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Securities Law Alert

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February 2015

First Circuit Rejects Per Se Rule That a Special Litigation Committee Member's Independence Is Compromised If That Member (1) Is Named as a Defendant in the Derivative Suit or (2) Reviewed and Approved the Statements at Issue

On February 4, 2015, the First Circuit affirmed dismissal of a shareholder derivative suit against Smith & Wesson's officers and directors on the grounds that an independent special litigation committee ("SLC"), acting in good faith and with a reasonable basis for its conclusions, had recommended against filing any claims. *Sarnacki v. Golden*, 2015 WL 467547 (1st Cir. 2015) (Lynch, C.J.). The court rejected plaintiff's contention that two of the three SLC members "could not be independent" because they were named as defendants in the derivative suit, and also because they had "reviewed and approved many of the allegedly misleading statements" at issue. The First Circuit determined that "[t]here are no per se rules holding that" the independence of an SLC member "is destroyed by either naming [that] member as a defendant" in a derivative action, or by virtue of the SLC "member's past approval of a disputed statement."

The First Circuit explained that "[t]here are good reasons to reject such per se rules." The court reasoned that "[i]f an SLC member's status as a defendant in the litigation categorically subverted the independence of the committee, a shareholder would be able to manipulate the process: he or she would be able to name SLC members as defendants after the committee's formation, thereby undercutting the legitimacy of its conclusions." The First Circuit further observed that "[t]he realities of corporate governance, in which some corporations have small boards, suggest that an SLC will frequently include at least one director who also approved the relevant transaction."

The First Circuit acknowledged that its rejection of such "per se rules" does not

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necessarily "mean that there is no cause for concern" when an SLC member is either a defendant in the action or approved the statements at issue. The court recognized that "[t]hose who are asked to evaluate conduct which they have approved may have a tendency not to find fault." However, the First Circuit explained that under Delaware law, "a director is [considered] independent when he is in a position to base his decision on the merits of the issue rather than being governed by extraneous considerations or influences" (quoting *Kaplan v. Wyatt*, 499 A.2d 1184 (Del. 1985)). In the case before it, the First Circuit found that plaintiff had "offer[ed] no evidence of actual bias affecting any [SLC member] or of extraneous considerations having motivated either the [SLC's] process or [its] ultimate recommendation." The court also found it significant that the SLC had "not use[d] in-house counsel, a disapproved practice, but [instead had] chose[n] independent counsel."

As to the scope of the SLC's investigation, the First Circuit determined that there was "inadequate evidence to permit a reasonable finder of fact to conclude that [the] SLC counsel [had been] conflicted, that the SLC members [had] read too few discovery materials, or that the SLC's involvement [had been] merely perfunctory." To the contrary, the court found that "the SLC [had] relied on experienced independent counsel, reviewed relevant discovery materials, and released a lengthy final report, all indicia of a reasonable process and good faith." The First Circuit held that Smith & Wesson had proved both the SLC's independence as well as the SLC's good faith and reasonable bases for its conclusions, and therefore affirmed dismissal of plaintiff's derivative suit.

First Circuit Determines That the Materiality and Scienter Analyses Are Linked, and Holds That a Statement's Marginal Materiality Can Weigh Against a Finding of Scienter

On February 6, 2015, the First Circuit affirmed dismissal of a securities fraud action against Abiomed on scienter grounds. *Fire and Police Pension Ass'n of Colorado v. Abiomed*, 2015 WL 500748 (1st Cir. 2015) (Lynch, C.J.). In evaluating plaintiffs' scienter allegations, the First Circuit explained that "the materiality and scienter inquiries are linked." The court found 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." The First Circuit noted 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."

Here, plaintiffs claimed that Abiomed had "fail[ed] to state that some of the [company's] increased revenues were due to off-label marketing" of the Impella 2.5, a micro heart pump. The First Circuit found "[t]he materiality of [this] impugned omission" to be "marginal at best." The court explained that "[p]laintiffs' contention that the omission would have mattered to a reasonable investor depend[ed] on a long chain of inferences, most of which [were] not sufficiently substantiated by the allegations in the complaint." While plaintiffs "allege[d] that off-label promotion was widespread," the court pointed out that plaintiffs did "not state or even suggest what proportion of sales were made as a result of such efforts, or the significance of the contribution of those sales to Abiomed's stock price." The First Circuit concluded that "[t]he marginal materiality of the alleged statements and omissions concerning revenues weigh[ed] against an argument that defendants here [had] possessed the requisite scienter."

As to allegations that Abiomed had made misstatements concerning its compliance with the FDA's off-label marketing regulations, the First Circuit determined that "[s]cienter [was] not established" simply because there were "statements from confidential witnesses ["CWs"] that Abiomed management was in fact intentionally violating FDA regulations." The court explained that "even if the CWs' statements plausibly suggest[ed] that Abiomed [had been] acting improperly, they [did] not show that defendants' statements about company policy and the FDA's inquiries [had been] made with conscious intent to defraud or

recklessly." The First Circuit emphasized that the "key question" for scienter purposes "is not whether defendants had knowledge of certain undisclosed facts, but rather whether defendants knew or should have known that their failure to disclose those facts *present[ed] a danger of misleading buyers or sellers*." Here, the court found that "far from suggesting an intent to defraud investors," the CWs' statements "suggest[ed] instead that Abiomed [had been] aggressively marketing the Impella 2.5 'every which way' in order to sell more units."

Although the First Circuit recognized that "Abiomed's promotional and marketing activities for its core product might have been a risky course in terms of its likelihood of prompting sanctions from the FDA," the court emphasized that "allegations of corporate mismanagement are not actionable under Rule 10b-5." The First Circuit observed that "[n]ot all claims of wrongdoing by a company make out a viable claim that the company has committed securities fraud," and found that "[t]his case is an example." The court therefore affirmed dismissal of plaintiffs' complaint.

Delaware Supreme Court Affirms Chancery Court Decision to Rely on the Merger Price in a Section 262 Appraisal of CKx's Shares

Pursuant to Section 262 of the Delaware General Corporate Law ("DGCL"), stockholders in companies that engage in certain merger transactions may petition the court for an appraisal of "the fair value of [their] shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation." 8 *Del. C.* § 262. The court may not presumptively rely on the merger price in its appraisal analysis. *Golden Telecom v. Global GT LP*, 11 A.3d 214 (Del. 2010). Rather, the court must "take into account all relevant factors" when "determining [the] fair value" of the shares. If the court finds that the fair value exceeds the merger price, then the surviving corporation must pay the difference in value to the petitioning stockholders.

In *Huff Fund Investment Partnership v. CKx, Inc.* (*Huff Fund*), 2013 WL 5878807 (Del. Ch. 2013) (Glasscock, V.C.), the Chancery Court relied on the merger price in assessing the value of shares of CKx, an entertainment company that owns the rights to *American Idol*, following Apollo Global Management's 2011 acquisition of CKx. The court found the merger price to be "the most relevant exemplar of valuation available" given that other valuation methodologies were "either unreliable or unavailable." On February 12, 2015, the Delaware Supreme Court issued a two-paragraph order affirming the Chancery Court's appraisal determination. *Huff Fund Investment Partnership v. CKx, Inc.*, 2015 WL 631586 (Del. 2015) (Valihura, J.).

Chancery Court Explains That the Merger Price Is Among the "Relevant Factors" Courts May Consider in Section 262 Appraisal Actions

At the outset of its analysis, the Chancery Court explained that the Delaware Supreme Court "has interpreted the language of Section 262(h) ... to preclude the use of 'inflexible rules' or presumptions favoring any particular valuation method or analysis." *Huff Fund*, 2013 WL 5878807 (citing *Golden Telecom*, 11 A.3d 214). Under Section 262, courts have "'significant discretion' to consider the data and use the valuation methodologies they deem appropriate" (quoting *Golden Telecom,* 11 A.3d 214). A court "has the latitude to 'select one of the parties' valuation models as its general framework, or fashion its own, to determine fair value in an appraisal proceeding'" (quoting *Golden Telecom*, 11 A.3d 214).

The *Huff Fund* court recognized that under Section 262 and "the interpreting case law," courts may not "rely presumptively on the price achieved by exposing the company to the market." Courts must "evaluate 'all relevant factors,' and arrive at a going-concern value inclusive of any assets not properly accounted for in the sale, but exclusive of synergy value that may have been captured by the seller." Given the "complexity in valuing, marketing and selling an ongoing corporate enterprise," courts have "[t]ypically... relied on expert valuation, such as those employing discounted cash flow and comparable company analyses, to determine statutory fair value."

Nevertheless, the *Huff Fund* court found that "market value—where reliably derived—remains among the 'relevant factors' for arriving at fair value" for Section 262 purposes. The court explained that it has "previously recognized that 'an arms-length merger price resulting from an effective market check is entitled to great weight in an appraisal'" (citing *Global GT LP v. Golden Telecom, Inc.,* 993 A.2d 497 (Del. Ch. 2010), *aff'd*, 11 A.3d 214 (Del. 2010)). The *Huff Fund* court also pointed out that "[i]n at least one case involving judicial appraisal under Section 262, the [Chancery] Court decided to place 100% weight on the merger price" (citing *Union Illinois 1995 Inv. Ltd. P'Ship v. Union Fin. Grp., Ltd.* 847 A.2d 340 (Del. Ch. 2004)).

Chancery Court Determines That the Delaware Supreme Court's Decision in *Golden Telecom v. Global GT LP* Does Not Preclude Consideration of the Merger Price in a Section 262 Appraisal Action

The *Huff Fund* court rejected petitioners' contention that the Delaware Supreme Court's decision in *Golden Telecom,* 11 A.3d 214, stands for "the proposition that merger price is … irrelevant in an appraisal context" and that courts must "accord [the merger price] no weight when determining fair value."

The *Huff Fund* court explained that the petitioners in *Golden Telecom* "asked the Supreme Court to reform Delaware appraisal law by imposing a new presumption in favor of merger price as evidence of fair value." The Delaware Supreme Court declined to "establish a rule requiring the Court of Chancery to defer to the merger price in any appraisal proceeding." *Golden Telecom*, 11 A.3d 214. The Delaware Supreme Court reasoned that "[r]equiring the Court of Chancery to defer—conclusively or presumptively—to the merger price, even in the face of a pristine, unchallenged transactional process, would contravene the unambiguous language of the statute and the reasoned holdings of our precedent."

The *Huff Fund* court determined that "the ruling in *Golden Telecom*—like the appraisal statute itself—is inclusive, rather than exclusive." *Huff Fund*, 2013 WL 5878807. The *Golden Telecom* decision "recognizes that differing circumstances may support reliance on one or another valuation method under the particular circumstances there presented." Pursuant to the "clear" "holding and rationale of *Golden Telecom,*" courts have "an obligation to consider all relevant factors" in a Section 262 appraisal action. "[N]o per se rule should presumptively or conclusively exclude any of those factors from consideration[,]" including the merger price.

Chancery Court Holds That the Merger Price Is the Most Reliable Indicator of the Value of CKx's Shares

In appraising CKx's shares, the *Huff Fund* court determined that "the merger price [was] the most reliable indicator of value" given that "no comparable companies, comparable transactions, or reliable cash flow projections exist[ed]." The court found unreliable the "comparable companies" analysis presented by petitioners' expert because the expert "admitted at trial that he found no companies he could describe as 'comparable' to CKx."

The court also deemed unreliable petitioners' expert's discounted cash flow ("DCF") analysis because it was based on management projections that were "not prepared in the ordinary course of business." The *Huff Fund* court explained that "[t]he reliability of a DCF analysis … depends, critically, on the reliability of the inputs to the model." Management projections "are generally deemed reliable" when they "are made in the ordinary course of business." However, the Chancery Court "has disregarded management projections where the company's use of such projections was unprecedented, where the projections were created in anticipation of litigation, or where the projections were created for the purpose of obtaining benefits outside the company's ordinary course of business."

Here, the CKx management projections at issue were created "in connection with expressions of interest from potential acquirers" and were based on "an assumption that revenues under the to-be-negotiated *American Idol* contract would increase by approximately $20 million each year." The *Huff Fund* court found that the CKx management projections reflected "little more than guesswork" as to the likely outcome of the *American Idol* negotiations. The court

therefore determined that "[t]he unreliability of the revenue estimates, both including and excluding the $20 million estimate, [was] a serious impediment to creating a reliable DCF analysis."

"In the absence of comparable companies or transactions … and without reliable projections to discount in a DCF analysis," the *Huff Fund* court "rel[ied] on the merger price as the best and most reliable indication of CKx's value." The court explained that "[t]he sales process here [had] been challenged, reviewed and found free of fiduciary and process irregularities." Moreover, "[t]he company was sold after a full market canvas and auction." Under the circumstances, the *Huff Fund* court determined that the sales price was "the most reliable indication of CKx's value." The Delaware Supreme Court subsequently affirmed the Chancery Court's appraisal determination.

Delaware Chancery Court Relies on the Merger Price in Appraising Ancestry's Shares

On January 30, 2015, the Delaware Chancery Court determined that the merger price was "the best indicator" of the fair value of Ancestry's shares in a Section 262 appraisal action brought in connection with Permira's 2012 acquisition of Ancestry. *In re Appraisal of Ancestry.com, Inc.* (*Ancestry*), 2015 WL 399726 (Del. Ch. 2015) (Glasscock, V.C.). The *Ancestry* court explained that, "given Ancestry's unique business[,]" "there [were] no comparable companies to use for purposes of valuation." Moreover, because Ancestry's "management did not create projections in the normal course of business," the court found that there was "reason to question management projections, which were done in light of the transaction and in the context of obtaining a fairness opinion." In view of the inherent unreliability of management's projections, the court had no "great confidence" in the discounted cash flow ("DCF") analyses based on those projections.

The *Ancestry* court determined that "fair value in these circumstances [was] best represented by the market price." The court found that the sales process "was reasonable, wide-ranging and produced a motivated buyer." Moreover, the court noted that the merger "ha[d] been approved of, as free from the taint of breaches of fiduciary, by this [c]ourt." In light of the "robust" nature of the sales process, the court concluded that the merger price was "unlikely to have left significant stockholder value unaccounted for."

The *Ancestry* court explained that in *Huff Fund Investment Partnership v. CKx*, 2013 WL 5878807 (Del. Ch. 2013) (Glasscock, V.C.), the Chancery Court had "relied on the merger price as an indicia of fair value" where "the process leading to the transaction [was] a reliable indicator of value" and "merger-specific value [was] excluded."[1] The court also noted that in *Highfields Capital, Ltd. v. AXA Fin., Inc.*, 939 A.3d 34 (Del. Ch. 2007), the Delaware Chancery Court had stated that "a reviewing court should give substantial evidentiary weight to the merger price as an indicator of fair value" provided that "the transaction giving rise to the appraisal resulted from an arm's-length process between two independent parties" and "no structural impediments existed that might materially distort the crucible of objective market reality."

Significantly, the *Ancestry* court did conduct its own DCF analysis based on management projections under two different scenarios, and arrived at a value just a few cents short of the merger price ($31.79 per share as compared to the merger price of $32 per share). The court explained that because its own DCF valuation was "close to the market," the court felt "comfort[able] that no undetected factor [had] skewed the sales process." The *Ancestry* court therefore held "that the merger price of $32 [was] the best indicator of Ancestry's fair value as of the [m]erger [d]ate."

1 Notably, Vice Chancellor Glasscock wrote both the *Huff Fund* and *Ancestry* opinions.

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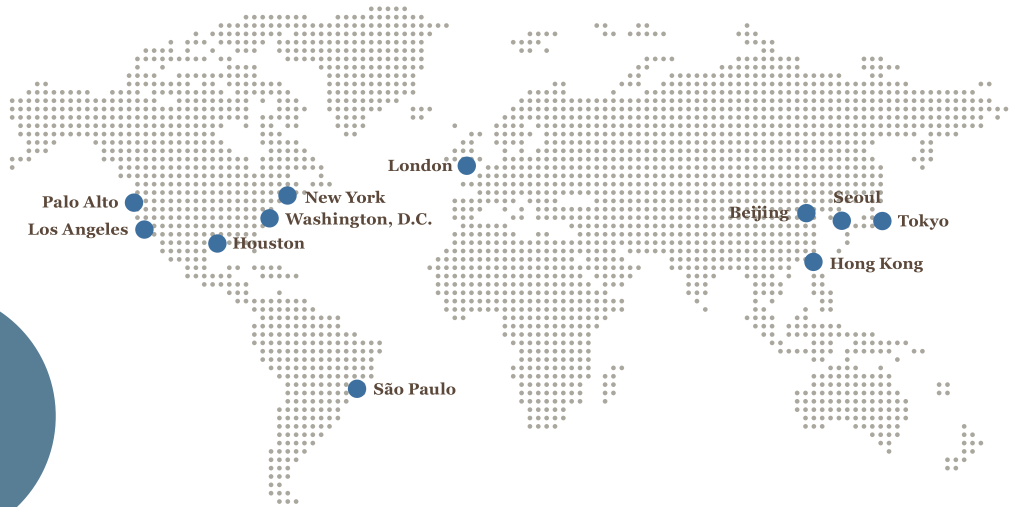

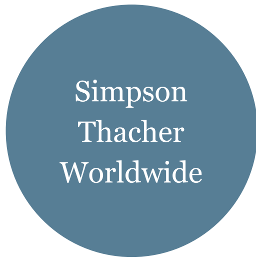

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