

This month's Alert addresses the Supreme Court's grant of certiorari in *Standard Fire Ins. Co. v. Knowles* (No. 11-1450) to determine whether plaintiffs can avoid removal under the Class Action Fairness Act of 2005 ("CAFA") by stipulating to damages of less than \$5 million.

We also discuss a Second Circuit decision addressing the standard for tipper and tippee liability in insider trading actions brought under the misappropriation theory, and a Ninth Circuit opinion finding allegations that a pharmaceutical company used the "wrong" statistical methodology in reporting clinical trial results insufficient to state a Section 10(b) claim. In addition, we cover a decision from the District Court for the District of Columbia applying the Supreme Court's decision in *Morrison v. National Australia Bank*, 130 S. Ct. 2869 (2010) (Scalia, J.) to dismiss Section 10(b) claims involving Carlyle Capital Corporation.

Finally, we address a Delaware Chancery Court decision addressing the scope of a controlling shareholder's fiduciary duties in the merger context.

The Supreme Court Will Determine Whether Plaintiffs Can Avoid Removal under CAFA by Stipulating to Damages of Less Than \$5 Million

Last year, in *Smith v. Bayer Corp.*, 131 S. Ct. 2368 (2011) (Kagan, J.), the Supreme Court held that "the mere proposal of a class ... could not bind persons who

were not parties" to that proposed class. *Id.* at 2382. On August 31, 2012, the Supreme Court granted certiorari to determine whether, in light of *Smith*, "a named plaintiff [can] defeat a defendant's right of removal under [CAFA] by filing ... a 'stipulation' that attempts to limit the damages he 'seeks' for the absent putative class members to less than the \$5 million threshold for federal jurisdiction" under CAFA.¹ Question Presented, *Standard Fire Ins. Co. v. Knowles* (No. 11-1450). This marks the first time that the Court has agreed to review a question arising under CAFA.

¹ CAFA provides, *inter alia*, that "[t]he district courts shall have original jurisdiction of any civil action in which the matter in controversy exceeds the sum or value of \$5,000,000, exclusive of interest and costs, and is a class action in which ... any member of a class of plaintiffs is a citizen of a State different from any defendant[.]" 28 U.S.C. § 1332(d)(2) (A). CAFA further establishes that "[i]n any class action, the claims of the individual class members shall be aggregated to determine whether the amount in controversy exceeds the sum or value of \$5,000,000, exclusive of interests and costs." 28 U.S.C. § 1332(d)(6).

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Background

The plaintiff in this action originally filed a proposed class action complaint in Miller County Circuit Court, Arkansas. The complaint included an affidavit signed by the plaintiff stating that he “will not at any time during the pendency of the case ... ‘seek damages for the class as alleged in the complaint to which this stipulation is attached in excess of \$5,000,000 in the aggregate (inclusive of costs and attorneys’ fees).” *Knowles v. Standard Fire Ins. Co.*, 2011 WL 6013024, at *2 (W.D. Ark. Dec. 2, 2011) (Holmes, III, J).

Standard Fire removed the case to the Western District of Arkansas, and the plaintiff moved to remand. The District of Arkansas found that Standard Fire had “satisfied its initial burden of proving by a preponderance of the evidence that the actual amount in controversy reaches, if not exceeds, the federal court’s minimum threshold for jurisdiction [of \$5,000,000] pursuant to CAFA.” *Id.* at *3. However, the court found “[t]he law in [the Eighth] [C]ircuit ... clear that a binding stipulation sworn by a plaintiff in a purported class action will bar removal from state court if the stipulation limits damages to the state jurisdictional minimum.” *Id.* at *4 (citing *Bell v. Hershey Co.*, 557 F.3d 953, 958 (8th Cir. 2009) (Murphy, J.) (noting that “[i]n order to ensure that any attempt to remove would have been unsuccessful, [the plaintiff] could have included a binding stipulation

with his petition stating that he would not seek damages greater than the jurisdictional minimum upon remand”). The district court also found it significant that the Arkansas legislature had enacted a statute earlier that year that “explicitly allows a plaintiff to file a binding stipulation ‘with respect to the amount in controversy’ in order to establish subject matter jurisdiction.” *Id.* at *5 (quoting Ark. Code Ann. § 16-63-221(a)). The district court therefore remanded the action.

Standard Fire petitioned the Eighth Circuit for permission to appeal the district court’s decision, a request the Eighth Circuit denied. Subsequently, in *Rolwing v. Nestle Holdings, Inc.*, 666 F.3d 1069 (8th Cir. 2012) (Gruender, J.), the Eighth Circuit affirmed an order of remand under CAFA of a proposed class action based on the plaintiff’s stipulation that the damages would be under the \$5 million threshold. The Eighth Circuit held that “remand based on CAFA’s amount-in-controversy requirement was appropriate” because the plaintiff had “shown that it [was] legally impossible for the amount in controversy to meet CAFA’s threshold[.]” *Id.* at 1073-74. After issuing its decision in *Rolwing*, the Eighth Circuit denied Standard Fire’s petition for rehearing.

Standard Fire then petitioned the Supreme Court for certiorari of the District of Arkansas’ decision. The Court granted Standard Fire’s petition on August 31, 2012.



Standard Fire Contends That a Named Plaintiff Has No Authority to Limit the Damages of Proposed Class Members Prior to Class Certification

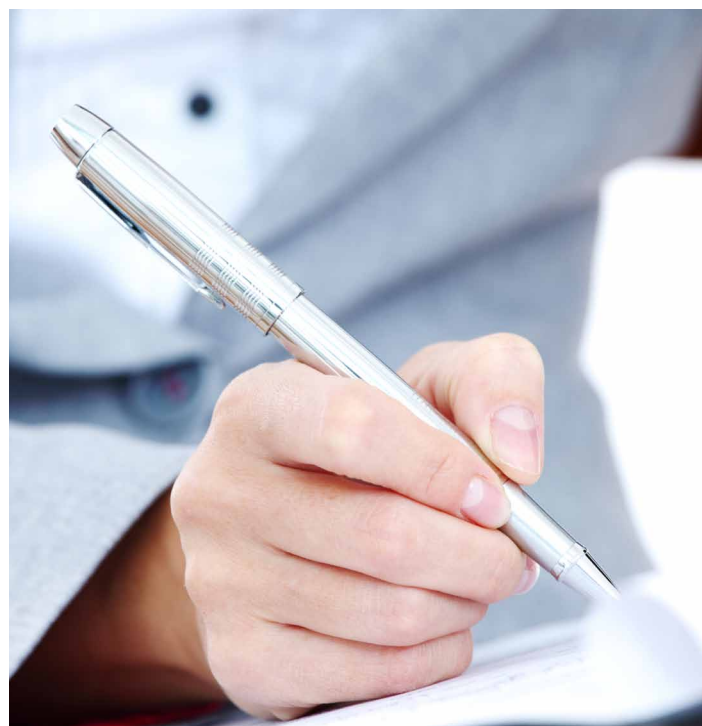
Standard Fire argued that under the Supreme Court's decision in *Smith* and "longstanding principles of class action law, putative class members are *not* bound by actions taken by named plaintiffs or litigation outcomes before certification." Petition for Writ of Certiorari, *Standard Fire Ins. Co. v. Knowles*, 2012 WL 1979957, at *10 (U.S. May 30, 2012) (No. 11-1450). In *Smith*, "[t]he Court adopted a rule that 'in the absence of certification ... [n]either a proposed class action nor a rejected class action may bind nonparties,' and 'the mere proposal of a class ... could not bind persons who were not parties.'" *Id.* at *11 (quoting *Smith*, 131 S. Ct. at 2380, 2382).² Standard Fire contended that "[u]nder *Smith*, [the] [p]laintiff's unauthorized 'stipulation' on behalf of people he ha[d] not been authorized to represent [was] a legal nullity." *Id.*

Standard Fire emphasized that "the amount in controversy is determined at the time of removal, and cannot be based on any events that may occur subsequent to removal." *Id.* at *10 (citing *St. Paul. Mercury Ins. Co. v. Red Cab Co.*, 303 U.S. 283, 293 (1938) (Roberts, J.)). "[B]ecause the stipulation was [concededly] not binding [on proposed class members] at the time of removal, the stipulation must be disregarded in determining whether federal jurisdiction exists." *Id.* at *13.

² In *Smith*, the Court reviewed a district court decision "enjoin[ing] a state court from considering a plaintiff's request to approve a class action" on the grounds that the district court "had earlier denied a motion to certify a class in a related case, brought by a different plaintiff against the same defendant alleging similar claims." 131 S. Ct. at 2373. The Supreme Court ruled that "[i]n issuing this order to a state court, the federal court [had] exceeded its authority under the 'relitigation exception' to the Anti-Injunction Act." *Id.* The Court reasoned, *inter alia*, that "[n]either a proposed class action nor a rejected class action may bind nonparties." *Id.* at 2380.

Standard Fire Argues That Permitting Damages Stipulations to Govern in the CAFA Removal Context Violates the Due Process Rights of Absent Putative Class Members

Standard Fire further contended that "[a]llowing a named plaintiff to bind absent putative class members to a limitation on damages, and giving effect to such a 'stipulation' as of the time of removal, plainly violates basic due process rights of the absent putative class members." *Id.* at *13-14. "This Court has held that a state court *cannot* bind members of a putative class before providing them with adequate notice and an opportunity to be heard." *Id.* at *14 (citing *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 811-12 (1985) (Rehnquist, J.)). ("If the forum State wishes to bind an absent plaintiff [class member] concerning a claim for money damages ... [t]he plaintiff must receive notice plus an opportunity to be heard and participate in the litigation.")). "Here, the absent putative class members did not receive any notice, and therefore had no opportunity to be heard." *Id.*



Standard Fire Asserts That the District of Arkansas' Ruling and the Eighth Circuit's Decision in *Rolwing* Contravene CAFA

Standard Fire argued that the District of Arkansas' remand order and the Eighth Circuit's decision in *Rolwing* do not comport with CAFA. "There is nothing in the text of CAFA that permits a plaintiff to limit the damages of putative class members he or she is not authorized to represent." *Id.* at *15. CAFA "requires the aggregation of the full claims of the putative class members as alleged in the complaint." *Id.* "It does not provide that full aggregation is optional, or that aggregation can be followed by a reduction of the aggregate amount to under \$5 million based on a 'stipulation' of a putative class representative not yet appointed to represent a class." *Id.* at *15-16. "If federal courts permit the use of stipulations by plaintiffs to avoid CAFA, 'Congress's obvious purpose in passing [CAFA]—to allow defendants to defend large interstate class actions in federal court—can be avoided almost at will ...'" *Id.* (citation omitted).

Standard Fire Cites a Circuit Split on Whether Damages Stipulations May Defeat Removal Under CAFA

After Standard Fire filed its Petition for Writ of Certiorari (but before it filed its reply), the Tenth Circuit held that "a plaintiff's attempt to limit damages in the complaint is not dispositive when determining the amount in controversy" for purposes of removal under CAFA. *Frederick v. Hartford Underwriters Ins. Co.*, 683 F.3d 1242, 1247 (10th Cir. 2012) (Lucero, J.). The Tenth Circuit ruled that "[r]egardless of the plaintiff's pleadings, federal jurisdiction is proper if a defendant proves jurisdictional facts by a 'preponderance of the evidence' such that the amount in controversy may exceed \$5,000,000." *Id.* Standard



Fire argued that "*Frederick* is at odds with the decision of the Eighth Circuit in *Rolwing*, which allowed the plaintiff's limitation on damages to control over the defendants' evidence." Reply to Brief in Opposition to Petition for Writ of Certiorari, *Standard Fire Ins. Co. v. Knowles*, 2012 WL 2917967, at *6 (U.S. July 16, 2012) (No. 11-1450). Standard Fire also contended that "[s]everal [other] circuits, at least in dicta, have rejected the Eighth Circuit's view on the effect of 'stipulations' that purport to limit damages in putative class actions." Petition for Writ of Certiorari, *Standard Fire*, at *17-18.

The Plaintiff Contends That *Smith* Is Inapposite

In opposition to Standard Fire's Petition for Writ of Certiorari, the plaintiff contended that *Smith* "did not involve a binding stipulation or subject-matter

jurisdiction under CAFA.” Brief in Opposition to Petition for Writ of Certiorari, *Standard Fire Ins. Co. v. Knowles*, 2012 WL 2645080, at *11 (U.S. July 2, 2012) (No. 11-1450). While *Smith* involved “a decision to enjoin a state-court proceeding and the implications of the Anti-Injunction Act[.]” this case “involves a question of removal under CAFA.” *Id.* at *12. The plaintiff further asserted that “this case is different from *Smith* ... because here there has been no ruling on class certification by any court” and, moreover, *Smith* “did not involve a case at the time of removal.” *Id.* at *12-13.

The Plaintiff Argues That Limiting Damages Is Just One of Many Case-Determinative Decisions Made by a Lead Plaintiff

The plaintiff contended that “the decision to stipulate to damages of a certain size is no different from innumerable other decisions that class representatives inevitably make as masters of their complaints.” *Id.* at *14. “Named plaintiffs bringing putative class actions necessarily ‘limit’ the recovery of the proposed class by, for example, picking and choosing which defendants to sue, which causes of action and elements of damages to include, and what kinds of litigation tactics to pursue in discovery, pretrial motions, and beyond.” *Id.* “Nothing that Congress included in CAFA suggests that a plaintiff bringing a class action is no longer the master of her complaint or is somehow prevented from ‘suing for less than the jurisdictional amount.’” *Id.* at *22 (citation omitted). “[A]ny putative class members who disagree with the [plaintiff’s] limitation of damages have the ability to opt out from the class at the appropriate time.” *Id.* at *23 (citation omitted).

* * *

The Court will review the *Standard Fire* case this coming term. A date for oral argument has not yet been set.

The Second Circuit Addresses Tipper and Tippee Liability in Insider Trading Actions Brought Under the Misappropriation Theory

On September 6, 2012, the Second Circuit vacated summary judgment in favor of the defendants in a civil SEC enforcement action alleging insider trading in violation of Section 10(b) and Rule 10b-5. *SEC v. Obus*, 2012 WL 3854797 (2d Cir. Sept. 6, 2012) (*Obus II*) (Walker, Jr., J.). The Second Circuit’s decision addressed the standard for tipper and tippee liability in insider trading actions brought under the misappropriation theory.³

Background

The SEC claimed that Thomas Bradley Strickland, an assistant vice president and underwriter at General Electric Capital Corporation (“GE Capital”), “learned material non-public information” concerning Allied Capital Corporation’s planned acquisition of Sunsource, Inc. “in the course of his employment” at GE Capital. *Id.* at *1. Strickland allegedly “revealed” this information to Peter F. Black, a hedge fund analyst who was also a friend of Strickland’s from college. *Id.* “Black in turn [allegedly] relayed the information to his boss,” Nelson J. Obus, who then allegedly “traded on the information.” *Id.*

Following a trial, the Southern District of New

³ “Under the classical theory of insider trading, a corporate insider is prohibited from trading shares of that corporation based on material non-public information in violation of the duty of trust and confidence insiders owe to shareholders.” *Id.* at *6. “A second theory, grounded in misappropriation, targets persons who are not corporate insiders but to whom material non-public information has been entrusted in confidence and who breach a fiduciary duty to the source of the information to gain a personal profit in the securities market.” *Id.*

York “granted summary judgment in favor of the defendants on both the classical and misappropriation theories of insider trading.” *Id.* The SEC appealed the district court’s ruling “only with respect to the misappropriation theory.” *Id.* at *5.

The Second Circuit Addresses the Standard for Tipper Liability in Misappropriation Cases

The Second Circuit held that “tipper liability requires that (1) the tipper had a duty to keep material non-public information confidential; (2) the tipper breached that duty by intentionally or recklessly relaying the information to a tippee who could use the information in connection with securities trading; and (3) the tipper received a personal benefit from the tip.” *Id.* at *10. “[T]he tipper must know that the information that is the subject of the tip is non-public and is material for securities trading purposes, or act with reckless disregard of the nature of the information.” *Id.* at *8. “[T]he tipper must [also] know (or be reckless in not knowing) that to disseminate the information would violate a fiduciary duty.” *Id.* The Second Circuit noted that “a deliberate tip with knowledge that the information is material and non-public” “can often be deduced from the same facts that establish the tipper acted for personal benefit.” *Id.*

Significantly, “a defendant cannot be held liable for negligently tipping information.” *Id.* (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 & n. 12 (1976) (Powell, J.)). While “[t]he line between unactionable negligence and actionable recklessness is not a bright one[.]” the Second Circuit emphasized that “a tipper cannot avoid liability merely by demonstrating that he did not know to a certainty that the person to whom he gave the information would trade on it.” *Id.* “One who intentionally places such ammunition in the hands of individuals able to use it to their advantage on the market has the requisite state of mind.” *Id.* (quoting

Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 167 (2d Cir. (1980) (Mansfield, J.)).

The Second Circuit Finds the SEC Presented Sufficient Evidence of Tipper Liability to Survive Summary Judgment

The Second Circuit held that the SEC had “presented sufficient evidence to survive summary judgment” with respect to its claims against Strickland. *Id.* at *10. First, the court found it “undisputed that Strickland, an employee of GE Capital, owed GE Capital a fiduciary duty.” *Id.* The court also determined that there was “sufficient evidence that Strickland knew he owed GE Capital a duty to keep information about the SunSource/Allied acquisition confidential and not to convert it for his own profit.” *Id.*

Second, the court concluded that “[a] rational jury could reasonably infer from the SEC’s evidence that Strickland did tell Black that SunSource was about to be acquired” and that “Strickland knew the material non-public information [was] ‘ammunition’ that Black was in a position to use.” *Id.* at *12 (citing *Elkind*, 635 F.2d at 167). The Second Circuit held that “[t]his evidence easily supports a finding of knowing or reckless tipping to someone who likely would use the information to trade in securities.” *Id.*

Third, the court found it “readily apparent that ... if the tip occurred, Strickland made the tip intentionally and received a personal benefit from it.” *Id.* “Personal benefit to the tipper is broadly defined: it includes not only ‘pecuniary gain,’ such as a cut of the take or a gratuity from the tippee, but also a ‘reputational benefit’ or the benefit one would obtain from simply ‘mak[ing] a gift of confidential information to a trading relative or friend.’” *Id.* at *7 (quoting *Dirks v. SEC*, 463 U.S. 646, 663-64 (1983) (Powell, J.)). “Here,” the Second Circuit held that “the undisputed fact that Strickland

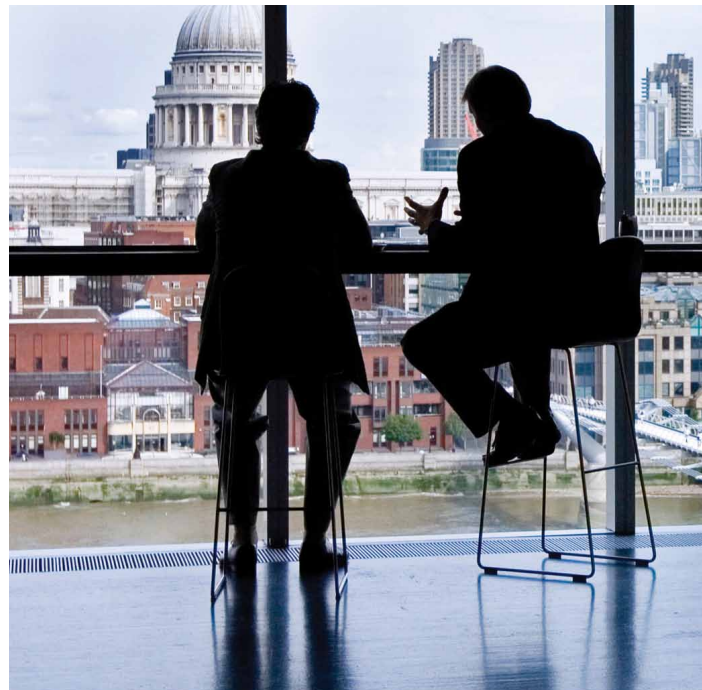
and Black were friends from college is sufficient to send to the jury the question of whether Strickland received a benefit from tipping Black.” *Id.* at *12. “This same evidence ... is sufficient for a jury to conclude that Strickland intentionally or recklessly revealed material non-public information to Black, knowing that he was making a gift of information Black was likely to use for securities trading purposes.” *Id.*

Finally, the Second Circuit held that “the district court [had] erred by requiring the SEC to make an additional showing of ‘deception’ beyond the tip itself.” *Id.* at *13. “[E]mployees who misappropriate confidential information ‘deal in deception.’” *Id.* (quoting *U.S. v. O’Hagan*, 521 U.S. 642, 653 (1997) (Ginsburg, J.)). “If the jury accepts that a tip of material non-public information occurred and that Strickland acted intentionally or recklessly, Strickland knowingly deceived and defrauded GE Capital.” *Id.* “That is all the deception that [S]ection 10(b) requires.” *Id.*

The Second Circuit Addresses the Standard for Tippee Liability

The Second Circuit held that “[t]ippee liability requires that (1) the tipper breached a duty by tipping confidential information; (2) the tippee knew or had reason to know that the tippee improperly obtained the information (i.e., that the information was obtained through the tipper’s breach); and (3) the tippee, while in knowing possession of the material non-public information, used the information by trading or by tipping for his own benefit.” *Id.* at *10.

In *Dirks*, the Supreme Court held that a tippee has a duty to abstain from trading (or to disclose the information to the source) “only when the insider has breached his fiduciary duty ... and the tippee *knows or should know* that there has been a breach.” *Id.* at *9 (quoting *Dirks*, 463 U.S. at 660) (emphasis added by the Second Circuit). “The parties dispute[d] whether the *Dirks* rule [was] in conflict with *Hochfelder’s* holding



that negligence does not satisfy [S]ection 10(b)’s scienter requirement because the ‘knows or should know’ rule ... sounds somewhat similar to a negligence standard.” *Id.*

The Second Circuit “reconcil[e]d” the holdings in *Dirks* and *Hochfelder* by “recogniz[ing] that the two cases were not discussing the same knowledge requirement when they announced apparently conflicting scienter standards.” *Id.* “*Dirks* knows or should know standard pertains to a tippee’s knowledge that the tipper breached a duty ... by relaying confidential information.” *Id.* “This is a fact-specific inquiry turning on the tippee’s own knowledge and sophistication, and on whether the tipper’s conduct raised red flags that confidential information was being transmitted improperly.” *Id.* “*Hochfelder’s* requirement of intentional ... conduct pertains to the tippee’s eventual use of the tip through trading or further dissemination of the information.” *Id.* “Thus, tippee liability can be established if a tippee knew or had reason to know that confidential information was initially obtained and transmitted improperly (and thus through deception), and if the tippee intentionally or recklessly traded while in knowing possession of that information.” *Id.*

The Second Circuit explained that cases involving “chains of tipping ... follow [this] same basic analysis[.]” *Id.* at *10. “The first tippee must both know or have reason to know that the information was obtained and transmitted through a breach, and intentionally or recklessly tip the information further for her own benefit.” *Id.* “The final tippee must both know or have reason to know that the information was obtained through a breach, and trade while in knowing possession of the information.” *Id.*

The Second Circuit Determines the SEC Presented Sufficient Evidence of Tippee Liability to Survive Summary Judgment

The Second Circuit held that the SEC had “presented sufficient evidence to send the question of Black’s liability to a jury.” *Id.* at *13. First, the court found sufficient evidence for a jury to conclude that



“Strickland [had] breached a duty to his employer in tipping Black” and that “Black inherited Strickland’s duty of confidentiality.” *Id.*

Second, the court determined that there was sufficient evidence for a “jury to conclude that Black knew or had reason to know that any tip from Strickland on SunSource’s acquisition would breach Strickland’s fiduciary duty to GE Capital.” *Id.* “Black, a sophisticated financial analyst, testified that he knew Strickland worked at GE Capital, which provided loans to businesses; that he knew Strickland was involved in developing financing packages for other companies and performing due diligence; and that information about a non-public acquisition would be material inside information that would preclude someone from buying stock.” *Id.*

Third, the court held that “a jury could find that by passing along what he was told by Strickland, Black hoped to curry favor with his boss” and thus “derived some personal benefit from relaying the tip.” *Id.* “In light of the broad definition of personal benefit set forth in *Dirks*,” the Second Circuit explained that the bar for establishing a personal benefit “is not a high one.” *Id.*

Finally, the Second Circuit held that “the SEC ha[d] established genuine questions of fact about whether Black’s boss, Obus, knew that Strickland had breached a duty to GE Capital and whether Obus traded in SunSource stock while in knowing possession of the material non-public information that SunSource was about to be acquired.” *Id.* at *14. The court found the evidence “sufficient to allow a jury to infer that Obus was aware that Strickland’s position with GE Capital [had] exposed Strickland to information that Strickland should have kept confidential.” *Id.* The court also determined that the evidence was “sufficient for the jury to find that Obus subjectively knew he possessed material non-public information” when he purchased SunSource shares prior to Allied’s acquisition of SunSource, regardless of “whether or not his purchase was directly caused by his knowledge of the pending acquisition.” *Id.*

The Ninth Circuit Finds Allegations That a Pharmaceutical Company Used the Wrong Statistical Methodology in Reporting Clinical Trial Results Insufficient to State a Section 10(b) Claim

On September 6, 2012, the Ninth Circuit held that a plaintiff had failed to “adequately plead falsity” with respect to the reported results of a clinical drug trial in a Section 10(b) action where the plaintiff did “not allege that [the] [d]efendants misrepresented their own statistical methodology, analysis, and conclusions, but instead criticize[d] only the statistical methodology employed by [the] [d]efendants.” In *re Rigel Pharmaceuticals, Inc. Sec. Litig.*, 2012 WL 3858112, at *9 (9th Cir. Sept. 6, 2012) (Hug, J.).

Background

Rigel Pharmaceuticals is “a clinical-stage drug development company that discovers and develops novel, small-molecule drugs[.]” *Id.* at *1. “One of those drugs is R788, which Rigel is developing to treat and stop the progression of rheumatoid arthritis.” *Id.*

On December 13, 2007, Rigel issued a press release discussing the results of its Phase 2 clinical study of R788. The press release reported that R788 had “demonstrated statistically significant results” in the treatment of rheumatoid arthritis. *Id.* at *2. With respect to side effects, the press release stated that “[t]he most common clinically meaningful adverse events noted in the clinical trial were dose-related neutropenia, mild elevations of liver function tests, and gastrointestinal (GI) side effects.” *Id.*



Rigel presented “much more extensive, detailed, and scientific information” about the R788 Phase 2 clinical trial in an article published in the November 2008 edition of *Arthritis and Rheumatism*, a medical journal. *Id.* at *4. “[I]n addition to the more severe adverse events disclosed in the original reports,” the journal article noted that several patients had experienced other side effects such as “smaller elevations of liver enzymes” and “mild hypertension[.]” *Id.*

A plaintiff subsequently brought suit alleging that the results of Rigel’s Phase 2 clinical trial for R788 were “false” because Rigel had used “statistically false p-values” and had relied on “inaccurate and improper statistical analysis.” *Id.* at *7 (internal quotations omitted). The plaintiff also contended that the December 2007 press release was misleading insofar as it failed to provide a complete list of R788 side effects. The plaintiff asserted claims under Sections 10(b) and Rule 10b-5, among others. In August 2010, the district court dismissed the complaint, holding, *inter alia*, that “disagreements over statistical methodology and study design are insufficient to allege a materially false statement.” *Id.*

The Ninth Circuit Holds That Using the “Wrong” Statistical Methodology in Compiling and Reporting Drug Trial Data Does Not Render That Data False or Misleading

On appeal, the Ninth Circuit held that the plaintiff’s allegations were “not about false statements” but instead “concern[ed] two different judgments about the appropriate statistical methodology to be used by [the] [d]efendants.” *Id.* The plaintiff “did not allege that [the] [d]efendants [had] inaccurately reported the results of their own statistical analysis[.]” or that they “had chosen or changed their statistical methodology after seeing the unblinded raw data from the clinical trial.” *Id.* Rather, the plaintiff’s “allegations of ‘falsity’ essentially [were] disagreements with the statistical methodology adopted by the doctors and scientists who designed and conducted the study, wrote the journal article, and selected the article for publication.” *Id.*

The plaintiff contended that it was “simply challenging the truth of the reported results, not the study design[.]” *Id.* The Ninth Circuit found “multiple problems with this argument.” *Id.* First, the court emphasized that the plaintiff was “alleging that [the] [d]efendants should have used different statistical methodologies, not that [the] [d]efendants [had] misrepresented the results they obtained from the methodologies they employed.” *Id.* Second, the Ninth Circuit explained that accepting the plaintiff’s argument would require it “to draw a line between *using* a particular method of statistical analysis that was part of a study’s protocol ... and *disclosing results* that were calculated using that statistical analysis.” *Id.* “Drawing such a distinction would suggest that a company should announce statistical results that are obtained using a statistical methodology that is adopted after the study data is made available to the researchers and that is different from the methodology used as part of the clinical trial.” *Id.* “Such a post-hoc adoption of a statistical method could raise concerns

regarding reliability, biased scientific methods, or even fraud.” *Id.*⁴

The Ninth Circuit noted that “[n]either the Supreme Court nor [the Ninth Circuit] has addressed the question of whether statements concerning statistical results of a clinical trial may be considered false or misleading under Rule 10b-5 because the statistical methodology that produced those results was not the best or most acceptable methodology.” *Id.* at *8. However, other district courts to consider the issue have held that “merely alleging that defendants should have used different statistical methodology in their drug trials is not sufficient to allege falsity.” *Id.* For example, in *Padnes v. Scios Nova Inc.*, 1996 WL 539711 (N.D. Cal. Sept. 18, 1996) (Patel, J.), the court determined that “the fact that the plaintiffs disagreed with the researchers about the import of the data did not make the defendants’ summaries of the study false or misleading.” In *re Rigel*, 2012 WL 3858112, at *8. The *Padnes* court “concluded that the securities laws do not require that companies report information only from optimal studies” and held that “companies reporting information from imperfect studies are not required to disclose alternative methods for interpreting the data.” *Id.*⁵

Finding this reasoning “persuasive,” the Ninth Circuit held that the plaintiff “did not adequately plead falsity with respect to [the] statistic results” of the R788 clinical trial. *Id.* at *9.

⁴ The Ninth Circuit stated that “[b]ecause there are many ways to statistically analyze data, it is necessary to choose the statistical methodology before seeing the data that is collected during the clinical trial; otherwise someone can manipulate the unblinded data to obtain a favorable result.” *Id.* at *8.

⁵ The *Rigel* court also cited *In re Adolor Corp. Sec. Litig.*, 616 F. Supp. 2d 551, 568 n.15 (E.D. Pa. 2009) (Surrick, J.) (where a plaintiff’s statistician identified what he believed were problems with a defendant’s statistical analysis of a clinical trial, plaintiff merely alleged a disagreement about how to conduct and analyze the study, not a false or misleading statement); and *DeMarco v. DepoTech Corp.*, 149 F. Supp. 2d 1212, 1225 (S.D. Cal. 2001) (Whelan, J.) (“Although Plaintiffs may have established a legitimate difference in opinion as to the proper statistical analysis, they have hardly stated a securities fraud claim.”). In *re Rigel*, 2012 WL 3858112, at *8 (parentheticals included in the court’s opinion).

The Ninth Circuit Determines Rigel Had No Duty to Disclose More Information Concerning R788's Side Effects in the December 2007 Press Release

The Ninth Circuit found that the “subsequent release of more extensive information” concerning the side effects of R788 in a medical journal article did not render the statements in the December 2007 press release false or misleading because the later-disclosed information “was not inconsistent with the results that originally were reported.” *Id.* at *10.

The plaintiff relied on the Supreme Court’s decision in *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011) (Sotomayor, J.) to argue that “once a company chooses to disclose any safety information, it must disclose all material information regarding safety.” In *re Rigel*, 2012 WL 3858112, at *14 n.8. The Ninth Circuit held that “[t]his contention misconstrues” *Matrixx*. *Id.* “The *Matrixx* Court made it clear that not all adverse events would be material and, more importantly, that not all material adverse events would have to be disclosed.” *Id.* “Thus, as long as the omissions do not make the actual statements misleading, a company is not required to disclose every safety-related result from a clinical trial, even if the company discloses some safety-related results and even if investors would consider the omitted information significant.” *Id.*



The District Court for the District of Columbia Applies *Morrison* in Dismissing Section 10(b) Claims Involving Carlyle Capital Corporation

On August 13, 2012, the District Court for the District of Columbia held that the Supreme Court’s decision in *Morrison v. National Australia Bank*, 130 S. Ct. 2869 (2010) (Scalia, J.) precludes Section 10(b) claims involving securities purchased on Euronext. *Phelps v. Stomber*, 2012 WL 3276969 (D.D.C. Aug. 13, 2012) (Jackson, J.). Although a U.S. entity owns Euronext, the court found that “Euronext is not a U.S. exchange” under *Morrison* because “[t]he exchange is located in the Netherlands.” *Id.* at *14.

The *Phelps* court further held that *Morrison* does not preclude Section 10(b) claims involving Restricted Depository Shares (“RDSs”) purchased in the United States. Rejecting the argument that RDSs are the “functional equivalent” of shares traded on a foreign exchange, the court emphasized that *Morrison*’s bright-line test “focuses specifically and exclusively on where the plaintiff’s purchase occurred.” *Id.* at *16. The court nevertheless dismissed the plaintiff’s RDS-related Section 10(b) claims for failure to allege a misstatement or omission and failure to allege loss causation.

Background

Carlyle Capital Corporation (“CCC”) was “a closed-end investment fund ... formed as a limited company under the laws of Guernsey[.]” *Id.* at *4. The company’s “business model involved using highly leveraged financing in the form of repurchase loan agreements (‘repos’) to invest in residential mortgage-backed securities (‘RMBS’).” *Id.*

In an offering on July 11, 2007 (the “Offering”),

CCC sold more than 18 million Class B shares and RDSs. CCC's Class B shares were listed exclusively on Euronext and "sold only outside the United States to foreign investors." *Id.* at *4. CCC's RDSs were "sold to investors in the United States, as well as foreign investors." *Id.*

"The Offering Memorandum emphasized that CCC would 'utilize leverage extensively' and 'without limit.'" *Id.* at *6. "The Offering Memorandum also discussed the risk factors associated with CCC's business model[.]" *Id.* For example, CCC warned investors that it could not guarantee that the liquidity cushion would be "sufficient to satisfy margin calls." *Id.* CCC also cautioned that "[t]he price of Class B shares and the RDSs may fluctuate significantly" and investors "could lose all or part of [their] investment[s]." *Id.* at *7. In June 2007, CCC issued a Supplemental Offering Memorandum disclosing a significant decline in CCC's fair value reserves.

In March 2008, CCC entered into liquidation proceedings. The plaintiffs subsequently brought suit on behalf of (1) purchasers of Class B shares and/or RDSs in CCC's Offering; and (2) certain aftermarket purchasers of Class B shares. The defendants moved to dismiss the plaintiffs' claims under Section 10(b) and Rule 10b-5 based, *inter alia*, on *Morrison*.

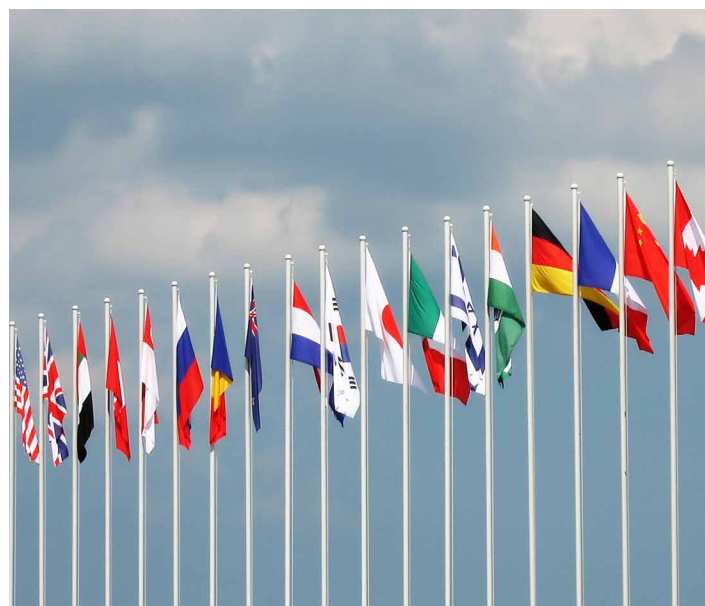
The Court Holds *Morrison* Precludes Section 10(b) Claims Involving Class B Shares

Turning first to the plaintiffs' Section 10(b) claims involving Class B shares, the district court found "no allegation in the complaint that any plaintiff [had] purchased Class B shares in the Offering in the United States." *Id.* at *14. "Indeed, the Offering Memorandum specifically state[d] that 'the Class B shares [could] not be offered or sold within the United States or to U.S. persons.'" *Id.*

As to claims involving aftermarket purchases of

Class B shares, the plaintiffs argued that *Morrison* was not dispositive because (1) "CCC was actually a U.S. company, even though it was incorporated under the laws of Guernsey," and (2) "Euronext was actually a U.S. exchange because ... it was owned by a Delaware company." *Id.* The district court rejected the "plaintiffs' effort to label everything 'Made in America' to get around *Morrison*["] *Id.* "According to [the] plaintiffs' own allegations, CCC [was] not a U.S. company—it was incorporated under the laws of Guernsey." *Id.* Moreover, the court determined that "Euronext is not a U.S. exchange. The exchange is located in the Netherlands." *Id.*

The court noted that the plaintiffs could "point[] to no authority that would suggest that there is any significance to the fact that a foreign exchange was owned by a U.S. entity." *Id.* "To the contrary, *Morrison* specifically directed courts to focus on the geographic location of the *transaction*, and here, the aftermarket purchase of Class B shares occurred on a foreign exchange." *Id.* (internal citation omitted). "[O]ther courts that have considered similar questions after *Morrison* have treated Euronext as a foreign exchange." *Id.* (citing *In re Vivendi Universal, S.A. Sec. Litig.*, 842 F. Supp. 2d 522 (S.D.N.Y. 2012) (Holwell, J.); *In re Société Générale Sec. Litig.*, 2010 WL 3910286, at *5 (S.D.N.Y.



Sept. 29, 2010) (Berman, J.)).

The district court therefore held that “[t]he federal securities claims with respect to the aftermarket are barred by *Morrison* because the Class B shares were purchased on a foreign exchange and therefore were not bought or sold in the United States.” *Id.* at *16.

The Court Finds *Morrison* Does Not Preclude Section 10(b) Claims Involving RDSs

The court next considered the defendants’ motion to dismiss Section 10(b) claims arising out of the RDS transactions. CCC’s “RDSs were sold to U.S. investors in the Offering under Regulation D and Rule 144A, which are the two registration exemptions applicable to securities sold in the United States.” *Id.* at *15 (internal citations omitted). “The RDSs were issued by the Bank of New York, which described them as ‘U.S. securities’ on their website.” *Id.* “U.S. investors were only permitted to purchase RDSs in the Offering because they were not eligible to buy Class B shares.” *Id.* “Taking [the] allegations together,” the court found that there was “no question that the RDSs were ‘bought and sold in the United States[.]’” *Id.* The court observed that the “defendants do not appear to challenge [this] conclusion seriously.” *Id.*

“Rather,” the defendants’ “primary” argument was that “the RDSs sold here were ‘tethered’ to the Class B shares sold only on [a] foreign exchange.” *Id.* The “defendants urge[d] the [c]ourt to look at the ‘economic reality’ underlying the transaction and to conclude that purchasing an RDS was ‘a transaction that has a necessary foreign connection’ for *Morrison* purposes.” *Id.*

The defendants cited the Southern District of New York’s decisions in *Société Générale* and *Elliott Associates v. Porsche Automobil Holdings SE*, 759 F. Supp. 2d 469 (S.D.N.Y. 2010) (Baer, J.) as support for their argument. In *Société Générale*, the court considered claims arising

out of the plaintiffs’ purchases of American Depository Receipts (“ADRs”), “which are similar to RDSs in that they represent the shareholder’s ownership of a foreign security traded on a foreign exchange.” *Phelps*, 2012 WL 3276969, at *15. The *Société Générale* court “determined that because ‘trade in ADRs is considered to be a predominately foreign securities transaction,’ [S]ection 10(b) did not apply.” *Id.* (quoting *Société Générale*, 2010 WL 3910286, at *1).⁶

Elliott concerned “the purchase of securities-based swap agreements that referenced the share price of foreign stock.” *Id.* The court found that the swap agreements at issue were the “functional equivalent of trading the underlying company’s shares on a [foreign] exchange.” *Elliott*, 759 F. Supp. 2d at 476. “Accordingly,” the *Elliott* court held that “the economic reality is that [the] [p]laintiffs’ swap agreements [were] essentially ‘transactions conducted upon foreign exchanges and markets,’ and not ‘domestic transactions’ that merit the protection of § 10(b).” *Id.* (quoting *Morrison*, 130 S. Ct. at 2882, 2884).⁷

“Relying on these cases,” the defendants in *Phelps* “suggest[ed] that the [c]ourt employ an ‘economic reality’ or ‘functional equivalent’ test to determine whether the claims [were] barred under *Morrison*.” *Phelps*, 2012 WL 3276969, at *16. The District Court for the District of Columbia found “the ‘functional equivalent’ gloss that the *Elliott* and *Société Générale* courts have developed” to be “inconsistent with the bright line test set forth by the Supreme Court in *Morrison*, which focuses specifically and exclusively on where the plaintiff’s purchase occurred.” *Id.* “While [the] defendants’ contention that an investor could not purchase an RDS in the United States without a corresponding overseas transaction may be true,” the court held that this “does not change the fact that a purchase in the United States still took place.” *Id.*

⁶ Please [click here](#) to read our discussion of the *Société Générale* case in the October 2010 edition of the Alert.

⁷ Please [click here](#) to read our discussion of the *Elliott* case in the January 2011 edition of the Alert.

The court concluded that “[t]he federal securities claims with respect to the Offering are not barred by *Morrison* because [the] plaintiffs’ purchases of RDSs constituted a ‘purchase or sale of [a] security in the United States.’” *Id.* (quoting *Morrison*, 130 S. Ct. at 2993).

The Court Dismisses the RDS-Related Section 10(b) Claims for Failure to State a Claim

Although the court held that *Morrison* does not preclude the plaintiff’s RDS-related Section 10(b) claims, the court ruled that those claims must nevertheless be dismissed for failure to allege a misstatement or omission and failure to allege loss causation.

The court noted that the “gravamen of the complaint is that the CCC Offering Memorandum was materially false and misleading because while it disclosed that liquidity issues that would affect the company *could* occur, it omitted information that would have alerted investors to the fact that those events were *already occurring*.” *Id.* at *1. Rejecting the plaintiffs’ core argument, the court found that the Offering materials “specifically placed buyers on notice of what CCC was doing and the fact that it had recently experienced the very reversals that [the] plaintiffs claim should have been disclosed.” *Id.* at *2. “So, this action lacks the defining element of fraud: a falsehood.” *Id.* The court held that “[t]he federal claims also fall short of supporting the necessary allegation that the alleged fraud caused the plaintiffs’ losses.” *Id.*

“Essentially,” the court explained that “this complaint is an attack on how CCC was managed, and ultimately, it questions the wisdom behind the adoption of its business model in the first place.” *Id.* at *1. “But chiding CCC with the benefit of hindsight for its failure to resist the stampede to purchase mortgage-backed securities is not the same thing as alleging fraud, particularly given the stringent standards of the [Private Securities Litigation Reform Act].” *Id.*

The Delaware Chancery Court Addresses the Scope of a Controlling Shareholder’s Fiduciary Duties in the Merger Context

On August 17, 2012, the Delaware Chancery Court dismissed a shareholder suit alleging that a controlling shareholder had breached his fiduciary duties by “refus[ing] to consider an acquisition offer that would have cashed out all the minority stockholders of [the corporation], but required the controlling stockholder to remain as an investor in [the corporation].” *In re Synthes, Inc. S’holder Litig.*, 2012 WL 3641014, at *1 (Del. Ch. Aug. 17, 2012) (Strine, J.). The court explained that “Delaware does not require a controlling stockholder to penalize itself and accept less than the minority, in order to afford the minority better terms.” *Id.*

Background

Synthes was a Swiss global medical device company incorporated in Delaware. The Chairman of Synthes’s Board of Directors, Hansjoerg Wyss, owned 38.5% of Synthes’ shares and allegedly “controlled” an additional 13.25% of Synthes’ shares “owned by [his] family members and trusts.” *Id.* at *2.

The plaintiffs claimed that Wyss was “getting ready... to step down as Chairman of the Board” and “wanted to divest his stockholdings in Synthes and free up that wealth in order to achieve certain estate planning and tax goals.” *Id.* “Doing so piecemeal would be problematic” because “unloading that much stock on the public market in blocs would cause the share price to drop[.]” *Id.* Wyss thus allegedly “needed to sell his personal holdings to a single buyer.” *Id.*

In April 2010, “[t]he idea to find a potential buyer for Synthes [allegedly] arose ... as part of the Board’s

ongoing review of the company's strategic initiatives." *Id.*⁸ On December 23, 2010, Johnson & Johnson ("J&J") submitted an offer "to acquire Synthes at an indicative price range of CHF [Swiss Franc] 145-150 per share, with more than 60% of the consideration to be paid in the form of J&J stock." *Id.* at *3. On February 9, 2011, a group of three private equity firms (the "PE Buyers") submitted an all-cash offer of CHF 151 per share and indicated that this was their maximum offer. "[T]he PE Buyers did not have deep enough pockets to make a bid for the whole company." *Id.* at *4. Instead, the PE Buyers' offer "'required' Wyss to 'convert a substantial portion of his equity investment in Synthes into an equity investment in the post-merger company.'" *Id.* at *4. "In other words," the PE Buyers' offer "was contingent on Wyss' financing part of the transaction with his own equity stake ... and Wyss remaining as a major investor in Synthes." *Id.*

Wyss allegedly opposed the PE Buyers' offer "because he wanted to cash out alongside the rest of Synthes' shareholders rather than trade one illiquid bloc of stock (his Synthes shares) for another (shares in the private post-merger entity)." *Id.* Accepting the PE Buyers' offer would have left Wyss with "a substantial bloc tied up in a company where he no longer had the same voting clout, and thus [he] would have [had] an illiquid, private company-bloc with no control or exit power." *Id.* "[T]o avoid what could be seen as a down trade in status, Wyss allegedly caused the Board to cease consideration" of the PE Buyers' offer.

Synthes ultimately entered into a merger agreement with J&J (the "Merger") at a price of "CHF 159 per share, with a consideration mix of 65% stock (subject to a collar) and 35% cash." *Id.* at *5. The merger agreement provided that "[a]ll stockholders, including Wyss, would receive the same per share Merger consideration." *Id.* "There [were] no allegations that Wyss tried to negotiate a higher price for his own shares." *Id.*

⁸ While "[t]he complaint alleges that Wyss 'supported' the decision to explore a sale transaction, ... the complaint does not allege whose idea it was in the first instance." *Id.*

Shareholder plaintiffs subsequently brought suit alleging that Wyss had breached his fiduciary duties by "preventing the Synthes Board from pursuing the [PE Buyers'] Bid, which at the time presented the highest-value and greatest-certainty proposal for Synthes' minority stockholders." *Id.* at *6. "[T]he plaintiffs contend[ed] that Wyss had financial motives adverse to the best interests of the Synthes stockholders because he was supposedly anxious ... to sell the company as a whole to facilitate his own exit" and "was only willing to accept a deal that delivered for him the liquidity he wanted for his shares in accordance with his retirement objectives." *Id.*

The Chancery Court Finds the Complaint Fails to Allege That Wyss Had a Conflicting Interest

The Delaware Chancery Court "focus[ed] [its] analysis on whether Wyss had any conflicting interest in the Merger that would justify depriving the Board of the protections of the business judgment rule." *Id.* at *8. Here, the plaintiffs contended that "Wyss was conflicted because ... [he] would only accept [a deal] in which he received liquidity for his shares[.]" *Id.* at *11. The court found that "Wyss' supposed liquidity conflict was not really a conflict at all because he and the minority stockholders wanted the same thing: liquid currency and, all things being equal, at the highest dollar value amount of that currency." *Id.* at *12.

The Chancery Court noted that "a fiduciary's financial interest in a transaction as a stockholder (such as receiving liquidity value for her shares) does not [generally] establish a disabling conflict of interest when the transaction treats all stockholders equally, as does the Merger." *Id.* at *9. "This notion stems from the basic understanding that when a stockholder who is also a fiduciary receives the same consideration for her shares as the rest of the shareholders, their interests are aligned." *Id.* The court explained that

“there is a good deal of utility to making sure that when controlling stockholders afford the minority pro rata treatment, they know they have docked within the safe harbor created by the business judgment rule.” *Id.* “If, however, controlling stockholders are subject to entire fairness review when they share the [control] premium ratably with everyone else, they might as well seek to obtain a differential premium for themselves or just to sell their control bloc, and leave the minority stuck in.” *Id.*

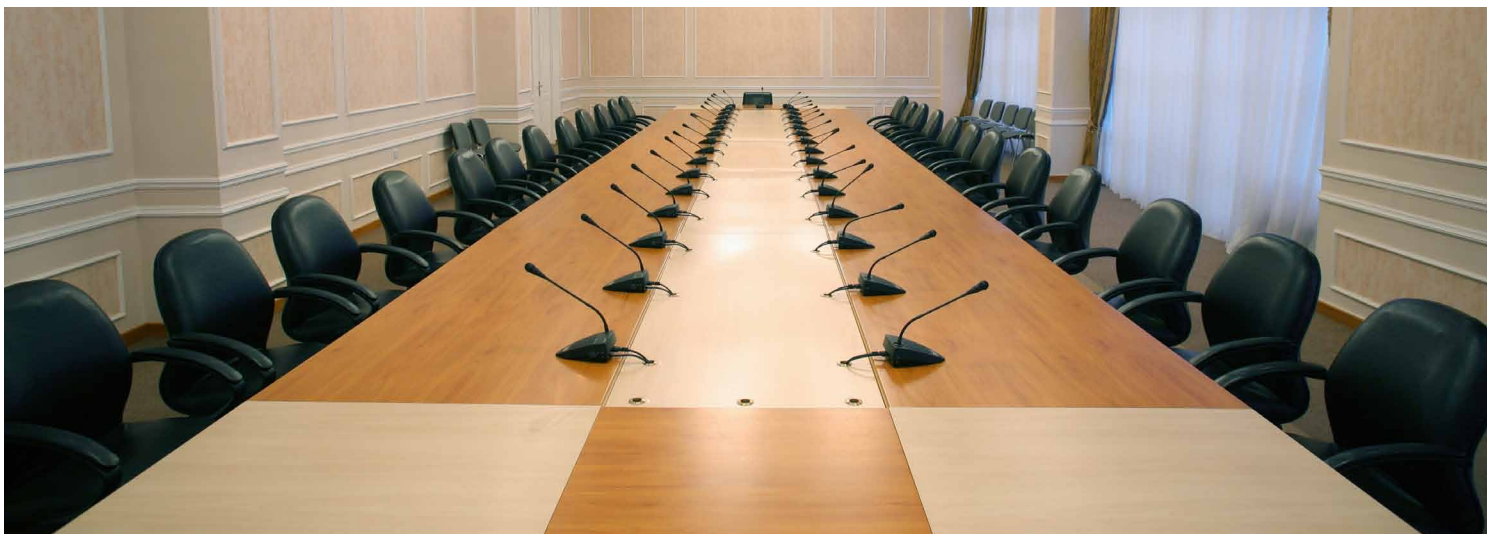
The Chancery Court determined that “the plaintiffs’ main gripe [was] that Wyss refused to consider an all-cash offer that might have delivered a better deal for the minority shareholders *at Wyss’ expense.*” *Id.* at *12. “In other words, they complain that Wyss refused to facilitate a potentially better deal for the minority because he was not willing to roll a ‘substantial’ part of his equity stake into the post-merger entity and thereby accept a different, less liquid, and less value-certain form of consideration than that offered to the minority stockholders.” *Id.* The Chancery Court found this to be “an astonishing argument that reflects a misguided view of the duties of a controlling stockholder under Delaware law.” *Id.*

“A primary focus of [Delaware] corporate jurisprudence has been ensuring that controlling stockholders do not use the corporate machinery to unfairly advantage themselves at the expense of

the minority.” *Id.* “Delaware law does not, however, go further than that and impose on controlling stockholders a duty to engage in self-sacrifice for the benefit of minority shareholders.” *Id.* at *13. There is no requirement that a controlling shareholder “subrogate his own interests so that the minority stockholders can get the deal that they want.” *Id.*

The Chancery Court held that “Wyss was thus entitled to oppose a deal that required him to subsidize a better deal for the minority stockholders by subjecting him to a different and worse form of consideration.” *Id.* “To hold otherwise would turn on its head the basic tenet that controllers have a right to vote their shares in their own interest.” *Id.* “Put simply, minority stockholders are not entitled to get a deal on better terms than what is being offered to the controller, and the fact that the controller would not accede to that deal does not create a disabling conflict of interest.” *Id.*

The court “conclude[d] that the plaintiffs have not pled facts supporting an inference that Wyss’ interest in obtaining liquidity in a sale of Synthes constituted a conflict of interest justifying the invocation of the entire fairness standard[.]” *Id.* at *16. “Rather, the pled facts demonstrate that Wyss received equal treatment in the Merger and that the business judgment rule applies to the Board’s decision to approve the Merger.” *Id.*



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