Simpson Thacher

Securities Law Alert

In This Edition:

- Second Circuit: *American Pipe* Tolling Does Not Apply to the Five-Year Statute of Repose for Claims Brought Under Section 10(b) and Rule 10b-5
- Tenth Circuit: Failure to Disclose Project Delays and Cost Overruns Reflected "Benign Optimism" Rather Than Scienter
- Eastern District of New York: Confidential Witness Allegations Too Vague to Form the Basis of a Securities Fraud Claim
- Delaware Chancery Court: Business Judgment Rule Applies to Two-Step Section 251(h) Mergers If the Target Corporation's Fully-Informed, Uncoerced Stockholders Tender a Majority of the Company's Shares in a First-Step Tender Offer
- Delaware Chancery Court: No Material Breach of "Commercially Reasonable" Efforts Clause in a Merger Agreement Where Defendant Did Not Actively Interfere with Meeting the Condition Precedent

July 2016

Simpson Thacher offers "[g]lobal capacity when it comes to M&A-related litigation, particularly for foreign clients operating in US markets."

– Chambers USA 2016

Second Circuit: *American Pipe* Tolling Does Not Apply to the Five-Year Statute of Repose for Claims Brought Under Section 10(b) and Rule 10b-5

In *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974), the Supreme Court held "the commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class who would have been parties had the suit been permitted to continue as a class action."

On July 14, 2016, the Second Circuit determined "*American Pipe* tolling does not apply to" 28 U.S.C. § 1658(b)(2), which establishes a five-year statute of repose for securities fraud claims brought under Section 10(b) and Rule 10b-5. *SRM Global Master Fund Ltd. P'ship v. Bear Stearns Cos.*, 2016 WL 3769735 (2d Cir. 2016) (Lohier, J.).

The Second Circuit explained that in *Police & Fire Ret. Sys. of City of Detroit v. IndyMac MBS*, 721 F.3d 95 (2d Cir. 2013) (*IndyMac*), it previously held *American Pipe* tolling inapplicable to the three-year statute of repose set forth in Section 13 of the Securities Act of 1933, which governs claims brought under Sections 11 and 12(a) of that Act. The *IndyMac* court reasoned that if *American Pipe* tolling is "viewed as a form of equitable tolling," then it "does not apply to Section 13 because 'a statute of repose is subject only to legislatively created exceptions, and not to equitable tolling.'" *SRM Global*, 2016 WL 3769735 (quoting *IndyMac*, 721 F.3d 95).

The *IndyMac* court further determined *American Pipe* tolling could not apply to Section 13 if it were "legal in nature and based on Rule 23 of the Federal Rules of Civil Procedure." *Id.* (discussing *IndyMac*, 721 F.3d 95). The *IndyMac* court found that applying *American Pipe* tolling to Section 13 would violate the Rules Enabling Act, which "forbids interpreting Rule 23 to 'abridge, enlarge, or modify any substantive right.'" *Id.* (quoting *IndyMac*, 721 F.3d 95). The *IndyMac* court emphasized that "statutes of repose create a substantive right in those protected to be free from liability after a legislatively-determined period of time." *Id.* The *IndyMac* court found that "[p]ermitting a plaintiff to file a complaint . . . after the repose period set forth in Section 13 of the Securities Act has run would therefore necessarily enlarge or modify a substantive right and violate the Rules Enabling Act." *Id.*

For the same reasons set forth in *IndyMac*, the Second Circuit held "*American Pipe* tolling does not apply to § 1658(b)(2)'s five-year statute of repose." The court explained that "as a statute of repose, § 1658(b)(2) is not subject to equitable tolling." Moreover, the court found § 1658(b)(2) "creates a <u>substantive</u> right in defendants to be free from liability after five years—a right that *American Pipe* tolling cannot modify without running afoul of the Rules Enabling Act."

Notably, the Second Circuit rejected plaintiff's contention that *IndyMac* was distinguishable because of "textual differences between Section 13 and § 1658(b)(2)—in particular, Section 13's 'in no event' language."[1] The court found *IndyMac* was not based on Section 13's "in no event" language, and therefore applied with equal force to § 1658(b)(2).

Tenth Circuit: Failure to Disclose Project Delays and Cost Overruns Reflected "Benign Optimism" Rather Than Scienter

On July 6, 2016, the Tenth Circuit affirmed dismissal of a securities fraud action against Spirit AeroSystems Holdings and several of its executives for allegedly misrepresenting cost overruns and production delays. *Anderson v. Spirit Aerosystems Holdings*, 2016 WL 3607032 (10th Cir. 2016) (Bacharach, J.). The Tenth Circuit found plaintiffs' allegations failed to raise a strong inference of scienter. The court determined it was "more probable that the Spirit executives were overly optimistic and failed to give adequate weight to financial red flags."

1. Section 13 provides that "*[i]n no event* shall any . . . action be brought to enforce a liability . . . more than three years after the security was bona fide offered to the public, or . . . more than three years after the sale." 15 U.S.C. § 77m (emphasis added). 28 U.S.C. § 1658(b)(2) does not include the words "in no event."

Background

Spirit Aerosystems "agreed to supply parts for three types of aircraft," including the Boeing 787. The company "managed production of the parts through three projects," each of which "encountered production delays and cost overruns." In periodic public reports in 2011 and 2012 concerning the progress of these projects, "Spirit acknowledged risks but expressed confidence about its ability to meet production deadlines and ultimately break even on the projects." However, on October 25, 2012, Spirit disclosed "that it expected to lose hundreds of millions of dollars on the three projects." Following the announcement, Spirit's share price fell approximately thirty percent.

Spirit's shareholders brought suit in the District of Kansas alleging that Spirit and several of its executives knew long before the October 2012 announcement that "the three projects were behind schedule and were generating so much in additional costs that a loss would be inevitable." The district court dismissed plaintiffs' complaint for failure to allege facts showing scienter, among other grounds. Plaintiffs appealed.

Tenth Circuit Finds Plaintiffs' Allegations Insufficient to Raise a Strong Inference of Scienter

On appeal, the Tenth Circuit observed that "Spirit's executives [allegedly] knew that Spirit had encountered problems in containing costs and meeting production deadlines." The court also "assume[d] (without deciding) that Spirit did not adequately communicate these problems to the public." The Tenth Circuit found that the key question here was *why*. The court noted at the outset that plaintiffs did not allege that "defendants had a particularized motive for committing securities fraud." While the court explained that this was not dispositive, the court found "the absence of a motive allegation . . . relevant" to the scienter analysis.

The court found plaintiffs had "suppl[ied] little reason to suspect malevolence rather than benign optimism." The court held plaintiffs' allegations inadequate to "create a cogent, compelling inference of scienter."

Testimony of Lower-Level Employees Does Not Support High-Level Executives' Scienter

The Tenth Circuit deemed insufficient plaintiffs' "generalized descriptions of internal meetings, cost reports, delays, and mismanagement" bolstered by the allegations of "ten corroborating witnesses." The court found the corroborating witnesses "were too far removed" in the corporate hierarchy from the four Spirit executives named as defendants, and these witnesses "did not provide sufficiently particularized accounts of what the Spirit executives must have known."

Plaintiffs also alleged that one of the Spirit executives "had a culpable intent." However, the court found plaintiffs did "not tie [his] potentially culpable state of mind to any public disclosures."

"Core Operations" Theory Is Not Sufficient, Standing Alone, to Allege Scienter

The Tenth Circuit rejected plaintiffs' effort to allege scienter based on the executives' alleged involvement in monitoring and overseeing the company's "core operations." The court explained that it could not "infer scienter based only on a defendant's position in a company or involvement with a particular project." Similarly, the court stated that "mere attendance at meetings does not contribute to an inference of scienter." The Tenth Circuit held that it could infer from plaintiffs' "core operations" allegations "only that the four executives were overly optimistic about Spirit's ability to achieve the forecasted production schedules and cost reductions." The court found plaintiffs did not "provide[ ] a good reason to believe that the executives *knew* that the projects were unlikely to meet forecasts."

Company's Implementation of a Project "Recovery Plan" Does Not Establish Scienter

The Tenth Circuit also found meritless plaintiffs' efforts to allege scienter based on a "recovery plan" adopted in July 2012 to put the Boeing 787 project back on schedule. Plaintiffs' asserted that "the existence of this plan show[ed] that Spirit executives knew that their subsequent representations about the Boeing 787 project were false or misleading." However, the court found plaintiffs' allegations did not "support [the] logical leap" that "Spirit executives knew that the recovery plan could not accomplish the plan's stated objectives." The Tenth Circuit acknowledged that the company's "eventual announcement of a forward loss suggest[ed] that Spirit had placed too much confidence in the recovery plan." But the court explained that "the same [could] always be said when a company delays announcement of a forward loss based on remedial efforts to increase profitability or production."

The Tenth Circuit noted that it had "addressed an analogous issue in *In re Zagg, Inc. Sec. Litig.*, 797 F.3d 1194 (10th Cir. 2015)."[2] There, a company "adopted a corrective policy restricting executives' pledges of corporate shares" after the company "allegedly failed to disclose that [its] chief executive officer had pledged approximately half of his shares in the corporation as collateral in a personal margin account." *Spirit Aerosystems*, 2016 WL 3607032 (discussing *In re Zagg*, 797 F.3d 1194). The *In re Zagg* court rejected plaintiffs' contention that "adoption of the policy showed that the corporation had a fraudulent intent." *Id.* Rather, the *In re Zagg* court determined that "the new policy showed only that the corporation had 'identified a better way of doing things moving forward.'" *Id.* (quoting *In re Zagg*, 797 F.3d 1194).

Finding *In re Zagg* "instructive," the Tenth Circuit stated that Spirit's implementation of a recovery plan indicated that the company had "identified an interim step to reduce costs and expedite production on the Boeing 787 project." The court determined that rather than inferring scienter, "[t]he stronger inference is that the Spirit executives thought they had 'identified a better way of doing things.'" *Id.* (quoting *In re Zagg*, 797 F.3d 1194).

Disclosure of Project-Related Risks Does Not Indicate Scienter

With respect to defendants' disclosure of project-related risks, plaintiffs claimed that "these warnings suggest[ed] a culpable mental state because the four executives must have known that the risks had already materialized." Plaintiffs asserted that "the more a defendant speaks about a topic, the likelier it is that [the defendant] knows about the topic." The Tenth Circuit "disagree[d],"

2. Please click here to read our prior discussion of the *In re Zagg* decision.

and explained that "[o]rdinarily, a defendant's warnings weaken an inference of scienter."

CEO's After-the-Fact Explanation Suggested an Honest Mistake, Not Scienter

After Spirit announced a forward loss, the company's CEO publicly explained why the loss had occurred. Among other factors, the CEO "acknowledged that Spirit had mistakenly projected Spirit's ability to improve efficiency and that Spirit ultimately learned that it could not meet projections." Plaintiffs contended that the CEO's "statements show[ed] that Spirit [had] recklessly ignored production delays and cost overruns." However, the Tenth Circuit found the CEO's statements only "suggest[ed] an honest mistake in predicting Spirit's future production and costs, not an inference of scienter."

Size of Forward Loss Does Not Support an Inference of Scienter

The Tenth Circuit also rejected plaintiffs' contention that "because the forward loss was so large, the executives must have known long before October 2012 that Spirit would incur a loss." The court stated that "[t]he loss of $434.6 million was undoubtedly significant," but found that "[t]he size of the loss does not suggest that the four executives knew or recklessly disregarded the risks that Spirit was eventually going to lose money on the three projects."

Judge Lucero, Dissenting in Part, Opines Plaintiffs Adequately Pled Scienter as to Statements Concerning Then-Present Facts

Judge Lucero concurred with the majority opinion with respect to "statements regarding Spirit's projected ability to meet cost targets." However, he "part[ed] ways with the majority with respect to the portion of plaintiffs' claim based on false statements . . . regarding the then-current performance of Spirit's 787 project" which did "not rely on any prediction as to future costs."

Judge Lucero observed that according to plaintiffs, "defendants stated both 'we will be on budget' and 'we are on budget.'" He noted that although "[t]hese two statements differ markedly for purposes of a securities fraud claim . . . the majority opinion focuse[d] its scienter analysis exclusively on the former."

Eastern District of New York: Plaintiffs' Confidential Witness Allegations Too Vague to Form the Basis of a Securities Fraud Claim

On July 22, 2016, the Eastern District of New York dismissed a securities fraud action against VOXX International in which a "single confidential witness" provided "nearly all of the information [d]efendants allegedly failed to disclose in their public statements." *Ford v. Voxx Int'l*, 2016 WL 3982466 (E.D.N.Y. 2016) (Seybert, J.). The court held "the statements and opinions attributed to" the confidential witness were "too vague to form the basis of a fraud claim."

The court also rejected plaintiffs' attempt to plead securities fraud based on VOXX's "ambitious" fiscal guidance. Finally, the court found inactionable alleged misstatements of opinion concerning the value of the company's goodwill and trademark assets.

Background

In March 2011, VOXX acquired Klipsch Holding, a company that produces home audio speaker systems and headphones. Klipsch had an increase in net sales of 1.7% in 2012, and 2.6% in 2013. For 2014, VOXX projected a 9% increase in Klipsch's net sales, but instead net sales declined that year by 3.7%. When VOXX announced its financial results for the fourth quarter of 2014, VOXX's share price fell by 25%. VOXX also took a $57.6 million impairment charge in the fourth quarter of 2014 consisting largely of write-downs to Klipsch's goodwill value and the impairment of certain trademarks.

Plaintiffs subsequently brought the instant securities fraud action alleging that VOXX and two of its executives had made misrepresentations with respect to (1) Klipsch's financial prospects and performance, and (2) the value of VOXX's goodwill and asset value. Defendants moved to dismiss for failure to plead actionable misstatements or omissions.

Court Finds Plaintiffs' Confidential Witness Allegations Too Vague to Meet the Particularized Pleading Requirements for a Securities Fraud Claim

Plaintiffs relied on statements by a single confidential witness to support their claims that defendants misrepresented Klipsch's financial prospects and performance.

The court explained that "to the extent a complaint relies upon confidential witnesses to show that company insiders made fraudulent public statements, the information must be alleged with sufficient particularity to demonstrate that the insiders' statements were actually false." The *VOXX* court noted that other "courts have dismissed securities fraud claims that [were] solely based upon vague allegations supplied by confidential sources." For example, in *City of Roseville Employees' Retirement System v. Energysolutions*, 814 F. Supp. 2d 395 (S.D.N.Y. 2011), the court declined to rely on confidential witness statements in considering allegations that a company had overstated the value of certain trust fund assets in its registration statement. The court "found the information supplied by the confidential witness to be overly vague because the witness did not provide any information about the period over which the [trust fund] balance declined, the amount of the decline, or the accuracy of the statements in the registration statement." *Id.* (discussing *Energysolutions*, 814 F. Supp. 2d 395).

In the case before it, the *VOXX* court similarly found plaintiffs' confidential witness allegations "too vague to form the basis of a [securities] fraud claim." First, the confidential witness represented "that Klipsch's sales [had been] 'flat or declining for years.'" The court found these statements "overly vague because there [was] no indication of the time period to which the statements refer[red], the magnitude of the alleged decline in sales, or the extent to which the decline impacted the [c]ompany's reported sales figures."

Second, the confidential witness opined that (1) Klipsch's "products were too expensive relative to the competition" and (2) the company's "advertising campaigns 'did not generate the recognition or increase in sales that Klipsch had hoped.'" The court explained that "[a]s a general matter, the mere opinions of confidential witnesses . . . are not actionable in securities fraud cases." Moreover, the court found the confidential witness's "opinions about the price point of [Klipsch's] products and the effectiveness of its advertising campaigns [were] untethered to any particular facts about how [the company's] pricing and advertising actually affected sales," and therefore "lack[ed] the particularity necessary to allege [falsity]."

Finally, the confidential witness stated that Klipsch "started to lose market share with headphones/earbuds [in 2012]." The court observed that given the witness's role at the company, the confidential witness was "plausibly in a position to know the [c]ompany's standing in the market for headphones relative to competitors." Nevertheless, the court deemed the confidential witness's "market share claims . . . too vague to support a cause of action under Rule 9(b)." The court found it significant that the confidential witness "provide[d] no information about whether [the company's] position in the market changed during the [c]lass [p]eriod or to what extent its reported sales figures during the [c]lass period were impacted by its market position."

Court Finds Allegations of Ambitious Earnings Estimates, Standing Alone, Insufficient to Support a Securities Fraud Claim

Plaintiffs "place[d] great weight upon [d]efendants' 2014 financial guidance as a basis for their securities fraud allegations."

The court explained that statements projecting "future performance may be actionable under Section 10(b) or Rule 10b-5 if . . . the speaker does not genuinely or reasonably believe them." The court acknowledged that defendants' "estimated 9% growth rate [for Klipsch] was lofty" considering "Klipsch's 1.7% growth rate in 2012 and 2.6% growth rate in 2013." However, the court observed that "Klipsch's past performance was publicly known at the time [d]efendants issued their 2014 financial guidance."

The court explained that plaintiffs cannot allege fraud simply by asserting defendants' "financial estimates were unreasonable in light of publicly available information." Instead, plaintiffs "must set forth specific facts showing why [d]efendants' fiscal guidance was false or misleading, and not merely ambitious." Here, the court held plaintiffs "failed to meet this burden."

Court Holds Plaintiffs Failed to Allege a Misstatement of Opinion Concerning the Value of VOXX's Intangible Assets

Plaintiffs claimed that VOXX's statements of opinion concerning the value of its goodwill and trademark assets were "materially false or misleading because the reported values were inflated." According to plaintiffs, VOXX should have tested these assets for impairment no later than the third quarter of fiscal 2013 rather than waiting until the fourth quarter of fiscal 2014 to report an impairment charge.

The *VOXX* court explained that in order "[t]o state a fraud claim based upon a misstatement of opinion" under the Supreme Court's decision in *Omnicare v. Laborers' Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318 (2015),[3] plaintiffs must allege "material facts that call the basis for the [c]ompany's opinion into question and 'whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context.'" *Id.* (quoting *Omnicare*, 135 S. Ct. 1318). The *VOXX* court noted that prior to *Omnicare*, the Second Circuit in *Fait v. Regions Fin. Corp.*, 655 F.3d 105 (2d Cir. 2011)[4] held that a complaint asserting "a misstatement of a company's goodwill assets . . . must 'plausibly allege that defendants did not believe the statements regarding goodwill at the time they made them.'" *Id.* (quoting *Fait*, 655 F.3d 105).

The *VOXX* court also found "instructive" the Second Circuit's decision in *City of Omaha, Nebraska Civilian Ems.' Ret. Sys. v. CBS Corp.*, 679 F. 3d 64 (2d Cir. 2012).[5] In that case, plaintiffs contended that "various publicly-known 'red flags,' should have caused the defendants to perform an impairment test" of the company's goodwill assets several months earlier than the company reported an impairment charge. Following the Second Circuit's precedent in *Fait*, the *CBS* court "held that the plaintiffs failed to state a claim because they did not plead any facts which 'plausibly demonstrate[d] that defendants knew, nor even had reason to know . . . it was more likely than not that the goodwill of any specific reporting unit was overvalued.'" *Id.* (quoting *CBS*, 679 F.3d 64).

In the case before it, the *VOXX* court similarly found plaintiffs' complaint did "not contain facts suggesting that [d]efendants knew at any point during the [c]lass [p]eriod that VOXX's goodwill or trademark assets were inflated and should have been tested for impairment." Although VOXX "lowered its sales guidance in the third quarter of 2013," the court held that "lower than expected sales [do] not implicate the kind of adverse market conditions that should have triggered an impairment test." As to the fact that "the reported value of VOXX's intangible assets exceeded its market capitalization," the court held this "insufficient to show [d]efendants made an actionable misstatement of opinion absent factual allegations regarding 'the inquiry the [defendants] did or did not conduct or the knowledge [they] did or did not have.'" *Id.* (quoting *Omnicare*, 135 S. Ct. 1318). The *VOXX* court concluded plaintiffs' allegations fell "short of what is needed to plead an actionable misstatement of opinion" under *Omnicare* and *Fait*.

3. Please click here to read our prior discussion of the Supreme Court's decision in *Omnicare*.

4. Please click here to read our prior discussion of the Second Circuit's opinion in *Fait*.

5. Please click here to read our prior discussion of the Second Circuit's opinion in *CBS*.

Delaware Chancery Court: Business Judgment Rule Applies to Two-Step Section 251(h) Mergers If the Target Corporation's Fully-Informed, Uncoerced Stockholders Tender a Majority of the Company's Shares in a First-Step Tender Offer

Pursuant to Section 251(h) of the Delaware General Corporation Law ("DGCL"), companies may complete two-step mergers without a stockholder vote if the acquiring corporation consummates a first-step tender offer.

On June 30, 2016, the Delaware Chancery Court held that "the acceptance of a first-step tender offer by fully informed, disinterested, uncoerced stockholders representing a majority of a corporation's outstanding shares in a two-step merger under Section 251(h) has the same cleansing effect under" the Delaware Supreme Court's decision in *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015),[6] "as a vote in favor of a merger by a fully informed, disinterested, uncoerced stockholder majority." *In re Volcano Corporation S'holder Litig.*, 2016 WL 3583704 (Del. Ch. 2016) (Montgomery-Reeves, V.C.). Under *Corwin*, claims of fiduciary duty breaches against the target corporation's directors must be dismissed absent allegations of waste.

Background

On December 16, 2014, Volcano Corporation's board approved a cash-out merger by Philips Holding USA, to be consummated as a two-step merger under Section 251(h) of the DGCL.

Volcano's stockholders tendered 89.1% of the company's outstanding shares into the first-step tender offer. On February 17, 2015, after the expiration of the tender offer, Volcano and Philips consummated the merger without a stockholder vote, as permitted under Section 251(h).

Volcano stockholders subsequently brought suit alleging the Volcano board breached its duties of care and loyalty in connection with the merger. Defendants moved to dismiss the complaint.

Chancery Court Holds the Business Judgment Rule Applies Because Volcano's Fully-Informed, Uncoerced Stockholders Approved the Merger by Tendering a Majority of the Company's Shares

The court first considered "what standard of review to apply in evaluating [d]efendants' alleged fiduciary duty breaches." The court determined "the business judgment rule irrebuttably applie[d] to the [m]erger because Volcano's disinterested, uncoerced, fully informed stockholders tendered a majority of the [c]ompany's outstanding shares into the [t]ender [o]ffer."

The *Volcano* court explained that "recent [Delaware] Supreme Court decisions confirm that the approval of a merger by a majority of a corporation's outstanding shares pursuant to a statutorily required vote of the corporation's fully informed, uncoerced, disinterested [stockholders] renders the business judgment rule irrebuttable." *Id.* (citing *Corwin*, 125 A.3d 304, and *Singh v. Attenborough*, 2016 WL 2765312 (May 6, 2016)[7]). The *Volcano* court further noted "such an approved transaction can only be challenged on the basis that it constituted waste." *Id.* (citing *Attenborough*, 2016 WL 2765312).

The *Volcano* court "conclude[d] that stockholder approval of a merger under Section 251(h) by accepting a tender offer has the same cleansing effect as a vote in favor of that merger." The court rejected plaintiffs' contention that "stockholder acceptance of a tender offer and a stockholder vote differ in a manner that should preclude the cleansing effect articulated by the [Delaware] Supreme Court in *Corwin* from applying to tender offers."

First, the court found meritless plaintiffs' claim that there is no explicit role for a target corporation's board of directors in responding to a tender offer. The court explained that "[a] target board's role in negotiating a

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

7. Please click here to read our prior discussion of the Delaware Supreme Court's decision in *Attenborough*.

two-step merger subject to a first-step tender offer under Section 251(h) . . . is substantially similar to its role in a merger subject to a stockholder vote under Section 251(c) of the DGCL." A target corporation's board must "negotiate, agree to, and declare the advisability of the terms of both the first-step tender offer and the second-step merger in a Section 251(h) merger, just as a target corporation's board must negotiate, agree to, and declare the advisability of a merger involving a stockholder vote under Section 251(c)." Moreover, "[t]he target board also is subject to the same common law fiduciary duties, regardless of the subsection under which the merger is consummated."

The *Volcano* court found similarly baseless plaintiffs' suggestion that "a first-step tender offer in a two-step merger . . is more coercive than a stockholder vote in a one-step merger." The court explained that "Section 251(h) . . . alleviates the coercion that stockholders might otherwise be subject to in a tender offer because (1) the first-step tender offer must be for all the target company's outstanding stock, (2) the second-step merger must 'be effected as soon as practicable following the consummation of the' first-step tender offer, (3) the consideration paid in the second-step merger must be of 'the same amount and kind' as that paid in the first-step tender offer, and (4) appraisal rights are available in all Section 251(h) mergers, subject to the conditions and requirements of Section 262 of the DGCL." *Id.* (quoting Del. C. tit. 8 § 251(h)).

Finally, the *Volcano* court found "the policy considerations underlying the [Delaware Supreme Court's] holding in *Corwin* do not provide any basis for distinguishing between a stockholder vote and a tender offer." The *Volcano* court reasoned that "[a] stockholder is no less exercising her 'free and informed choice to decide on the economic merits of a transaction' simply by virtue of accepting a tender offer rather than casting a vote." *Id.* (quoting *Corwin*, 125 A.3d 304). The *Volcano* court further noted that "judges are just as 'poorly positioned to evaluate the wisdom of' stockholder-approved mergers under Section 251(h) as they are in the context of corporate transactions with statutorily required stockholder votes." *Id.* (quoting *Corwin*, 125 A.3d 304). In concluding that "the [Delaware] Supreme Court did not intend that its holding in *Corwin* be limited to stockholder votes only," the *Volcano* court found it significant that the *Corwin* court included a case involving a two-step merger with a first-step tender offer among the cases it cited as support for its decision.

Court Holds Plaintiffs Failed to State Breach of Fiduciary Duty Claims Against Volcano's Board

Because the court found "the business judgment rule irrebuttably applie[d]" to the Volcano-Philips merger, the court determined the transaction could "only . . . be challenged on the basis that it constituted waste." The court noted that it was "logically difficult to conceptualize how a plaintiff [could] ultimately prove a waste . . . claim in the face of a decision by fully informed, uncoerced, independent stockholders to ratify the transaction, given that the [t]est for waste is whether any person of ordinary sound business judgment could view the transaction as fair." The court held that "[b]ecause the [m]erger did not constitute waste, the [c]omplaint fail[ed] to state a valid breach of fiduciary duty claim against the [Volcano] [b]oard."

Delaware Chancery Court: No Material Breach of "Commercially Reasonable" Efforts Clause in a Merger Agreement Where Defendant Did Not Actively Interfere with Meeting the Condition Precedent

On June 24, 2016, the Delaware Chancery Court considered the requirement in a merger agreement that the parties use "commercially reasonable" efforts to obtain a tax opinion as a condition precedent to the consummation of the merger. *The Williams Cos. v. Energy Transfer Equity*, 2016 WL 3576682 (Del. Ch. 2016) (Glasscock, V.C.). In the case before the court, intervening economic circumstances allegedly changed both the buyer's desire to consummate the merger *and* the designated law firm's willingness to issue the favorable tax opinion mandated by the merger agreement. The court found the buyer had not breached the requirement to use "commercial reasonable" efforts to obtain the tax opinion because there was no evidence that the buyer's "activity or lack thereof caused, or had a material effect upon" the law firm's "inability" to issue the necessary tax opinion.

Background

Pursuant to the terms of a merger agreement dated September 28, 2015 (the "Merger Agreement"), Energy Transfer Equity (the "Partnership") was to acquire The Williams Companies in an "unusual structure" in which Williams was to merge into Energy Transfer Corp ("ETC"), an entity created by the Partnership. The acquisition was to be accomplished in multiple steps: "ETC would . . . transfer the former Williams assets and 19% of ETC's common stock to the Partnership, in return for partnership units equivalent in value to the ETC stock on a one-share-for-one-unit basis, together with $6 billion in cash" that "would then be distributed to the former Williams stockholders."

The Merger Agreement made "it clear . . . that a tax-free transfer of the Williams [a]ssets between ETC and the Partnership was necessary for the deal to make economic sense." The parties "conditioned consummation of the deal on the opinion of a third party—Latham [& Watkins]—that the transaction 'should' survive an IRS challenge and be considered tax free under Section 721(a)" (the "721 Opinion"). At the time the deal was struck, the transaction "involved assets of equivalent value" and Latham would have been "able, under those conditions, to issue an opinion that the transaction should be considered a tax-free event."

Williams and the Partnership were both in the gas pipeline business. Sometime after the execution of the Merger Agreement, "the energy market—and thus the value of assets used in the transport of energy, of the type held by Williams and the Partnership—experienced a precipitous decline." The merger "quickly became financially unpalatable to the Partnership" because it would have "resulted in a value discrepancy amounting to a $3 to $4 billion overpayment by the Partnership." Latham & Watkins subsequently determined that it could not issue the requisite 721 Opinion because the underlying transaction no longer involved equivalent assets and thus there was "a sufficient likelihood" that the transaction was not tax free.

The Partnership attempted to terminate the Merger Agreement based on Latham's failure to issue the 721 Opinion. Williams then brought suit asserting that "the Partnership [had] breached the Merger Agreement by failing to use commercially reasonable efforts to obtain the 721 Opinion" and therefore could not "rely on the failure of Latham to deliver the 721 Opinion as a basis to terminate the Merger Agreement." The parties conducted expedited discovery and the court held a two-day trial to consider the issues.

Court Finds No Material Breach Because the Partnership's Actions Did Not Cause Latham to Refuse to Issue the Tax Opinion

As an initial matter, the court determined that Latham's refusal to issue the 721 Opinion was not in bad faith but instead, reflected the changed economics of the deal. In reaching this conclusion, the court found it significant that Latham's change of position was "not in the reputational interest of the individual tax attorneys at Latham, nor the interest of the firm generally."

The court then considered whether the Partnership was in "material breach" of its obligation to use "commercially reasonable efforts" to obtain a 721 Opinion from Latham. The court observed that the term "commercially reasonable efforts" was neither "defined in the Merger Agreement" nor "addressed with particular coherence in [Delaware] case law." In the absence of guidance on the meaning of the term, the court found that "by agreeing to make 'commercially reasonable efforts' to achieve the 721 Opinion, the Partnership necessarily submitted itself to an objective standard—that is, it bound itself to do those things objectively reasonable to produce the desired 721 Opinion, in the context of the agreement reached by the parties."

The court recognized that the Partnership had "experienced a bitter buyer's remorse." However, the court explained that Williams could "point to no commercially reasonable efforts that the Partnership could have taken to consummate the [merger]." Williams did not suggest that there were "actions available to the Partnership that would have caused Latham, acting in good faith, to issue the 721 Opinion" either based on "the current structure of" the merger or "any alternative structure suggested to date." Finding that there were "no such actions available to the Partnership," the court held the Partnership was not in "material breach" of the Merger Agreement "[d]espite [its] motivations."

Significantly, the *Williams* court distinguished an earlier decision in *Hexion Specialty Chemicals v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008). There, the Chancery Court held that a buyer who no longer wished to consummate an agreed-upon merger had breached its obligation to use "reasonable best efforts" to obtain financing for the transaction as required under the merger agreement. The *Williams* court found that in *Hexion*, "the buyer [had] actively and affirmatively torpedoed its ability to finance" the merger by, among other actions, "knowingly" providing its financial advisor with "misleading or inaccurate information" concerning the transaction. Here, however, the *Williams* court found no evidence that "the Partnership [had] instructed Latham, directly or indirectly," to refuse to issue the necessary tax opinion. The court explained that "[i]f the record here reflected affirmative acts by the Partnership to coerce or mislead Latham, by which actions it prevented issuance of the 721 Opinion, the facts here would more resemble *Hexion,* and the outcome here would likely be different."

The court therefore denied Williams' request to enjoin the Partnership from terminating the Merger Agreement based on Latham's failure to issue a Section 721 tax opinion.

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.

New York

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

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

Susannah S. Geltman
+1-212-455-2762
sgeltman@stblaw.com

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

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

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

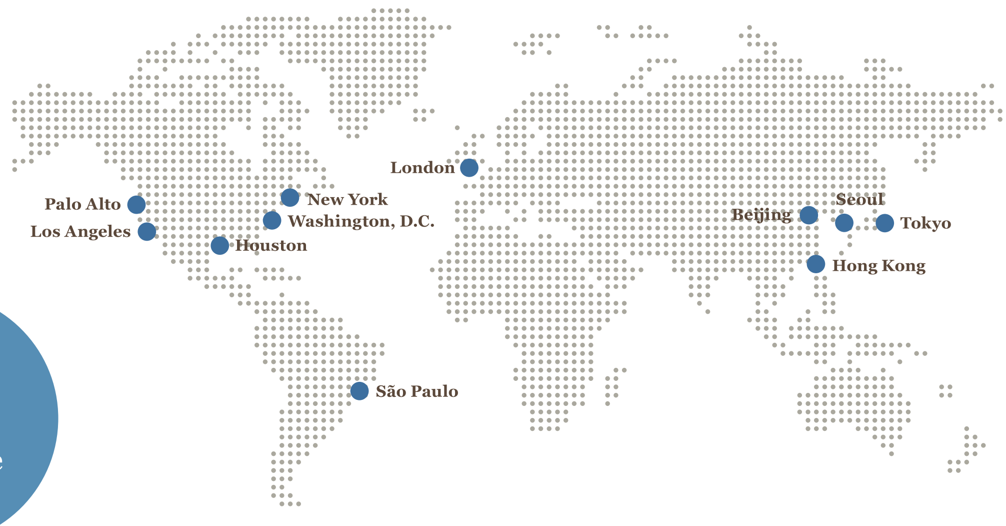
Jeffrey H. Knox
+1-202-636-5532
jeffrey.knox@stblaw.com

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

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

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

Simpson Thacher



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