Simpson Thacher

Securities Law Alert

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Sixth Circuit: "Prudent-Process" Standard Applies to ERISA Claims Challenging Investment Decisions by Fiduciaries of Employee Stock Ownership Plans

On November 10, 2015, the Sixth Circuit applied a "prudent-process standard" in considering ERISA claims brought by investors in the GM Common Stock Fund, an employee stock ownership plan ("ESOP"), against State Street Bank, the ESOP's fiduciary. *Pfeil v. State Street Bank and Trust Company*, 2015 WL 6874769 (6th Cir. 2015) (Boggs, J.). The court found that plaintiffs had "failed to demonstrate a genuine issue of material fact concerning the methods of State Street's investigation of the merits of investing in GM, or the appropriateness of those methods," and therefore affirmed the district court's grant of summary judgment to State Street.

The Sixth Circuit further held that under the Supreme Court's decision in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014), "a plaintiff claiming that an ESOP's investment in a publicly traded security was imprudent must show special circumstances to survive a motion to dismiss."

Background

The purpose of the GM Common Stock Fund "was to enable [p]articipants to acquire an ownership interest in General Motors." It was one of various investment options offered to GM employees.

State Street, in its capacity as fiduciary of the GM Stock Fund, had in place "a formal, three-tiered structure and process for the exclusive purpose of monitoring and evaluating" the GM Stock Fund, as well as the other plans under State Street's management. Between January 2008 and March 31, 2009, GM's three committees discussed GM stock in the context of the GM Stock Fund 58 times. Notwithstanding "[e]vents in 2008 [that] imperiled GM's ability to continue as a going concern," State Street's Stock Review Committee "actively decided not to stop buying [GM stock for the GM Stock Fund], let alone to sell." However, the Stock Review Committee did "decide[ ] to maintain a level of internal scrutiny on the investment."

It was not until November 2008 that State Street ceased buying GM stock for the GM Stock Fund. On March 31, 2009, State Street made the decision to divest the plan of GM stock; that process was completed by April 24, 2009.

In June 2009, plaintiffs brought suit alleging that State Street had failed to manage the GM Stock Funds' assets prudently, as required under ERISA. In April 2014, the Eastern District of Michigan granted summary judgment to State Street based on the presumption of prudence set forth in *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995). Two months later, the Supreme Court in *Dudenhoeffer* held that ESOP fiduciaries are not entitled to a special presumption of prudence. The *Dudenhoeffer* Court stated that "the same standard of prudence applies to all ERISA fiduciaries, including ESOP fiduciaries, except that an ESOP fiduciary is under no duty to diversity the ESOP's holdings."

Following the Supreme Court's decision in *Dudenhoeffer*, plaintiffs appealed the district court's grant of summary judgment.

Sixth Circuit Applies a "Prudent-Process" Standard to State Street's Investment Decisions

On appeal, the Sixth Circuit explained that in light of *Dudenhoeffer*, it could not apply a presumption of prudence to State Street's investment decisions. The Sixth Circuit instead "evaluate[d] State Street's actions according to a prudent-process standard." The court stated that this test "'focus[es] ... on whether the fiduciary engaged in a reasoned decision-making *process*, consistent with that of a prudent man acting in a like capacity'" (quoting *Tatum v. RJR Pension Inv. Comm.*, 761 F.3d 346 (4th Cir. 2014)). The Sixth Circuit noted that "'courts have readily determined that fiduciaries who act reasonably—i.e., who appropriately investigate the merits of an investment decision prior to acting—easily clear this bar" (quoting *Tatum*, 761 F.3d 346 (emphasis added)).

Applying this "prudent-process" standard, the Sixth Circuit found that "State Street [had] discussed GM stock scores of times during the class period." The court pointed out that "State Street's Independent Fiduciary Committee [had] held more than forty meetings during the [c]lass [p]eriod of less than nine months to discuss whether to retain GM stock." In addition, State Street had sought the advice of outside legal and financial advisors in making its investment decisions. Given what the court found to be "the prudent process in which State Street engaged," the Sixth Circuit determined that plaintiffs had "failed to demonstrate a genuine issue as to whether State Street [had] satisfied its duty of prudence."

Significantly, the Sixth Circuit found "the mere fact that GM's stock value decreased after certain dates" on which State Street continued to hold GM stock did not "affect [the court's] judgment." The court emphasized that "State Street's decisions were not imprudent or unreasonable simply because it could have made a different decision in response to GM's financial difficulties." The Sixth Circuit explained that it had to "evaluate the prudence or imprudence of State Street's conduct as of 'the time it occurred,' not 'post facto.'"

Sixth Circuit Holds That a Plaintiff Asserting ERISA Claims Based on the Alleged Imprudence of an Investment in a Publicly-Traded Security Must Show "Special Circumstances" to Survive a Motion to Dismiss

In *Dudenhoeffer*, the Supreme Court stated that "where a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible as a general rule, at least in the absence of special circumstances." The Court explained that "a fiduciary usually is not imprudent to assume that a major stock market ... provides the best estimate of the value of the stocks traded on it that is available to him."

Relying on this language from the *Dudenhoeffer* opinion, the Sixth Circuit in *Pfeil* held that "a plaintiff claiming that an ESOP's investment in a publicly traded security was imprudent must show special circumstances to survive a motion to dismiss." The court noted that the Southern District of New York recently reached the same conclusion in *In re Citigroup ERISA Litig.*, 2015 WL 2226291 (S.D.N.Y. May 13, 2015) (interpreting *Dudenhoeffer* to find that

"fiduciaries may rely on the market price, absent any special circumstances affecting the reliability of the market price"). The Sixth Circuit reasoned that "[t]his rule accords with Modern Portfolio Theory (MPT)," which "rests on the understanding that organized securities markets are so efficient at discounting securities prices that the current market price of a security is highly likely already to impound the information that is known or knowable about the future prospects of that security."

Applying this "special circumstances" requirement, the Sixth Circuit deemed "implausible" plaintiffs' contention that "State Street's investment strategy [had] failed to function as a prudent process [because] it did not recognize 'that the market was over- or undervaluing' GM common stock." The court found that plaintiffs had "failed to show a special circumstance such that State Street should not have relied on market pricing" of GM stock in making its investment decisions.

The Sixth Circuit concluded that "State Street's actions were not actionably imprudent," and affirmed the district court's grant of summary judgment to State Street.

Judge White, Dissenting, Expresses Her View That an ESOP Fiduciary's Investment Decisions May Be Actionably Imprudent Even If the Fiduciary Conducted a Reasonable Investigation

In a dissenting opinion, Judge Helene N. White stated that "[o]ne can concede that the market is generally efficient in pricing stocks without concluding that all decisions to buy, sell or hold are therefore prudent." She wrote that "the fact that a stock's price accurately reflects the company's risk of failing does not mean that it is prudent to retain the stock as that possibility becomes more and more certain and buyers are willing to pay less and less for a stake in the upside potential."

With respect to the majority's finding that "the process employed by State Street was prudent as a matter of law," Judge White stated that she "might agree were it not for the fact that [p]laintiffs [had] presented evidence that the decision makers were operating under an incorrect standard." Judge White wrote that "[a] necessary part of a prudent decision-making process is the yardstick applied to the information yielded by prudent investigation and consideration."

Central District of California: Rule 14e-3's Contemporaneous Trading Requirement Can Be Met Even If (1) Defendants Did Not Purchase Stock Directly But Caused a Third Party to Purchase Stock; and (2) Defendants Traded Stock Options, Not Common Stock

Section 14(e) of the Securities Exchange Act and corresponding SEC Rule 14e-3 "prohibit[ ] trading while in possession of nonpublic information in connection with a tender offer." *Basile v. Valeant Pharmaceutical Int'l, Inc.*, 2015 WL 7352005 (C.D. Cal. 2015) (Carter, J.). "Private plaintiffs may bring an insider suit only if they traded 'contemporaneously' with the defendant" (quoting § 20A of the Exchange Act).

On November 9, 2015, the Central District of California held that the contemporaneous trading requirement for insider trading claims brought under Rule 14e-3 can be met even if defendants caused a third party to purchase stock and then traded with that third party, rather than buying stock in the market directly. The court further held that stock options are part of the "same class" of security as common stock for purposes of § 20A's contemporaneous trading requirement.

Background

On February 25, 2014, Valeant Pharmaceuticals International and hedge fund management company Pershing Square Capital Management, L.P., entered into a relationship agreement to pursue a merger between Valeant and Allergan. Over the next several months, a newly-created Pershing Square-owned entity, PS Fund 1, acquired 9.7% of Allergan's shares through a series of transactions, including over-the-counter call options executed through Nomura International plc, as well as through an equity forward contract between PS Fund 1 and Nomura.

On April 21, 2014, PS Fund 1 publicly disclosed its 9.7% stake in Allergan through a Schedule 13D filing. The following day, Valeant submitted an unsolicited merger offer to Allergan. On June 17, 2014, Valeant announced a tender offer for Allergan.

On December 16, 2014, plaintiffs who had sold Allergan common stock between February 25 and April 21, 2014 brought a securities fraud class action against various defendants, including Valeant, Pershing Square, and PS Fund 1. Among other claims, plaintiffs alleged that defendants had engaged in insider trading in violation of § 14(e) of the Securities Exchange Act and Rule 14(e)-3. Defendants moved to dismiss plaintiffs' claims on the grounds that, *inter alia*, plaintiffs could not meet § 20A's contemporaneous trading requirement for insider trading claims.[1]

Court Finds PS Fund 1's Private Trades with Nomura May Be Considered for Purposes of the Contemporaneous Trading Analysis Because PS Fund 1 Caused Nomura to Purchase Allergan Stock within the Meaning of Rule 14e-3

Defendants contended that PS Fund 1's trades with Nomura could not be considered for purposes of the contemporaneous trading analysis. The court found that the "limited authority on this issue suggest[ed] otherwise."

The court explained that "Rule 14e-3 prohibits an insider with nonpublic information related to a tender offer from purchasing '*or caus[ing] to be purchased* … any of such securities … unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise'" (quoting Rule 14e-3 (emphasis added)). The court determined that "under the plain language of Rule 14e-3 and the accompanying regulations, entities can be held liable for causing others to purchase securities on their behalf."

Here, the court found that plaintiffs alleged that "[d]efendants, using nonpublic information relating to a tender offer, deliberately caused Nomura to purchase Allergan stock on their behalf." While "[p]laintiffs may not have traded face-to-face with [d]efendants on the open market," the court explained that plaintiffs "could have traded directly with Nomura, who allegedly purchased Allergan stock at [d]efendants' behest." The court concluded that "[d]efendants' private trades with Nomura involving Allergan stock should be considered as part of the contemporaneous trading analysis."

In so holding, the court found persuasive the Central District of California's reasoning in *Johnson v. Aljian*, 257 F.R.D. 587 (C.D. Cal. 2009). The *Johnson* court rejected defendants' argument that their private stock sales with a bank should be excluded from the contemporaneous trading analysis for purposes of § 20A. The *Johnson* court reasoned that "if [d]efendants' argument were adopted as law, then all a person would need to do to avoid liability under § 20A would be to funnel sales of shares through a broker." The *Valeant* court found "the logic of *Johnson* directly applicable here," and emphasized that "individuals and entities should not be permitted to use third parties in order to avoid liability under the insider trading laws."

The *Valeant* court also deemed meritless defendants' contention that PS Fund 1's trades with Nomura should be excluded from the contemporaneous trading analysis because plaintiffs did "not allege a formal broker relationship between PS Fund 1 and Nomura." The court explained that Rule 14e-3 does not "require a formal agency relationship between the insider and the person or entity caused to purchase securities" on the insider's behalf.

The court found the allegations in the complaint sufficient for purposes of Rule 14e-3 to "establish [that] PS Fund 1 [had] used Nomura to acquire shares on its behalf." The court pointed to allegations that "PS Fund 1 [had] solely traded with Nomura to minimize its risk; Nomura [had] acted 'just like a broker' for PS Fund 1; and that [Pershing Square's CEO had] referred to these trades as 'our purchases.'" The court therefore determined that it could and should consider PS Fund 1's trades with Nomura for purposes of the contemporaneous trading analysis.

1. Section 20(A) provides that "[a]ny person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable … to any person who, *contemporaneously* with the purchase or sale of securities that is the subject of such violation, has purchased … or sold … securities *of the same class*" (emphasis added).

Court Finds the "Same Class" Element of the Contemporaneous Trading Requirement Met Even Though Plaintiffs Sold Common Stock While Defendants Purchased Stock Options

Defendants further argued that the contemporaneous trading requirement was not met because plaintiffs did not sell securities of the "same class" that defendants purchased, as required under § 20A. Defendants claimed that "since [p]laintiffs traded only in [Allergan] common stock, they [could not] establish standing based on PS Fund 1's purchase of [over the counter] options and equity forward contracts."

Rejecting this "narrow interpretation of the insider trading laws," the court found that "the correct reading of § 20(A) … is that plaintiffs who trade in common stock have standing to pursue insider trading claims against insiders who trade in stock options." The court noted that in *Clay v. Riverwood International Corp.*, 157 F.3d 1259 (11th Cir. 1998), the Eleventh Circuit explained that "[i]nsider trading in options could have a damaging effect on common stock" because "after exercising [a stock option], the investor must still sell his shares through the market in order to realize his profit." The *Valeant* court found that the Eleventh Circuit's analysis "[bore] directly" on the question of whether "stock options … should be considered part of the 'same class' as common stock." The *Valeant* court concluded that claims involving an insider's purchase or sale of stock options "should not be dismissed 'absent some evidence that the stock and options markets … [were] not part of interdependent markets.'"

Moreover, the court explained that even if it were to "[a]dopt[ ] [d]efendants' distinction between common stocks and options," it would still conclude that plaintiffs had standing based on allegations that "[d]efendants caused Nomura to purchase common stocks of Allergan on the open market."

The court therefore denied defendants' motion to dismiss plaintiffs' claims under § 14(e) and Rule 14(e)-3.

Delaware Chancery Court: Under *Corwin*, Business Judgment Rule Governs Transactions Approved by a Fully Informed Vote of a Majority of Disinterested Stockholders, and Plaintiffs Must Allege Gross Negligence to Survive Dismissal

On October 29, 2015, on a motion for reconsideration of *In re Zale Corp. S'holdrs. Litig.*, 2015 WL 5853693 (Del. Ch. 2015) (Parsons, V.C.) (*Zale I*) in light of the Delaware Supreme Court's decision in *Corwin v. KKR Financial Holdings LLC*, 2015 WL 5772262 (Del. Oct. 2, 2015) (Strine, C.J.) (*Corwin*), the Chancery Court dismissed claims alleging that Merrill Lynch had aided and abetted breaches of the duty of care by the directors of Zale in connection with its merger with Signet Jewelers. *In re Zale Corp. S'holdrs. Litig.*, 2015 WL 6551418 (Del. Ch. 2015) (Parsons, Jr., V.C.) (*Zale II*). The *Zale II* court concluded that it had "misapprehended the law" and "incorrectly applied" the *Revlon* enhanced scrutiny standard of review in *Zale I* rather than the business judgment rule standard of review in considering whether plaintiffs had pled any predicate duty of care breaches by Zale's directors.

The *Zale II* court further found that "under *Corwin* the gross negligence standard for a duty of care breach" applies and it was "not reasonably conceivable" that Zale's directors had "breached their duty of care by acting in a grossly negligent manner as to their engagement of Merrill Lynch."

Background

In *Zale I*, plaintiffs alleged, *inter alia*, that Zale's directors had breached their duty of care by failing to "act in an informed manner" when they retained Merrill Lynch to act as the board's financial advisor in connection with the company's merger with Signet, and further alleged that Merrill Lynch had aided and abetted those breaches. Merrill Lynch had represented to Zale's directors that it had "limited prior relationships and no conflicts with Signet," when "[i]n fact Merrill Lynch [had] received approximately $2 million in fees from Signet from 2012

to 2013." According to plaintiffs, prior to the board's retention of Merrill Lynch as its financial advisor, Merrill Lynch did not inform Zale's directors that the firm had made a presentation to Signet's CFO regarding a possible acquisition of Zale at a price of between $17 and $21 per share and that a Merrill Lynch managing director who served on the team presenting to Signet, also served on the team that advised the Zale board during the merger with Signet. Plaintiffs alleged that the Signet presentation was not disclosed to Zale's directors until after the merger agreement was signed.

In its October 1, 2015 decision, the Chancery Court determined that the *Revlon* enhanced scrutiny standard applied to plaintiffs' claims against Zale's directors even though the court found that a majority of Zale's disinterested stockholders had approved the merger in a fully informed vote. The *Zale I* court declined to follow the Chancery Court's approach in *In re KKR Financial Holdings LLC Shareholder Litigation*, 101 A.3d 980 (Del. Ch. 2014) (*KKR Financial*), which held that the business judgment rule governs transactions approved by a fully informed vote of a majority of disinterested stockholders. The *Zale I* court found that Delaware law on this issue was "unsettled." The *Zale I* court explained that "[u]ntil the Delaware Supreme Court signal[ed] otherwise," it would apply a "strict reading" of the Delaware Supreme Court's decision in *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009). The *Zale I* court interpreted *Gantler* as holding that "an enhanced standard of review cannot be pared down to the business judgment rule as a result of a statutorily required vote, even one rendered by a fully informed, disinterested majority of stockholders." The *Zale I* court "conclude[d] that where, as here, the merger consideration paid to the target company's shareholders [was] cash, *Revlon* enhanced scrutiny applie[d], even after the merger ha[d] been approved by a fully informed, disinterested majority of stockholders."

Turning to the allegations of the complaint, the court found it "reasonably conceivable" that the Zale directors' reliance "without question" on Merrill Lynch's representations regarding its prior relationship with Signet "could constitute a breach of their duty of care in this *Revlon* context." The *Zale I* court observed that in *In re Rural Metro Corp.*, 88 A.3d 54 (Del. Ch. 2014), Vice Chancellor Laster had underscored that given the "central role played by investment banks" in the transactional process, "directors must act reasonably to identify and consider the implications of the investment banker's … relationships, and potential conflicts." The *Zale I* court explained that "[i]n the context of detecting a preexisting conflict when engaging a financial advisor, this oversight duty could include negotiating for representations and warranties in the engagement letter as well as asking probing questions to determine what sorts of past interactions the advisor has had with known potential buyers, such as Signet here."

The *Zale I* court further determined that it was "reasonably conceivable" that the alleged failure by Merrill Lynch to disclose that it had previously made a presentation to Signet about a potential acquisition of Zale at a price between $17 and $21 per share had "hampered the ability of Merrill Lynch and, consequently, the Board to seek a higher price for Zale's stockholders."

While the *Zale I* court determined that Zale's Section 102(b)(7) exculpatory provision shielded Zale's directors from monetary liability for breaches of the duty of care, the court found that plaintiffs had adequately stated a claim against Merrill Lynch for aiding and abetting those breaches and therefore denied Merrill Lynch's motion to dismiss plaintiffs' claims.

Merrill Lynch Moves for Reconsideration Following the Delaware Supreme Court's Decision in *Corwin*

The day after the *Zale I* court issued its decision, the Delaware Supreme Court affirmed the Chancery Court's approach in *KKR Financial*. The Delaware Supreme Court held in *Corwin* that "when a transaction not subject to the entire fairness standard is approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies." The *Corwin* court also clarified that *Gantler* did not focus on "the question of what standard of review applies if a transaction not subject to the entire fairness standard is approved by an informed, voluntary vote of disinterested stockholders."

Merrill Lynch subsequently moved for reconsideration of the Chancery Court's

decision in *Zale I*. Merrill Lynch contended that the court should have applied the business judgment rule standard of review rather than the *Revlon* enhanced scrutiny standard when determining whether plaintiffs had adequately alleged a predicate breach of the duty of care by Zale's directors. In a letter opinion dated October 29, 2015, the Chancery Court granted Merrill Lynch's motion for reconsideration.

Chancery Court Finds Gross Negligence Is the Standard for Duty of Care Claims in Transactions Approved by a Fully Informed Majority of Disinterested Stockholders

On reconsideration in light of *KKR II*, the Chancery Court in *Zale II* determined that the business judgment rule was the appropriate standard of review given that a majority of Zale's disinterested stockholders had approved the merger in a fully informed vote.

The *Zale II* court then considered the appropriate standard of review for rebutting the business judgment presumption and finding a breach of the duty of care in cases where, as here, "the merger has been approved by a majority of disinterested stockholders in a fully informed vote." The *Zale II* court noted that in *KKR Financial*, Chancellor Bouchard stated that "the business judgment rule applies and insulates the transaction from all attacks other than on the grounds of waste." However, the *Zale II* court found that in *Corwin*, the Delaware Supreme Court "suggested that 'the gross negligence standard for director due care liability under *Van Gorkom*' is the proper standard for evaluating 'post-closing money damages claims'" (quoting *Corwin*, 2015 WL 5772262). The *Zale II* court also observed that in *In re TIBCO Software, Inc. Stockholders Litigation*, 2015 WL 6155894 (Del. Ch. Oct. 20, 2015) (*TIBCO*), a post-*Corwin* decision, the Chancery Court had applied a gross negligence standard in considering a motion to dismiss breach of the duty of care claims.

The *Zale II* court "conclud[ed] 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 *Zale II* court explained that in order "[t]o support an inference of gross negligence, 'the decision has to be so grossly off-the-mark as to amount to reckless indifference or a gross abuse of discretion'" (quoting *Solash v. Telex Corp.*, 1988 WL 3587 (Del. Ch.1988)). The *Zale II* court emphasized that "gross negligence 'requires the articulation of facts that suggest a wide disparity between the process the directors used … and [a process] which would have been rational'" (quoting *TIBCO*, 2015 WL 6155894).

Chancery Court in *Zale II* Dismisses Aiding and Abetting Claims Against Merrill Lynch Because There Were No Allegations That Zale's Directors Had Been "Grossly Negligent"

Applying this standard to the allegations of the complaint, the *Zale II* court determined that it was "not reasonably conceivable that the Zale [d]irector [d]efendants [had] breached their duty of care by acting in a grossly negligent manner as to their engagement of Merrill Lynch." Since the court found "no basis for a predicate fiduciary duty breach," the court held that "the [c]omplaint also fail[ed] to allege that Merrill Lynch [had] aided and abetted such a breach."

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Los Angeles

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

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

Palo Alto

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

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

Washington, D.C.

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

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

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

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

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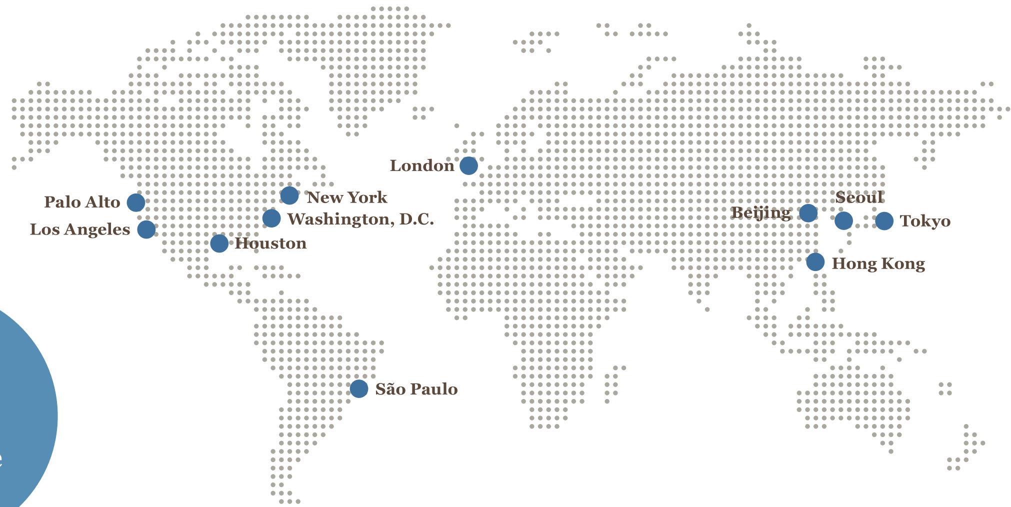

UNITED STATES

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