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This month's Alert addresses three decisions from the Second Circuit: one holding that price recovery does not defeat an inference of economic loss in securities fraud suits; another ruling that the SEC need not establish proximate causation in aiding and abetting actions brought under Section 20(e); and a third finding that an investor in a collateralized debt obligation ("CDO") was a third-party beneficiary of the CDO's portfolio management agreement.

We also discuss a Southern District of New York decision relying on *Fait v. Regions Financial Corp.*, 655 F.3d 105 (2d Cir. 2011) (Parker, J.) to dismiss a securities fraud suit against Deutsche Bank. In addition, we address a ruling from the Supreme Court of Pennsylvania holding that Section 1105 of Pennsylvania's Business Corporation Law precludes post-merger remedies other than appraisal except in cases of fraud or fundamental unfairness. Finally, we cover a First Department of New York opinion adopting Delaware's test for determining whether a claim is direct or derivative.

The Second Circuit Holds That Price Recovery Does Not Defeat an Inference of Economic Loss in Securities Fraud Suits

On August 1, 2012, the Second Circuit "consider[ed] whether the fact that a stock's share price recovered soon after the fraud became known defeats an inference of economic loss in a securities fraud suit." *Acticon AG v. China North East Petroleum Holdings Ltd.*, 2012 WL 3104589, at *1 (2d Cir. Aug. 1, 2012) (Straub, J.). Holding that "price recovery does not defeat an inference of economic loss[,]" the Second Circuit vacated dismissal of a securities fraud suit against China North Petroleum Holdings Limited ("NEP") where NEP's stock price had rebounded after the final alleged corrective disclosure.

Background

The plaintiffs contended that "beginning on May 15, 2008, NEP [had] misled investors regarding the financial health and prospects of the company." *Id.* Specifically, the plaintiffs alleged that "NEP [had] inflated its proven oil reserves and did not account for certain warrants … in accordance with Generally Accepted Accounting Principles ('GAAP')." *Id.* In addition, the plaintiffs claimed that "NEP's former CEO and his mother [had] transferred funds from the company's corporate coffers into their own accounts." *Id.* The plaintiffs alleged that "this information gradually became public [through

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a number of corrective disclosures] as NEP was required to withdraw its financial statements and revise its prior earnings downwards." *Id*. "NEP's stock price fell sharply in the days following each of these disclosures." *Id*.

The lead plaintiff had purchased a total of 60,000 NEP shares at an average price of $7.25 per share, and "held all 60,000 shares for months after the final allegedly corrective disclosure was made on September 1, 2010." *In re China North East Petroleum Holdings Ltd. Sec. Litig.*, 819 F. Supp. 2d 351, 353 (S.D.N.Y. 2011) (Cedarbaum, J.) (*China North I*). "On twelve days between October and November 2010, NEP stock closed at a price higher than $7.25." *Id*. "Had [the lead plaintiff] chosen to sell on those post-disclosure dates, it would have turned a profit." *Id*. However, the lead plaintiff instead sold a portion of its NEP stock between December 2010 and May 2011, at prices ranging from $3.50 to $6.33.

On October 6, 2011, the Southern District of New York dismissed the plaintiffs' claims for failure adequately to allege economic loss. *Id*. at 354. The *China North I* court explained that since the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) (Breyer, J.), "courts have held as a matter of law that a purchaser suffers no economic loss if he holds stock whose post-disclosure price has risen above the purchase price—even if that price had initially fallen after the corrective disclosure was made." *Id*. at 352. The plaintiffs appealed.

The Second Circuit Holds That A Plaintiff Can Suffer Economic Loss Even If the Stock Price Later Rebounds to the Plaintiff's Purchase Price

At the outset of its analysis, the Second Circuit emphasized that the Supreme Court's holding in *Dura* was "by its own terms … quite limited." *China North II*, 2012 WL 3104589, at *5. The *Dura* Court did "not alter or abandon the traditional out-of-pocket measure for damages." *China North II*, 2012 WL 3104589, at *6. "Rather, the Court merely clarified that a securities fraud plaintiff who purchased stock at an inflated price must still prove that she suffered an economic loss, and that that loss was proximately caused by [the] defendant's misrepresentation." *Id*. The *Dura* Court explained that "as a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that *at that instant* possesses equivalent value." *Dura*, 544 U.S. at 342.

In a line of cases beginning with *Malin v. XL Capital Ltd.*, 2005 WL 2146089 (D. Conn. Sept. 1, 2005) (Dorsey, J.), courts have relied on *Dura* to hold that "a securities fraud plaintiff suffers no economic loss if the price of the stock rebounds to the plaintiff's purchase price at some point after the final alleged corrective disclosure." *China North II*, 2012 WL 3104589, at *4. The *Malin* court reasoned that "a price fluctuation without any realization of an economic loss is functionally equivalent to the Supreme Court's rejection of an artificially inflated purchase price alone as economic loss." *Malin*, 2005 WL 214608, at *4.

The Second Circuit found the *Malin* court's rationale to be "inconsistent with [both] the traditional out-of-pocket measure of damages, which calculates economic loss based on the value of the security at the time that the fraud became known," and the "bounce-back provision" set forth in the Private Securities Litigation Reform Act ("PSLRA"), "which refines the traditional measure by capping recovery based on the mean [share] price over [a 90-day] look-back period."

China North, 2012 WL 3104589, at *6.

Moreover, the Second Circuit observed that "a share of stock that has regained its value over a period of decline is not functionally equivalent to an inflated share that has never lost value." *Id.* "This analysis takes two snapshots of the plaintiff's economic situation and equates them without taking into account anything that happened in between; it assumes that if there are any intervening losses, they can be offset by intervening gains." *Id.* The Second Circuit found that "it is improper to offset gains that the plaintiff recovers after the fraud becomes known against losses caused by the revelation of the fraud if the stock recovers value for completely unrelated reasons." *Id.* "Such a holding would place the plaintiff in a worse position than he would have been absent the fraud." *Id.*

The Second Circuit explained that "[i]n the absence of fraud, the plaintiff would have purchased the security at an uninflated price and would also have benefited from the unrelated gain in stock price." *Id.* "If we credit an unrelated gain against the plaintiff's recovery for the inflated purchase price, he has not been brought to the same position as a plaintiff who was not defrauded because he does not have the opportunity to profit (or suffer losses) from 'a second investment decision unrelated to his initial decision to purchase the stock.'" *Id.* (quoting *Harris v. Am. Inv. Co.*, 523 F.2d 220, 228 (8th Cir. 1975) (Bright, J.), *cert. denied*, 423 U.S. 1054 (1976)).

Finally, the Second Circuit noted that it was "aware of no circuit court or Supreme Court decision imposing the economic-loss rule embraced by *Malin*." *Id.* The court also found it "significant" that the PSLRA "did not impose the limitation on damages favored by Malin." *Id.*

The Court Finds The Complaint Adequately Pleads Economic Loss

On appeal, NEP contended that the plaintiffs had "failed to plead economic loss as a matter of law" because NEP's "stock price rose higher than [the lead plaintiff's] average purchase price on various dates in the months following the close of the class period[.]" *Id.* at *2. NEP argued that "the rebound in share price demonstrate[d] that the market was so unfazed by the alleged corrective disclosures, so the disclosures were unrelated to [the lead plaintiff's] ultimate loss." *Id.* at *5.

The Second Circuit found that "[a]t this stage in the litigation," it could not determine "whether the price rebounds represent[ed] the market's reactions to the disclosure of the alleged fraud or whether they represent[ed] unrelated gains." *Id.* at *7. "[D]rawing all reasonable inferences in favor of [the lead plaintiff]," the Second Circuit "assume[d] that the price rose for reasons unrelated to its initial drop." *Id.* at *5. "Accordingly," the Second Circuit held that "the recovery [did] not negate the inference that [the lead plaintiff] ha[d] suffered an economic loss." *Id.* at *7.

The Second Circuit Did Not Rule on the Applicable Pleading Standard for Allegations of Economic Loss

The Second Circuit noted that the "Circuits have split in the wake of *Dura* as to which [pleading standard] applies to loss causation." *Id.* at *3. "The

Fourth Circuit has held that heightened pleading requirements of Rule 9(b) apply to the element of loss causation because it is 'among the circumstances constituting fraud.'" *Id.* (quoting *Katyle v. Penn Nat'l Gaming, Inc.*, 637 F.3d 462, 471 & n. 5 (4th Cir. 2011) (Baldock, J.)). "The Fifth Circuit, in contrast, has held that only the requirements of Rule 8(a)(2) apply[.]" *Id.* (citing *Lormand v. U.S. Unwired, Inc.*, 565 F.3d 228, 256-58 (5th Cir. 2009) (Dennis, J.)). "And the Ninth Circuit has recognized that ambiguity exists regarding which pleading standard applies, but has found it unnecessary to resolve which standard applies because in each case where it could address the issue, either pleading standard was satisfied." *Id.* (citing *WPP Lux. Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1053-1054 (9th Cir. 2011) (Gwin, J.); *In re Gilead Scis. Sec. Litig.*, 536 F.3d 1049, 1056 (9th Cir. 2008) (Hawkins, J.)).

Finding that "the price fluctuations here would not rebut an inference of economic loss under either standard," the Second Circuit determined that it was "unnecessary to resolve" the question of which pleading standard applies to allegations of economic loss. *Id.*

The Second Circuit Holds That the SEC Need Not Establish Proximate Causation in Aiding and Abetting Actions Brought Under Section 20(e)

On August 8, 2012, the Second Circuit "clarif[ied] that, in enforcement actions brought under [Section 20(e)], the SEC is not required to plead or prove that an aider and abettor proximately caused the primary securities law violation." *SEC v. Apuzzo*, 2012 WL 3194303, at *7 (2d Cir. Aug. 8, 2012) (Rakoff, J.) (*Apuzzo II*).[1]

Background

"Section 20(e) of the Securities Exchange Act of 1934 allows the SEC, but not private litigants, to bring civil actions against aiders and abettors of securities fraud." *Id.* at *6. "The SEC may bring such an action against 'any person that knowingly provide[d] substantial assistance' to a primary violator of the securities laws." *Id.* (quoting 15 U.S.C. § 78t(e)). In order to state an aiding and abetting claim under Section 20(e), the SEC must plead "(1) the existence of a securities law violation by the primary (as opposed to the aiding and abetting) party; (2) 'knowledge' of this violation on the part of the aider and abettor; and (3) 'substantial assistance' by the aider and abettor in the achievement of the primary violation." *SEC v. DiBella*, 586 F.3d 553, 566 (2d Cir. 2009) (Wesley, J.) (quoting *Bloor v. Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57, 62 (2d Cir. 1985) (Meskill, J.)).

Here, the SEC claimed that "defendant Joseph Apuzzo [had] aided and abetted securities law violations through his role in a fraudulent accounting scheme." *Apuzzo II*, 2012 WL 3194303, at *1. Allegedly "with Apuzzo's assistance," United Rentals, Inc. ("URI") and its chief financial officer "carried out

1. The Honorable Jed S. Rakoff of the Southern District of New York was "sitting by designation" on the Second Circuit for purposes of this ruling. *Id.* at *1 n.*.

two fraudulent 'sale-leaseback' transactions" that were "designed to allow URI to 'recognize revenue prematurely and to inflate the profit generated from URI's sales.'" *Id.* at *2. Apuzzo's role in the alleged scheme included "execut[ing] various agreements that disguised URI's continuing risks and financial obligations" and "approv[ing] inflated invoices[.]" *Id.*

The District of Connecticut "concluded that the SEC had adequately alleged [Apuzzo's] actual knowledge of the violation." *Id.* at *5. For example, the court found that the SEC's allegations "support[ed] a conclusion that … Apuzzo knew that the results from the transactions would be inaccurately reflected in URI's financial statements if the true structure of the transactions was not known to URI's auditor[.]" *SEC v. Apuzzo*, 758 F. Supp. 2d 136, 148 (D. Conn. 2010) (Thompson, J.). However, "the district court found that the SEC had not adequately alleged substantial assistance." *Apuzzo II*, 2012 WL 3194303, at *5. "Specifically, the district court held that the 'substantial assistance' component required that the aider and abettor proximately cause the harm on which the primary violation was predicated," and found that the SEC's complaint "did not plausibly allege such proximate causation." *Id.* at *1. The SEC appealed.

The Court Determines That Proximate Causation Is Not a Requirement for Pleading "Substantial Assistance"

Because Apuzzo did not contest the district court's finding with respect to the "actual knowledge" allegations, "the only disputed question on appeal [was] whether the facts alleged plausibly [pled] that Apuzzo [had] substantially assisted the primary violator in committing the fraud." *Id.* at *6.

In considering the "substantial assistance" requirement, the Second Circuit turned to "the well-developed law of aiding and abetting liability in criminal cases." *Id.* The *Apuzzo II* court reasoned that "if the conduct of an aider and abettor is sufficient to impose criminal liability, *a fortiori* it is sufficient to impose civil liability in a government enforcement action." *Id.*

The Second Circuit noted that "[n]early seventy-five years ago, Judge Learned Hand famously stated that in order for a criminal defendant to be liable as an aider and abettor, the Government … must [ ] prove 'that he in some sort associate[d] himself with the venture, that [the defendant] participate[d] in it as something that he wishe[d] to bring about, [and] that he [sought] by his action to make it succeed.'" *Id.* (quoting *United States v. Peoni*, 100 F.2d 401, 402 (2d. Cir. 1938) (Hand, J.)). "The Supreme Court later adopted Judge Hand's formulation." *Id.* (citing *Nye & Nissen v. United States*, 336 U.S. 613, 619 (1949) (Douglas, J.)).

The Second Circuit found Judge Hand's standard to be "clear, concise, and workable," and held that it is "the appropriate standard for determining the substantial assistance component of aider and abettor liability in an SEC civil enforcement action[.]" *Id.* at *6-7. Notably, the Second Circuit rejected Apuzzo's contention "that substantial assistance should … be defined as proximate cause[.]" *Id.* at *6. The court explained that this "argument ignores the difference between an SEC enforcement action and a private suit for damages." *Id.* "'Proximate cause' is the language of private tort actions; it derives from the need of a private plaintiff, seeking compensation, to show that

his injury was proximately caused by the defendants' actions." *Id*. "But, in an enforcement action, civil or criminal, there is no requirement that the government prove injury, because the purpose of such actions is deterrence, not compensation." *Id*.

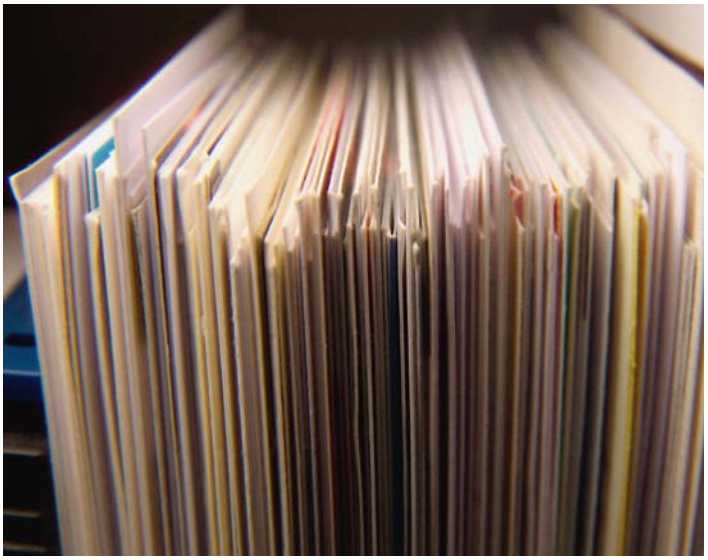
The Second Circuit further explained that "the statute under which the SEC here proceeds, 15 U.S.C. § 78t(e), was passed in the wake of [*Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (Kennedy, J.)] to allow the SEC to pursue aiders and abettors who, under the reasoning of *Central Bank*, were not themselves involved in the making of the false statements that proximately caused the plaintiffs' injuries." *Id*. at *7. "This statutory mandate would be undercut if proximate causation were required for aider and abettor liability in SEC enforcement actions." *Id*. Because "the activities of an aider and abettor are rarely the direct cause of the injury brought about by the fraud," the Second Circuit found that "most aiders and abettors would escape all liability if such a proximate cause requirement were imposed[.]" *Id*.

The Complaint Adequately Alleges Apuzzo's "Substantial Assistance"

Applying Judge Hand's standard for aider and abettor liability, the Second Circuit found it "clear that the [c]omplaint plausibly alleges that Apuzzo [had] provided substantial assistance to the primary violator in carrying out the fraud[.]" *Id*. at *8. "Apuzzo associated himself with the venture, participated in it as something that he wished to bring about, and sought by his action to make it succeed." *Id*.

The Second Circuit also took into account Apuzzo's "high degree of actual knowledge of the primary violation (the second component of aiding and abetting)" when considering whether he rendered "substantial assistance." *Id*. The court explained that "the three components of the aiding and abetting test 'cannot be considered in isolation from one another.'" *Id*. (quoting *DiBella*, 587 F.3d at 566). "Where, as here, the SEC plausibly alleges a high degree of actual knowledge, this lessens the burdens it must meet in alleging substantial assistance." *Id*.

The Second Circuit found that "[i]t is particularly appropriate to consider the degree of scienter in evaluating substantial assistance in light of the test for substantial assistance" based on Judge Hand's standard for aider and abetter liability. *Id*. at *9. "[I]f a jury were convinced that the defendant had a high degree of actual knowledge about the steps he was taking and the role those steps played in the primary violation, they would well be justified in concluding that the defendant's actions, which perhaps could be viewed innocently in some contexts, were taken with the goal of helping the fraud succeed." *Id*.



"In sum," the Second Circuit "conclude[d] that the [c]omplaint should not have been dismissed because it adequately alleged that Apuzzo [had] aided and abetted the primary violator in carrying out his fraudulent scheme." *Id*. at *11. The Second Circuit reversed the district court's opinion and remanded for further proceedings consistent with its opinion.

The Second Circuit Holds That a CDO Investor Was a Third-Party Beneficiary of the CDO's Portfolio Management Agreement

On August 6, 2012, the Second Circuit considered "whether an investor in a special investment vehicle—a synthetic collateralized debt obligation ('CDO') that sold interests in a credit default swap—[could] bring an action against the manager of the investment portfolio for the loss of its investment where the investor was not a party to the contract that defined the manager's roles and duties." *Bayerische Landesbank, New York Branch v. Aladdin Capital Mgmt. LLC*, 2012 WL 3156441, at *1 (2d Cir. Aug. 6, 2012) (Rakoff, J.).[2] Based on the allegations in the complaint, the Second Circuit found it "more than plausible" that "the parties intended the [portfolio management agreement] to inure to the benefit of" investors in the CDO and therefore permitted the investors to proceed with their breach of contract claims against the portfolio manager. *Id*. at *11.

Background

In December 2006, Bayerische Landesbank and Bayerische Landesbank New York Branch (collectively, "Bayerische") invested $60 million in a CDO "structured and marketed by" Aladdin Capital Management LLC, Goldman Sachs & Co. and Goldman Sachs International. *Id*. at *1. Aladdin "manag[ed] the CDO as an independent investment manager on behalf of" purchasers of interests in the CDO (the "Noteholders"). *Id*. at *3. In a marketing book provided to Bayerische, Aladdin allegedly "represented that its interests were aligned with investors' interests in the CDO and that it would manage the [CDO's] Reference Portfolio in 'a conservative and defensive manner' to avoid losses to the Noteholders[.]" *Id*. at *12. "Aladdin's formal responsibilities, however, were spelled out in the Portfolio Management Agreement ('PMA'), an agreement between Aladdin and [the shell entity that issued the CDO notes] that was not signed by the Noteholders." *Id*. at *3. Bayerische "did not enter into any direct contract with Aladdin." *Id*.

"[F]ollowing the issuance of the Aladdin CDO on December 19, 2006, Aladdin [allegedly] managed the portfolio in a grossly negligent fashion, … thereby causing [Bayerische's] Notes to default." *Id*. "As a result, [Bayerische] lost [its] entire $60 million principal investment and any future interest from the remaining four years of the CDO term." *Id*. Bayerische subsequently brought suit against Aladdin "assert[ing] two claims: (1) a claim in contract alleging that Aladdin [had] breached its obligations under the PMA; and (2) a claim in tort alleging that Aladdin's conduct was grossly negligent, resulting in harm to the Noteholders." *Id*. at *4. Bayerische did not name Goldman Sachs & Co. or Goldman Sachs International as defendants in the suit.

On July 8, 2011, the Southern District of New York granted Aladdin's motion to dismiss the complaint. "The district court held that because of a provision of the [PMA] limiting intended third-party beneficiaries

2. The Honorable Jed S. Rakoff of the Southern District of New York was "sitting by designation" on the Second Circuit for purposes of this ruling. *Id*. at *1 n*.

to those 'specifically provided herein,' [the] plaintiffs could not bring a third-party beneficiary breach of contract claim, and held also that [the] plaintiffs could not 'recast' their failed contract claim in tort." *Id.* at *1. Bayerische appealed.

The Allegations Plausibly Indicate that the Parties Intended the PMA to Benefit the Noteholders

The Second Circuit noted that "[t]he PMA is governed by New York law." *Id.* at *8. "Under New York law, a third party may enforce a contract when 'recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and … the circumstances indicate that the promise intends to give the beneficiary the benefit of the promised performance.'" *Id.* (quoting *Levin v. Tiber Holding Corp.*, 277 F.3d 243, 248 (2d Cir. 2002) (Jacobs, J.)). "In determining whether the parties intended to benefit the third party, a court 'should consider the circumstances surrounding the transaction as well as the actual language of the contract.'" *Id.* (quoting *Subaru Distribs. Corp. v. Subaru of Am., Inc.*, 425 F.3d 119, 124 (2d Cir. 2005) (Gibson, J.)).

Aladdin contended that "section 29 of the PMA expressly rules out any intent to benefit the Noteholders." *Id.* Section 29 provides in relevant part as follows:

> *Beneficiaries*[:] This Agreement is made solely for the benefit of the Issuers and the Portfolio Manager, their successors and assigns, and no other person shall have any right, benefit or interest under or because of this Agreement, *except as otherwise specifically provided herein*.

Id. (quoting PMA § 29) (emphasis added by the court). The Second Circuit found that "[o]n its face," it was not clear that "section 29 precludes an intent by the parties to benefit the Noteholders." *Id.* at *9. "The 'herein' in 'except as otherwise specifically provided herein' is not defined." *Id.* "While it might be read to refer, as Aladdin argues, to only section 29, it could just as reasonably be read to refer, as Bayerische argues, to the PMA as a whole." *Id.* The Second Circuit found that "the latter interpretation seems more likely." *Id.*

"[L]ook[ing] beyond section 29 to the contract as a whole[,]" the Second Circuit found that "other portions of the PMA evince an intent to benefit the Noteholders by defining Aladdin's obligations and delineating the scope of its liability to the Noteholders." *Id.* at *10. "For example, section 6 of the PMA states that 'the Portfolio Manager shall use all reasonable efforts to ensure that [it takes no action that would] … adversely affect the interest of the holders of the Notes in any material respect (other than as permitted under the Transaction Documents).'" *Id.* "Even more tellingly, section 8 of the PMA, entitled 'Benefit of this Agreement; Limit on Liability,' states in relevant part:

> The Portfolio Manager shall perform its obligations hereunder in accordance with the terms of this Agreement and the terms of the Transaction Documents applicable to it. The Portfolio Manager agrees that such obligations shall be enforceable at the insistence of each Issuer, the Trustee on behalf of the holders of the relevant Notes, or the requisite percentage of holders of the relevant Notes on behalf of themselves, as provided in the relevant Indenture.

Id. (quoting PMA § 8). The Second Circuit found that "[t]ogether, these sections plausibly demonstrate an intent to benefit the Noteholders." *Id.*

"Drawing all inferences in favor of the plaintiff[s]," the Second Circuit determined that "a plausible reading of the parties' [a]greement is that the PMA expressly requires the Portfolio Manager to perform various obligations—including managing the Reference Portfolio—on behalf of the Noteholders."

Id. "The limitations on liability that discuss the Noteholders suggest that the parties intended that the Noteholders be able to sue Aladdin directly, albeit only for acts of gross negligence." *Id*. Moreover, the Second Circuit noted that other "allegations set forth in the [complaint] regarding Bayerische's decision to invest in the CDO" also reflected the parties' intent that the PMA benefit Noteholders such as Bayerische. *Id*. at *12.

"In short," the court found it "more than plausible that the parties intended the PMA to inure to the benefit of the Noteholders." *Id*. at *11. The Second Circuit "therefore conclude[d] that the district court [had] erred in dismissing [the plaintiff's] contract claim." *Id*. at *14.

The Complaint Adequately Alleges That Aladdin Owed a Duty of Care to the Noteholders

The Second Circuit "turn[ed] then to Bayerische's second, alternative claim: that Aladdin [had] breached a duty of care, in tort, to the Noteholders, by engaging in acts that amounted to gross negligence in its management of the [CDO's] Reference Portfolio." *Id*. at *14. "Under New York law, a breach of contract will not give rise to a tort claim unless a legal duty independent of the contract itself has been violated." *Id*. "Such a 'legal duty must spring from circumstances extraneous to, and not constituting elements of, the contract, although it may be connected with and dependent on the contract." *Id*. (quoting *Clark-Fitzpatrick v. Long Island R.R. Co.*, 70 N.Y.2d 382, 389 (1987) (Alexander, J.)).

The Second Circuit found that "in light of Bayerische's allegations that it [had] detrimentally relied on Aladdin's representations of how it would select the Reference Portfolio and manage the Portfolio for the life of the CDO, Bayerische ha[d] sufficiently established that '[a] legal duty independent of contractual obligations may be imposed by law as an incident to the parties' relationship' in this case." *Id*. at *15 (quoting *Sommer v. Fed. Signal Corp.*, 79 N.Y.2d 540, 551 (1992) (Kaye, J.)). "This legal duty, though *assessed* largely on the standard of care and the other obligations set forth in the contract, would *arise* out of the independent characteristics of the relationship between Bayerische and Aladdin, and the circumstances under which Bayerische purchased the Notes linked to the [CDO's] Reference Portfolio that Aladdin, under the PMA, was to manage." *Id*.

"This conclusion is not the end of our inquiry," the Second Circuit explained. *Id*. "Under New York law, in the absence of privity, the scope of the 'orbit of duty' to third parties must be carefully examined[.]" *Id*. The Second Circuit "consider[ed], in particular, the requirements for recognizing liability of professionals to third parties that New York courts have developed in the analogous context of negligent misrepresentation claims." *Id*. Under the test set forth in *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536 (1985) (Jasen, J.), "a plaintiff must establish that (1) the defendant had awareness that the work was to be used for a particular purpose; (2) there was reliance by a third party known to the defendant in furtherance of that purpose; and (3) there existed some conduct by the defendant linking it to that known third party evincing the defendants' understanding of the third party's reliance." *Id*. The

Second Circuit determined that "a plaintiff that can satisfy these requirements will … also be within the limits established under New York law for tort claims sounding in negligence that are brought by non-privy third parties." *Id*.

"Here," the Second Circuit found that "Bayerische ha[d] plausibly alleged facts sufficient to meet the test of *Credit Alliance* and its precursors." *Id*. at *16. "Bayerische ha[d] properly alleged that (1) Aladdin was aware that the PMA had the particular purpose of installing Aladdin as the Portfolio Manager to manage the [CDO's] Reference Portfolio on behalf of the Noteholders; (2) Bayerische was known to Aladdin and relied on Aladdin to perform its obligations pursuant to the PMA; and (3) Aladdin's conduct in soliciting Bayerische's investment and its representation that it would manage the CDO in Bayerische's favor evinced an understanding by Aladdin that Bayerische would rely on its performance." *Id*. "Thus," the Second Circuit held that "Bayerische ha[d] properly alleged a relationship between Aladdin and the Noteholders sufficiently close that recognizing a duty running from Aladdin to Bayerische would not offend the limitations imposed by New York law on tort liability to non-privy third parties." *Id*.

The Second Circuit reversed the district court's dismissal of Bayerische's complaint and remanded for further proceedings consistent with its opinion.

The Southern District of New York Relies on *Fait v. Regions Financial Corp.* to Dismiss a Securities Fraud Suit against Deutsche Bank

On August 10, 2012, the Southern District of New York found that the Second Circuit's decision in *Fait v. Regions Financial Corp.*, 655 F.3d 105 (2d Cir. 2011) (Parker, J.) "constitute[d] a change in intervening law warranting reconsideration" of the court's earlier order denying in part the defendants' motions to dismiss a securities fraud suit against Deutsche Bank AG. *In re Deutsche Bank AG Sec. Litig.*, 2012 WL 3297730, at *1 (S.D.N.Y. Aug. 10, 2012) (Batts, J.).

Background

The plaintiffs brought claims under Sections 11 and 15 of the Securities Act alleging that Deutsche Bank's "internal valuation systems were faulty." *Id*. at *2. With respect to securities offerings in 2007 and 2008, the plaintiffs claimed that Deutsche Bank's "internal valuations of subprime and mortgage-backed assets were inconsistent with market indices" and asserted that "a more accurate valuation may have required the [c]ompany to disclose those holdings[.]" *Id*. As to a May 2008 securities offering, the plaintiffs alleged that Deutsche Bank had "relied on faulty Value-at-Risk ('VAR') metrics, resulting in trading losses almost 700% above stated V[A]R limits." *Id*.

The defendants moved to dismiss the complaint. On August 19, 2011, the Southern District of New York granted in part and denied in part the defendants' motion. Just four days later, the Second Circuit issued its decision in *Fait* holding that "valuation decisions such as goodwill and statements of loan loss reserves are 'opinions' rather than facts, and will not give rise to liability unless a plaintiff can 'plausibly allege that [the] defendants did not believe the statements … at the time they made them.'" *Id*. at *2 (quoting *Fait*, 655 F.3d at 112). (Please click here to read our discussion of the *Fait* opinion in the September 2011 edition of the Alert.)

In *City of Omaha, NE Civilian Emps. Ret. Sys. v. CBS Corp.*, 679 F.3d 64 (2d Cir. 2012) (per curiam), the Second Circuit relied on *Fait* to hold that allegations that defendants "*should have known* that their valuation decisions were false or misleading will not state a plausible claim for relief under the Securities Act." *Deutsche Bank*, 2012 WL 3297730, at *2. The *City of Omaha* court found that "[a]fter *Fait*, [p]laintiffs must allege that [d]efendants did not believe their valuation statements at the time they made them." *Id*. (citing *City of Omaha*, 679 F.3d at 68). (Please click here to read our discussion of the *City of Omaha* decision in the May 2012 edition of the Alert.)

The defendants moved for reconsideration of the court's August 19, 2011 decision on the grounds that "*Fait* is an intervening change in the governing law." *Id*. at *1.

Fait Is a Change in Controlling Law Warranting Reconsideration of the Court's August 2011 Decision

"Reconsideration is … appropriate when there has been a change in controlling law." *Id*. (citing *King County, WA v. IKB Deutche Industriebank AG*, 2012 WL 2160285, at *1 (S.D.N.Y. June 7, 2012) (Scheindlin, J.). The Southern District of New York found it "clear" that the Second Circuit's rulings in *Fait* and *City of Omaha* represented "a change in intervening law" warranting reconsideration of the court's August 2011 decision. *Id*. at *2 (citing *In re General Elec. Co. Sec. Litig.*, 2012 WL 1371016, at *5 (S.D.N.Y. Apr. 18, 2012) (Cote, J.) (granting reconsideration to consider the impact of *Fait* on a prior decision)).

The Complaint Fails to Allege That the Defendants Did Not Believe Their Valuations When Made

Turning to the complaint, the Southern District of New York found that the "allegations suggest that the [d]efendants were wrong, and perhaps egregiously so, in their internal valuation metrics." *Id*. Nevertheless, the court explained that under *Fait*, "such valuations are matter[s] of opinion rather than fact." *Id*. "Accordingly, [p]laintiffs must allege that [the] [d]efendants did not honestly believe those valuations when made." *Id*. The court noted that "[t]he [c]omplaint in this matter contains no such allegations." *Id*.

The Southern District of New York also found it significant that "the claims in the [c]omplaint 'exclusively rely on theories of strict liability and negligence.'" *Id*. The plaintiffs "therefore specifically aver that none of their claims are based on knowing misconduct by the [d]efendants." *Id*. The court held that "[t]his alone is fatal to [the] [p]laintiffs' claims after *Fait*." *Id*. (citing *In re General Elec. Sec. Litig.*, 2012 WL 1371016, at *9) (finding statement that allegations were not based on 'knowing misconduct' equivalent to a concession that statements of opinion were not disbelieved when made).

The court granted the defendants' motion for reconsideration, dismissing the complaint in its entirety with prejudice and without leave to replead. *Id*. at *3.

The Pennsylvania Supreme Court Holds That Section 1105 Precludes Post-Merger Remedies Other Than Appraisal Except in Cases of Fraud or Fundamental Unfairness

On July 24, 2012, in response to a question of law from the Third Circuit, the Supreme Court of Pennsylvania held that Section 1105 of Pennsylvania's Business Corporation Law ("BCL") "precludes post-merger remedies other than appraisal [for dissenting shareholders] only in the absence of fraud or fundamental unfairness." *Mitchell Partners, L.P. v. Irex Corp.*, 2012 WL 3007224, at *8 (Pa. July 24, 2012) (Saylor, J.) (*Mitchell III*). The court emphasized that "the fraud or fundamental unfairness exception may not be invoked lightly" and explained that "appraisal is intended as the usual remedy in the absence of exceptional circumstances." *Id.* at *7.

Background

"Mitchell Partners, L.P., was a minority shareholder of Irex Corporation, a privately-held Pennsylvania business corporation." *Id.* at *1. "In 2006, Irex participated in a merger transaction structured so that some minority shareholders would be 'cashed out' and would not receive an equity interest in the surviving corporation, a wholly owned subsidiary of North Lime Holdings Corporation." *Id.* "Mitchell objected to the acquisition, as it viewed the transaction as a 'squeeze out' of minority interests at an unfair price." *Id.* "The merger proceeded nonetheless[.]" *Id.*

"Irex commenced valuation proceedings in state court, per Section 1579 of the BCL, to address the dispute with Mitchell." *Id.* At the same time, Mitchell brought a diversity action in federal court against Irex, its directors, most of its officers, and North Lime, and asserted common law claims for breach of fiduciary duties, aiding and abetting breach of fiduciary duties and unjust enrichment. The defendants moved to dismiss the federal action, arguing that "under Section 1105 of the BCL, judicial valuation is the sole remedy available to dissenting shareholders in the post-merger timeframe." *Id.*

Section 1105 provides, in relevant part, as follows:

> A shareholder of a business corporation shall not have any right to obtain, in the absence of fraud or fundamental unfairness, an injunction against any proposed plan … except that he may dissent and claim such payment if and to the extent provided in [the statutory provisions of the BCL relating to dissenters' rights]. … *Absent fraud or fundamental unfairness, the rights and remedies so provided shall be exclusive.*

15 Pa. C.S. § 1105 (emphasis added).

The Eastern District of Pennsylvania Finds That Section 1105 Precludes the Plaintiff's Common Law Claims

On September 29, 2010, the Eastern District of Pennsylvania found that under *In re Jones & Laughlin Steel Corporation*, 488 Pa. 524 (1980) (Nix, J.), the plaintiff's "'post-merger remedies were limited to the appraisal of the fair market value of their stock.'" *Mitchell Partners, L.P. v. Irex Corp.*, 2010 WL 3825719, at *5 (E.D. Pa. Sept. 29, 2010) (Gardner, J.) (*Mitchell I*) (quoting *Jones*, 488 Pa. at 533-34). "While the district court appreciated that several decisions of the Third Circuit Court of Appeals and the Pennsylvania Superior Court sanctioned remedies beyond appraisal," the *Mitchell I* court "distinguished these [cases] on the ground that they involved separate litigation that was filed *before* the consummation of merger transactions." *Mitchell III*, 2012 WL 3007224, at *2 (internal citations omitted).

The Third Circuit Reverses the District Court's Decision

On August 31, 2011, "a divided three-judge panel of the Third Circuit reversed" the district court's decision. *Id*. The Third Circuit "disagreed … with the district court's position that [Section 1105] precludes *all* other remedies" besides appraisal. *Id*. "Acknowledging that some of the broader language from *Jones* supported the defendants' position," the Third Circuit distinguished *Jones* on the grounds that it "arose in the context of a statutory valuation proceeding, such that 'the narrow issue of whether a suit for damages based on breach of fiduciary duties may be brought post-merger was not directly presented to the Supreme Court.'" *Id*. (quoting *Mitchell Partners, L.P. v. Irex Corp*., 656 F.3d 201, 212 (3d Cir. 2011) (Sloviter, J) (*Mitchell II*)).

The Third Circuit "predict[ed] that the Supreme Court of Pennsylvania would hold that Pennsylvania's appraisal statute does not exclude separate, post-merger suits for damages alleging that majority shareholders breached their fiduciary duties to minority shareholders in the process of consummating a freeze out merger." *Mitchell II*, 656 F.3d at 216. The *Mitchell II* court held:

> [I]t is a clear holding in Pennsylvania [that] the statutory appraisal cause of action coexists with common law causes of action. Indeed, no other rule makes sense, for the appraisal remedy is available even absent misconduct of corporate officials. It was hardly intended to provide a shield for misconduct.

Id. (quoting *Herkowitz v. Nutri-System, Inc*., 857 F.2d 179, 187 (3d Cir. 1988) (Gibbons, J.)).

The Third Circuit Petitions the Pennsylvania Supreme Court for Certification of the Section 1105 Issue

The defendants sought rehearing of the Third Circuit's decision, and the Governor of Pennsylvania moved for leave to file a supportive *amicus* brief. The Governor "expressed particular concern that the Third Circuit had interpreted the BCL's provisions relating to dissenting shareholders' rights in a manner inconsistent with *Jones*" and "found it troubling that resolution of this significant corporate law issue might depend on whether a litigant seeks redress in federal or state court." *Mitchell III*, 2012 WL 3007224, at *4. "Accordingly, he urged the Third Circuit to grant rehearing and certify a question of law to [the Supreme Court of Pennsylvania]." *Id*.

The Third Circuit petitioned the Pennsylvania Supreme Court for certification of the following issue:

> Does [Section 1105], providing for appraisal of the value of the shares of minority shareholders who are 'squeezed out' in a cash-out merger[,] preclude all other post-merger remedies including claims of fraud, breach of fiduciary duty, and other common law claims[?]

Id. (quoting Petition for Certification of Question of Law, at 7). On February 28, 2012, the Pennsylvania Supreme Court granted certification.

The Pennsylvania Supreme Court Holds That Section 1105 Does Not Preclude Other Remedies But Only in the Event of Fraud or Fundamental Unfairness

The Supreme Court of Pennsylvania explained at the outset that "[t]his matter presents an issue of statutory interpretation[.]" *Id.* at *6. "Section 1105 indicates that the remedies it provides shall be exclusive '[a]bsent fraud or fundamental unfairness.'" *Id.* (quoting 15 Pa.C.S. § 1105). "By straightforward implication," the Pennsylvania Supreme Court found that "this language conveys that, where fraud or fundamental unfairness are present, the statutory remedies are not made to be exclusive." *Id.*

The court noted that "[e]xceptions to exclusivity of the appraisal remedy based on fraud, illegality or fundamental unfairness are common in the state corporate law of many jurisdictions and, indeed, are reflected in the Model Business Corporations Act[.]" *Id.* "Such exceptions obviously reflect a policy concern that, despite the desire to authorize and streamline fundamental changes beneficial to majoritarian interests, the appraisal remedy may be inadequate to vindicate the essential interests of minority shareholders where they encounter wrongful conduct." *Id.* "Their application is also consistent with the scrutiny usually required, under corporate law, with respect to conflict transactions." *Id.*

The Pennsylvania Supreme Court stated that this was "not to say … that Section 1105 does not serve as a restriction on non-appraisal proceedings." *Id.* at *7. The court explained that "the General Assembly did intend for the notion of exclusivity—as modified by the exception for fraud or fundamental unfairness—to curtail actions outside the appraisal context." *Id.* "Such qualified preclusion is suggested by the language of exclusivity appearing in Section 1105 and is supported by the general policy of reducing the burdensomeness of fundamental corporate changes." *Id.* "In light of such purposes," the Pennsylvania Supreme Court underscored that "the fraud or fundamental unfairness exception may not be invoked lightly." *Id.* "For example, the Legislature has made clear that the exception does not apply merely by virtue of the character of a cash-out transaction." *Id.* (citing 15 Pa.C.S. § 1105).[3] "Plainly, appraisal is … the usual remedy in the absence of exceptional circumstances." *Id.*

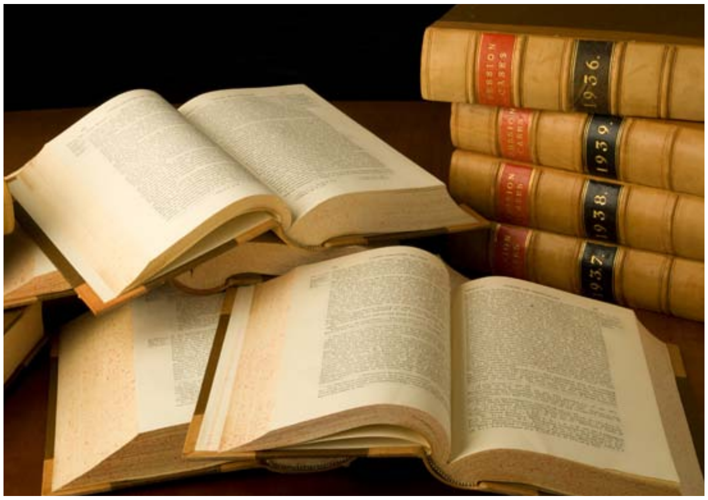
The First Department Adopts Delaware's Test for Determining Whether a Claim Is Direct or Derivative

On August 7, 2012, the First Department "adopt[ed] the test the Supreme Court of Delaware developed in" *Tooley v. Donaldson, Lufin & Jerette, Inc.*, 845 A.2d 1031, 1039 (Del 2004) (Veasey, J.) for differentiating between direct and derivative claims. *Yudell v. Gilbert*, 2012 WL 3166788, at *1 (N.Y. App. Div. 1st Dept. Aug. 7, 2012) (Moskowitz, J.). The First Department found that "[t]he *Tooley* test is consistent with New York law and has the added advantage of providing a clear and simple framework to determine whether a claim is direct or derivative." *Id.*

Background

Trustees of one member of a joint venture brought suit against "(1) the managing agent of the joint venture's sole asset, a shopping center on Long Island, (2) the other members of the joint venture and (3) the joint venture as a nominal defendant." *Id.* "The complaint purported to bring both derivative and direct claims and pleaded demand futility[.]" *Id.*

3. The statute provides that "[s]tructuring a plan or transaction for the purpose or with the effect of eliminating or avoiding the application of dissenters rights is not fraud or fundamental unfairness within the meaning of this section." 15 Pa.C.S. § 1105.



"The first cause of action alleged that [the managing agent] had 'squandered, mismanaged and wasted joint venture partnership funds and property'" and had "'failed properly to account to the joint venture partners.'" *Id.* at *2. "The second cause of action alleged that [the managing agent] had breached the management agreement." *Id.* at *3. The third cause of action alleged that the managing agent and certain other members of the joint venture had breached fiduciary duties owed to the joint venture and each of the joint venture partners. "The fourth cause of action was against [the managing agent] for negligence[,]" and "[t]he sixth cause of action alleged that [the managing agent had] breached the joint venture agreement." *Id.*

On May 3, 2010, the motion court found that these causes of action "were derivative in nature and granted [the] defendants' motion to dismiss … for failure to plead demand futility with the requisite particularity." *Id.* at *3, 5. "On appeal, [the] plaintiffs contend[ed] [that] this was error because … not every aspect of [these] causes of action … was derivative in nature." *Id.* Specifically, the plaintiffs argued that "the third cause of action for breach of fiduciary duty was a direct claim." *Id.*

The First Department Rejects New York's Case-by-Case Approach for Differentiating Between Direct and Derivative Claims in Favor of the Delaware Supreme Court's Test in *Tooley*

"A plaintiff asserting a derivative claim seeks to recover for injury to the business entity" while "[a] plaintiff asserting a direct claim seeks redress for injury to him or herself individually." *Id.* "Sometimes whether the nature of a claim is direct or derivative is not readily apparent." *Id.*

The First Department explained that "New York does not have a clearly articulated test" for differentiating between direct and derivative claims, but instead "approaches the issue on a case by case basis depending on the nature of the allegations." *Id.* "For instance, where shareholders suffer solely through depreciation in the value of their stock," New York courts have found that "the claim is derivative, even if the diminution in value derives from a breach of fiduciary duty." *Id.* (internal citations omitted). New York courts have also found that "[a]llegations of mismanagement or diversion of corporate assets also plead a wrong to the corporation[.]" *Id.* The First Department observed that these "case by case analyses … are sometimes difficult to apply to new fact patterns." *Id.* at *1.

Recognizing the need for "a clear approach for determining [the] difference" between direct and derivative claims, *id.*, the First Department adopted the Delaware Supreme Court's test in *Tooley*. *Id. Tooley* provides that:

> A court should look to the nature of the wrong and to whom the relief should go. The stockholder's claimed direct injury must be independent of any alleged injury to the corporation. The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation.

Tooley, 845 A.2d at 1039. Under the "common sense approach" set forth in *Tooley*, "a court should consider '(1) who suffered the alleged harm (the corporation or the stockholders); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders individually)'[.]" *Yudell*, 2012 WL 3166788, at *4 (quoting *Tooley*, 845 A.2d at 1035).

The First Department Finds That the Plaintiffs' Claims Were Derivative in Nature

Applying the *Tooley* test, the First Department found that the "plaintiffs' claim for breach of fiduciary duty [was] derivative, because any pecuniary loss [the] plaintiffs suffered derive[d] from a breach of duty and harm to the [joint venture]." *Id*. The "[p]laintiffs' allegations of breach of fiduciary duty involve[d] failure to collect rent, back taxes and common charges that tenants would have owed to [the joint venture]." *Id*. Thus, "[i]t [was] only through loss to [the joint venture] that [the] plaintiffs suffer[ed] a loss at all." *Id*. "Although [the] plaintiffs may own a minority interest in the joint venture, all members suffer[ed] losses from the failure to collect rents and other obligations owed the joint venture." *Id*.

The First Department further noted that under *Tooley*, it should consider "who would receive the benefit of any recovery or other remedy, the joint venture or the members individually." *Id*. "[H]ere, any recovery would represent the value of lost rent, CAM charges and the like that inure to the benefit of the joint venture." *Id*. "Only if and when the joint venture receives this compensation would plaintiffs then be entitled to receive their proportionate share." *Id*. Therefore, the First Department held that the "plaintiffs' claims [were] derivative." *Id*.

"To the extent, if any, that [the] plaintiffs have asserted direct claims," the First Department determined that those claims were "embedded in an otherwise derivative claim for partnership waste and mismanagement." *Id*. The First Department held that "the motion court [had] correctly determined that [the] plaintiffs' causes of action [were] derivative because … none of the grounds for excusing demand appear[ed] in the complaint." *Id*.

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