

This month's Alert addresses the Supreme Court's grant of certiorari in *Gabelli v. SEC* (11-1274) to determine when a government penalty claim accrues for purposes of the limitations period set forth in Section 2462.

We also discuss two decisions from the Southern District of New York: one dismissing a securities fraud action against UBS AG and holding that the group pleading doctrine does not survive the Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) (Thomas, J); and another denying a motion to stay a derivative suit against the directors of News Corporation notwithstanding a similar action pending in the Delaware Chancery Court.

In addition, we address a District of Connecticut decision holding that the definition of "whistleblower" is broader under the Dodd-Frank Act's anti-retaliation provision than it is under the rest of the statute; as well as a decision from the Eastern District of North Carolina dismissing a say-on-pay derivative suit against the directors and officers of Dex One Corporation on the merits.

Finally, we discuss a Delaware Chancery Court decision holding that plaintiffs who file *Caremark* claims without first conducting a reasonable investigation are presumed disloyal to the corporation.

The Supreme Court Will Address When a Government Claim Accrues Under the Limitations Period Set Forth in 28 U.S.C. § 2462

Under Section 2462 of Title 28, any government action "for the enforcement of any civil fine, penalty, or forfeiture" must be "commenced within five years from the date when the claim first accrued." 28 U.S.C. § 2462. On September 25, 2012, the Supreme Court granted certiorari to determine whether "the government's claim first accrue[s] for purposes of" Section 2462 "when the government can first bring an action for a penalty." Petition for Writ of Certiorari,

Gabelli v. SEC, 2012 WL 1419938, at *i (U.S. Apr. 20, 2012) (11-1274).

Background

On April 24, 2008, the SEC filed a complaint against Marc J. Gabelli ("Gabelli"), the portfolio manager of

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the Gabelli Global Growth Fund (“GGGF”) and Bruce Alpert, the chief operating officer for GGGF’s adviser, Gabelli Funds, LLC (the “Adviser”). Petition for Writ of Certiorari, *Gabelli*, at *6-7. “In essence, the SEC’s complaint charge[d] [the] defendants with failing to disclose favorable treatment accorded one GGGF investor in preference to other investors.” *SEC v. Gabelli*, 653 F.3d 49, 52 (2d Cir. 2011) (Rakoff, J.)¹ (*Gabelli II*). While the Adviser “prohibit[ed] most GGGF investors from engaging in a form of short-term trading called ‘market timing,’” the Adviser allegedly “secretly permitted one investor to market time [GGGF] in exchange for an investment in a hedge fund managed by Gabelli.” *Id.* at 52-53. The SEC claimed, *inter alia*, that “both Alpert and Gabelli had aided and abetted violations by the Adviser of the antifraud provisions of Sections 206(1) and 206(2) of the Advisers Act.” *Id.* at 55.



The SEC’s complaint alleged that the market timing at issue ended in August 2002, more than five years prior to the date the SEC brought suit. Petition for Writ of Certiorari, *Gabelli*, at *7. However, the SEC contended that its claims were still timely because it did not discover the fraud until September 2003. *Gabelli II*, 653 F.3d at 58-59. The SEC argued that under the “discovery rule,” “a claim accrues and the statute of limitations begins to run for purposes of § 2462, when

the fraud or misstatement is discovered ... rather than when the violation occurs.” *SEC v. Gabelli*, 2010 WL 1253603, at *5 (S.D.N.Y. Mar. 17, 2010) (Batts, J.) (*Gabelli I*).

On March 17, 2010, the Southern District of New York determined that “the discovery rule does not apply to claims subject to the limitations of § 2462” and held that “the statute of limitations ha[d] run on [the SEC’s] claims for civil penalties under the Investment Adviser Act.” *Gabelli I*, 2010 WL 1253603, at *5-6.

The Second Circuit Holds That the Discovery Rule Applies to Section 2462’s Limitations Period for Claims That Sound in Fraud

On August 1, 2011, the Second Circuit reversed the district court’s ruling. The court stated that “it has been long established that the discovery rule applies [to statutes of limitations] where, as here, a claim sounds in fraud.” *Gabelli II*, 653 F.3d at 59. Although “Section 2462 does not expressly state a discovery rule,” the Second Circuit found that “it would [have] be[en] unnecessary for Congress to expressly mention the discovery rule ... given the presumption that the discovery rule applies to [fraud] claims unless Congress directs otherwise.” *Id.* at 60 (citing *Holmberg v. Armbrecht*, 327 U.S. 392, 397 (1946) (Frankfurter, J.) (explaining that the discovery rule for claims of fraud “is read into every federal statute of limitation”) (emphasis added)).

The Second Circuit determined that “the discovery rule applies to fraud claims” even if there are “no special circumstances or efforts on the part of the party committing the fraud to conceal it from the knowledge of the other party.” *Id.* at 59 (quoting *Bailey v. Glover*, 88 U.S. 342, 348 (1874) (Miller, J.)). The court explained that “fraud claims by their very nature involve self-concealing conduct.” *Id.*

“In this case, since the [SEC’s] Advisers Act claim

1. The Honorable Jed S. Rakoff of the Southern District of New York was sitting by designation on the Second Circuit panel.



is made under the antifraud provisions of that Act and alleges that the defendants aided and abetted Gabelli Funds' fraudulent scheme," the Second Circuit held that "the discovery rule defines when the claim accrues." *Id.* at 60. The Second Circuit further held that "the SEC need not plead that the defendants took affirmative steps to conceal their fraud." *Id.*

Citing a Circuit Split, the Defendants Petition the Supreme Court for Certiorari

The defendants petitioned the Supreme Court for certiorari, contending that "[t]he Second Circuit's holding creates a circuit split with respect to the question of how to interpret the limitations period for government penalty actions set forth in Section 2462." Petition for Writ of Certiorari, *Gabelli*, at *13. The petitioner-defendants argued that prior to the Second Circuit's decision,

[F]our circuit courts ha[d] unambiguously read the term "accrual" as used in Section 2462 to refer to the date of the underlying violation, and, thus, [] required the government to bring a penalty claim within five years of the earliest date on which it could sue absent a statute expressly providing otherwise.²

Id. This circuit split was deepened by the Fifth Circuit's decision in *SEC v. Bartek*, 2012 WL 3205446 (5th Cir. Aug. 7, 2012) (per curiam), issued after the Second Circuit's decision but before the petitioner-defendants filed their reply. The Fifth Circuit "held that Section 2462's 'first accrued' language refers to the date of the violation and that the discovery rule did not apply even when the Government alleged the defendant [had] violated an antifraud statute." Reply Brief in Support of Petition for Writ of Certiorari, *Gabelli v. SEC*, 2012 WL 4428088, at *1-2 (U.S. Aug. 14, 2012) (No. 11-1274).

The petitioner-defendants asserted that "[t]here is no room in Section 2462 or the federal securities laws to find a discovery rule for penalty actions under the [Advisers Act]." Petition for Writ of Certiorari, *Gabelli*, at *21. "This Court has held—in a decision the [Second Circuit] ignored—that '[i]n common parlance a right accrues when it comes into existence.'" *Id.* at *19-20 (alteration in original) (quoting *United States v. Lindsay*, 346 U.S. 568, 569 (1954) (Black, J.)). Moreover, "Congress explicitly legislated a discovery rule in the federal securities laws when it wanted the courts to apply such a rule, providing that the discovery rule

2. Citing *3M Co. v. Browner*, 17 F.3d 1453, 1462-63 (D.C. Cir. 1994) (Randolph, J.) (holding that the Environmental Protection Agency could not bring an action seeking penalties under the Toxic Substances Control Act for conduct that occurred more than five years earlier and rejecting the application of the discovery rule to Section 2462); *FEC v. Williams*, 104 F.3d 237, 240 (9th Cir. 1996) (Beezer, J.) (agreeing with the *3M Co.* court that the discovery rule does not apply to Section 2462); *U.S. v. Core Labs., Inc.*, 759 F.2d 480, 481-83 (5th Cir. 1985) (Gee, J.) (finding that the Commerce Department could not bring a penalty action for violations of the Export Administration Act more than five years after the last allegedly unlawful act and holding that a claim under Section 2462 "accrues at the time of the underlying violation"); *United States v. Witherspoon*, 211 F.2d 858, 861 (6th Cir. 1954) (McAllister, J.) (finding a government penalty action untimely under Section 2462 where the complaint "was filed more than five years after the last alleged act of fraud").

The Second Circuit "asserted that its decision did not create a conflict with [prior] cases because it was considering a statute that 'sounds in fraud.'" Petition for Writ of Certiorari, *Gabelli*, at *18. But the petitioner-defendants claimed that each of the cases it cited "involved conduct that could be said to 'sound in fraud'" and "some of them involved explicitly 'concealing' conduct." *Id.* at *18-19.

would apply to ‘a private right of action’ and not to a governmental penalty action.” *Id.* at *20-21.

The petitioner-defendants also contended that the Second Circuit’s “decision cannot be reconciled with this Court’s intervening decision in” *Credit Suisse Securities (USA) LLC v. Simmonds*, 132 S. Ct. 1414 (2012) (Scalia, J.). *Id.* at *25. In *Simmonds*, “the Court rejected a court-created exception to clear statutory text directly analogous to the rule created by the [Second Circuit] below.”³ *Id.* at *26. “*Simmonds* also explained that the doctrine of fraudulent concealment was the only appropriate basis for avoiding a statutory limitations period where Congress had not specified otherwise” *Id.* at *27.

Finally, the petitioner-defendants claimed that “[u]nder the Second Circuit’s holding, a defendant whom the Government can allege violated an antifraud statute will forever be at the peril of a governmental penalty, so long as the Government claims it discovered the claim recently and did not know of it earlier.” Reply Brief in Support of Petition for Writ of Certiorari, *Gabelli*, at *1. “The potential for such endless tolling in cases in which a reasonably diligent plaintiff would know of the facts underlying the action is out of step with the purpose of limitations periods in general.” Petition for Writ of Certiorari, *Gabelli*, at *28 (quoting *Simmonds*, 132 S. Ct. at 1420).

The SEC Responds That the Discovery Rule Is Read Into Every Federal Statute of Limitations for Fraud Claims

In opposition to the defendants’ Petition for Writ of Certiorari, the SEC argued that the Supreme Court has “repeatedly recognized that, unless Congress

specifies a different rule, the limitations period in a suit for fraud does not begin to run until the plaintiff discovers, or in the exercise of reasonable diligence could have discovered, the facts underlying the claim.” Brief for the Respondent in Opposition, *Gabelli v. SEC*, 2012 WL 3041165, at *7 (U.S. July 25, 2012) (No. 11-1274). The SEC stated that:

This Court long ago adopted as its own the old chancery rule that where a plaintiff has been injured by fraud and “remains in ignorance of it without any fault or want of diligence or care on his part, the bar of the statute does not begin to run until the fraud is discovered, though there be no special circumstances or efforts on the part of the party committing the fraud to conceal it from the knowledge of the other party.”

Brief for the Respondent in Opposition, *Gabelli*, at *9 (quoting *Holmberg*, 327 U.S. at 397). The SEC contended that “the discovery rule has long been understood as a background principle that presumptively governs the application of federal limitations statutes unless Congress specifies otherwise.” *Id.* at *12. “Its applicability does not depend on express language incorporating the discovery rule into Section 2462.” *Id.*

As support for its position, the SEC pointed to the Seventh Circuit’s decision in *SEC v. Koenig*, 557 F.3d 736 (7th Cir. 2009) (Easterbrook, C.J.). The *Koenig* court “explained that it did not need to decide ‘when a “claim accrues” for purposes of [Section] 2462 generally, because the nineteenth century recognized a special rule for fraud, a concealed wrong.’” *Id.* at *10 (quoting *Koenig*, 557 F.3d at 739). The Seventh Circuit held that “a victim of fraud has the full time from the date that the wrong came to light, or would have done had diligence been employed.” *Koenig*, 557 F.3d at 739. The SEC noted that, “[i]n *Koenig*, as in this case, the [SEC] brought its enforcement action within five years after it was able to discover the fraud at issue.” Brief for the Respondent in Opposition, *Gabelli*, at *10. “The

3. The *Simmonds* Court held that “the plain language of the statutory limitations period [under Section 16(b) of the Exchange Act of 1934] was controlling” and that the limitations period began to run on “the date any profit was ‘realized’ ... not the date of a later required filing as the [Ninth Circuit] court of appeals had held.” Petition for Writ of Certiorari, *Gabelli*, at *26.

Seventh Circuit therefore concluded that the [SEC's] enforcement action was timely." *Id.*

The SEC contended that "[l]ike the Seventh Circuit in *Koenig*," the Second Circuit had "correctly applied the discovery rule in this case." *Id.* "[T]he [SEC] was required to bring its suit within five years after it discovered, or with reasonable diligence could have discovered, petitioners' fraudulent scheme." *Id.* at *12. "Applying that rule to the facts of this case, the [Second Circuit] correctly held that the [SEC's] complaint was not subject to dismissal on limitations grounds." *Id.*

Finally, the SEC explained that "the relevant statutory provisions create ample incentives for the [SEC] to pursue its claims diligently." *Id.* at *17-18. "[T]o bring an enforcement action like this one, the [SEC] must satisfy ... the pleading standards for fraud, which may become more difficult to meet as the defendants' conduct becomes more remote in time." *Id.* at *17. If "the [SEC] prevails on the merits, the district court has discretion to set the amount of any civil penalty, and it can consider the passage of time as well as other relevant factors." *Id.*

* * *

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

The Southern District of New York Dismisses a Securities Fraud Action against UBS, and Holds That the Group Pleading Doctrine Does Not Survive *Janus*

On September 28, 2012, the Southern District of New York dismissed in its entirety a securities fraud action against UBS AG, certain UBS executives, and several underwriters of UBS securities. *In re UBS AG Sec. Litig.*, 2012 WL 4471265 (S.D.N.Y. Sept. 28,



2012) (Sullivan, J.).⁴ The court held that in light of the Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) (Thomas, J.), plaintiffs could not rely on the group pleading doctrine to assert Section 10(b) and Rule 10b-5 claims against individual UBS defendants who did not themselves make a misstatement.

Background

The plaintiffs alleged that UBS and a number of its executives had violated Sections 10(b) and 20(a) of the Exchange Act, and Rule 10b-5, by allegedly:

[I]ssuing fraudulent statements with respect to (1) UBS's mortgage-related securities portfolio (the alleged "mortgage-related securities fraud"); (2) UBS's Auction Rate Securities ("ARS") portfolio (the alleged "ARS fraud"); and (3) UBS's purported compliance with United States tax and securities laws by UBS's Swiss-based cross-border private banking business for American clients (the alleged "tax fraud").

In re UBS, 2012 WL 4471265, at *1. The plaintiffs also asserted claims under Sections 11, 12(a)(2), and 15 of the Securities Act against UBS, certain individual

4. Simpson Thacher represents the underwriters in this action.

defendants, and seven underwriters in connection with the company's June 13, 2008, Rights Offering. *Id.* The defendants moved to dismiss the complaint. *Id.*

The Court Dismisses All Claims against the Individual Defendants for Failure to Allege That Each Defendant "Made" a Misstatement under *Janus*

In response to the UBS defendants' motion to dismiss, the plaintiffs invoked the group pleading doctrine. *Id.* at *9. This doctrine:

[A]llows a plaintiff to circumvent the general pleading rule that fraudulent statements must be linked directly to the party accused of [] fraudulent intent, by allowing a court to presume that certain group-published documents such as SEC filings and press releases are attributable to corporate insiders involved in the everyday affairs of the company.

Id. (internal quotation marks, citation, and alterations omitted). The UBS defendants contended that the group-pleading doctrine "does not survive the [Private Securities Litigation Reform Act ('PSLRA')] and has been abrogated by the Supreme Court's recent *Janus* decision." *Id.* at *10.

The UBS court began its analysis by noting that, while the Second Circuit "never squarely addressed whether the [group-pleading] doctrine survived the PSLRA," most courts in the Southern District of New York to consider the issue pre-*Janus* "held that it did."⁵ *Id.* The court observed that "the majority view in this district" was "wholly at odds with the view of each circuit court to have squarely addressed the issue prior to *Janus*." *Id.*

Nevertheless, the UBS court explained that courts have "since acknowledged" that "the Supreme Court's decision in '*Janus*' calls into question the viability of

the group pleading doctrine for federal securities law claims." *Id.* (quoting *In re Optimal U.S. Litig.*, 837 F. Supp. 2d 244, 263 (S.D.N.Y. 2011) (Scheidlin, J.)). "In *Janus*, the Supreme Court held that because 'none of the statements in the prospectuses were attributed, explicitly or implicitly, to [a defendant],' there was no basis for concluding that it made any actionable misrepresentations or omissions." *Id.* (alteration in original) (quoting *Janus*, 131 S. Ct. at 2304-05 & n. 11). "Indeed, the Court explained that defendants must have 'made' the allegedly problematic statement by having 'authority over the content of the statement and whether and how to communicate it.'" *Id.* (quoting *Janus*, 131 S. Ct. at 2303). "Therefore, even 'significant involve[ment]' in preparing a statement was deemed insufficient for liability." *Id.* (quoting *Janus*, 131 S. Ct. at 2305).

The plaintiffs argued that *Janus* "does not apply to 'corporate insider[s] responsible for the day to day affairs' of a company." *Id.* Rejecting this argument, the UBS court found that the plaintiffs were "attempt[ing] to read into *Janus* a distinction that does not appear in the [Court's] opinion." *Id.* "[W]hile it is true that *Janus* might not alter the well-established rule that a corporation can act only through its employees and agents, it is ... also true that a theory of liability premised on treating corporate insiders as a group cannot survive a plain reading of the *Janus* decision." *Id.* (internal quotation marks and citation omitted). The court explained that "[a]lthough *Janus* might not necessarily imply that there can be only one maker of a statement in the case of express or implicit attribution, the individual defendants still must have actually

5. The UBS court cited *In re Am. Int'l Grp., Inc. 2008 Sec. Litig.*, 741 F. Supp. 2d 511, 529-30 (S.D.N.Y. 2010) (Swain, J.) (applying the group pleading doctrine and finding that the plaintiffs had sufficiently stated a claim against individual defendants); *In re Refco, Inc. Sec. Litig.*, 503 F. Supp. 2d 611, 642 (S.D.N.Y. 2007) (Lynch, J.) ("[T]his Court joins the majority of district courts in this district and others in holding that the group pleading doctrine is 'alive and well.'"); and *In re Van der Moolen Holding N.V. Sec. Litig.*, 405 F. Supp. 2d 388, 399 (S.D.N.Y. 2005) (Sweet, J.) ("The majority rule in this district is that the group pleading doctrine has survived the PSLRA.").

'made' the statements under the new *Janus* standard to be held liable under Section 10(b)." *Id.* (internal quotation marks and citation omitted).

The court emphasized that the complaint did not allege that any of the individual UBS defendants themselves made any allegedly material misstatements. "[W]here an [i]ndividual [d]efendant has not 'made' the allegedly material misstatements," the court held that "he cannot be liable under the Exchange Act." *Id.* at *11 (citing *Janus*, 131 S. Ct. at 2301). The court therefore dismissed all Section 10(b) claims against the individual defendants. *Id.*

The Court Dismisses the Remaining Section 10(b) Claims for Failure to Allege Scienter and Materiality

With respect to the plaintiffs' Section 10(b) claims concerning the alleged mortgage-related securities and ARS frauds, the court determined that "a reasonable person would not deem [the] [p]laintiffs' purported inference of scienter to be 'at least as compelling as an opposing inference one could draw from the facts alleged.'" *Id.* at *21. The court reasoned that "[t]he more compelling inference, at least based on the facts as they are alleged in the [a]mended [c]omplaint, is that the UBS [d]efendants simply did not anticipate that there would be a market-wide downturn impacting its various businesses and, ultimately, UBS's



shareholders." *Id.* The court therefore found that "any alleged failure to disclose was 'more likely attributable to the financial turmoil occurring in 2007 than to fraud or recklessness.'" *Id.*

As to the alleged misstatements concerning UBS's alleged tax fraud, the court found that "generalized statements" addressing UBS's "adherence to ethical and legal standards" amounted to "non-actionable puffery" and did "not constitute material misstatements within the context of ... the Exchange Act[.]" *Id.* at *34, *36. The *UBS* court cited the Second Circuit's decision in *ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187 (2d Cir. 2009) (Kelly, Jr., J.), which "refined the puffery standard." *Id.* at *35. In *JP Morgan*, the Second Circuit explained that "statements that are 'too general to cause a reasonable investor to rely upon them,' including 'mere [] generalizations regarding ... business practices' are no more than non-actionable 'puffery.'" *Id.* (alterations in original) (quoting *JP Morgan*, 553 F.3d at 205-06). The *JP Morgan* court held that alleged statements regarding the company's "highly disciplined" risk management and "standard-setting reputation for integrity" were "precisely the type of puffery that this and other circuits have consistently held to be inactionable." *JP Morgan*, 553 F.3d at 205-06 (internal quotation marks omitted).

Finally, the *UBS* court found immaterial the plaintiffs' claims that "UBS [had] inflated the amount of net new money it generated each year by including net new money ... from its cross-border business." *UBS*, 2012 WL 4471265, at *22-23. The defendants represented that "UBS's Swiss-based cross-border business contributed just 0.3% of the overall net new money of UBS's Global Wealth Management business in 2007." *Id.* The *UBS* court explained that "the Second Circuit and district courts within this Circuit have repeatedly held that accounting categorizations of such small magnitude, when compared against a company's much larger total assets, are not 'material.'" *Id.* at *23.

The Southern District of New York Permits a Derivative Suit to Proceed Against the Directors of News Corporation Despite a Similar Suit Pending in Delaware

On September 18, 2012, the Southern District of New York denied a motion to stay derivative suits against various News Corporation directors and officers pending resolution of a similar derivative action in the Delaware Court of Chancery. *Shields v. Murdoch*, 2012 WL 4097199 (S.D.N.Y. Sept. 18, 2012) (Gardephe, J.). The court found that abstention from federal jurisdiction was not appropriate under *Colorado River Water Conservation District v. United States*, 424 U.S. 800 (1976) (Brennan, J.) because the federal suits asserted Exchange Act claims in addition to the state law claims asserted in the Delaware suit. *Shields*, 2012 WL 4097199, at *6.

Background

Following revelations of phone-hacking at *News of the World*, one of News Corporation's publications, a number of plaintiffs brought suit in the Delaware Chancery Court on March 16, 2011 (the "Delaware Action"). *Id.* at *1. The operative complaint in the Delaware Action alleges four state law breach of fiduciary duty claims. *Id.* at *4. After the Delaware Action was filed, other plaintiffs filed three separate derivative suits in the Southern District of New York. *Id.* at *3. Two of these suits (the "Federal Actions") asserted violations of Section 14(a) of the Exchange Act, in addition to state law claims. *Id.* On December 8, 2011, the defendants in the three federal suits moved for a stay pending the resolution of the Delaware Action. *Id.* at *4.

The Court Holds That Abstention Is Not Appropriate Under the *Colorado River* Doctrine Because the Federal Actions and the Delaware Action Are Not Parallel

Under the *Colorado River* doctrine, "a federal court, in 'exceptional' circumstances, may dismiss a federal suit based on 'considerations of wise judicial administration, giving regard to conservation of judicial resources and comprehensive disposition of litigation.'" *Id.* at *5 (quoting *Colorado River*, 424 U.S. at 817-18). "Before a court evaluates the appropriateness of abstention under *Colorado River*, it must make a threshold determination that the federal and state court cases are 'parallel.'" *Id.* "Federal and state proceedings are concurrent or parallel for purposes of abstention when the two proceedings are essentially the same; that is, there is an identity of parties, and the issues and relief sought are the same." *Id.* (internal quotation marks omitted). "If a court finds that the federal and state cases are not parallel, *Colorado River* abstention does not apply, whether or not issues of state law must be decided by the federal court." *Id.* at *6 (internal quotation marks omitted).

Here, the Federal Actions alleged violations of Section 14(a) of the Exchange Act, in addition to state law claims. *Id.* at *3-4 "[B]ecause federal courts have



exclusive jurisdiction over Exchange Act claims,” the court determined that the Federal Actions and the Delaware Action “are not parallel, and *Colorado River* abstention is therefore inappropriate.” *Id.* (internal quotation marks, alterations, and citation omitted).

The defendants argued that abstention was nonetheless warranted because the question of demand futility would have to be determined under Delaware state law. *Id.* at *6. The court acknowledged that “abstention may be warranted if the demand futility issue is particularly complex or if there is a high likelihood that the demand futility issue will dispose of the instant litigation.” *Id.* at *7 (internal quotation marks and alterations omitted). Here, however, the court found that the defendants “ha[d] not demonstrated that the demand futility issue [was] ‘particularly complex.’” *Id.* “[N]or ha[d] they shown that it [was] highly likely that the Delaware court [would] find that [the] [p]laintiffs failed to satisfy the demand futility requirement”; thus, “[t]he possibility that the Delaware court’s finding on the demand futility issue [would] dispose of the federal actions [was] not sufficient to warrant abstaining from deciding [the] [p]laintiffs’ federal claims.” *Id.*

Finally, the court rejected the defendants’ argument that the plaintiffs “should not be allowed to sidestep the stay called for here, by tacking on a meritless Section 14(a) claim.” *Id.* at *8. The court found that the defendants “ha[d] not demonstrated that [the] [p]laintiffs’ Section 14(a) claims [were] meritless” and, “[i]n any event, in determining whether abstention is appropriate under *Colorado River*,” it was “not required to evaluate the merits of a plaintiff’s claims.” *Id.*

The Court Finds That Even If the Actions Were Parallel, Abstention Would Not Be Appropriate Under the *Colorado River* Doctrine

“To determine whether abstention under *Colorado River* is appropriate, a district court is required to

weigh six factors, with the balance heavily weighted in favor of the exercise of jurisdiction.” *Id.* at *5 (internal quotation marks omitted). These factors are:

- (1) the assumption of jurisdiction by either court over any res or property;
- (2) the inconvenience of the federal forum;
- (3) the avoidance of piecemeal litigation;
- (4) the order in which jurisdiction was obtained;
- (5) whether state or federal law supplies the rule of decision; and
- (6) whether the state court proceeding will adequately protect the rights of the party seeking to invoke federal jurisdiction.

Id.

The Southern District of New York determined that “[e]ven if the federal and state actions here were parallel, abstention would not be appropriate, because a majority of the *Colorado River* factors weigh in favor of the exercise of federal jurisdiction.” *Id.* at *8. First, because neither the Delaware Chancery Court nor the Southern District of New York had assumed jurisdiction over any res or property, the court found that this factor “weighs against abstention.” *Id.* at *9. Second, the court observed that “[t]he federal forum is not inconvenient for the [d]efendants” because “News Corp. maintains its executive offices in New York City” and “at least eight of the individual defendants are citizens of either New York or Connecticut.” *Id.*

Third, because the Delaware Chancery Court does not have jurisdiction over the Exchange Act claims asserted in the Federal Actions, “abstention might only serve to encourage piecemeal litigation of the issues raised in the federal suit.” *Id.* at *10 (internal quotation marks omitted). “A related aspect of piecemeal litigation ... is whether resolution in one forum will resolve the claims as to all parties.” *Id.* at *11 (internal quotation marks omitted). Here, one of the Federal Actions names two defendants not included in the Delaware Action. The court explained that “[w]here the parties to the suits are not identical and thus not all bound by the judgment of any given court, the

problem of piecemeal litigation is exacerbated by the risk of inconsistent results.” *Id.* (internal quotation marks omitted). The court found that “[t]his factor thus weighs slightly against abstention.” *Id.* at *12.

Fourth, the court determined that “[b]ecause the Delaware Action is more advanced than the [F]ederal [A]ctions, this factor weighs in favor of abstention.” *Id.* at *13. Fifth, “[b]ecause [f]ederal law supplies the rule of decision for [the] [p]laintiffs’ Section 14(a) claims, this factor weighs heavily against abstention.” *Id.* Finally, “[b]ecause [the] [p]laintiffs’ federal claims cannot be vindicated in the state court proceeding, it will not adequately protect their rights.” *Id.* The court found that “[t]his factor therefore weighs heavily against abstention.” *Id.*

“Given that all but one of the six *Colorado River* factors weigh against abstention,” the court found that “exceptional circumstances that justify the surrender of federal court jurisdiction ... do not exist.” *Id.* at *14 (internal citation and quotation marks omitted). “Accordingly, even if the federal and state actions were parallel,” the court held that “a stay ... would not be [] warranted.” *Id.*

The District of Connecticut Considers the Question of Who Qualifies as a “Whistleblower” for Purposes of the Dodd-Frank Act’s Anti-Retaliation Provision

On September 25, 2012, the District of Connecticut held that the definition of “whistleblower” is broader under the Dodd-Frank Act’s anti-retaliation provision than it is under the rest of the statute. *Kramer v. Trans-Lux Corp.*, 2012 WL 4444820 (D. Conn. Sept. 25, 2012) (Underhill, J).

Background

Richard Kramer (“Kramer”) was Trans-Lux (“Trans-Lux”) Corporation’s Vice-President of Human Resources and Administration for eighteen years. *Kramer*, 2012 WL 4444820, at *2. His responsibilities included “oversight of the Trans-Lux ERISA governed [p]ension [p]lan” and “ensuring company compliance with all federal and state laws and regulations” with respect to that plan. *Id.* Kramer repeatedly alerted his superiors to a number of compliance issues with the Trans-Lux pension plan. *Id.* at *2-3. For example, Angela Toppi, Trans-Lux’s Chief Financial Officer and Kramer’s direct supervisor, served on the pension plan committee and also acted as the pension plan’s sole trustee. *Id.* at *2. “Kramer believed that Toppi’s position created a conflict of interest,” and he “reported his concerns to Trans-Lux.” *Id.*



In March 2009, Trans-Lux amended its pension plan. *Id.* “Toppi was [] required to bring the 2009 amendments to the board of directors for approval, and failed to do so.” *Id.* “Toppi also failed to file the 2009 amendments with the SEC.” *Id.* In March 2011, Kramer emailed his superiors “express[ing] concern that ... the 2009 amendment, which had frozen salaries, had not been presented to the board of directors or filed with the SEC.” *Id.* On May 16, 2011, Kramer contacted Trans-Lux’s audit committee regarding “the failure to present the 2009 amendment to the appropriate bodies,” among other issues. *Id.*

at *3. “Shortly thereafter, Kramer sent a letter to the SEC about Trans-Lux’s failure to submit the 2009 amendment to the board of directors or the SEC.” *Id.*

In May 2011, Trans-Lux “began stripping Kramer of his responsibilities.” *Id.* “On July 11, 2011, Trans-Lux announced via email that July 22, 2011 would be the last day of employment for all human resources personnel, including Kramer.” *Id.* Kramer thereafter filed a whistleblower retaliation claim under the Dodd-Frank Act. *Id.* at *1. Trans-Lux moved to dismiss Kramer’s claims. *Id.* at *1, *3.

The Court Holds That Plaintiffs May Bring Dodd Frank Anti-Retaliation Claims Even If They Did Not Provide Information to the SEC in a Manner Established by the SEC

The anti-retaliation provision of the Dodd-Frank Act provides that:

No employer may discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistleblower in the terms and conditions of employment because of any lawful act done by the *whistleblower*—(i) in providing information to the [SEC] ... or (iii) in making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002, the Securities Exchange Act of 1934, including section 10A(m) of such Act, and any other law, rule, or regulation subject to the jurisdiction of the [SEC].

15 U.S.C. § 78u-6(h)(1)(A) (emphasis added). A “whistleblower” is defined as “any individual who provides, or [two] or more individuals acting jointly who provide, information relating to a violation of the securities laws to the [SEC], in a manner established, by rule or regulation, by the [SEC].” 15 U.S.C. § 78u-6(a)(6).

“Trans-Lux argue[d] that the retaliation provision applies only to those individuals who are both (a) a whistleblower under section 78u-6(a)(6), and (b) have engaged in one of the protected activities listed in section 78u-6(h)(1)(A).” *Kramer*, 2012 WL 4444820, at *3. “Under this theory, Kramer would not [have been] entitle[d] to sue under the retaliation provision, because he [did] not provide[] information to the SEC in a manner required by the SEC, and [was] therefore not a ‘whistleblower.’”⁶ *Id.*

Kramer responded that “Trans-Lux’s interpretation would effectively make section (iii) of the retaliation provision moot, because individuals who have engaged in activity described in section (iii) are not, by definition, whistleblowers.” *Id.* at *4. “Kramer argue[d] that those who make disclosures that are required or protected under the Sarbanes-Oxley or the Securities Exchange Act of 1934 are clearly entitled to protection against whistleblower retaliation, even if those individuals do not otherwise fall under the definition of ‘whistleblower’ found in section 78u-6(a)(6).” *Id.*

The District of Connecticut found that it was not “unambiguously clear that the Dodd-Frank Act’s retaliation provision only applies to those individuals who have provided information relating to a securities violation to the [SEC], and have done so in a manner established by the [SEC].” *Id.* This interpretation “would dramatically narrow the available protections [for] potential whistleblowers.” *Id.* Moreover, the court found that “[s]uch a reading seems inconsistent with the goal of the Dodd-Frank Act, which was to ‘improve the accountability and transparency of the financial system,’ and create ‘new incentives and protections for whistleblowers.’” *Id.* The District of Connecticut also noted that “the only two courts to consider the matter both have held that the definition of ‘whistleblower’ is broader with respect to the anti-retaliation section

6. “In order to have provided information in the manner provided by the SEC, an individual would have either had to submit the information online, through the [SEC]’s website, or by mailing or faxing a Form TCR (Tip, Complaint or Referral). Mailing a regular letter is insufficient.” *Kramer*, 2012 WL 4444820, at *4 (citing 17 C.F.R. § 240.21F-9(a)).

than it is for the rest of the statute.” *Id.* (citing *Nollner v. S. Baptist Convention, Inc.*, 852 F. Supp. 2d 986 (M.D. Tenn. 2012) (Trauger, J.); *Egan v. TradingScreen, Inc.*, 2011 WL 1672066 (S.D.N.Y. May 4, 2011) (Sand, J.)).

The court next considered an SEC rule promulgated in August 2011 “to clarify the interplay between section 78u-6(h)(1)(A), the retaliation provision, and section 78u-6(a)(6), the statutory definition of ‘whistleblower.’” *Id.* The SEC rule provides in relevant part:

For the purposes of the retaliation protections afforded by Section 21F(h)(1) of the Exchange Act (15 U.S.C. 78u-6(h)(1)), you are a whistleblower if:

- (i) You possess a reasonable belief that the information you are providing relates to a possible securities law violation ... that has occurred, is ongoing, or is about to occur, and;
- (ii) You provide that information in a manner described in Section 21F(h)(1)(A) of the Exchange Act (15 U.S.C. 78u-6(h)(1)(A)).

17 C.F.R. § 240.21F-2(b)(1). Trans-Lux contended that “the SEC’s rule is an impermissible construction of the statute because it would allow potential plaintiffs to pursue under the Dodd-Frank Act retaliation claims they would have otherwise pursued under

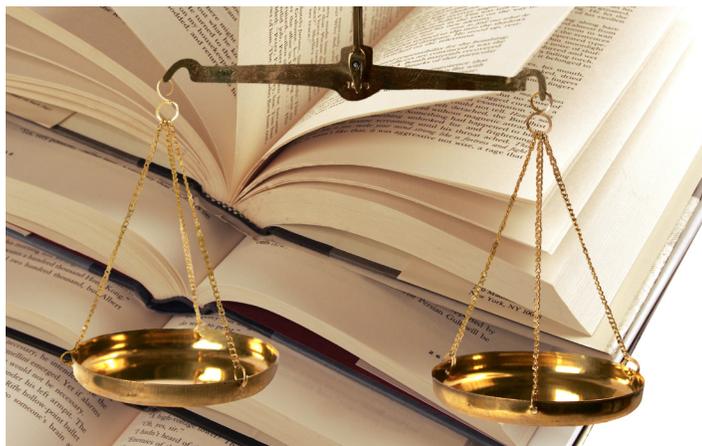
Sarbanes-Oxley,” which also provides protections for whistleblowers. *Kramer*, 2012 WL 4444820, at *5. “This is problematic, Trans-Lux assert[ed], because the Dodd-Frank Act has a longer statute of limitations than Sarbanes-Oxley, and no exhaustion requirement.” *Id.*

Rejecting Trans-Lux’s argument, the District of Connecticut found that “the Dodd-Frank Act appears to have been intended to expand upon the protections of Sarbanes-Oxley, and thus the claimed problem is no problem at all.” *Id.* Because “[t]he SEC’s rule is a permissible construction of the Dodd-Frank Act,” the court explained that it was obligated to follow it. *Id.*

Applying the SEC’s rule, the District of Connecticut determined that “Section 78u-6(a)(6)’s requirement that the information [must] have been provided ‘in a manner established, by rule or regulation, to the [SEC]’ does not apply to section 78u-(h)(1)(A).” *Id.* “Instead, an individual must only allege that he possessed a ‘reasonable belief that the information’ provided ‘relates to a possible securities law violation,’ and that he provided the information in a manner described in section 78u-(h)(1)(A).” *Id.* The court explained that “[t]he contradictory provisions of the Dodd-Frank Act are best harmonized by reading 15 U.S.C. § 78u6(h)(1)(A)(iii)’s protection of certain whistleblower disclosures not requiring reporting to the SEC as a narrow exception to 15 U.S.C. § 78u-6(a)(6)’s definition of a whistleblower as one who reports to the SEC.” *Id.* (quoting *Egan*, 2011 WL 1672066, at *5).

The Court Finds That the Complaint States a Dodd-Frank Act Retaliation Claim

Pursuant to 15 U.S.C. § 78u-6(h)(1)(A)(iii), “disclosures that are protected under Sarbanes-Oxley’s whistleblower provision are also protected under the Dodd-Frank Act’s whistleblower provision.” *Id.* at *6. “Sarbanes-Oxley protects persons who disclose information [to their supervisors that] they *reasonably believe* constitutes a violation of SEC rules



or regulations” *Id.* “[T]he conduct at issue need not have *actually* constituted a violation of the SEC rules or regulations—by the language of the whistleblower provision, the whistleblower need only have reasonably believed that it was a violation.” *Id.*

Here, the court found that “[t]he language of the emails and letter in which Kramer raised his concerns demonstrates that he may have reasonably believed Trans-Lux to be committing violations of SEC rules or regulations.” *Id.* at *7. “Therefore,” the court determined that “Kramer ha[d] alleged sufficient facts to support a Dodd-Frank Act whistleblower claim based on his internal and external communications.” *Id.*

The Eastern District of North Carolina Dismisses a Say-on-Pay Suit Against the Directors and Officers of Dex One Corporation on the Merits

On September 26, 2012, the Eastern District of North Carolina dismissed a derivative suit brought against the directors and certain executive officers of Dex One Corporation following a negative say-on-pay vote. *Haberland v. Bulkeley*, 2012 WL 4788442 (E.D.N.C. Sept. 26, 2012) (Dever III, C.J.). Unlike other courts dismissing say-on-pay suits, the Eastern District of North Carolina did not reach the defendants’ demand futility and business judgment rule defenses, but instead dismissed the plaintiff’s claims on the merits.

Background

“Dex One is a ‘marketing solutions company’ incorporated under Delaware law and headquartered in Cary, North Carolina.” *Id.* at *1. On December 31, 2008, the New York Stock Exchange suspended trading

of shares of RHD, Dex One’s predecessor company, due to a loss of market capitalization. *Id.* RHD filed for Chapter 11 bankruptcy in May 2009 and emerged from Chapter 11 in January 2010 as Dex One. *Id.* “On February 1, 2010, the New York Stock Exchange began trading Dex One stock at \$33.56 per share.” *Id.* “By December 31, 2010, Dex One’s share price had fallen to \$7.46, a 78[%] decline.” *Id.*

“On March 17, 2011, Dex One’s Board solicited a shareholder vote on, among other things, the [company’s] 2010 Executive Compensation Plan.” *Id.* at *4. The company’s 2011 Proxy Statement “recommended that Dex One shareholders vote to approve the 2010 Executive Compensation Plan” but “stated that the stockholder vote ... was advisory only, and did not bind Dex One, its Board or its Compensation and Benefits Committee in any way.” *Id.* However, the Proxy Statement noted that if there was a significant negative vote, “the Board and the Compensation and Benefits Committee ‘[would] consider such stockholders’ concerns and the Compensation and Benefits Committee [would] evaluate whether any actions [were] necessary to address those concerns.’” *Id.*

On May 3, 2011, fifty-two percent of voting Dex One shareholders rejected the 2010 Executive Compensation Plan. *Id.* After “consider[ing] and investigat[ing] shareholder concerns,” the Compensation and Benefits Committee “decided not to amend or alter the 2010 Executive Compensation Plan, or to recoup any portion of the compensation



paid under it.” *Id.* “The committee did, however, implement other changes to Dex One’s compensation practices in response to the May 3, 2011 negative say-on-pay vote.” *Id.*

On September 1, 2011, the plaintiff in the instant action brought suit alleging that Dex One’s directors and executive officers had breached their fiduciary duties in connection with the company’s 2010 Executive Compensation Plan and the say-on-pay vote. *Id.* at *5. The defendants moved to dismiss the plaintiff’s complaint. *Id.*

The Court Finds That the Defendants Did Not Misrepresent the 2010 Executive Compensation Plan as a Strict Pay-for-Performance Scheme

The plaintiff contended that the defendants had breached their fiduciary duties by “issuing a 2011 Proxy Statement that [allegedly] falsely and misleadingly described the 2010 Executive Compensation Plan as a strict pay-for-performance scheme.” *Id.* According to [Dex One’s] 2011 Proxy Statement:

The 2010 Executive Compensation Plan was designed to achieve six objectives: (1) to “enable the [c]ompany to attract and retain the key leadership talent required to successfully execute its business strategy”; (2) to “align executive pay with performance, both annual and long-term”; (3) to “ensure internal equity, both as compared to other executives based upon position and contributions, and to the broader employee population”; (4) to “strongly link the interests of executives to those of the [c]ompany’s shareholders and other key constituencies”; (5) to “keep the executive compensation practices transparent, in line with best practices in corporate governance”; and (6) to “administer executive compensation on a cost-effective and tax-efficient basis.”

Id. at *9. The court found that the plaintiff “[i]gnor[ed] four of these six objectives” and instead “seize[d] on enumerated goals (2) and (4) and argue[d] that they [were] the only objectives.” *Id.* The court explained that “the 2010 Executive Compensation Plan was more complex, more intricate, and more nuanced than [the plaintiff] allege[d].” *Id.*

“[E]ven if the 2011 Proxy Statement described the 2010 Executive Compensation Plan as a strict pay-for-performance scheme,” the court found that the plaintiff “fail[ed] to demonstrate that [the] defendants did not in fact pay for performance as actually measured under the plan.” *Id.* at *10. The plaintiff did not “challenge the propriety or prudence of, or business justification offered for, the metrics used to calculate [Dex One’s] annual incentive compensation or [long-term incentive plan] payments.” *Id.* “Rather,” the plaintiff “invent[ed] his own criteria” and “argue[d] that [Dex One’s] executives] failed to meet them.” *Id.*

The Court Holds That the Defendants Had No Obligation to Disclose the Plaintiff’s Suit in Dex One’s 2012 Proxy Statement

In March 2012, Dex One distributed a proxy statement “solicit[ing] a shareholder vote to, among other things, re-elect the Board and approve the executive compensation plan for 2011.” *Id.* at *5. While the 2012 Proxy Statement discussed the negative say-on-pay vote and the Board’s response, it did not “expressly disclose this litigation.” *Id.* The plaintiff subsequently amended his complaint to allege that the defendants had “breached their fiduciary duties” by failing to disclose the existence of the plaintiff’s suit in the 2012 Proxy Statement. *Id.*

The court determined that “the mere fact of this litigation was not material” because the 2012 Proxy Statement, the 2011 Proxy Statement and the Form 8-K together “provided all of the facts underlying the claims raised in [the plaintiff’s] original complaint.” *Id.*



at *12-13. “[E]ven if the fact of this litigation had been material,” the court held that the defendants “were not obligated to disclose it.” *Id.* at *13. The complaint “misrepresents the structure, components, nature, and purposes of the 2010 Executive Compensation Plan” and “misstates [the] defendants’ representations to shareholders before, and response after, the May 3, 2011 negative say-on-pay vote.” *Id.* Because the complaint “presents sensationalized and meritless allegations,” the court found that the defendants “bore no obligation to engage in self-flagellation by disclosing them.” *Id.*

The Court Holds That the Defendants Did Not Breach Their Fiduciary Duties by Increasing Executive Compensation in 2010

The plaintiff contended that the defendants had breached their fiduciary duties by increasing executive compensation in 2010 despite the company’s performance. *Id.* at *5. First, the court found that there were no allegations that Dex One’s executive officers “directly approved or authorized their 2010 compensation” or “aided and abetted the Board in approving and authorizing their 2010 compensation.” *Id.* at *14. The court further determined that “[a]s to the remaining defendants,” the plaintiff’s claim “rest[ed] on [the] flawed factual foundation” that the 2010

Executive Compensation Plan was “a strict pay-for-performance scheme.” *Id.*

The Court Finds That the Defendants Did Not Breach Their Fiduciary Duties by Failing to Amend the 2010 Executive Compensation Plan or Recoup Compensation Paid Thereunder

The plaintiff claimed that the defendants had breached their fiduciary duties by “failing to alter or amend the 2010 Executive Compensation Plan, to recoup any of the compensation paid under that plan, or to issue any other response to the May 3, 2011 negative say-on-pay vote.” *Id.* at *5. The court determined that there were no allegations that Dex One’s executive officers “had any direct duty to respond to the May 3, 2011 negative say-on-pay vote” or any factual allegations supporting the plaintiff’s claim that Dex One’s executive officers had “aided and abetted the Board and the Compensation and Benefits Committee” in their response to the vote. *Id.* at *15.

The court held that this claim “likewise fail[ed]” as to Dex One’s directors because the “plain language” of the Dodd-Frank Act “defeats the argument” that the directors had “any legal duty ... to respond to the May 3, 2011 negative say-on-pay vote.” *Id.* at *16. Moreover, while the Board “promised [] to ‘consider’ stockholder concerns expressed through the vote,” this statement did not “change the advisory, non-binding

7. The Dodd-Frank Act provides that a say-on-pay vote:

“[S]hall not be binding on the [corporation] or the board or directors of [the corporation], and may not be construed ... as overruling a decision by such [corporation] or board of directors[.]... to create or imply any change to the fiduciary duties of such [corporation] or board of directors[.]... [or] to create or imply any additional fiduciary duties for such [corporation] or board of directors ...”

Haberland, 2012 WL 4788442, at *16 (alterations in original) (quoting 15 U.S.C. § 78n-1(c)(1)-(3)).

nature of the say-on-pay vote, and did not obligate Dex One's Board or Compensation and Benefits Committee to alter or amend the 2010 Executive Compensation Plan, or to recoup any part of the compensation paid under it, in response to a negative say-on-pay vote." *Id.* "In any event, the information provided in the 2012 Proxy Statement demonstrates that the Board and the Compensation and Benefits Committee kept their promises." *Id.*

The Court Finds No Basis for the Plaintiff's Unjust Enrichment Claim

Finally, as to the plaintiff's unjust enrichment claim, the court explained that the director defendants "were not compensated under the 2010 Executive Compensation Plan" and determined that the plaintiff had not "pled sufficient facts to hold [these defendants] liable on this unjust enrichment claim as aiders and abettors." *Id.* at *17. The court further held that the unjust enrichment claim was meritless as to the executive officer defendants because it was based on a misunderstanding of the nature of Dex One's Executive Compensation Plan. *Id.* Since the plaintiff "failed to plausibly allege that the 2010 Executive Compensation Plan, as actually conceived, resulted in unjust enrichment to" Dex One's executive officers, the court held that the plaintiff's "unjust enrichment claim fail[ed]." *Id.*



The Delaware Chancery Court Holds That Plaintiffs Who File *Caremark* Claims Without First Conducting a Reasonable Investigation Are Presumed Disloyal to the Corporation

On September 25, 2012, the Delaware Chancery Court held that "a plaintiff who files a *Caremark* claim hastily and without ... [first] conducting a meaningful investigation" is presumed to have "acted disloyally to the corporation." *South v. Baker*, 2012 WL 4372538, at *16 (Del. Ch. Sept. 25, 2012) (Laster, V.C.). Applying this presumption, the court held that the with-prejudice dismissal of hastily-filed *Caremark* claims against the directors of Hecla Mining Company would "not have preclusive effect on the efforts of more diligent stockholders to investigate potential claims and, if warranted, file suit." *South*, 2012 WL 4372538, at *1.

Background

"During 2011, Hecla experienced a series of incidents at the Lucky Friday mine," including a rock fall in April 2011 and a rock burst in December 2011. *Id.* at *3, *4. On January 25, 2012, the United States Mine Safety and Health Administration ("MSHA") "issued a press release noting that Hecla had been cited for numerous safety violations." *Id.* at *1, *6. A week later, "the first of two securities class actions was filed." *Id.* at *6. "Seven stockholder derivative actions [soon] followed." *Id.*

On March 1, 2012, Steven and Linda South ("the Souths") filed the instant derivative action, asserting *Caremark* claims against Hecla's directors. *Id.* "A *Caremark* claim contends that the directors set in motion or 'allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in doing so they violated a duty to

be active monitors of corporate performance.” *Id.* at *8 (quoting *In re Caremark Int’l Inc. Der. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996) (Allen, C.)). “Because a plaintiff asserting a *Caremark* claim must plead facts sufficient to establish board involvement in conscious wrongdoing,” the Delaware Supreme Court “has admonished stockholders repeatedly to use Section 220 of the General Corporation Law, 8 Del. C. § 220, to obtain books and records and investigate their claims before filing suit.” *Id.* at *1. However, the Souths neither filed a Section 220 request nor made any demand on the Board prior to bringing suit. *Id.* at *7-8.



The defendants moved to dismiss the Souths’ complaint “pursuant to [Chancery Court] Rule 23.1 for failure to make demand or adequately plead demand futility.” *Id.* at *1.

The Chancery Court Dismisses the Souths’ Complaint with Prejudice for Failure to Plead a Connection Between the Board’s Actions and the Lucky Mine Incidents

“To plead demand futility” in a *Caremark* case, “a stockholder plaintiff must plead facts establishing a sufficient connection between the corporate trauma

and the board such that at least half of the directors face ‘a substantial likelihood of personal liability.’” *Id.* at *9. “Without a connection to the board, a corporate trauma will not lead to director liability.” *Id.*

“A plaintiff can plead the necessary connection by alleging with particularity actual director involvement in a decision or series of decisions that violated positive law.” *Id.* “A plaintiff who cannot point to facts supporting such a decision can plead that the board consciously failed to act after learning about evidence of illegality—the proverbial ‘red flag.’” *Id.* However, in most cases:

[T]he plaintiff must fall back to the final means of connecting the directors to illegality: the board’s obligation to adopt internal information and reporting systems that are “reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.”

Id.

Here, the Souths did “not cite any statute, regulation, or other provision of positive law that the [Hecla] Board allegedly decided consciously to violate, nor facts from which such a decision could be inferred.” *Id.* at *10. The Chancery Court noted that “[t]he plaintiffs might have looked for evidence of such a decision by using Section 220 to obtain minutes and related materials from Board and Safety Committee meetings.” *Id.* Instead, the plaintiffs relied on the January 2012 MSHA press release and a report issued by the MSHA in November 2011. *Id.* The court found that neither of these documents “supports a reasonable inference that the Board consciously decided to violate positive law.” *Id.*

The Souths’ “central argument” was that “the unfortunate incidents at the Lucky Friday mine

amounted to ‘red flags’ sufficient to put the Board ‘on notice’ of safety issues.” *Id.* at *11. “Although the complaint asserts that the directors knew of and ignored the 2011 safety incidents, the complaint nowhere alleges ... that the directors were told about the incidents, what the Board’s response was, or even that the incidents were connected in any way.” *Id.* “Here again,” the court found that “the Souths might have used Section 220 to investigate what the directors knew and did, evaluate their theories of liability, and make an informed decision about whether or not to sue.”⁸ *Id.*

Finally, the Chancery Court found that “the Souths’ complaint does not contain allegations from which a court could infer ‘a sustained or systemic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists.’” *Id.* at *12. “The complaint instead pleads affirmatively that the Board established a Safety Committee” comprised of “the four outside directors with the most mining industry experience.” *Id.*

“Because the complaint lacks particularized facts supporting a reasonable inference that a majority of the Board faces a substantial risk of liability,” the court determined that dismissal of the Souths’ suit was warranted under Rule 23.1. *Id.* at *13. The court found it significant that the Souths offered no “explanation as to why [they] did not use Section 220 before filing suit, as the Delaware Supreme Court has recommended repeatedly.” *Id.* at *14. Given the circumstances, the court held that “dismissal with prejudice as to the Souths [was] a fitting consequence that [did] not seem likely to work any prejudice on the corporation.”⁹ *Id.*

8. The Chancery Court rejected the plaintiffs’ argument that “the members of the [Hecla Board’s] Safety Committee must have known about and consciously ignored the problems at the Lucky Strike mine because they were charged with overseeing safety.” *South*, 2012 WL 4372538, at *11. “[A]n allegation that the underlying cause of a corporate trauma falls within the delegated authority of a board committee does not support an inference that the directors on that committee knew of and consciously disregarded the problem for purposes of Rule 23.1.” *Id.*

The Chancery Court Holds That the Dismissal of the Souths’ Complaint Does Not Preclude *Caremark* Claims Brought by Other Plaintiffs Because the Souths Did Not Adequately Represent Hecla

The Chancery Court next considered whether the “with-prejudice dismissal of [the Souths’] lawsuit could have preclusive effect on the litigation efforts of other stockholders.” *Id.* at *1. The court explained that “[t]here is a broad consensus” that “a with-prejudice dismissal does not have preclusive effect if the initial plaintiff failed to provide adequate representation for the corporation.” *Id.*

The court noted that recent Chancery Court decisions “have suggested a presumption that when a stockholder hastily files a *Caremark* claim after the public announcement of a corporate trauma, in an effort to shift the still-developing losses to the corporation’s fiduciaries, but without first conducting a meaningful investigation, the plaintiff has not adequately represented the corporation.”¹⁰ *Id.* at *7. This “presumption recognizes that when a plaintiff asserts a *Caremark* claim, the plaintiff must plead a connection between the underlying corporate trauma and the board.” *Id.* at *17. In “other types of derivative actions in which a plaintiff challenges a specific and identifiable board decision,” the court explained that “a plaintiff may well be able to plead particularized allegations without using Section 220 that are sufficient

9. The court noted that “[t]here [were] at least two stockholders who [had] served Section 220 demands on Hecla and who appear[ed] to be proceeding ... in accordance with the best interests of the corporation and the recommendations of the Delaware Supreme Court.” *South*, 2012 WL 4372538, at *14.

10. Among other authorities, the Chancery Court cited its earlier opinion in *La. Mun. Police Emp.’s. Ret. Sys. v. Pyott*, 46 A.3d 313, 335-36 (Del. Ch. 2012) (Laster, V.C.) (appeal pending) (*Allergan*). Please [click here](#) to read our discussion of the *Allergan* opinion in the June 2012 edition of the Alert.

to survive a Rule 23.1 motion to dismiss." *Id.* "For a *Caremark* claim, however, the connection to the board is neither readily apparent nor reasonably inferable from the occurrence of the corporate trauma." *Id.*

This "presumption also recognizes that there usually will not be any need to rush when filing a *Caremark* claim" because Delaware courts routinely stay *Caremark* claims pending the resolution of direct suits and regulatory proceedings. *Id.* Moreover, since *Caremark* claims "are premised on corporate liability, pursuing a *Caremark* claim during the pendency of [an] underlying litigation or governmental investigation may well compromise the corporation's position on the merits, thereby causing or exacerbating precisely the harm that the *Caremark* plaintiff ostensibly seeks to remedy." *Id.* at *18. The court explained that "[a] plaintiff who hurries to file a *Caremark* claim after the announcement of a corporate trauma behaves contrary to the interests of the corporation but consistent with the desires of the filing law firm to gain control of (or a role in) the litigation." *Id.* at *17.

The Chancery Court stated that a plaintiff could rebut the presumption of disloyalty by demonstrating that he "did not file hastily and conducted a meaningful and thorough investigation." *Id.* "To be adequate, the investigation would have to address not only the merits of the corporation's claim, but also the connection between the trauma and the board, the critical issue on which a Rule 23.1 motion to dismiss the *Caremark* claim will turn." *Id.* "Alternatively, the plaintiff could

rebut the inference itself by persuading the [c]ourt that filing the *Caremark* claim in that form and at that time, based on the investigation conducted, served the best interests of the corporation." *Id.*

Here, the court determined that "[t]he circumstances surrounding the filing of this case gave rise to a presumption of disloyalty." *Id.* at *18. "First, the plaintiffs filed [their *Caremark* claim] hastily," even though "there was no reason to rush that would [have] further[ed] the interests of the corporation." *Id.* Moreover, the plaintiffs "admittedly did not make use of Section 220," nor did the complaint "suggest a meaningful investigation by the plaintiffs or their counsel into whether there was a connection between the incidents and action or conscious inaction by the Board." *Id.* at *19. Finally, the plaintiffs "failed to produce any evidence, much less persuasive evidence, to rebut either the requisite facts giving rise to the presumption or the resulting inference." *Id.* at *18. "To the contrary, the plaintiffs' counsel confirmed that he filed when he did because of [first-to-file] pressures" and "the fear that plaintiffs who moved more quickly ... might gain control of the suit." *Id.*

Finding that "the Souths and their counsel failed to provide adequate representation for Hecla," the Chancery Court held that "the dismissal of the Souths' complaint should not have preclusive effect on the litigation efforts of more diligent stockholders." *Id.* at *1, *20.



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“[T]he cream of the financial community regularly engage[s] [Simpson Thacher’s securities litigation] team for the most high-profile matters ...”

— *Chambers USA 2012*

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