Simpson Thacher

Securities Law Alert

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– Legal 500 2016

Ninth Circuit: Section 77p(d)(1)(A) of SLUSA Does Not Provide an Independent Basis for Federal Question Jurisdiction Under 28 U.S.C. § 1331

On December 21, 2016, the Ninth Circuit held that Section 77p(d)(1)(A) of the Securities Litigation Uniform Standards Act ("SLUSA") does not "provide[ ] an independent basis for federal question jurisdiction under 28 U.S.C. § 1331."[1] *Rainero v. Archon Corp.*, 2016 WL 7384031 (9th Cir. 2016) (Thomas, J.).

The question arose in the context of a putative class action in which the "sole claim ... was a breach-of-contract claim arising under Nevada law." Plaintiff contended that federal question jurisdiction existed under § 1331 "because [SLUSA] is a federal statute that allows certain class actions ... to be maintained in either state or federal court." Plaintiff relied specifically on 15 U.S.C. § 77p(d)(1)(A), which provides that certain "covered class action[s]" that are "based upon the statutory or common law of the State in which the issuer is incorporated ... may be maintained in a State or Federal court by a private party."

The Ninth Circuit rejected plaintiff's argument as a misreading of SLUSA. In so holding, the court "agree[d] with and adopt[ed]" the D.C. Circuit's analysis in *Campbell v. American International Group*,

1. 28 U.S.C. § 1331 provides that "[t]he district courts shall have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States."

760 F.3d 62 (D.C. Cir. 2014). The D.C. Circuit found that 15 U.S.C. § 77p(d) only "carves out exceptions to the preclusive reach of" 15 U.S.C. § 77p(b), which prohibits plaintiffs from bringing certain state-law based securities fraud class actions in state or federal court. *Id.* (quoting *Campbell*, 760 F.3d 62). The D.C. Circuit determined that there was "no indication … that Congress intended subsection (d)(1)(A) to go substantially further, so as to *create* federal jurisdiction over a category of state-law securities class actions." *Id.* (quoting *Campbell*, 760 F.3d 62).

Following the D.C. Circuit's reasoning, the Ninth Circuit held Section 77p(d)(1)(A) of "SLUSA does not create an independent basis for federal question jurisdiction."[2]

Tenth Circuit: SEC's Appointment of Administrative Law Judges Violates the Appointments Clause of the U.S. Constitution

On December 27, 2016, the Tenth Circuit held that the SEC's appointment of administrative law judges ("ALJs") for its in-house tribunals violates the Appointments Clause of the United States Constitution. *Bandimere v. SEC*, 2016 WL 7439007 (10th Cir. 2016) (Matheson, J.). The Tenth Circuit expressly disagreed with the D.C. Circuit, which recently held that the SEC's ALJs are not "Officers of the United States" for purposes of the Appointments Clause. *See Raymond J. Lucia Cos. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016) (Rogers, J.).[3]

Tenth Circuit Relies on the Supreme Court's Decision in *Freytag v. Commissioner of Internal Revenue* to Hold SEC ALJs Are "Inferior Officers" Subject to the Appointments Clause

The Tenth Circuit began its analysis with the text of the Appointments Clause, which provides in relevant part that Congress may "vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments." U.S. Const. art. II, § 2, cl. 2. The court explained that "[t]he term 'inferior officer' connotes a relationship with some higher ranking officer or officers below the President." The Tenth Circuit observed that while "the Supreme Court has not stated a specific test for inferior officer status," the Court's prior decisions indicate that "the term's sweep is unusually broad."

The Tenth Circuit stated that the Supreme Court's decision in *Freytag v. Commissioner of Internal Revenue*, 501 U.S. 868 (1991) "provide[d] the guidance needed to decide" the question of whether SEC ALJs qualify as inferior officers. In *Freytag*, the Supreme Court held that special trial judges ("STJs") of the federal Tax Court were inferior officers within the meaning of the Appointments Clause because (1) the position of STJ was "established by Law"; (2) "the duties, salary, and means of appointment" of STJs were "specified by statute"; and (3) STJs "perform more than ministerial tasks" and "exercise significant discretion" in "carrying out [their] important functions." *Id.* (quoting *Freytag*, 501 U.S. 868).

The Tenth Circuit found that these three *Freytag* factors apply equally to SEC ALJs. First, the court noted that "the position of the SEC ALJ was established by Law" pursuant to the Administrative Procedures Act. Second, the Tenth Circuit explained that "statutes set forth SEC ALJs' duties, salaries, and means of appointment."

Third, and most importantly, the Tenth Circuit determined that "SEC ALJs exercise significant discretion in performing important functions commensurate with the STJs' functions described in *Freytag*." The court noted, for example, that SEC ALJs have the "authority to shape the administrative record by taking testimony, regulating document production and depositions, ruling on the admissibility of evidence, … and presiding over trial-like hearings," among other responsibilities.

Finding that "SEC ALJs closely resemble the STJs described in *Freytag*," the Tenth Circuit held "SEC ALJs are inferior officers who must be appointed in conformity with the Appointments Clause."

2. However, the Ninth Circuit stated that under Section 77p(c) of SLUSA, "federal courts have jurisdiction for the limited purpose of determining whether a certain state action is precluded under § 77p(b)" of SLUSA.

3. Please click here to read our discussion of the D.C. Circuit's decision.

Court Rejects Final Decision-Making Power as the Key Criterion for Determining Whether the Appointments Clause Applies

In *Raymond Lucia*, the D.C. Circuit held that SEC ALJs were not "Officers of the United States" for purposes of the Appointments Clause because "no initial decision of [the SEC's] ALJs is independently final" under the SEC's regulatory framework. 2016 WL 4191191.

The Tenth Circuit expressly disagreed with the D.C. Circuit's decision. While the court acknowledged that "[f]inal decision-making power is relevant in determining whether a public servant exercises significant authority," the Tenth Circuit determined that not "*every* inferior officer *must* possess final decision-making power." *Bandimere*, 2016 WL 7439007. The Tenth Circuit stated that the *Freytag* Court "did not make final decision-making power the essence of inferior officer status." Rather, the *Freytag* Court focused on the nature of the officers' duties and the discretion they exercised in executing those duties.

Court Holds Deference to Congress Does Not Mandate a Different Result

The Tenth Circuit also rejected the SEC's contention that it must defer to Congress's intent that SEC ALJs be categorized as employees rather than inferior officers subject to the Appointments Clause. Once again, the court found *Freytag* "instructive." The *Freytag* Court stated that the Appointments "Clause forbids Congress to grant the appointment power to inappropriate members of the Executive Branch." 501 U.S. 868.

Judge McKay, Dissenting, Emphasizes That SEC ALJs Lack the Power to Issue Final Decisions

In a dissenting opinion, Judge McKay expressed his view that "the special trial judges at issue in *Freytag* had the sovereign power to bind the Government and third parties" while "SEC ALJs do not." *Bandimere*, 2016 WL 7439007. He stated that "under the Appointments Clause, that difference makes all the difference."

Fourth Circuit Holds Constitutional Challenges to Pending SEC ALJ Proceedings Are Premature

In a related decision, the Fourth Circuit joined the Second, Seventh, Eleventh and D.C. Circuits in rejecting as premature claims brought in federal court by a respondent in a pending SEC enforcement proceeding challenging the appointment of the SEC ALJ on constitutional grounds.[4] *Bennett v. SEC*, 2016 WL 7321231 (4th Cir. 2016) (Duncan, J.). The Fourth Circuit relied on the Supreme Court's decision in *Thunder Basin Coal Co. v. Reich*, 510 U.S. 200 (1994), to hold that "it is fairly discernible that Congress intended to channel all objections to [rulings by SEC ALJs]—including challenges rooted in the Appointments Clause—through the administrative adjudication and judicial review process set forth in the statute." The Fourth Circuit further determined that the *Thunder Basin* factors "indicate[d] that [petitioner's constitutional] claims [were] of the type Congress intended to be reviewed within [the SEC's administrative] framework."

Eleventh Circuit: (1) Under *Janus*, a Company Is Not the "Maker" of Stock Promoters' Statements Unless It Had "Ultimate Authority" Over Those Statements, and (2) Companies Have No Duty to Disclose Payments to Stock Promoters

On December 15, 2016, the Eleventh Circuit affirmed dismissal of securities fraud claims arising out of a company's retention of stock promoters "to write flattering articles" about the company and "tout" its stock. *In re Galectin Therapeutics, Inc. Sec. Litig.*, 2016 WL 7240146 (11th Cir. 2016) (Hull, J.). The Eleventh Circuit held the company could not be liable under Section 10(b) and Rule 10b-5 for the stock promoters' statements because plaintiffs did not allege the company was the "maker" of those statements within the

4. Please click here to read our discussion of the Second and Eleventh Circuits' decisions. Please click here to read our discussion of the D.C. Circuit's decision, and here to read our discussion of the Seventh Circuit's decision.

meaning of the Supreme Court's decision in *Janus Capital Group v. First Derivative Traders*, 564 U.S. 135 (2011).[5] The court further held the company had no duty to disclose payments to stock price promoters, and also ruled that engaging the services of stock promoters "is not stock price 'manipulation' as a matter of law."

Plaintiffs Did Not Allege the Company Had "Ultimate Authority" Over the Stock Promoters' Statements As Required Under *Janus*

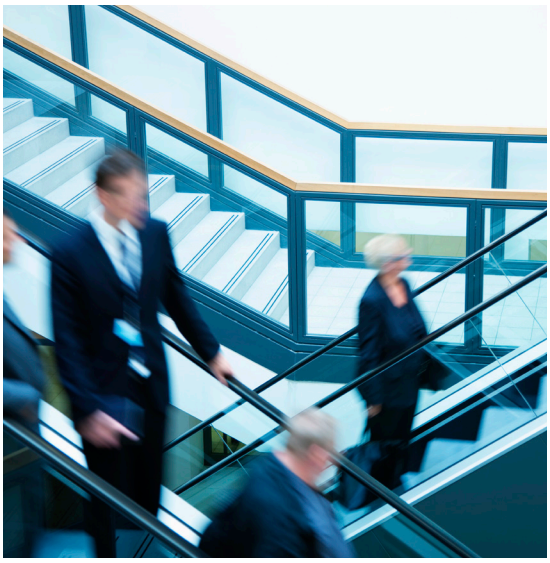
In *Janus*, the Supreme Court held that "[f]or purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." 564 U.S. 135. The Court stated that "[w]ithout control, a person or entity can merely suggest what to say, not 'make' a statement in its own right."

The Eleventh Circuit held that "[t]o the extent that [plaintiffs] base[d] [their] Rule 10b-5(b) claim on the content of, or the omissions in, the articles by the stock promoters, the Supreme Court has foreclosed that claim." *Galectin*, 2016 WL 7240146. The court found that while plaintiffs "set forth allegations that the defendants worked in conjunction with stock promoters to promote [the company's] stock," the complaint did not "include[ ] sufficient allegations to support a finding that [the company] had 'ultimate authority' or 'control' over the stock promoters' statements." Significantly, the Eleventh Circuit found the company's payment for the promotional articles, standing alone, insufficient for liability under Section 10(b) and Rule 10b-5. The court underscored that "[p]ayment for the promotional articles does not mean that [the company] is the maker of the statements in the articles."

Company Had No Duty to Disclose Its Retention of Stock Promoters

With respect to plaintiffs' claim that the company had a duty to disclose its retention of stock promoters, the Eleventh Circuit explained that "[t]here is no statutory duty to disclose imposed on the issuer" to inform investors that it paid stock promoters for

5. Please click here to read our discussion of the *Janus* decision.



"promotional articles or activities." Rather, Section 17(b) of the Securities Act puts the onus on stock promoters to disclose any payments received for their "promotional activities." While the court acknowledged that the statutory scheme may "seem odd to the uninitiated," the court stated that it reflects a "practical recognition of the fact that most market research is performed by analysts who are paid by brokerage firms, investments banks, and other marketers of securities."

Because "the securities laws … place the duty to disclose payments only on the stock promoters," the Eleventh Circuit held defendants "had no additional duty to disclose their payments to the stock promoters."

Paying for Promotional Articles Is Not Stock Price Manipulation

The Eleventh Circuit also rejected plaintiffs' contention that the company's retention of stock price promoters constituted stock price manipulation.[6] The court explained that "nothing in the securities laws prohibits" a company from "hiring analysts to promote" the company by "circulating positive articles" about the company's initiatives or "recommending the purchase" of company stock. Rather, engaging stock promoters "is both contemplated and permitted under the securities laws."

6. The court explained that for securities law purposes, "manipulation" is "virtually a term of art" that refers to practices such as wash sales or rigged prices. Here, plaintiffs did not allege that the defendants "engaged in any kind of simulated market activity or transactions designed to create an unnatural and unwanted appearance of market activity, which is required to constitute market manipulation."

Central District of California: United States Purchases of ADRs Sponsored by Foreign Issuers Are "Domestic Transactions" Under *Morrison*

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."[7]

On January 4, 2017, the Northern District of California held that purchases within the United States of American Depositary Receipts ("ADRs") sponsored by a foreign issuer qualified as "domestic transactions in other securities" within the meaning of the second prong of the *Morrison* test. *In re Volkswagen 'Clean Diesel' Marketing, Sales Practices, and Products Liability Litig.*, 2017 WL 66281 (N.D. Cal. 2017) (Breyer, J.). The court reasoned that Section 10(b) reached the purchases because the foreign issuer "sponsored the ADRs in the United States," investors "purchased the ADRs here," and "the United States has an interest in protecting domestic investors against securities fraud."

The court also ruled that over-the-counter markets are not "domestic exchanges" for purposes of the first prong of the *Morrison* test.

Morrison Reaches Domestic Transactions in ADRs Sponsored by Foreign Issuers

At the outset of its analysis, the court explained that "ADRs may be either sponsored or unsponsored." While an "unsponsored ADR is established with little or no involvement of the issuer of the underlying security," a sponsored ADR "is established with the active participation of the issuer." In the case before it, the court found the foreign issuer "sponsored the ADRs and thus was directly involved in the domestic offering of the ADRs."

The court found it significant that the foreign issuer had taken "affirmative steps to make its securities available to investors … in the United States." For example, the governing deposit agreements provided that New York law would apply to the ADRs. The foreign issuer also "provided on its website English versions of its public disclosures in compliance with United States regulations so that it could offer ADRs to investors in the United States." The court held these actions "establish[ed] a sufficient connection between the [foreign issuer's] ADRs and the United States" for purposes of the second prong of *Morrison*'s test.

United States Purchases of ADRs Sponsored by a Foreign Issuer Are Not "Predominantly Foreign" Transactions

Defendants attempted to rely on the Second Circuit's decision in *Parkcentral Global Hub v. Porsche Automobile Holdings*, 763 F.3d 198 (2d Cir. 2014)[8] to argue that "even where a domestic transaction exists, Section 10(b) does not apply if the transaction is 'predominantly foreign.'" In *Parkcentral*, the Second Circuit affirmed dismissal of Section 10(b) claims involving securities-based swap agreements that referenced a foreign issuer's stock, where there were no allegations that the foreign issuer was a party to, or participated in any way, in the swap agreements at issue. The Second Circuit held that "the imposition of liability under § 10(b) on … foreign defendants with no alleged involvement in plaintiffs' transactions, on the basis of the defendants' largely foreign conduct, … would constitute an impermissibly extraterritorial extension of the statute." 763 F.3d 198.

The Northern District of California found that "the unique circumstances of *Parkcentral*" were not present in the case before it. *Volkswagen*, 2017 WL 66281. Here, the foreign issuer's actions were "clearly tied to the United States." The court found "the ADRs [were] not independent from [the issuer's] foreign securities or from [the issuer] itself."

7. Please click here to read our discussion of the *Morrison* decision.

8. Please click here to read our discussion of the Second Circuit's decision in *Parkcentral*.

Over-the-Counter Markets Are Not "Domestic Exchanges" Under *Morrison*

The court further ruled that the over-the-counter market on which the ADRs traded did not constitute a "domestic exchange" within the meaning of the first prong of the *Morrison* test. The court reasoned that the statement of purpose of the Securities Exchange Act, 15 U.S.C. § 78b, "explicitly references over-the-counter ["OTC"] markets as well as securities exchanges," and "thus recognizes a distinction between securities exchanges and OTC markets."

Delaware Supreme Court: Limited Partner's Claim That a Transaction Violated the Partnership Agreement Was Derivative in Nature and Extinguished by a Subsequent Merger

On December 20, 2016, the Delaware Supreme Court considered whether a limited partner's claim that the partnership overpaid the general partner in an allegedly conflicted transaction, in violation of the governing limited partnership agreement, was direct or derivative in nature. *El Paso Pipeline GP Co. v. Brinckerhoff*, 2016 WL 7380418 (Del. 2016) (Valihura, J.). Applying the two-pronged test set forth in *Tooley v. Donaldson, Lufkin & Jenrette*, 845 A.2d 1031 (Del. 2004),[9] the court held the limited partner's claim was derivative rather than direct because the harm from the alleged overpayment "solely affected the [p]artnership" and "the benefit of any recovery must flow solely to the [p]artnership." The court further ruled that the limited partner's claim was extinguished when the partnership was acquired in a merger.

The Delaware Supreme Court underscored that not every claim by a limited partner that implicates the terms of the limited partnership agreement is a direct claim. The court explained that the determination of whether a limited partner's claim "is derivative or direct requires the usual examination" under *Tooley* "of who owns the claim."

Background

In the case before the Delaware Supreme Court, the Chancery Court found that a limited partnership's conflicts committee had approved a transaction that "it did not believe was in the best interests of the limited partnership" and was "unduly favorable to the limited partnership's general partner."

After trial but before the Chancery Court issued its ruling, the limited partnership was acquired in a merger. Defendants contended that the merger transferred the limited partner's derivative claims to the acquiror, and extinguished the limited partner's standing to sue. The Chancery Court found the limited partner's claims "could also be considered direct, or, even if derivative, should survive the merger for the core policy reason that dismissal would leave the unaffiliated limited partners without recompense for the general partner's prior unfair dealing." Defendants appealed.

9. In *Tooley*, the Delaware Supreme Court held that the question of "whether a stockholder's claim is derivative or direct … turn[s] *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?" 845 A.2d 1031.

Delaware Supreme Court Holds *Tooley*'s Direct/Derivative Test Governs Claims Implicating the Terms of a Partnership Agreement

On appeal, the Delaware Supreme Court acknowledged that the limited partner's claims stemmed from the conflict-of-interest and good faith provisions of the limited partnership agreement. However, the court rejected the Chancery Court's suggestion that *Tooley*'s test for determining whether a claim is direct or derivative in nature "does not apply where the alleged harm involves contract rights." The Delaware Supreme Court reasoned that "[s]uch a rule would essentially abrogate *Tooley* with respect to alternative entities merely because they are creatures of contract."

The Delaware Supreme Court stated that a limited partnership agreement is "the constitutive contract of the [p]artnership" and not a "separate commercial contract." While "limited partnership agreements often govern the territory that in corporate law is covered by equitable principles of fiduciary duties," the Delaware Supreme Court stated that this "does not make all provisions of a limited partnership agreement enforceable by a direct claim."

Applying *Tooley*, Court Holds the Limited Partner's Claims Were Derivative in Nature

The Delaware Supreme Court then applied the *Tooley* test to the limited partner's claims. Under the first prong of the *Tooley* analysis, the court found that the harm alleged by the limited partner "solely affected the [p]artnership." The court explained that "claims of corporate overpayment are normally treated as causing harm solely to the corporation and, thus, are regarded as derivative."

Pursuant to the second prong of the *Tooley* test, the court held that "the benefit of any recovery must flow solely to the [p]artnership." The court observed that if the limited partner were "to recover directly for the alleged decrease in the value of the [p]artnership's assets, the damages would be proportionate to his ownership interest." The court found "[t]he necessity of a *pro rata* recovery to remedy the alleged harm indicates that [the limited partner's] claim is derivative."

Significantly, the Delaware Supreme Court rejected the limited partner's effort to rely on *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006), to argue that the claim was both derivative and direct. The court explained that *Gentile* involved a controlling stockholder transaction "that resulted in an improper transfer of both economic value *and* voting power from the minority stockholders to the controlling stockholder." The court found that here, the limited partner's claim did "not satisfy the unique circumstances" of the *Gentile* decision because there was no assertion of any "voting rights dilution."

The Delaware Supreme Court expressly "decline[d] the invitation to further expand the universe of claims that can be asserted 'dually' to hold here that the extraction of solely economic value from the minority by a controlling stockholder constitutes direct injury." The court found that "[t]o do so would deviate from the *Tooley* framework and largely swallow the rule that claims of corporate overpayment are derivative by permitting stockholders to maintain a suit whenever the corporation transacts with a controller on allegedly unfair terms."

Court Finds the Merger Extinguished the Limited Partner's Claim

The Delaware Supreme Court determined that the limited partner's derivative claims "were an asset of the [p]artnership" that were "transferred to and bec[ame] an asset of the acquiring corporation as a matter of statutory law." The court concluded the merger "therefore extinguished [the limited partner's] standing to assert these claims."

Delaware Chancery Court: Plaintiffs Challenging a Transaction Approved by a Majority of Disinterested Stockholders in a Fully-Informed, Uncoerced Vote Bear the Burden of Pleading Disclosure Deficiencies

In *Corwin v. KKR Financial Holdings*, 125 A.3d 304 (Del. 2015), the Delaware Supreme Court held that "when a transaction not subject to the entire fairness standard is approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies."[10]

On January 5, 2017, the Delaware Chancery Court considered the question of how "the burden of proof operate[s] when applying the standard-shifting principles ... reaffirmed in *Corwin*." *In re Solera Holdings, Inc. Stockholder Litig.*, 2017 WL 57839 (Del. Ch. 2017). The court held that "a plaintiff challenging the decision to approve a transaction must first identify a deficiency in the operative disclosure document, at which point the burden ... fall[s] to defendants to establish that the alleged deficiency fails as a matter of law in order to secure the cleansing effect of the vote."

The court recognized that "defendants asserting a 'ratification' defense" bear "the burden to show the vote was fully-informed." However, the court stated that it would make "little sense" for defendants to have "the *burden to plead* disclosure deficiencies in the first place to test whether the vote really was fully-informed." The court reasoned that such a rule "would create an unworkable standard, putting a litigant in the proverbially impossible position of proving a negative." The court found it "far more sensible" for plaintiffs to bear the initial burden of identifying allegedly inadequate disclosures.

10. Please click here to read our discussion of the *Corwin* decision.

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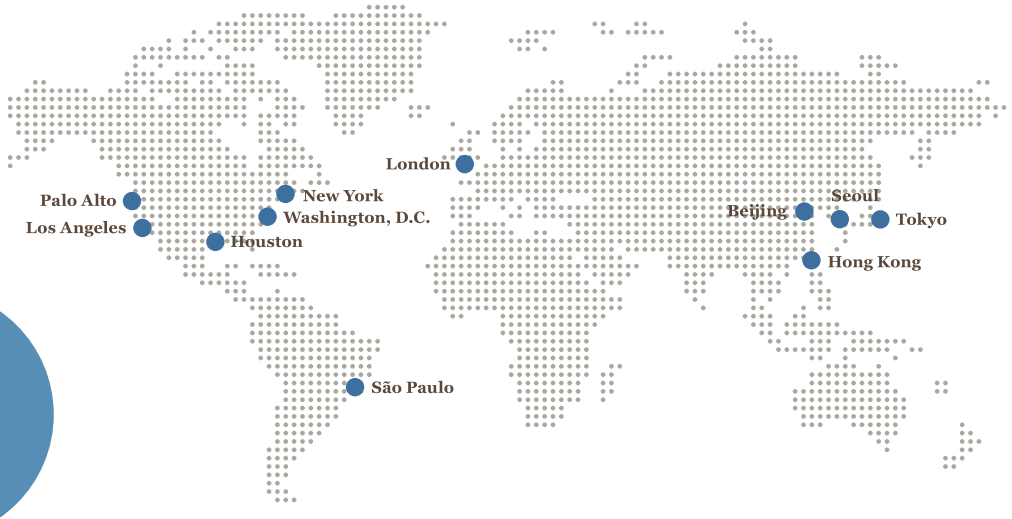

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