Securities Law Alert

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Omnicare: Supreme Court Clarifies Pleading Requirements for Claims Premised on Statements of Opinion Under Section 11 of the Securities Act of 1933

Section 11 of the Securities Act of 1933 provides a private right of action for any investor who purchases a security pursuant to a registration statement which "contained an untrue statement of a material fact or omitted to state a material fact … necessary to make the statements therein not misleading."

On March 24, 2015, in an opinion written by Justice Kagan, the Supreme Court clarified the pleading requirements for Section 11 claims based on statements of opinion. *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015) (Kagan, J.). The Court held that an opinion can be "an untrue statement of a material fact" under the first clause of Section 11 only if the speaker subjectively disbelieved the opinion at the time the statement was made. The Court made it clear that a defendant cannot be liable under Section 11 merely because his or her opinion ultimately proved to be wrong. The Court explained that "a sincere statement of pure opinion is not an 'untrue statement of material fact' regardless whether an investor can ultimately prove the belief wrong."

However, the *Omnicare* Court also held that an opinion can form the basis for omissions liability under the second clause of Section 11 if a plaintiff can plead particular material facts underlying the opinion, the omission of which made the opinion misleading "to a reasonable person reading the statement fairly and in context." The Court stated that a reasonable investor could understand a statement of opinion to convey "facts about how the speaker has formed the opinion" or "about the speaker's basis for holding that view." The Court went on to explain that "if a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, then § 11's omissions clause creates liability." The Court cautioned that the facts which can be inferred are inherently contextual, and the reasonable inferences that can be made are dependent on the type of opinion being given, the specificity of the statement, and the context of the opinion in the registration statement as a whole.

Circuit Court Decisions Addressing the Supreme Court's Decision in *Janus Capital Group v. First Derivative Traders*

In *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), the Supreme Court defined what it means to "make" a statement for purposes of Rule 10b-5. The *Janus* Court held that "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."

Second Circuit: *Janus*'s Definition of What It Means to "Make" a Misstatement Under Rule 10b-5 Does Not Apply to Section 17(a)(2)

On April 9, 2015, the Second Circuit found that the *Janus* "Court's definition of 'to make' in Rule 10b-5 does not apply to § 17(a)(2)" of the Securities Act of 1933. *SEC v. Big Apple Consulting USA,* 783 F.3d 786 (2d Cir. 2015) (Siler, Jr., J.). Section 17(a)(2) renders it unlawful "for any person in the offer or sale of any securities … to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." The Second Circuit found that the phrase "*by means of* any untrue statement" in Section 17(a)(2) "encompasses a broader range of conduct than 'mak[ing]' such a statement as defined in SEC Rule 10b-5(b)" (emphasis added by the court).

The Second Circuit found that the *Janus* Court's "narrow holding" does not apply "to the *entirety"* of Section 17(a) because subsections (1) and (3) of Section 17(a)—like subsections (a) and (c) of Rule 10b-5—"do not use the word 'make' or even address misstatements." The Second Circuit determined that the *Janus* Court "did not alter the potential for liability under Rule 10b-5(a) and (c)." Even after *Janus*, a defendant "who is not the 'maker' of an untrue statement of material fact" could "nonetheless … be liable as a primary violator of Rule 10b-5(a) and (c)." The Second Circuit explained that it would be "incongruous" to apply *Janus* "to remove the potential for liability under" Sections 17(a)(1) and (3) given that "Rule 10b-5(a) and (c) [were] modeled" after those provisions.

The Second Circuit further found that the text of Rule 10b-5(b) differs from "the expansive language of [S]ection 17(a)(2)." Under Rule 10b-5(b), a defendant may not "make any untrue statement of a material fact or [ ] omit to state a material fact" in connection with the purchase or sale of securities. Section 17(a)(2), however, prohibits defendants from "obtain[ing] money or property" in connection with "the offer or sale of any securities" "*by means of* any untrue statement of a material fact or any omission to state a material fact" (emphasis added by the court). While a defendant can only be held liable under Rule 10b-5(b) for "mak[ing]" a material misstatement, the Second Circuit found that the statutory text suggested that a defendant may be liable under Section 17(a)(2) regardless of whether the defendant "'use[d] his own false statement or one made by another individual'" (quoting *SEC v. Tambone*, 550 F.3d 106 (1st Cir. 2008)).

Finally, the Second Circuit found *Janus* inapplicable to Section 17(a)(2) for the additional reason that the *Janus* Court addressed the implied private right of action under Rule 10b-5. The *Janus* Court stated that it was "mindful" of the need to "give narrow dimensions … to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law." The Second Circuit explained that "the same concern regarding the expansion of a judicially-created private cause of action" does not apply with respect to claims under Section 17(a)(2) because "there is no private right of action under § 17(a)."

Seventh Circuit: *Janus* Applies to Corporate Insiders as Well as Legally Independent Third Parties

On May 21, 2015, in connection with a securities fraud action against Household International, Inc. (now known as HSBC Finance Corp.), the Seventh Circuit held that the district court had erred in concluding that the Supreme Court's decision in *Janus* "applie[s] only to legally independent third parties (like the investment adviser in *Janus* itself), not corporate insiders." *Glickenhaus & Co. v. Household Int'l, Inc.*, 787 F.3d 408 (7th Cir. 2015) (Sykes, J.). The Seventh Circuit found that "[n]othing in *Janus* limits its holding to legally independent third parties." Rather, the court determined that the Supreme Court's interpretation of Rule 10b-5 "applies generally, not just to corporate outsiders."

The Seventh Circuit found that the district court's jury instruction on what it means to "make" a statement for Rule 10b-5 purposes "directly contradict[ed] *Janus*." The court had "instructed the jury that the plaintiffs could prevail on their Rule 10b-5 claim if they proved that the defendant [had] 'made, *approved, or furnished information* to be included in a false statement'" (emphasis added by the Seventh Circuit). The Seventh Circuit found that this went "well beyond the narrow interpretation [of Rule 10b-5] adopted in *Janus*" and "plainly misstated the law."

The Seventh Circuit found that the error prejudiced the individual defendants, including HSBC's CEO. For example, the Seventh Circuit found no basis for plaintiffs' claim that the CEO had "'made' the statements in the [company's] press releases." The court recognized that the CEO "had authority over the press releases in the sense that he *could have* exercised control over their content." However, the Seventh Circuit explained that "if that were enough to satisfy *Janus*, then CEOs would be liable for *any* statements made by their employees acting within the scope of their employment." The court found that such an approach "wouldn't square with the Court's reminder about 'the narrow scope that we must give the implied private right of action' under Rule 10b-5." To satisfy *Janus*'s requirements, the Seventh Circuit explained that HSBC's CEO "must have *actually exercised* control over the content of the press releases and whether and how they were communicated."

Circuit Court Decisions Addressing Liability for Omissions Under Section 10(b)

Second Circuit: Failure to Comply With Item 303 of Regulation S-K May Only Be Actionable Under Section 10(b) If the Alleged Omission Was Material Under *Basic*'s Probability/Magnitude Test

Item 303 of Regulation S-K sets forth the disclosure requirements for the Management's Discussion and Analysis (MD&A) section of a public company's Form 10-Qs and other SEC filings. In relevant part, Item 303 states that a public company must "[d]escribe 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 or income from continuing operations."

On January 12, 2015, the Second Circuit held "as a matter of first impression … that a failure to make a required Item 303 disclosure … is indeed an omission that can serve as the basis for a Section 10(b) securities fraud claim." *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94 (2d Cir. 2015) (Livingston, J.). The court explained that "Form 10-Qs are mandatory filings that speak … to the entire market," and reasoned that "omitting an item required to be disclosed on a 10-Q can render that financial statement misleading."

Significantly, the Second Circuit found that "such an omission is actionable only if it satisfies the materiality requirements outlined in [*Basic Inc. v. Levinson*, 485 U.S. 224 (1988)], and if all of the other requirements to sustain an action under Section 10(b) are fulfilled." The Second Circuit explained that "[t]he SEC's test for a duty to report under

Item 303 … involves a two-part … inquiry" that is "different" from the test for materiality under *Basic*. When determining whether Item 303 mandates disclosure of a "known trend," "management must make two assessments." First, management must consider whether the known trend is "likely to come to fruition." Second, in the event that "management cannot make that determination, it must evaluate objectively the consequences of the known trend … on the assumption that it will come to fruition." Item 303 then requires disclosure of the trend "unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur." Under the *Basic* test, on the other hand, "the materiality of an allegedly required forward-looking disclosure is determined by 'a *balancing* of both the *indicated probability* that the event will occur and the *anticipated magnitude* of the event in light of the totality of the company activity.'" *Stratte-McClure*, 776 F.3d 94 (quoting *Basic*, 485 U.S. at 224) (emphasis added by the Second Circuit). The Second Circuit held that a plaintiff alleging "a violation of Item 303's disclosure requirements can only sustain a claim under Section 10(b) and Rule 10b-5 if the allegedly omitted information … was material under *Basic*'s probability/magnitude test" and if all other requirements for a claim under Section 10(b) and Rule 10b-5 are satisfied.

In so holding, the Second Circuit recognized that its decision was "at odds" with the Ninth Circuit's opinion in *In re NVIDIA Corp. Securities Litigation*, 768 F.3d 1046 (9th Cir. 2014). The *NVIDIA* court held that "Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5." The Second Circuit determined that the Ninth Circuit's decision was based on an overbroad reading of the Third Circuit's decision in *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000). The Second Circuit found that "*Oran* actually suggested, without deciding, that in certain instances a violation of Item 303 *could* give rise to a material [Rule] 10b-5 omission."

Fourth Circuit: Partial Disclosure Can Give Rise to a Duty to Disclose for Section 10(b) Purposes

On March 16, 2015, in a securities fraud action brought against Chelsea Therapeutics International and several of its executives, the Fourth Circuit found "plaintiffs' allegations … permit[ted] a strong inference that … defendants [had] either knowingly or recklessly misled investors by failing to disclose critical information received from the FDA during the new drug application process, while releasing less damaging information that they knew was incomplete." *Zak v. Chelsea Therapeutics Int'l*, 780 F.3d 597 (4th Cir. 2015) (Keenan, J.). The court concluded that plaintiffs had adequately pled scienter by alleging a "conflict[ ]" between the "material, non-public information known to [ ] defendants about the status of" the company's application for FDA approval and "defendants' public statements on those subjects."

The Fourth Circuit "emphasize[d] that [its] conclusion [did] not stand for the proposition that a strong inference of scienter can arise merely based on a defendant's failure to disclose information." The court recognized that "Chelsea and its corporate officers may have lacked an independent, affirmative duty to disclose" adverse information received from the FDA in connection with the company's application for FDA approval. However, the Fourth Circuit stated that "defendants' failure" to disclose "must be viewed under Section 10(b) and Rule 10b-5(b) in the context of the statements that they affirmatively elected to make" regarding the likelihood of FDA approval. The Fourth Circuit noted that under *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011), "companies can control what they have to disclose under [Section 10(b) and Rule 10b-5(b)] by controlling what they say to the market" (quoting *Matrixx*, 131 S. Ct. 1309).

Circuit Court Decisions Addressing Section 10(b)'s Scienter Requirement

First Circuit: (1) Materiality and Scienter Analyses Are Linked, and (2) a Statement's Marginal Materiality Can Weigh Against a Finding of Scienter

In a decision dated February 6, 2015, the First Circuit stated that "the materiality and scienter inquiries are linked." *Fire & Police Pension Ass'n of Colorado v. Abiomed, Inc.*, 778 F.3d 228 (1st Cir. 2015) (Lynch, C.J.). The court reaffirmed that "'[t]he question of whether a plaintiff has pled facts supporting a strong inference of scienter has an obvious connection to the question of the extent to which the omitted information is material'" (quoting *City of Dearborn Heights Act 345 Police & Fire Ret. Sys. v. Waters Corp.*, 632 F.3d 751 (1st Cir. 2011)). The First Circuit reasoned that "'[i]f it is questionable whether a fact is material or its materiality is marginal, that tends to undercut the argument that defendants acted with the requisite intent or extreme recklessness in not disclosing the fact'" (quoting *Waters Corp.*, 632 F.3d 751).

On December 8, 2015, the First Circuit applied the same reasoning in holding that a "thin materiality showing" could not "support a finding of scienter" in an SEC action against two former employees of State Street Bank and Trust Company. *Flannery v. SEC*, 2015 WL 8121647 (1st Cir. 2015) (Lynch, J.).

Second Circuit: 10b5-1 Plan Stock Trades May Support an Inference of Scienter If Plan Participation Commenced After the Alleged Fraud Began

On July 24, 2015, in a securities fraud action against Green Mountain Coffee Roasters, Inc. and certain of its executives, the Second Circuit rejected defendants' contention that the executives' stock sales did "not support an inference of scienter because they were made pursuant to … pre-determined 10b5-1 trading plans." *Emps.' Ret. Sys. of Gov't. of V.I. v. Blanford*, 794 F.3d 297 (2d Cir. 2015) (Chin, J.). The court underscored the allegation that defendants began participating in these plans "long after … Green Mountain's fraudulent growth scheme [allegedly] began." The court held that "[w]hen executives enter into a trading plan during the [c]lass [p]eriod and the [c]omplaint sufficiently alleges that the purpose of the plan was to take advantage of an inflated stock price, the plan provides no defense to scienter allegations."

In the case before it, the Second Circuit found that defendants had allegedly "made positive public statements about Green Mountain's growth that drove up its stock price immediately before" scheduled sales of stock in their 10b5-1 trading plans. Although the sales "were made pursuant to their 10b5-1 trading plans," the court found it significant that defendants "knew the dates of their scheduled sales [were] imminent when they made allegedly misleading statements to investors."

Ninth Circuit: Adverse Interest Exception to Imputing an Executive's Scienter to the Corporation Does Not Apply If (1) the Executive Acted with Apparent Authority; and (2) an Innocent Third Party Relied on the Executive's Misrepresentations

On October 23, 2015, the Ninth Circuit held that fraudulent misrepresentations made by Ron Chan, the founder and CEO of ChinaCast Education Corporation, could be imputed to ChinaCast even though Chan had acted adversely to ChinaCast's interests by "embezzl[ing] millions" from the company. *In re ChinaCast Educ. Corp. Sec. Litig.*, 2015 WL 6405680 (9th Cir. 2015) (McKeown, J.). The Ninth Circuit determined that the adverse interest exception to the general rule imputing an executive's scienter to the corporation did not apply because the complaint alleged that (1) "Chan [had] acted with apparent authority on behalf of the corporation" and (2) "third-party shareholders [had] understandably relied on Chan's representations, which were made with the imprimatur of the corporation that selected him to speak on its behalf and sign SEC filings." The Ninth Circuit found that "the adverse interest exception itself has an exception: the principal is charged with even the faithless agent's knowledge when an innocent third-party relies on representations made with apparent authority."

Tenth Circuit: Failure to Comply with a Securities Regulation Disclosure Requirement Is Insufficient, Standing Alone, to Raise a Strong Inference of Scienter

On August 18, 2015, the Tenth Circuit found that "the bare identification of a securities regulation violation is not enough," standing alone, to raise a strong inference of scienter. *In re ZAGG, Inc. Sec. Litig.*, 797 F.3d 1194 (10th Cir. 2015) (Tymkovich, J.).

The court affirmed dismissal of a securities fraud action alleging that ZAGG, Inc. had failed to disclose the number of company shares pledged as collateral in a margin account by Robert Pedersen, the company's then-CEO, in violation of Item 403(b) of Regulation S-K. The Tenth Circuit held that the fact of the Item 403(b) disclosure violation was "insufficient" to raise a strong inference of Pedersen's scienter absent "some other facts evidencing [that] Pedersen [had] signed the filings with the knowledge that they omitted a required disclosure." The court also rejected plaintiffs' contention that the disclosure violation was "evidence of conduct that was an extreme departure from the standards of ordinary care, or akin to conscious disregard," particularly given that Pedersen had "personally disclosed the margin account after each margin call."

Tenth Circuit: Allegations of GAAP Violations and Claims That Defendants "Must Have Known" of the Fraud Are Insufficient, Standing Alone, to Allege Scienter Under the PSLRA's Heightened Pleading Standards

On January 16, 2015, the Tenth Circuit reaffirmed that "'allegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim.'" *In re Gold Resource Corp. Sec. Litig.*, 776 F.3d 1103 (10th Cir. 2015) (Seymour, J.) (quoting *City of Philadelphia v. Fleming Cos., Inc.*, 264 F.3d 1245 (10th Cir. 2001)). The court held that such allegations may only "'be sufficient to state a claim'" where they are "'coupled with evidence that the violations or irregularities were the result of the defendant's fraudulent intent to mislead investors'" (quoting *Fleming*, 264 F.3d 1245).

The Tenth Circuit further ruled that plaintiffs in the case before it could not meet the scienter pleading requirements of the Private Securities Litigation Reform Act ("PSLRA") merely by alleging that defendants "must have known" of the alleged fraud or financial discrepancy at issue in light of the size of the misstatement or the significance of the product line at issue. The Tenth Circuit emphasized that "plaintiffs' view of the situation fail[ed] to take account of other plausible inferences" as required under the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007). The court noted that one such "plausible inference" is that a "prudent executive" might "want to investigate and confirm [a] claimed discrepancy before disclosing it publicly." The Tenth Circuit explained that "'[k]nowing enough to launch an investigation … is a very great distance from convincing proof of intent to deceive'" (quoting *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753 (7th Cir. 2007)).

Eleventh Circuit: Allegations That a Corporate Executive "Must Have Known" of an Alleged Fraud Given Her Role at the Company Are Insufficient to Plead Scienter Absent Other Particularized Allegations Supporting the Executive's Knowledge

On March 25, 2015, the Eleventh Circuit affirmed dismissal of a securities fraud action against Jiango Pharmaceuticals' CFO and auditor on scienter grounds. *Brophy v. Jiangbo Pharm.*, 781 F.3d 1296 (11th Cir. 2015) (Pryor, J.). The court rejected plaintiffs' attempt to establish scienter on the part of Elsa Sung, Jiangbo's former CFO, by claiming that "the disparity between Jiangbo's actual and reported cash balances" was so large "that it would have been difficult or impossible for Ms. Sung not to have known about it in her capacity as CFO."

The Eleventh Circuit found that plaintiffs essentially wanted the court to "rely solely on Ms. Sung's position as CFO to overlook [the] omissions and ambiguities in the complaint." In support of this argument, plaintiffs "cite[d] cases in which courts [have] recognized a strong inference of scienter based in part on a senior financial executive's oversight of the processes that produce a company's financial statements." The court deemed those cases inapposite because they all "involve[d] particularized allegations that the executives knew or were severely reckless in disregarding how those processes were distorted by fraud." Here, however, plaintiffs had "allege[d] no particularized facts that directly show[ed] [that] Ms. Sung intended to deceive shareholders or knew about or was severely reckless with respect to deficiencies in reporting." The court determined that "[t]he seriousness of Jiangbo's errors and Ms. Sung's proximity to those errors at most impl[ied] negligence, which is not enough to establish scienter."

Circuit Court Decisions Addressing the PSLRA's Safe Harbor for Forward-Looking Statements

D.C. Circuit: Forward-Looking Statements Fall Within the PSLRA's Safe Harbor Only If Accompanied by Tailored, Company-Specific Warnings

On June 23, 2015, in a securities fraud action against Harman International Industries, the D.C. Circuit found that two forward-looking statements were not entitled to safe harbor protection under the PSLRA because the statements were not (1) "accompanied by warnings specific to the [c]ompany"; (2) "tailored to the specific forward-looking statements" made; and (3) "consistent with the historical facts when the statements were made." *In re Harman Int'l Indus. Sec. Litig.*, 791 F.3d 90 (D.C. Cir. 2015) (Rogers, J.).

The court explained that in order "[t]o come within the [PSLRA's] statutory safe harbor, a statement must not only be forward looking (and identified as such), but [must] also [be] 'accompanied by meaningful cautionary statements'" (quoting 15 U.S.C. § 78u-5(c)(1)(A)(i)). The court found that "'[t]he requirement for 'meaningful' caution calls for substantive company-specific warnings based on a realistic description of the risks applicable to the particular circumstances'" (quoting *Southland Sec. Corp. v. INSpire Ins. Solutions,* 365 F.3d 353 (5th Cir. 2004)). The D.C. Circuit emphasized that "cautionary language cannot be 'meaningful' if it is 'misleading in light of historical fact[s]'" (quoting *Slayton v. Am. Express Co.*, 604 F.3d 758 (2d Cir. 2010)). "If a company were to warn of the potential deterioration of one line of its business, when in fact it was established that that line of business had already deteriorated, then … its cautionary language would be inadequate to meet the safe harbor standard." The court explained that "there is an important difference between warning that something '*might*' occur and that something '*actually* had' occurred."

Notably, the D.C. Circuit recognized that "Congress did not require the cautionary statement warn of '*all*' important factors, so long as 'an investor has been warned of risks of a significance similar to that actually realized,' such that the investor 'is sufficiently on notice of the danger of the investment to make an intelligent decision about it according to her own preferences for risk and reward.'" The court observed that "[p]erfect clairvoyance may be impossible because of events beyond a company's control of which it was unaware."

Eighth Circuit: Key Inquiry for Determining Whether a Statement Is Forward- Looking for Purposes of the PSLRA's Safe-Harbor Provision Is Whether the Statement's Veracity Is Discernible at the Time the Statement Is Made

On July 2, 2015, the Eighth Circuit held that "[i]n determining whether a statement is truly forward-looking" for purpose of the PSLRA's safe-harbor provision, "the determinative factor is not the tense of the statement." *Julianello v. K-V Pharm. Co.*, 791 F.3d 915 (8th Cir. 2015) (Shepherd, J.). Rather, the court found that "the key is whether [the statement's] 'truth or falsity is discernible only after it is made.'"

The Eighth Circuit found that alleged misstatements concerning the likelihood that the FDA would enforce a period of exclusive sales rights once K-V Pharmaceuticals launched Makena, a prescription drug for the prevention of preterm labor, fell within the PSLRA's safe-harbor provision because (1) the statements were "tied to a future event: the launch of Makena," and (2) the veracity of K-V's statements could not be determined until this future event took place.

The Eighth Circuit further found that "the use of the present tense in the challenged statements [did] not undermine [its] determination that they were forward looking." The court held that "[t]he critical inquiry in determining whether a statement is forward-looking is whether its veracity can be determined at the time the statement is made, not the tense of the statement."

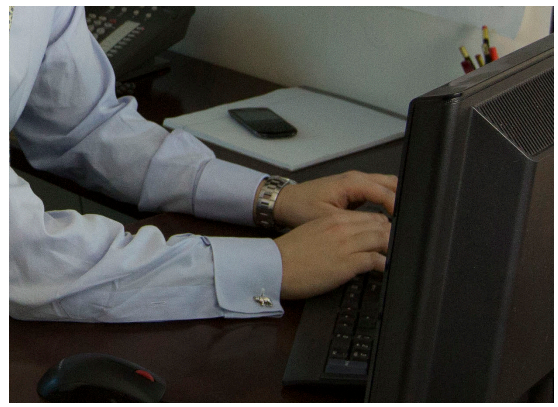
Circuit Court Decisions Addressing Inactionable Puffery Under Section 10(b)

D.C. Circuit: Descriptions Such as "Very Strong" May Be Actionable If Tied to a Specific Product and Time Period

On June 23, 2015, in a securities fraud action against Harman International Industries, the D.C. Circuit found that a statement describing product sales as "very strong" was "plausibly understood" as "a specific statement about [the company's] recent financial performance and not mere 'puffery'" because the statement was "specific about [both] product and time period." *In re Harman Int'l Indus. Sec. Litig.*, 791 F.3d 90 (D.C. Cir. 2015) (Rogers, J.).

The D.C. Circuit explained that "'conclusory terms [like 'high' value and 'fair'] in a commercial context are reasonably understood to rest on a factual basis that justifies them as accurate, the absence of which renders them misleading'" (quoting *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991)). The court determined that "given the context in which it was made," "the 'very strong' statement … [was] plausibly understood as a description of historical fact rather than unbridled corporate optimism, *i.e.*, immaterial puffery." The court explained that the statement referred to products that "were part of the [c]ompany's largest division and had been the focus of recent public statements." Moreover, the court found that the statement was not "too vague to be material" because it contained "specifics that an investor could use to evaluate the statement's veracity." The court noted that puffery, on the other hand, encompasses statements that are "'too untethered to anything measurable, to communicate anything that a reasonable person would deem important to a securities investment decision'" (quoting *City of Monroe Emps Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651 (6th Cir. 2005)).

Notably, the D.C. Circuit found "[n]othing" in the Sixth Circuit's *City of Monroe* decision that "purports to render inactionable any statement that does not contain its own metric." The court explained that the statements at issue in *City of Monroe*—such as claims that "Bridgestone sold 'the best tires in the world'"—were "more in line with generalized boasting" and were "more 'squishy' … than the [c]ompany's report of 'very strong' … sales" at issue here (quoting *City of Monroe*, 399 F.3d 651).



Second Circuit: Statements of General Corporate Optimism Are Typically Inactionable

On April 15, 2015, the Second Circuit found that the Royal Bank of Scotland's ("RBS") positive statements concerning its acquisition of ABN Amro were "inactionable puffery." *IBEW Local Union No. 58 Pension Trust Fund & Annuity Fund v. Royal Bank of Scotland Grp.*, 783 F.3d 383 (2d Cir. 2015) (Chin, J.). The court reaffirmed that "[s]tatements of general corporate optimism … do not give rise to securities violations" unless "'they are worded as guarantees or are supported by specific statements of fact, or if the speaker does not genuinely or reasonably believe them'" (quoting *In re IBM Sec. Litig.*, 163 F.3d 102 (2d Cir. 1998)). In the case before it, the Second Circuit determined that RBS's statements were mere puffery because the statements were "not worded as guarantees" and "there [were] no allegations that defendants did not reasonably believe" the statements at the time they were made.

Circuit Court Decisions Addressing Loss Causation and Damages in the Context of Section 10(b) Claims

Fifth Circuit: Damages Based on a "Materialization of the Risk" Theory Cannot Be Measured on a Class-Wide Basis for Rule 23(b)(3) Purposes, as Required Under the Supreme Court's Decision in *Comcast*

On September 8, 2015, in connection with a securities fraud action against BP arising out of the Deepwater Horizon oil spill, the Fifth Circuit held that damages based on plaintiffs' "materialization of the risk" theory could not be measured on a class-wide basis, as required under the Supreme Court's decision in *Comcast Corp. v. Behrend*, 133 S. Ct. 1426 (2013), because plaintiffs' damages model required an "individualized inquiry" into whether each investor would have purchased BP stock had that investor known of the true risk of a major spill. *Ludlow v. BP, P.L.C.*, 800 F.3d 674 (5th Cir. 2015) (Higginbotham, J.).

Plaintiffs contended that "BP [had] allegedly misstated the efficacy of its safety procedures, creating an impression that the risk of a catastrophic failure was lower than it actually was." According to plaintiffs, when the risk materialized in the form of the Deepwater spill, investors who were "defrauded into taking on that heightened risk" were entitled to recover their losses as damages.

The Fifth Circuit found that the district court had properly concluded that plaintiffs' damages theory "was not capable of class-wide determination" under *Comcast*. In *Comcast*, the Supreme Court held that "a model purporting to serve as evidence of damages in [a] class action must measure only those damages attributable to that theory" and must "establish that damages are susceptible of measurement across the entire class for purposes of Rule 23(b)(3)." Rule 23(b)(3) provides, in relevant part, that "questions of law or fact common to class members [must] predominate over any questions affecting only individual members." The Fifth Circuit reasoned that plaintiffs' "materialization of the risk" "theory hinge[d] on a determination that each plaintiff would not have bought BP stock *at all* were it not for the alleged misrepresentations—a determination not derivable as a common question, but rather one requiring individualized inquiry" into the specific risk tolerance of each investor.

The Fifth Circuit also rejected plaintiffs' claim that under the fraud-on-the-market theory, the court had to "presume[ ]" that plaintiffs had relied on BP's misrepresentations in purchasing the stock and that "'the misrepresentations were a cause-in-fact of their losses.'" The court explained that the fraud-on-the-market theory set forth in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) "does not provide any presumptions with regard to loss causation—whether the misstatement caused the loss."

Finally, the Fifth Circuit noted that the fraud-on-the-market theory "presume[s] reliance because (a) all information in an efficient market is priced into a security and (b) investors typically make investment decisions based on *price and price alone*." Here, however, "plaintiffs' own model assert[ed] that they [had] relied on something other than price: risk." The Fifth Circuit determined that "plaintiffs' argument thus undercut[ ] one of the rationales for the *Basic* presumption of reliance."

Seventh Circuit: Plaintiffs Must Eliminate Firm-Specific Nonfraud Factors from the Leakage Model for Quantifying Loss Causation in Securities Fraud Actions

On May 21, 2015, the Seventh Circuit vacated a jury verdict finding HSBC and several of its executives liable for $2.46 billion in damages for securities fraud. *Glickenhaus & Co. v. Household Int'l, Inc.*, 787 F.3d 408 (7th Cir. 2015) (Sykes, J.). Relying on the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), the Seventh Circuit held that defendants were entitled to a new trial because plaintiffs' leakage model of loss causation[1] "did not adequately account for the possibility that firm-specific, nonfraud related information

1. The leakage model assumes that "the information contained in a major disclosure event often leaks out to some market participants before its release." The leakage model factors in "every difference, both positive and negative, between the stock's predicted returns ... and the stock's actual returns during the disclosure period." Relying on the leakage model, plaintiffs' expert assumed that the effect of defendants' disclosures was equal to "[t]he total sum of these residual returns."

may have affected the decline in [HSBC's] stock price during the relevant time period."

The Seventh Circuit found that "in order to prove loss causation" under *Dura*, "plaintiffs in securities-fraud cases need to isolate the extent to which a decline in stock price is due to fraud-related corrective disclosures and not other factors." The court noted that in *Dura*, the Supreme Court recognized that a stock price decline "may reflect, not the earlier misrepresentation, but [also] changed economic circumstances, changed investor expectations, new industry-specific or *firm-specific facts, conditions, or other events*, which taken separately or together account for some or all of that lower price" (quoting *Dura*, 544 U.S. 336) (emphasis added by the Seventh Circuit).

The Seventh Circuit held that plaintiffs' "leakage theory … did not adequately account for the possibility that firm-specific, nonfraud related information may have affected the decline in [HSBC's] stock price." The court found that "[t]he model assume[d] that any changes in [HSBC's] stock price—other than those that [could] be explained by general market and industry trends—[were] attributable to the fraud-related disclosures." In the event that "there was significant negative information [during the class period] about [HSBC] unrelated to these corrective disclosures (and not attributable to market or industry trends)," then the court determined that "the model would [have] overstate[d] the effect of the disclosures and in turn of the false statements." Conversely, if "there was significant *positive* information about [HSBC]" during the class period, "then the model would [have] *understate*[d] the effect of the disclosures" (emphasis in the original).

The Seventh Circuit rejected defendants' contention that "*any* loss-causation model must *itself* account for, and perfectly exclude, any firm-specific, nonfraud related factors that may have contributed to the decline in a stock price." The court reasoned that "[i]t may be very difficult, if not impossible, for any statistical model to do this." The court found that "[a]ccepting the defendants' position likely would doom the leakage theory as a method of quantifying loss causation." However, the court also recognized that "if it's enough for a loss-causation expert to offer a conclusory opinion that no firm-specific, nonfraud related information affected the stock price during the relevant time period, then it may be far too easy for plaintiffs to evade the loss-causation principles explained in *Dura*."

Finding neither option perfect, the Seventh Circuit adopted a "middle ground" position. The court found that "[i]f the plaintiffs' expert testifies that no firm-specific, nonfraud related information contributed to the decline in stock price during the relevant time period and explains in nonconclusory terms the basis for this opinion," then defendants must "identify[ ] some significant, firm-specific, nonfraud related information that could have affected the stock price." If defendants cannot do this, then "the leakage model can go to the jury." If defendants can identify any firm-specific, nonfraud factors that may have impacted the stock price, however, then the burden "shifts back to the plaintiffs to account for that specific information or provide a loss-causation model that doesn't suffer from the same problem, like the specific-disclosure model." The court observed that "[o]ne possible way to address the issue is to simply exclude from the model's calculation any days identified by the defendants on which significant, firm-specific, nonfraud related information was released."

Other Noteworthy Circuit Court Decisions

Third Circuit: Irrevocable Liability Test Establishes the Location of a Securities Transaction for Purposes of Determining Whether a Transaction is "Domestic" for *Morrison* Purposes

In *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010), the Supreme Court held that "Section 10(b) applies only to transactions in securities listed on domestic exchanges and domestic transactions in other securities."

On January 20, 2015, the Third Circuit ruled that "irrevocable liability establishes the location of a securities transaction" for purposes of determining whether a transaction is "domestic" within the meaning of the *Morrison* decision. *United States v. Georgiou*, 777 F.3d 125 (3d Cir. 2015) (Greenaway, Jr., J.). Under the "irrevocable liability" test, "'a securities transaction is domestic when the parties incur irrevocable liability to carry out the transaction within the United States'" (quoting *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60 (2d Cir. 2012)). The Third Circuit noted that "[f]acts that demonstrate 'irrevocable liability' include the 'formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money'" (quoting *Absolute Activist*, 677 F.3d 60).

At issue in the case before the Third Circuit was an alleged "stock fraud scheme" involving stocks traded by foreign entities on two American over-the-counter stock markets, the OTC Bulletin Board and the Pink OTC Markets. The court held that these two over-the-counter stock markets are "not national securities exchanges within the scope of *Morrison."*

The court then considered whether the transactions qualified as "domestic transactions" under *Morrison*'s second prong. Applying the "irrevocable liability" test, the Third Circuit held "as a matter of first impression" that over-the-counter "purchases and sales of securities issued by U.S. companies through U.S. market makers acting as intermediaries for foreign entities constitute 'domestic transactions' under *Morrison*."

Ninth Circuit: "Personal Benefit" Requirement for Tippee Liability Is Met Where an Insider Discloses Confidential Information to a Trading Relative or Friend, Even If the Insider Received No Potential or Actual Financial Benefit

On July 6, 2015, the Ninth Circuit held that "[p]roof that [an] insider disclosed material nonpublic information with the intent to benefit a trading relative or friend is sufficient to establish the breach of fiduciary duty element of insider trading" for tippee liability purposes. *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015) (Rakoff, J.). The Ninth Circuit declined to follow the Second Circuit's decision in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014) "[t]o the extent *Newman* can be read to go so far" as to require that the insider stood to obtain "'at least a potential gain of a pecuniary or similarly valuable nature'" for disclosing confidential information to a trading relative or friend (quoting *Newman*, 773 F.3d 438). The Ninth Circuit reasoned that if it were to take this approach, "then a corporate insider or other person in possession of confidential and proprietary information would be free to disclose that information to her relatives, and they would be free to trade on it, provided only that [the insider] asked for no tangible compensation in return."

The Ninth Circuit also questioned whether *Newman* in fact requires evidence of such a tangible personal benefit in cases involving disclosures to family members of friends. The court noted that "*Newman* itself recognized that the 'personal benefit is broadly defined to include not only pecuniary gain, but also, *inter alia*, … the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend'" (quoting *Newman*, 773 F.3d 438).

Ninth Circuit: Rule 9(b)'s Particularized Pleading Requirements Apply to Loss Causation Allegations

Rule 9(b) requires that a plaintiff "alleging fraud or mistake … state with particularity the circumstances constituting fraud or mistake." On December 16, 2014, the Ninth Circuit held that "Rule 9(b) applies to all elements of a securities fraud action, including loss causation." *Oregon Public Emps.' Ret. Fund v. Apollo Group Inc.*, 774 F.3d 598 (9th Cir. 2014) (Smith, Jr., J.).

The Ninth Circuit determined that applying Rule 9(b) to loss causation allegations "is appropriate for at least three reasons." First, the court reasoned that "[s]ince Rule 9(b) applies to all circumstances of common-law fraud, … and since securities fraud is derived from common law fraud, it makes sense to apply the same pleading standard to all circumstances of securities fraud," including loss causation. The court noted that "[t]he requirement of loss causation, in particular, is founded on the common law of fraud and deceit." Second, the Ninth Circuit found that "[l]oss causation is part of the 'circumstances' constituting fraud" within the meaning of Rule 9(b) "because, without it, a claim of securities fraud does not exist." Third, the Ninth Circuit explained that its approach "creates a consistent standard through which to assess pleadings in [Section] 10(b) actions, rather than the piecemeal standard adopted by some courts."

The Ninth Circuit recognized the existence of a circuit split on whether Rule 9(b) applies to loss causation allegations. The court explained that it was "persuaded by the approach adopted in the Fourth Circuit." Courts in the Fourth Circuit "review allegations of loss causation for 'sufficient specificity,' a standard largely consonant with [Rule] 9(b)'s requirement that averments of fraud be pled with particularity." *Katyle v. Penn. Nat'l Gaming*, 637 F.3d 462 (2011).

Significant Delaware Supreme Court Decisions

Financial Advisor Held Liable for Intentionally Aiding and Abetting Board's Breaches of Fiduciary Duty

On November 30, 2015, the Delaware Supreme Court affirmed post-trial decisions (1) finding financial advisor RBC Capital Markets, LLC ("RBC") liable for aiding and abetting breaches of fiduciary duty by the Board of Rural/Metro Corporation ("Rural") in connection with Rural's 2011 acquisition by Warburg Pincus LLC ("Warburg"); and (2) holding RBC responsible for 83% of the total damages that the class suffered. *RBC Capital Markets, LLC v. Jervis*, 2015 WL 7721882 (Del. 2015) (Valihura, J.) (*Rural III*).[2]

Background

On June 30, 2011, Warburg acquired Rural at a price of $17.25 per share (the "Merger"). Rural's shareholders brought suit in connection with the acquisition. Plaintiffs contended that Rural's directors, including the company's President and CEO (collectively, the "individual defendants"), had "breached their fiduciary duties in two ways: first, by making decisions that fell outside the range of reasonableness during the process leading up to the Merger and when approving the Merger … , and second, by failing to disclose material information in the definitive proxy statement … that [Rural] issued in connection with the Merger." *In re Rural/Metro Corp. S'holdrs. Litig.*, 102 A.3d 205 (Del. Ch. 2014) (Laster, V.C.) (*Rural II*). Plaintiffs also asserted aiding and abetting claims against RBC, Rural's lead financial advisor, as well as Moelis & Company LLC, Rural's secondary financial advisor.

Prior to trial, plaintiffs reached an agreement in principle to settle their claims against the individual defendants and Moelis. The case proceeded to trial against RBC only.

On March 7, 2014, the Delaware Chancery Court issued a post-trial decision holding RBC liable for aiding and abetting breaches of fiduciary duty by Rural's directors. *In re Rural Metro Corp.*, 88 A.3d 54 (Del. Ch. 2014) (Laster, V.C.) (*Rural I*).

On October 10, 2014, the Chancery Court in *Rural II* issued an opinion addressing RBC's entitlement to a settlement credit under the Delaware Uniform Contribution Among Tortfeasors Act ("DUCATA") and holding RBC liable for $75.8 million in damages.

RBC appealed both decisions.

Delaware Supreme Court Finds the Chancery Court Did Not Err in Applying *Revlon*'s Enhanced Scrutiny Standard to the Special Committee's Actions in December 2010, Prior to the Rural Board's Formal Decision to Sell the Company in March 2011

The parties agreed that the enhanced scrutiny standard articulated in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) applied to plaintiffs' breach of the duty of care claims against Rural's directors. However, "they differ[ed] as to when, in the continuum between December 2010 and March 2011, *Revlon*'s enhanced scrutiny was triggered." *Rural III*, 2015 WL 7721882. RBC contended that "the business judgment rule—not *Revlon*—applie[d] to the Board's decision to explore strategic alternatives in December 2010." According to RBC, *Revlon* did not apply until March 2011, when there were two bids on the table for Rural and the Board was "'in a position of deciding to sell the [c]ompany—when the sale of the [c]ompany became inevitable.'"

On appeal, the Delaware Supreme Court explained that "enhanced scrutiny under *Revlon* is triggered … 'when a corporation initiates an active bidding process seeking to sell itself,'" among other scenarios (quoting

2. Please note that we discuss the Delaware Supreme Court's decision in *Rural III* at length because we have not previously covered it.

Revlon, 506 A.2d 173). The court explained that "the Court of Chancery, as a factual matter, found that there was no exploration of strategic alternatives" in December 2010. The Chancery Court instead "found that the Special Committee, acting 'without Board authorization,' 'hired RBC to sell the [c]ompany'" in December 2010. The Delaware Supreme Court determined that there was "sufficient evidence in the record to support [the Chancery Court's] conclusions."

The Delaware Supreme Court "reject[ed] RBC's attempt to delay the triggering of *Revlon* to late March 2011 for three reasons." First, the court explained that in March 2011, the Rural Board "purportedly 'restated and ratified' the actions of the Special Committee, including the initiation of the sale process that had transpired over the preceding months." The court found that "the March 15 'restatement and ratification,' which deemed the actions of the Special Committee to be acts of the [c]ompany, undermine[d] RBC's contention that *Revlon* should not apply because action by the *full Board* was required."

Second, the court found that its earlier decision in *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009) was distinguishable because "that case involved a third party putting the target company in play." Lyondell's "directors decided that they would neither put the company up for sale nor institute defensive measures to fend off a possible hostile offer," but instead "decided to take a 'wait and see' approach." The *Lyondell* court held that "[t]he time for action under *Revlon* did not begin until … the directors began negotiating the sale of Lyondell." Here, however, the Delaware Supreme Court found that the Special Committee had "initiated the sale process in December 2010" and the Board subsequently ratified those efforts. *Rural III*, 2015 WL 7721882. The court held that *Revlon*'s enhanced scrutiny standard therefore applied in this case beginning in December 2010. Notably, the court expressly "confine[d] [its] holding to these unusual facts" and did not consider its decision to be "a departure from" *Lyondell*.

Third, the Delaware Supreme Court found that delaying *Revlon* scrutiny until March 2011 "would allow the Board to benefit from a more deferential standard of review during the time when, due to its lack of oversight, the Special Committee and RBC [had] engaged in a flawed and conflict-ridden sale process."

Court Finds Rural's Directors Breached Their *Revlon* Duties

The Delaware Supreme Court "agree[d] with the Court of Chancery's principal conclusion that the Board's overall course of conduct fail[ed] *Revlon* scrutiny." Under *Revlon*, a board may "pursue the transaction it reasonably views as most valuable to the stockholders, provided 'the transaction is subject to an effective market check under circumstances in which any bidder interested in paying more has a reasonable opportunity to do so.'" The court noted that under its recent decision in *C & J Energy Services, Inc. v. City of Miami General Employees' & Sanitation Employees' Retirement Trust*, 107 A.3d 1049 (Del. 2014), "'[s]uch a market check does not have to involve an active solicitation, so long as interested bidders have a fair opportunity to present a higher-value alternative, and the board has the flexibility to eschew the original transaction and accept the higher-value deal.'" Here, the Delaware Supreme Court found that "the evidence fully support[ed] the trial court's findings that the solicitation process was structured and timed in a manner that impeded interested bidders from presenting potentially higher value alternatives."

Rural's Directors Did Not Fulfill Their Obligation to Uncover and Address RBC's Conflicts of Interest

Based on the record, the Delaware Supreme Court found that RBC had designed the sale process for Rural to run in parallel with the sale process for Rural's competitor, Emergency Medical Services Corporation, but did not disclose that RBC stood to benefit financially from this parallel sales structure. The court recognized that a parallel sales structure might arguably "fall within the range of reasonableness," but explained that "such decisions must be viewed more skeptically" where, as here, "undisclosed conflicts of interests exist." The court found that "Rural's Board was unaware of the implications of the dual-track structure of the bidding process," and consequently "took no steps to address or mitigate RBC's conflicts."

The Delaware Supreme Court underscored that "directors need to be active and reasonably informed when overseeing the sale process, including identifying and responding to actual or potential conflicts of interest." The court clarified that "a board is not required to perform searching and ongoing due diligence on its retained advisors in order to ensure that the advisors are not acting in contravention of the company's interests, thereby undermining the very process for which they have been retained." However, the court explained that "the board should require disclosure of, on an ongoing basis, material information that might impact the board's process." The court acknowledged that "a board may be free to consent to certain conflicts," but cautioned that "[a] board's consent to a conflict does not give the advisor a 'free pass' to act in its own self-interest and to the detriment of its client."

Rural's Directors and Stockholders Were Not Adequately Informed of Rural's Value

The Delaware Supreme Court further found that "Rural's directors were not adequately informed as to Rural's value." Specifically, the court noted that the Board was "unaware of RBC's conflicts and how they potentially impacted the Warburg offer." The court explained that "'[w]hen a board exercises its judgment in good faith, tests the transaction through a viable passive market check, and gives its stockholders a fully informed, uncoerced opportunity to vote to accept the deal,' a court will have difficulty determining that such board violated its *Revlon* duties" (quoting *C & J Energy*, 107 A.3d 1049). Here, however, the court found that "both the Board and the stockholders were operating on the basis of an informational vacuum created by RBC." The company's "stockholders were [therefore] not fully informed when they voted to accept the deal."

Plaintiffs Were Not Required to Plead Gross Negligence to Establish a Breach of the Directors' Revlon Duties

The Delaware Supreme Court explained that "[w]hen disinterested directors themselves face liability," plaintiffs must establish that the directors "acted with gross negligence in order to sustain a monetary judgment against them." However, the court stated that this prerequisite for monetary damages "does not mean … that if [directors] were subject to *Revlon* duties, and their conduct was unreasonable, that there was not a breach of fiduciary duty." The court agreed with the Chancery Court's determination that the directors had "breached their fiduciary duties by engaging in conduct that fell outside the range of reasonableness, and that this was a sufficient predicate for its finding of aiding and abetting liability against RBC."

Court Finds Rural's Directors Breached Their Disclosure Obligations

The Delaware Supreme Court affirmed the Chancery Court's finding that "the Proxy Statement incorporated a false valuation analysis" that "did not accurately represent RBC's analysis." The court also agreed with the Chancery Court's determination that "[t]he Proxy Statement's discussion of RBC's right to offer staple financing was a partial disclosure." The court explained that "[w]hen viewed in conjunction with the potential fees RBC was to receive for its financing services, the investment bank's pursuit of Warburg's financing business was demonstrative of a conflict that was unquestionably material, and necessitated full and fair disclosure for the benefit of the stockholders."

Court Holds RBC Knowingly Aided and Abetted the Board's Breaches

The Delaware Supreme Court explained that "'[a] third party may be liable for aiding and abetting a breach of a corporate fiduciary's duty to the stockholders if the third party 'knowingly participates' in the breach'" (quoting *Malpiede v. Townson,* 780 A.2d 1075 (Del. 2001)). The court emphasized that "the aider and abettor … must act with *scienter*."

Here, the court found that RBC had "knowingly induced" the Rural directors' duty of care breaches "by exploiting its own conflicted interests to the detriment of Rural and by creating an informational vacuum." The court further concluded that "RBC's failure to fully disclose its conflicts and ulterior motives to the Board, in turn, led to a lack of disclosure in the Proxy Statement." The court determined that "[t]he record evidence amply support[ed] the trial court's conclusion that RBC [had] purposely misled the Board so as to proximately cause the Board to breach its duty of care."

Significantly, the Delaware Supreme Court underscored that its "holding is a narrow one that should not be read expansively to suggest that any failure on the part of a financial advisor to *prevent* directors from breaching their duty of care gives rise to a claim for aiding and abetting a breach of the duty of care." The court explained that "the requirement that the aider and abettor act with *scienter* makes an aiding and abetting claim among the most difficult to prove."

In a footnote, the Delaware Supreme Court rejected the *Rural I* court's description of financial advisors as "'gatekeepers'" for directors (quoting *Rural I*, 88 A.3d 54). The Delaware Supreme Court explained that "[a]dhering to the [Chancery Court's] amorphous 'gatekeeper' language would inappropriately expand [its] narrow holding here."

Court Finds Rural's Section 102(b)(7) Exculpatory Provision Does Not Shield RBC From Aiding and Abetting Liability

The Delaware Supreme Court explained that "while Section 102(b)(7) insulates directors from monetary damages stemming from a breach of the duty of care, its protection does not apply to third parties such as RBC." The court reasoned that the Delaware legislature "did not intend for Section 102(b)(7) to safeguard third parties and thereby create a perverse incentive system wherein trusted advisors to directors could, for their own selfish motives, intentionally mislead a board only to hide behind their victim's liability shield when stockholders or the corporation seeks retribution for the wrongdoing." Here, the court found that RBC could not "commit a fraud upon the very directors who hired and relied upon it, and subsequently seek to exploit the Board's exculpatory provision."

The Delaware Supreme Court rejected the contention that it was inequitable to hold RBC "liable for damages for aiding and abetting the directors' breach of due care where the directors themselves would not have been liable for damages." The court found that the Chancery Court had "properly determined that RBC's conduct accounted for a disproportionate amount of the fault." Moreover, the Delaware Supreme Court emphasized that third-party advisors can only be held liable for aiding and abetting if they acted with *scienter*. The court explained that "[i]f an advisor knowingly induces directors to breach their duty to act reasonably under *Revlon*, the advisor is liable but only under a more stringent standard for imposing liability than a director faces when the director is not protected by a Section 102(b)(7) provision."

The Delaware Supreme Court stated that "[i]n essence, the aider and abettor standard affords the advisor a form of protection by insulating it from liability unless it acts with *scienter*."

Delaware Supreme Court Affirms the Chancery Court's Damages Ruling

Finally, the Delaware Supreme Court held that "the record reflects that the Court of Chancery properly exercised its broad discretionary powers in fashioning a remedy and making its award of damages."

The applicable settlement agreement provided that the damages recoverable against RBC would be reduced to the extent of the *pro rata* share of the settling defendants' liability, in accordance with 10 *Del. C.* § 6304(b) of DUCATA. RBC contended that "of the eight total defendants, each should have been allocated an equal 12.5% share" and thus "RBC claim[ed] it should have received a settlement credit … equal to 87.5% of the damages." On appeal, the Delaware Supreme Court found that the Chancery Court had "properly determined" that the term "*pro rata*" means "proportionate" rather than "equal." The Chancery Court "assigned 83% of the responsibility for the damages to the Class to RBC." The Delaware Supreme Court "agree[d] with the trial court's *pro rata* allocation of fault."

The court also concurred with the trial court's determination that "RBC [had] forfeited its right" to seek contribution from the settling defendants "by committing fraud against the very directors from whom RBC would seek contribution." The court explained that "if RBC were permitted to seek contribution for these claims from the directors, then RBC would be taking advantage of the targets of its own misconduct."

Business Judgment Rule Standard of Review Applies to Non-Controlling Stockholder Transactions Approved by a Majority of Fully Informed, Disinterested Stockholders

On October 2, 2015, the Delaware Supreme Court affirmed dismissal of an action brought by stockholders of KKR Financial Holdings LLC ("Financial Holdings") who sought post-closing damages in connection with Financial Holdings' acquisition by KKR & Co. L.P. ("KKR"). *Corwin v. KKR Financial Holdings LLC*, 2015 WL 5772262 (Del. 2015) (Strine, C.J.) (*KKR II*). The 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 Delaware Supreme Court reasoned that "Delaware corporate law has long been reluctant to second-guess the judgment of a disinterested stockholder majority that determines that a transaction with a party other than a controlling stockholder is in [its] best interests."

Allegations of Both a Close Friendship and a Business Relationship with an Interested Party May Be Sufficient to Plead That a Director Could Not Act Independently of the Interested Party for Demand Purposes

On October 2, 2015, the Delaware Supreme Court reversed dismissal of a shareholder derivative action brought against the directors of the Sanchez Energy Corporation alleging a "gross overpayment" in connection with a transaction involving Sanchez Resources, LLC. *Del. Cnty. Emps. Ret. Fund v. Sanchez*, 2015 WL 5766264 (Del. 2015) (Strine, C.J.). The Delaware Supreme Court found that "plaintiffs had pled particularized facts raising a pleading-stage doubt about the independence of" Alan Jackson, one of the other Sanchez Energy directors, by alleging that (1) Jackson "had a close friendship of over half a century with" the chairman of Sanchez Energy; and (2) Jackson's "primary employment (and that of his brother) was as an executive of a company over which the [chairman of Sanchez Energy] had substantial influence."

In the case before it, the Delaware Supreme Court found that plaintiffs had not pled "the kind of thin social-circle friendship ... which was at issue in" *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004). The court found that "[w]hen, as here, a plaintiff has pled that a director has been close friends with an interested party for a half century, the plaintiff has pled facts quite different from those at issue in *Beam*."

The court also found that the Chancery Court had erred in separately considering allegations concerning Jackson's personal relationship with Sanchez and allegations of Jackson's economic ties to Sanchez. The Delaware Supreme Court underscored that the "law requires that all the pled facts regarding a director's relationship to the interested party be considered in full context in making the, admittedly imprecise, pleading stage determination of independence."

Plaintiffs Must Plead a Non-Exculpated Claim Against Disinterested, Independent Directors to Survive a Motion to Dismiss Even If the Transaction at Issue Is Subject to Entire Fairness Review

On May 14, 2015, the Delaware Supreme Court addressed the following question: "in an action for damages against corporate fiduciaries, where the plaintiff challenges an interested transaction that is presumptively subject to entire fairness review, must the plaintiff plead a non-exculpated claim against the disinterested, independent directors to survive a motion to dismiss by those directors?" *In re Cornerstone Therapeutics Inc., S'holder Litig.*, 115 A.3d 1173 (Del. 2015) (Strine, C.J.). The court "answer[ed] that question in the affirmative," and held that "[a] plaintiff seeking only monetary damages must plead non-exculpated claims against a director who is protected by an exculpatory charter provision to survive a motion to dismiss, regardless of the underlying standard of review for the board's conduct."

The Delaware Supreme Court determined that "the mere fact that a plaintiff is able to plead facts supporting the application of the entire fairness standard to the transaction, and can thus state a duty of loyalty claim against the interested fiduciaries, does not relieve the plaintiff of the responsibility to plead a non-exculpated claim against each director who moves for dismissal." In so holding, the Delaware Supreme Court relied on its earlier decision in *Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001). There, the court "analyzed the effect of a Section 102(b)(7) provision on a due care claim against directors who [had] approved a transaction which the plaintiffs argued should be subject to review under the *Revlon* standard." The court found that "[b]ecause a director will only be liable for monetary damages if she has breached a non-exculpated duty, a plaintiff who pleads only a due care claim against that director has not set forth any grounds for relief" since the Section 102(b)(7) exculpatory provision bars such a claim as a matter of law.

The Delaware Supreme Court found that plaintiffs are not "entitled to an automatic inference that a director facilitating an interested transaction is disloyal because the possibility of conflicted loyalties is heightened in controller transactions." First, the court explained that "'independent directors are presumed to be motivated to do their duty with fidelity.'" Second, the court found that such an inference "would likely create more harm than benefit" because "the negotiating efforts of independent directors can help to secure transactions with controlling stockholders that are favorable to the minority." The court "decline[d] to adopt an approach that would create incentives for independent directors to avoid serving as special committee members, or to reject transactions solely because their role in negotiating on behalf of the stockholders would cause them to remain as defendants until the end of any litigation challenging the transaction." The court observed that "the fear that directors who faced personal liability for potentially value-maximizing business decisions might be dissuaded from making such decisions is why Section 102(b)(7) was adopted in the first place."

The Securities Law Alert is edited by Paul C. Gluckow pgluckow@stblaw.com / +1-212-455-2653, Peter E. Kazanoff pkazanoff@stblaw.com /+1-212-455-3525 and Jonathan K. Youngwood jyoungwood@stblaw.com / +1-212-455-3539).

Simpson Thacher

New York

Mark G. Cunha
+1-212-455-3475
mcunha@stblaw.com

Paul C. Curnin
+1-212-455-2519
pcurnin@stblaw.com

Michael J. Garvey
+1-212-455-7358
mgarvey@stblaw.com

Paul C. Gluckow
+1-212-455-2653
pgluckow@stblaw.com

Nicholas S. Goldin
+1-212-455-3685
ngoldin@stblaw.com

David W. Ichel
+1-212-455-2563
dichel@stblaw.com

Peter E. Kazanoff
+1-212-455-3525
pkazanoff@stblaw.com

Joshua A. Levine
+1-212-455-7694
jlevine@stblaw.com

Joseph M. McLaughlin
+1-212-455-3242
jmclaughlin@stblaw.com

Lynn K. Neuner
+1-212-455-2696
lneuner@stblaw.com

Thomas C. Rice
+1-212-455-3040
trice@stblaw.com

Mark J. Stein
+1-212-455-2310
mstein@stblaw.com

Alan C. Turner
+1-212-455-2472
aturner@stblaw.com

Mary Kay Vyskocil
+1-212-455-3093
mvyskocil@stblaw.com

Craig S. Waldman
+1-212-455-2881
cwaldman@stblaw.com

George S. Wang
+1-212-455-2228
gwang@stblaw.com

David J. Woll
+1-212-455-3136
dwoll@stblaw.com

Jonathan K. Youngwood
+1-212-455-3539
jyoungwood@stblaw.com

Los Angeles

Michael D. Kibler
+1-310-407-7515
mkibler@stblaw.com

Chet A. Kronenberg
+1-310-407-7557
ckronenberg@stblaw.com

Palo Alto

Alexis S. Coll-Very
+1-650-251-5201
acoll-very@stblaw.com

James G. Kreissman
+1-650-251-5080
jkreissman@stblaw.com

Washington, D.C.

Peter H. Bresnan
+1-202-636-5569
pbresnan@stblaw.com

Jeffrey H. Knox
+1-202-636-5532
jeffrey.knox@stblaw.com

Cheryl J. Scarboro
+1-202-636-5529
cscarboro@stblaw.com

Peter C. Thomas
+1-202-636-5535
pthomas@stblaw.com

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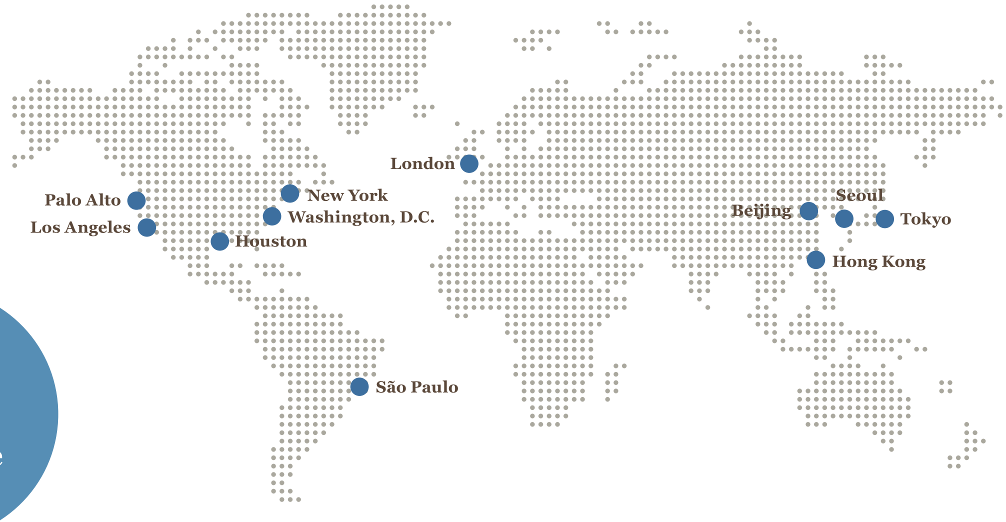

Simpson Thacher Worldwide

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
25th Floor, West Tower
Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000