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Securities Law Alert

In This Edition:

May 2016

Supreme Court: Federal Courts Have Exclusive Jurisdiction Over Suits "Brought to Enforce" the Securities Exchange Act

Section 27 of the Securities Exchange Act confers federal district courts with exclusive jurisdiction over all suits "brought to enforce any liability or duty created by [the Exchange Act] or the rules and regulations thereunder." On May 16, 2016, the Supreme Court held "the jurisdictional test established by [Section 27] is the same as the one used to decide if a cases 'arises under' a federal law" pursuant to 28 U.S.C. § 1331, the general federal question statute.[1] *Merrill Lynch, Pierce, Fenner & Smith v. Manning*, 2016 WL 2842450 (2016) (Kagan, J.) (*Merrill Lynch II*).

Background

At issue before the Supreme Court was a suit brought by several former shareholders of Escala Group alleging Merrill Lynch and a number of other financial institutions had devalued Escala stock through "naked" short sales. In a standard short sale, "a person borrows stock from a broker, sells

1. Section 1331 provides federal district courts with "original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States."

it to a buyer on the open market, and later purchases the same number of shares to return to the broker." The short seller profits if the stock price declines between the sale and the repurchase. In a "naked" short sale, on the other hand, the short seller does not actually borrow or otherwise obtain the stock, and thus "never delivers the promised shares to the buyer." The SEC "regulates such short sales at the federal level" through Regulation SHO, which "prohibits short sellers from intentionally failing to deliver securities."

The Escala plaintiffs brought suit in New Jersey state court claiming defendants' allegedly naked short sales violated New Jersey law. While the complaint "referred explicitly" to defendants' alleged violation of Regulation SHO, plaintiffs did not assert any claims under the federal securities laws or the SEC's rules. Merrill Lynch removed the case to federal court, asserting federal jurisdiction under both the general federal question statute (Section 1331) and Section 27 of the Exchange Act. The district court denied plaintiffs' motion to remand, but the Third Circuit reversed.

The Third Circuit held Section 1331 "did not confer jurisdiction of the suit, because all [plaintiffs'] claims were 'brought under state law' and none 'necessarily raised' a federal issue." *Id.* (quoting *Manning v. Merrill Lynch, Pierce, Fenner & Smith*, 772 F.3d 158 (3d Cir. 2014)). The Third Circuit further held Section 27 "covers only those cases involving the Exchange Act that would satisfy the 'arising under' test of the federal question statute." Finding no federal jurisdiction under either Section 27 or Section 1331, the Third Circuit remanded plaintiffs' case to New Jersey state court.

Merrill Lynch petitioned the Supreme Court for certiorari. On June 30, 2015, the Court granted certiorari to address the question of whether Section 27 "provides federal jurisdiction over state-law claims seeking to establish liability based on violations of the [Exchange Act] or its regulations or seeking to enforce duties created by the [Exchange Act] or its regulations." Petition for Certiorari, *Merrill Lynch, Pierce, Fenner & Smith v. Manning*, No. 14-1132 (U.S. March 17, 2015).

Supreme Court Holds Section 27 Provides for Exclusive Federal Jurisdiction of Suits "Arising Under" the Exchange Act Within the Meaning of the General Federal Question Statute

Agreeing with the Third Circuit's analysis, the Supreme Court "read § 27 as conferring exclusive federal jurisdiction of the same suits as 'aris[e] under' the Exchange Act pursuant to the general federal question statute." *Merrill Lynch II*, 2016 WL 2842450.

Section 1331's "arising under" test provides for exclusive federal jurisdiction when (1) "federal law creates the cause of action asserted[,]" or (2) a state-law claim "necessarily raise[s] a stated federal issue, actually disputed and substantial, which a federal forum may entertain without disturbing any congressionally approved balance of federal and state power." Applying the second prong of this "arising under" test to Section 27, the Supreme Court stated that federal courts would have exclusive jurisdiction over "a state law cause of action . . . 'brought to enforce' a duty created by the Exchange Act because the claim's very success depends on giving effect to a federal requirement." The Court further stated that a state-law action "could also fall within § 27's compass" if it "necessarily depends on a showing that the defendant breached the Exchange Act."

The Supreme Court rejected Merrill Lynch's contention that Section 27 should be read expansively to cover state law actions that explicitly or implicitly reference Exchange Act violations. The Court found Section 27 "confers federal jurisdiction when an action is commenced in order to give effect to an Exchange Act requirement" but "stops short of embracing any complaint that happens to mention a duty established by the Exchange Act."

Supreme Court Holds Section 1331's "Arising Under" Test Applies to Section 27 Even Though the Two Provisions Use Different Statutory Language

The Supreme Court acknowledged that the general federal question statute refers to cases "arising under" federal law, while Section 27 addresses cases "brought to enforce" duties or liabilities under the Exchange Act. However, the Court found "the test for § 1331 jurisdiction is not grounded in that provision's particular phrasing." Because the "arising under" test "does not turn on § 1331's text," the Court determined "there is nothing remarkable" in applying the test to "a differently worded statutory provision."

The Court rejected Merrill Lynch's contention that Congress's use of the phrase "brought to enforce" in Section 27 evinced an intent to depart from Section 1331's "arising under" test. The Court explained that "caselaw construing § 1331 was for many decades—including when the Exchange Act passed—highly 'unruly.'" "Against that muddled backdrop," the Court found it "impossible to infer that Congress, in enacting § 27, wished to depart from what we now understand as the 'arising under' standard."

Supreme Court Finds Applying the "Arising Under" Jurisdictional Test to Section 27 Gives Appropriate Due Deference to State Courts

In addition to the administrative simplicity of applying Section 1331's "arising under" test to Section 27, the Court found this approach "gives due deference to the important role of state courts in our federal system." The Court explained that "when a statute mandates, rather than permits, federal jurisdiction—thus depriving state courts of all ability to adjudicate certain claims—[the Court's] reluctance to endorse 'broad reading[s]' . . . grows stronger."

The Court observed that "Congress likely contemplated that some complaints intermingling state and federal questions would be brought in state court[.]" The Court pointed out that "Congress specifically affirmed the capacity of [state] courts to hear state-law securities actions, which predictably raise issues coinciding, overlapping, or intersecting with those under the [Exchange Act] itself."

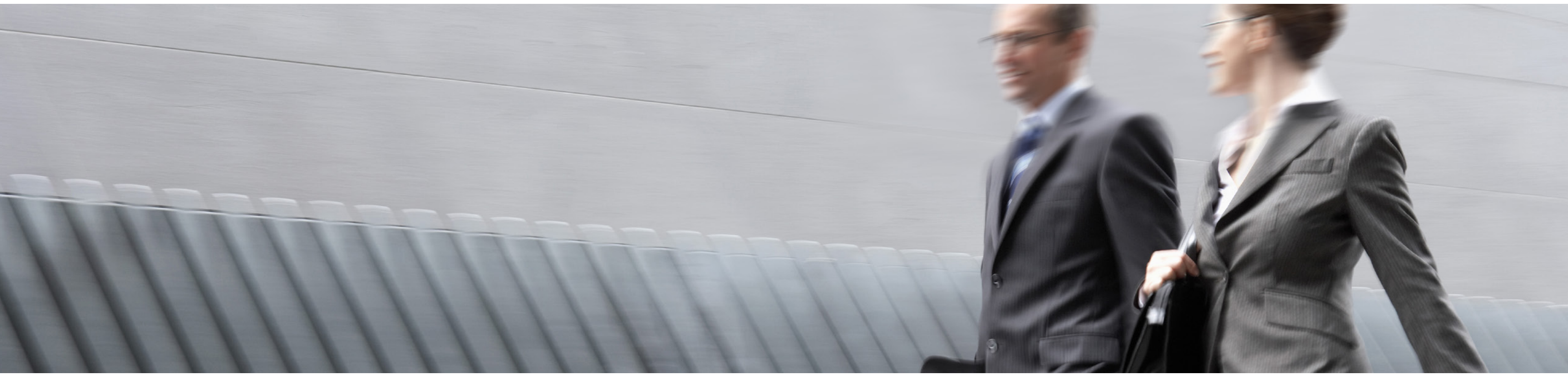
In cases like the one before it, the Court found it "hardly surprising" that plaintiffs "alleging short sales in violation of *state* securities law . . . might say the defendant previously breached a *federal* prohibition of similar conduct." The Court determined that "it is less troubling for a state court to consider such an issue than to lose all ability to adjudicate a suit raising only state-law causes of action."

The Court held the case before it did not "arise under" the Exchange Act within the meaning of Section 27, and affirmed the Third Circuit's decision remanding the action to New Jersey state court.

Justices Thomas and Sotomayor, Concurring, Express Their View That the "Arising Under" Test Does Not Apply to Section 27

In a concurring opinion joined by Justice Sotomayor, Justice Thomas expressed his view that Section 27 "does not use the phrase 'arising under' or provide a sound basis for adopting the arising-under standard." Justice Thomas underscored that Section 27 instead provides federal jurisdiction where a suit is "'brought to enforce' Exchange Act requirements." He stated that Section 27 "establishes a straightforward test: If a complaint alleges a claim that necessarily depends on a breach of a requirement created by the [Exchange Act], § 27 confers exclusive federal jurisdiction over that suit."

Justice Thomas concurred in the judgment remanding the action to state court because the complaint at issue did "not allege such claims."



Second Circuit: Breach of Contract Can Only Serve as the Basis for a Fraud Claim If There Is Proof of Fraudulent Intent at the Time of Contract Execution

On May 23, 2016, the Second Circuit considered the question of when a breach of contract can "also support a claim for fraud[.]" *United States v. Countrywide Home Loans*, 2016 WL 2956743 (2016) (Wesley, J.). The Second Circuit held that "where allegedly fraudulent misrepresentations are promises made in a contract, a party claiming fraud must prove fraudulent intent at the time of contract execution; evidence of a subsequent, willful breach cannot sustain the claim."

Based on these principles, the Second Circuit reversed a district court decision imposing civil penalties in excess of $1.2 billion on Countrywide Home Loans, Countrywide Bank, and Bank of America (collectively, "Countrywide") for allegedly violating federal mail and wire fraud statutes by selling low-quality mortgages to the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") in breach of the terms of Countrywide's contracts with Fannie Mae and Freddie Mac. The Second Circuit held the Government "failed to meet its burden" to prove a "scheme to defraud" because it "presented no proof at trial that any [loan] quality guarantee was made with fraudulent intent at the time of contract execution."

Background

Countrywide entered into contracts pursuant to which it agreed to sell mortgages of a certain quality level to Fannie Mae and Freddie Mac. According to the Government, Countrywide instead sold subpar loans under these contracts and allegedly intended to defraud Fannie Mae and Freddie Mac. The Government brought suit under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), which establishes civil penalties for violating or conspiring to violate the federal mail and wire fraud statutes in a manner that affects a federally insured financial institution.

During trial before a jury, "[t]he Government adduced no evidence and made no claim that Countrywide had fraudulent intent during the negotiation or execution" of the contracts at issue. The jury returned a verdict in favor of the Government. The district court subsequently imposed civil penalties of $1.27 billion against Countrywide, as well as $1 million in penalties against the COO of the Countrywide division that originated the loans in question.

The district court "concluded that the federal fraud statutes do not incorporate the common-law principle that actions brought in fraud cannot be premised solely upon evidence of contractual breaches—or, in the alternative, that the scheme alleged here fell into one of the recognized exceptions to this principle for actions premised on contractual breaches that nonetheless can sustain an action for fraud."

Defendants appealed, arguing "that the conduct alleged and proven by the Government [was], at most, a series of intentional breaches of contract."

Second Circuit Holds a Contractual Breach Can Only Support a Fraud Claim If the Defendant Had No Intent to Perform at the Time of Contract Execution

The Second Circuit began its analysis with the text of the federal mail and wire fraud statutes, and found the "gravamen" of these offenses is "a scheme to defraud." Under Supreme Court precedent, the court explained that "statutes employing common-law terms[,]" such as the phrase "scheme to defraud," "are presumed, 'unless the statute otherwise dictates, . . . to incorporate the established meaning of" those terms.'" *Id.* (quoting *Nationwide Mut. Ins. v. Darden*, 503 U.S. 318 (1992)).

The Second Circuit agreed with defendants that "the common law does not permit a fraud claim based solely on a contractual breach." However, the court also recognized that "a contractual relationship between the parties does not wholly remove a party's conduct from the scope of fraud." Rather, fraud in the context of a contractual relationship "turns on . . . *when* the representations were made and the intent of the promisor *at that time*." The Second Circuit held "a contractual promise can only support a claim for fraud upon proof of fraudulent intent not to perform the promise at the time of contract execution." The court emphasized that without proof of contemporaneous fraudulent intent, "a subsequent breach of that promise—even where willful and intentional—cannot in itself transform the promise into a fraud."

The Second Circuit "deem[ed] the common law's contemporaneous fraudulent intent principle incorporated into the federal mail and wire fraud statutes." The court reasoned that "[w]hat gives a scheme its fraudulent nature is" whether the scheme was "designed to *induce* reliance on a known misrepresentation." The Second Circuit held that "[o]nly if a contractual promise is made with no intent ever to perform it can the promise itself constitute a fraudulent misrepresentation" for purposes of the mail and wire fraud statutes.

Second Circuit Holds the Government Failed to Prove Fraud as a Matter of Law

Applying these principles to the case before it, the Second Circuit held the Government's evidence insufficient as a matter of law to prove fraud. The court noted that "[t]he Government did not prove—in fact, did not attempt to prove—that at the time the contracts were executed Countrywide never intended to perform its promise of investment quality." The court further observed that the Government did not "prove that Countrywide made any later misrepresentations—*i.e.*, ones not contained in the contracts—as to which fraudulent intent could be found." The court explained that "[t]he only representations alleged to be false were guarantees of future quality made in contracts as to which no proof of contemporaneous fraudulent intent was introduced at trial."

Because "the Government's proof show[ed] only post-contractual intentional breach of the [contractual] representations," the Second Circuit held "the jury had no legally sufficient basis on which to conclude that the misrepresentations alleged were made with contemporaneous fraudulent intent" as required under the federal mail and wire fraud statutes. The Second Circuit therefore reversed the district court's judgment.

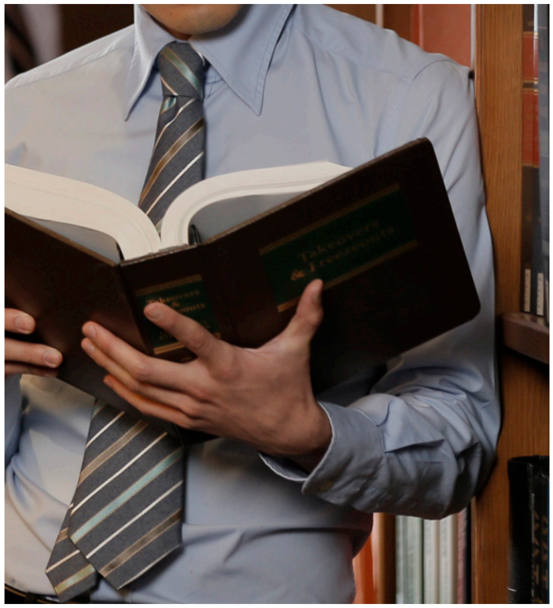
Second Circuit: Criminal Convictions Under Section 206 of the Investment Advisers Act Do Not Require Proof of Intent to Harm

Section 206 of the Investment Advisers Act prohibits investment advisers from engaging in certain types of transactions, including "any device, scheme, or artifice to defraud any client or prospective client." The Act provides for criminal penalties against anyone who "willfully violates" its provisions. On May 4, 2016, the Second Circuit held a criminal conviction premised on a violation of Section 206 does not require proof of intent to harm. *United States v. Tagliaferri*, 2016 WL 2342677 (2d Cir. 2016) (per curiam).

Second Circuit Holds Common Law Requirement of Intent to Harm Does Not Apply to Criminal Convictions Brought Under Section 206

In the case before the Second Circuit, an investment adviser appealed his conviction under Section 206 on the grounds that the district court "erred in declining to instruct the jury that [defendant's] intent to harm his clients was a necessary element of the investment adviser charge." Defendant contended "[S]ection 206 incorporates the common law requirement that intent to defraud includes both intent to deceive *and* intent to harm."

The Second Circuit began its analysis with the Supreme Court's decision in *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963), a case involving the SEC's authority to seek a preliminary injunction for conduct violating Section 206. The *Capital Gains* Court "held that [S]ection 206 departs from common law and does not 'require proof of intent to injure and actual injury to clients.'" *Id.* (quoting *Capital Gains*, 375 U.S. 180). In so holding, the Court took into account both "the delicate fiduciary nature of an investment advisory relationship" as well as the legislative history of the Investment Advisers Act. The Capital Gains Court emphasized that investment advisers have an obligation to proceed in "utmost good faith" with "full and fair disclosure of all material facts."



Defendant attempted to distinguish *Capital Gains* on the grounds that the Court's decision concerned a civil action rather than a criminal prosecution. However, the Second Circuit found "the only textual distinction between the civil and criminal enforcement mechanisms for [S]ection 206 is the Act's requirement that a criminal defendant commit a violation 'willfully.'" In light of "the special context of a fiduciary relationship," the Second Circuit determined "it would be inconsistent with the text of [S]ection 206 and the congressional purpose motivating it to require specific intent to harm." Rather, the Second Circuit held "the willfulness mental state" for criminal convictions under Section 206 only requires the Government to prove "the defendant acted with knowledge that his conduct was unlawful."

The Second Circuit emphasized that "[S]ection 206 prohibits not only common-law fraud by investment advisers but also 'any practice which operates as a fraud or deceit.'" *Id.* (quoting *Capital Gains*, 375 U.S. 180). The court explained that "[b]ecause the wrongfulness of [S]ection 206 violations derives from their deceptiveness, proof that the defendant intended to deceive his clients suffices to establish the requisite mens rea for guilt." The Second Circuit held the district court did not err in instructing the jury that Section 206 requires "only intent to deceive and not intent to harm."

Sixth Circuit: *American Pipe* Tolling Does Not Apply to Statutes of Repose for Securities Fraud Claims

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 May 19, 2016, the Sixth Circuit held *American Pipe* tolling does not apply either to the three-year statute of repose for claims brought under Sections 11 and 12 of the Securities Act of 1933, or the five-year statute of repose for claims brought under Section 10(b) of the Exchange Act. *Stein v. Regions Morgan Keegan Select High Income Fund*, 2016 WL 2909333 (6th Cir. 2016) (Clay, J.). Agreeing with the Second Circuit's decision in *Police & Fire Retirement System of the City of Detroit v. IndyMac MBS*, 721 F.3d 95 (2d Cir. 2013), the Sixth Circuit found *American Pipe* tolling inapplicable to statutes of repose because "they confer on defendants a right to be free of liability by imposing a temporal bar on claims." The Sixth Circuit expressly disagreed with the Tenth Circuit, which reached the opposite conclusion in *Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000).

Adopting the Second Circuit's Reasoning in *IndyMac*, Sixth Circuit Holds *American Pipe* Tolling Inapplicable to Statutes of Repose

In *IndyMac*, the Second Circuit determined *American Pipe* tolling does not apply to statutes of repose, including the three-year statute of repose for claims brought under Sections 11 and 12 of the Securities Act. The Second Circuit reasoned that "while statutes of limitation are often subject to tolling principles, a statue of repose *extinguishes* a plaintiff's cause of action after the passage of a fixed period of time, usually measured from one of the defendants' acts." *IndyMac*, 721 F.3d 95. The court found "statutes of repose create[ ] a *substantive* right in those protected to be free from liability after a legislatively-determined period of time."

Several years earlier, the Tenth Circuit held *American Pipe* tolling does in fact apply to statutes of repose, including those applicable to securities fraud claims. The Tenth Circuit found that if a class action is commenced before the expiration of a statute of repose, then the claims of all asserted members of that class should be deemed timely because claims on behalf of those plaintiffs were brought (in the form of the class action) before defendants' liability for those claims was extinguished.

The Sixth Circuit found the Second Circuit's decision in *IndyMac* provided "the more cogent and persuasive rule." *Stein*, 2016 WL 2909333. The Sixth Circuit also determined the *IndyMac* decision was "more consistent with" the Supreme Court's decision in *CTS Corp. v. Waldburger*, 134 S.Ct. 2175 (2014). There, the Court "discussed at length the incompatibility of equitable tolling and statues of repose" and explained that "'a statute of repose is a judgment that defendants should be free from liability after the legislatively determined period of time, beyond which the liability will no longer exist *and will not be tolled for any reason*.'" *Id.* (quoting *CTS*, 134 S.Ct. 2175).

The Sixth Circuit further found that *American Pipe* tolling would be inapplicable to statutes of repose even if it was "a form of class-action tolling deriving its authority from Rule 23" rather than equitable tolling. Agreeing with the Second Circuit, the Sixth Circuit reasoned that applying *American Pipe* tolling to statutes of repose could run afoul of the Rules Enabling Act, which "forbids interpreting Rule 23 to 'abridge, enlarge, or modify any substantive right.'" The Sixth Circuit underscored that "statutes of repose vest a substantive right in defendants to be free of liability" after a specified period of time.

The Sixth Circuit concluded that "regardless of whether *American Pipe* tolling is derived from courts' equity powers or from Rule 23, it does not apply to statutes of repose."

Southern District of New York: Court Dismisses Securities Fraud Action Against Weight Watchers for Failure to Allege Misleading Opinions Under the *Omnicare* Standard

On May 11, 2016, the Southern District of New York dismissed in its entirety a putative securities fraud class action alleging that Weight Watchers International and certain of its executives issued misleading opinions regarding competition from free mobile applications, software transition issues, and enrollment declines. *In re Weight Watchers Int'l Sec. Litig.*, 2016 WL 2757760 (S.D.N.Y. 2016) (Kaplan, J.).[2] The court held plaintiffs failed to meet the standard set forth in *Omnicare v. Laborers District Council Construction Industry Pension Fund*, 135 S.Ct. 1318 (2015), for pleading a securities fraud claim based on an alleged misstatement of opinion.[3]

Court Addresses *Omnicare*'s High Bar for Pleading a Securities Fraud Claim Based on an Allegedly Misleading Opinion

The court explained that under the *Omnicare* standard, a plaintiff asserting a securities fraud claim based on an allegedly misleading opinion must allege either that (1) the statement of opinion or belief itself "'constitute[d] a factual misstatement'" and "the speaker did not 'actually hold[ ] the stated belief'"; or (2) the "defendant 'omit[ted] to state a material fact necessary' to make whatever statement(s) it made 'not misleading.'" The court underscored that "a statement of opinion is not misleading just because external facts show the opinion to be incorrect."

The court observed that reasonable investors expect that certain types of opinions—including those made in "'formal documents,' like financial statements filed with the SEC"—do not "'reflect baseless, off-the-cuff judgments.'" Rather, reasonable investors

2. Simpson Thacher represents Weight Watchers International and the other defendants in this action.

3. Please click here to read our prior discussion of the *Omnicare* decision.

"properly may assume" that those opinions "'convey facts about how the speaker has formed the opinion'—*i.e.*, facts 'about the speaker's basis for holding that view.'" The court stated that opinions that fail to disclose such facts "may mislead their audiences in violation of Rule 10b-5."

The court explained that "a plaintiff who asserts that the defendant omitted to state a fact (or facts) necessary to make a statement of opinion or belief 'not misleading' must 'call into question the issuer's basis for offering the opinion.'" Under the *Omnicare* standard, "a plaintiff 'cannot just say that the issuer failed to reveal [the] basis' for the opinion." To state a valid claim, the "plaintiff 'must identify particular (and material) facts going to the basis for the issuer's opinion—facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have—whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context."

Court Holds Plaintiffs Failed to State a Claim Based on Weight Watchers' Opinions Concerning Competition From Free Mobile Applications

Plaintiffs contended "Weight Watchers made false and misleading statements regarding the competitive pressure it faced from free mobile apps." The court found "the essence of the claim" turned on "Weight Watchers' opinion . . . that its intended differentiation of its own product from the free apps would offset the 'potential . . . additional pressure' exerted by the apps."

To state a claim based on this opinion, the court explained that plaintiffs had "to do more than merely allege that Weight Watchers was wrong when it stated that free mobile applications were not having a significant impact on its business." Rather, plaintiffs had "to allege sufficiently facts that, if true, plausibly could justify a conclusion that defendants either knew that their statements were false or, at least, that they had no reasonable basis for making them."

Plaintiffs had attempted to meet the *Omnicare* standard through confidential witness allegations. The court explained that confidential witness allegations "may be credited on a motion to dismiss" if (1) the allegations in the complaint "support the probability that a person in the position occupied by the source would possess the information alleged[,]" and (2) "the confidential witness statements relied upon . . . support the assertions based upon them." The court found plaintiffs' allegations did not meet this bar.

Court Holds Plaintiffs Failed to State a Claim as to Weight Watchers' Opinions Regarding the Extent of Software Transition-Related Problems

Plaintiffs also contended that "Weight Watchers made false and misleading statements by failing to disclose the alleged severity of disruption" caused by the company's transition to new software. Weight Watchers had disclosed the existence of software issues and explained that they were "in the process of being addressed." The court found the company's statements were opinions subject to the *Omnicare* standard.

To support their claim that the software-related opinions were misleading, plaintiffs relied on a confidential witness who stated that management was aware that the new software was "a complete disaster." The court deemed this "rather grandiose and hyperbolic assertion" to be "a characterization or opinion of the witness, not an objectively testable statement of fact." The court explained that "[o]ne person's 'complete disaster' is another's 'setback' or 'problem.'" Plaintiffs also quoted a second confidential witness who stated that a number of clients had left the Weight Watchers program due to "system glitches." The court found "the observation of 'system glitches' [was] not a sufficient basis for the accusation that the company lied about its view or that it lacked a reasonable basis for its statements of opinion."

The court determined plaintiffs' confidential witness allegations did not "suggest that either defendants did not actually believe (1) that the technical issues were being addressed . . ., or (2) those statements did not rest on a meaningful inquiry" as required under *Omnicare*.

Court Holds Plaintiffs Failed to State a Claim as to Weight Watchers' Growth Forecast for 2012

Finally, plaintiffs claimed "Weight Watchers' statements forecasting top line growth for 2012 . . . were false or misleading" because the company "knew that its online-only business was cannibalizing its traditional meetings business and that it was facing a 'material decline' in traditional meeting attendance that would not be reversed until it updated its 'PointsPlus diet plan.'" The court found Weight Watchers' growth forecasts to be "clear statement[s] of opinion."

Because Weight Watchers "disclosed its enrollment trends in public SEC filings," the court held plaintiffs could not "demonstrate . . . that Weight Watchers omitted material facts" that rendered its forecasts misleading. The court further noted that "the online business had significantly higher margins than the traditional business and that the margins for the online business continued to grow." The court found that "even if the online business was cannibalizing customers from the traditional business and the traditional meetings business was in decline," these trends would not "necessarily . . . be inconsistent with an optimistic growth forecast."

The court agreed with defendants that "there is nothing fraudulent about a disappointing year," and held plaintiffs' allegations concerning Weight Watchers' growth forecasts insufficient to meet the demands of *Omnicare*.

Delaware Supreme Court: When Transactions Are Approved by a Fully Informed Majority of Disinterested Stockholders, the Business Judgment Rule Applies and Plaintiffs' Claims Against Disinterested Directors Must Be Dismissed Absent a Showing of Waste

On May 6, 2016, the Delaware Supreme Court held that when transactions are approved by a fully informed majority of disinterested stockholders, the business judgment rule applies and plaintiffs' breach of the duty of care claims against the disinterested directors must be dismissed absent a showing of waste. *Singh v. Attenborough*, 2016 WL 2765312 (Del. 2016) (Strine, C.J.). The court made it clear that as a practical matter, the waste exception has "little real-world relevance" because stockholders would be unlikely to approve a wasteful transaction.

Background

On October 29, 2015, the Delaware Chancery Court held the business judgment rule standard of review applied to duty of care claims brought against Zale Corporation's directors in connection with its merger with Signet Jewelers Limited because a majority of Zale's disinterested stockholders approved the merger in a fully informed vote. *In re Zale Corp. Stockholders Litig.*, 2015 WL 6551418 (Del. Ch. 2015) (Parsons, V.C.) (*Zale*).

However, the court held plaintiffs could "rebut the [business judgment rule] presumption . . . by showing that it [was] reasonably conceivable" that Zale's directors were "grossly negligent." The court stated that "when reviewing a board of directors' actions during a merger process after the merger has been approved by a majority of disinterested stockholders in a fully informed vote, the standard for finding a breach of the duty of care under [the business judgment rule] is gross negligence."

The court held plaintiffs had "not alleged sufficient facts to make it reasonably conceivable that" Zale's directors breached their duty of care under the gross negligence standard. Finding no predicate breach of the duty of care, the court dismissed with prejudice plaintiffs' aiding and abetting claims against Zale's financial advisor, Merrill Lynch.

Plaintiffs appealed.

Delaware Supreme Court Affirms But Holds the Chancery Court Erred in Applying a Gross Negligence Standard to Plaintiffs' Duty of Care Claims

The Delaware Supreme Court affirmed the Chancery Court's October 29, 2015 decision insofar as the court held that that "a fully informed, uncoerced vote of the disinterested stockholders invoked the business judgment rule standard of review." However, the Delaware Supreme Court found the Chancery Court erred in applying a gross negligence standard to plaintiffs' breach of the duty of care claims. The Delaware Supreme Court explained that "[a]bsent a stockholder vote and absent an exculpatory charter provision, the damages liability standard for an independent director or other disinterested fiduciary for breach of the duty of care is gross negligence." The court reasoned that "employing this same standard after an informed, uncoerced vote of the disinterested stockholders would give no standard-of-review shifting effect to the vote."

The Delaware Supreme Court held that once "the business judgment rule standard of review is invoked because of a vote," plaintiffs' breach of the duty of care claims can only survive dismissal if plaintiffs allege waste. The court stated that as a practical matter, this "waste exception has long had little real-world relevance because it has been understood that stockholders would be unlikely to approve a transaction that is wasteful." The court explained that if the business judgment rule applies, "dismissal [of plaintiffs' breach of the duty of care claims] is typically the result."

The court found that dismissal was warranted in the case before it because there was "no rational argument that waste occurred."

Delaware Supreme Court Also Affirms Dismissal of Plaintiffs' Aiding and Abetting Claim Against the Board's Financial Advisor

The Delaware Supreme Court also considered plaintiffs' aiding and abetting breach of fiduciary duty claims against the Zale board's financial advisor, Merrill Lynch. The court first emphasized that "Delaware has provided advisors with a high degree of insulation from liability by employing a defendant-friendly standard that requires plaintiffs to prove scienter and awards advisors an effective immunity from due-care [aiding and abetting] liability."

However, the Delaware Supreme Court recognized that an exception to this "immunity from due care liability" applies in rare cases in which an advisor's own "bad-faith actions cause its board clients to breach their situational fiduciary duties (e.g., the duties *Revlon* imposes in a change-of-control transaction)." Citing its earlier decision in *RBC Capital Markets v. Jervis*, 129 A.3d 816 (Del. 2015),[4] the Delaware Supreme Court explained an advisor may be held liable for aiding and abetting if "its clients' actions were taken in good-faith reliance on misleading and incomplete advice tainted by the advisor's own knowing disloyalty."

In the case before it, the Delaware Supreme Court found no "rational basis to infer scienter" as to Merrill Lynch. The court emphasized that nothing in the record even came "close to approaching the sort of behavior at issue in *RBC*." The Delaware Supreme Court concluded the Chancery Court "properly dismissed" plaintiffs' aiding and abetting claims against Merrill Lynch.

4. Please click here to read our prior discussion of the *RBC* decision.

New York Court of Appeals: Adopting Delaware's *MFW* Standard, Court Holds Business Judgment Rule Applies to Going-Private Mergers Conditioned on Independent Committee Approval and the Informed Voluntary Vote of a Majority of Minority Stockholders

In *Kahn v M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (*MFW*), the Delaware Supreme Court held "business judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned *ab initio* upon both the approval of an independent, adequately-empowered [s]pecial [c]ommittee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders."[5]

On May 5, 2016, the New York Court of Appeals adopted the MFW standard for going-private mergers. *In re Kenneth Cole Productions S'holder Litig.*, 2016 WL 2350133 (N.Y. 2016) (Stein, J.) (*Kenneth Cole III*). The Court of Appeals found "the *MFW* standard properly considers the rights of minority shareholders . . . and balances them against the interests of directors and controlling shareholders in avoiding frivolous litigation and protecting independently-made business decisions from unwarranted judicial interference."

Background

In February 2012, Kenneth Cole proposed a going-private merger of Kenneth Cole Productions ("KCP"). At the time, Cole was KCP's majority shareholder and controlled approximately 89% of the shareholders' voting power. Cole made an initial offer of $15 per share, conditioned on approval by (1) a special committee of the board formed to consider Cole's going-private offer; and (2) a majority of the company's minority shareholders. Cole indicated that he would not approve any other type of merger, but stated that "his relationship with KCP would not be adversely affected" if either the special committee or the minority stockholders rejected the going-private merger offer.

The special committee retained independent counsel and its own financial advisor, but did not explore the possibility of any other transactions. After several months of negotiation, Cole increased his offer to $15.25 per share, which the special committee approved. Almost all of the minority stockholders also approved Cole's offer.

Certain stockholders brought suit alleging that Cole and the directors had breached their fiduciary duties to the minority shareholders. The trial court dismissed plaintiffs' complaint. *In re Kenneth Cole Productions S'holder Litig.*, 2013 WL 4767369 (N.Y. Sup. Ct. 2013). The court determined it was "bound by the business judgment rule" because there were no allegations of "specific unfair conduct by the special committee." The First Department affirmed, finding the trial court's application of the business judgment rule "appropriate" because there were "no allegations sufficient to demonstrate that the members of the board or the special committee did not act in good faith or were otherwise interested." *In re Kenneth Cole Productions S'holder Litig.*, 122 A.D.3d 500 (N.Y. App. Div. 2014). Plaintiffs appealed.

Court of Appeals Holds the Business Judgment Rule Applies to Going-Private Mergers Provided "Certain Shareholder Protective Conditions Are Met"

The New York Court of Appeals considered the question of "what standard should be applied by courts reviewing a going-private merger that is subject from the outset to approval by both a special committee of independent directors and a majority of the minority shareholders." *Kenneth Cole III*, 2016 WL 2350133. The court held the business judgment rule applies "as long as the corporation's directors establish that certain shareholder-protective conditions are met."

The Court of Appeals began its analysis by observing that it has "long adhered to the business judgment rule, which provides that, where corporate officers or directors exercise unbiased judgment in determining

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

that certain actions will promote the corporation's interests, courts will defer to those determinations if they were made in good faith." The court noted it has previously "held that the substantive determination of a committee of disinterested directors is beyond judicial inquiry under the business judgment rule." However, the Court of Appeals has also made it clear that courts may "inquire as to the disinterested independence of the members of that committee and as to the appropriateness and sufficiency of the investigative procedures chosen and pursued by the committee." *Id.* (quoting *Auerbach v. Bennett*, 393 N.E. 2d 994 (1979)).

The Court of Appeals found the standard set forth in the Delaware Supreme Court's *MFW* decision to be adequately "deferential to corporate boards" while still ensuring that "minority shareholders are sufficiently protected" in going-private mergers. Adopting the *MFW* standard, the Court of Appeals held the business judgment rule will apply to going-private mergers:

> *[I]f and only if:* (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.

Id. (quoting *MFW*, 88 A.3d 635). Under this standard, the court explained that a plaintiff alleging breach of fiduciary duty claims in connection with a going-private merger may only "proceed to discovery" if the plaintiff "alleges a 'reasonably conceivable set of facts' showing that any of the six enumerated shareholder-protective conditions did not exist." *Id.* (quoting *MFW*, 88 A.3d 635). In the event "the evidence demonstrates that any of the protections were not in place, then the business judgment rule is inapplicable and the entire fairness standard applies."

Court of Appeals Applies the Business Judgment Rule and Dismisses Plaintiffs' Claims

Turning to the case at hand, the Court of Appeals affirmed dismissal of plaintiffs' breach of fiduciary duty claims arising out of KCP's going-private merger. The court found "[p]laintiffs did not sufficiently and specifically allege that any of *MFW*'s six enumerated conditions were absent from the merger here," and therefore held the business judgment standard of review applied. "Pursuant to that standard," the court "defer[red] to the determinations of the special committee and the KCP board of directors in recommending and approving the merger." Because plaintiffs did not allege fraud or bad faith, the Court of Appeals held the complaint was "properly dismissed."

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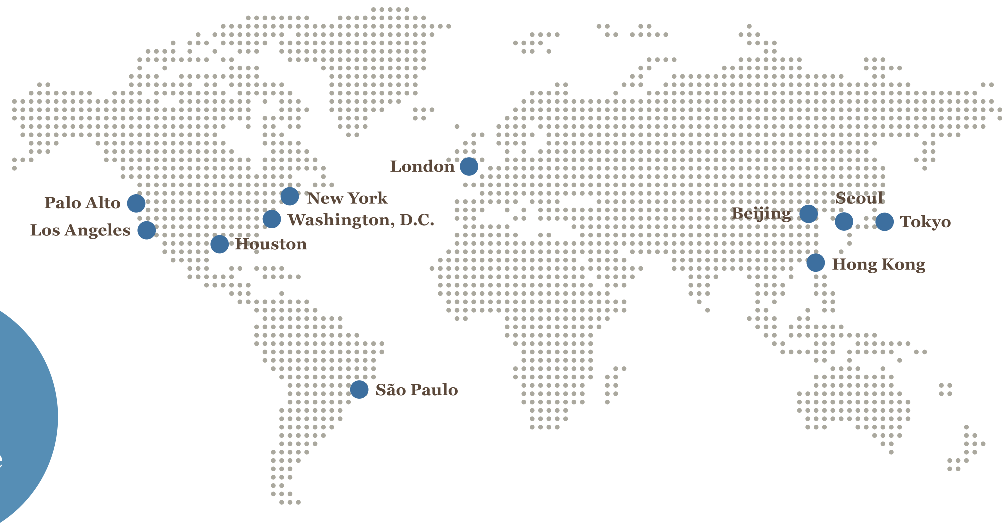

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