir. 2012), which held that there is no private right of action under Section 47(b) of the ICA.

Section 47(b) of the ICA provides in relevant part as follows:

Validity of Contracts

(1) A contract that is made, or whose performance involves, a violation of this subchapter . . . is unenforceable by either party . . .

(2) To the extent that a contract described in paragraph (1) has been performed, a court may not deny rescission at the instance of any party unless such court finds that under the circumstances the denial of rescission would produce a more equitable result than its grant and would not be inconsistent with the purposes of this subchapter.

15 U.S.C. § 80a-46(b).

The Second Circuit found that "[a]lthough Congress did not expressly state [in Section 47(b)(2)] that a party to an illegal contract may sue to rescind it, the clause that begins 'a court may not deny rescission at the instance of any party' necessarily presupposes that a party may seek rescission in court by filing suit." The court concluded that "[t]he language Congress used is thus effectively equivalent to providing an express cause of action." The Second Circuit found that "§ 47(b)(2) also identifies a 'class of persons' who benefit from the availability of the right of action." The court reasoned that "[t]he most natural reading of the clause providing for rescission, which appears in a section entitled 'Validity of Contracts' and provides a remedy that benefits a party to an illegal contract, is that 'any party' refers to parties to *a contract whose provisions violate the ICA*."

The Second Circuit stated that it "respectfully disagree[d]" with the Third Circuit's decision in *Santomenno*, 677 F.3d 178, because the Third Circuit "relied on interpretive canons that are intended to help resolve ambiguity" rather than "focusing on the text of the statute." The Second Circuit noted that "the Third Circuit failed to mention the strongest textual indication of Congressional intent to provide a private right of action: the clear language of § 47(b)(2) that 'a court may not deny rescission *at the instance of any party*.'"

Eighth Circuit: Omitting Projected Net Income/Loss Information May Render a Proxy Statement Materially Misleading in Violation of Section 14(a) and Rule 14a-9

On March 1, 2019, the Eighth Circuit reversed the dismissal of a securities fraud action alleging that a company's proxy statement in connection with a proposed merger was materially misleading in violation of Section 14(a) of the Securities Exchange Act of 1934 ("Exchange Act") and SEC Rule 14a-9, where the proxy statement failed to disclose projected net income/loss information for the pre-merger target company. *Campbell v. Transgenomic*, 916 F.3d 1121 (8th Cir. 2019) (Benton, C. J.). The court reasoned that "projected net income/loss is not trivial information" and "may be of more significance to investors than revenue."

The Eighth Circuit stated that, for purposes of SEC Rule 14a-9, "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." The court noted that "[u]nder this test it is not necessary to prove that disclosure of an omitted fact would have caused a reasonable investor to change his decision." The court underscored that "[d]oubts as to the critical nature of information misstated or omitted" should be "resolved in favor of those [SEC Rule 14a-9] is designed to protect."

In the case before it, the Eighth Circuit found that the pre-merger company's net income/

loss figures were particularly relevant because the proxy statement included gross profit projections for the pre-merger company. The court determined that "[b]y omitting the (allegedly) significantly lower projections for [the company's] net income/ loss, the proxy statement may have presented [the company] in a false light that was materially misleading."

Tenth Circuit: Pursuant to Section 929P(b) of the Dodd-Frank Act, the Conduct and Effects Tests Govern the Extraterritorial Reach of SEC Enforcement Actions

On January 24, 2019, the Tenth Circuit held that the conduct and effects tests codified in Section 929P(b) of the Dodd-Frank Act govern the extraterritorial reach of SEC enforcement actions brought under Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act. [*SEC v. Scoville*, 913 F.3d 1204 (10th Cir. 2019) (Ebel, C. J.)]. Enacted less than a month after the Supreme Court's decision in *Morrison v. National Australia Bank*, 561 U.S. 247 (2010), Section 929P(b) amended the securities laws to provide that district courts have jurisdiction over extraterritorial SEC enforcement actions brought under Section 10(b) of the Exchange Act or Section 17(a) of the Securities Act if the conduct and effects tests are met.[4]

Although Section 929P(b) addressed "the jurisdictional provisions of the securities acts," the Tenth Circuit determined that "Congress undoubtedly intended that the substantive antifraud provisions should apply extraterritorially" in SEC enforcement actions "when the statutory conduct and-effects test is satisfied." The Tenth Circuit based this conclusion on "the context and historical background surrounding Congress's enactment of those amendments," including the title of Section 929P(b), *Strengthening Enforcement by the Commission*.

Significant Delaware Supreme Court Decisions

Business Judgment Rule Did Not Apply to a Controlling Stockholder Transaction Where the Parties Allegedly "Set the Field of Play for the Economic Negotiations" Before the Transaction Was Conditioned on *MFW*'s Procedural Protections

On April 11, 2019, the Delaware Supreme Court found that the business judgment standard of review did not apply where plaintiffs alleged that the company and its controlling stockholder "substantially negotiated the financial state of play" before the transaction was conditioned on the procedural protections set forth in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (*MFW*). [*Olenik v. Lodzinski*, 208 A.D.3d 704 (Del. 2019) (Seitz, J.)].

The *MFW* 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 Special Committee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders."[5] In *Flood v. Synutra Int'l*, 195 A.3d 754 (Del. 2018), the Delaware Supreme Court held that *MFW*'s *ab initio* requirement is satisfied "so long as the controller conditions its offer on the key protections" before the commencement of "substantive economic negotiations with the controller."[6]

The *Olenik* court held that the *ab initio* requirement was not met in the case before it because "the *MFW* procedural protections were [allegedly] not put in place until after

4. In *Morrison*, the Supreme Court found that the extraterritorial reach of Section 10(b) is a merits question rather than a jurisdictional question. The Court repudiated the conduct and effects tests, and instead held that Section 10(b) applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities." 561 U.S. 247.

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

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

almost eight months of substantive economic dealings among the parties." The court found it significant that the parties allegedly "engaged in a joint exercise to value" the target company, which allegedly "fix[ed] the range in which offers and counteroffers might be made."

Chancery Court Erred in Appraising Shares Using the Unaffected Market Price, Rather Than the Merger Price Less Synergies, in an Arm's Length Transaction Following a Fair Sales Process

On April 16, 2019, the Delaware Supreme Court held that the Chancery Court erred in appraising a company's shares using the unaffected market price, rather than the merger price less synergies, in an arm's length transaction following a fair sales process. *Verition Partners Master Fund v. Aruba Networks*, 210 A.D.3d 128 (Del. 2019) (per curiam). The Chancery Court found the deal price less synergies valuation unreliable because "it needed to make an additional deduction . . . for unspecified 'reduced agency costs.'" But the Delaware Supreme Court determined that there was no evidence of any "agency cost reductions that were not already captured by [the acquirer's] synergies estimate."

The Delaware Supreme Court noted that a stock's market price "is an important indicator of its economic value." However, the court underscored that when a company is sold in an arm's length transaction that is preceded by extensive due diligence, "the price that results . . . is even more likely to be indicative of so-called fundamental value" than the unaffected market price. The court found that the deal price "could be seen as reflecting a better assessment of [the company's] going-concern value" than the unaffected market price because the acquirer "had more incentive to study [the company] closely than ordinary traders in small blocks of [the company's] shares, and also had material, nonpublic information that, by definition, could not have been baked into the public trading price."

Caremark Imposes a "Bottom-Line" Requirement of a Board-Level Oversight System

On June 19, 2019, the Delaware Supreme Court reversed the dismissal of a derivative suit alleging that the directors of an ice cream manufacturing company "breached their duty of loyalty under *Caremark*" by failing to oversee the company's operations.[7] *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019) (Strine, C.J.). The court found "the complaint supports an inference that no system of board-level compliance monitoring and reporting existed at [the company]."

The Delaware Supreme Court recognized that "*Caremark* is a tough standard for plaintiffs to meet" and imposes an "onerous pleading burden." The court noted that "directors have great discretion to design context- and industry-specific approaches tailored to their companies' businesses and resources" when establishing a board-level oversight system. The court also observed that Delaware "case law gives deference to boards and has dismissed *Caremark* cases even when illegal or harmful activities escaped detection" by the board's oversight system. However, the court underscored that *Caremark* imposes a "bottom-line requirement" that directors must at least "try . . . to put in place a reasonable board-level system of monitoring and reporting."

7. In *In re Caremark International Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), the Delaware Chancery Court stated that "where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systemic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability."

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." *Sheldon v. Pinto Tech Ventures*, 2019 WL 4892348 (Del. 2019) (Valihura, J.). 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 court found these allegations insufficient to demonstrate that the venture capital firms "were connected in a legally significant way, either before or during" the transactions at issue.

The Delaware Supreme Court noted that the voting agreement "bound all of [the company's stockholders]" and "was unrelated" to the transactions in question. Moreover, the court observed that the agreement "does not require [the stockholders] to vote together on any transaction." The court also pointed out 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 court found the "allegations merely indicate that venture capital firms in the same sector crossed paths in a few investments" and had a "concurrence of self-interest."

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. The court also deemed it significant that the company engaged in a lengthy sales process that included outreach to "numerous potential buyers."

Because the court found the transaction was approved by a majority of the company's uncoerced and fully-informed stockholders, the Chancery Court dismissed the complaint based on the application of the business judgment rule. The Delaware Supreme Court affirmed the dismissal "on the basis of and for the reasons assigned by" the Chancery Court. *English*, 2019 WL 5681416.

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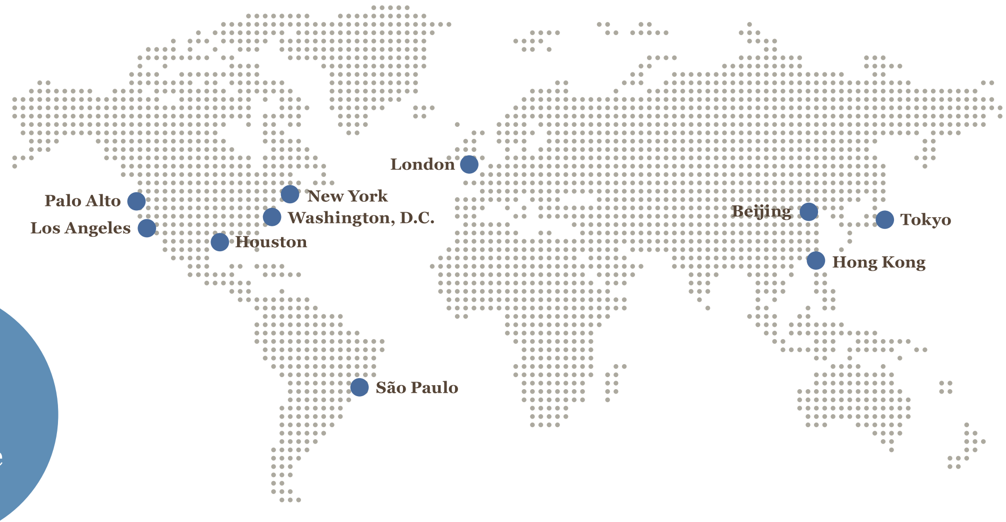

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