Simpson
Thacher

Securities Law Alert

In This Edition:

- Second Circuit Finds *Janus*'s Definition of What It Means "to Make" a Misstatement Under Rule 10b-5 Does Not Apply to Section 17(a)(2)
- Second Circuit Holds SLUSA Only Precludes Claims Based on Allegations of Fraudulent Conduct (1) by the Defendant (2) That Are Not "Extraneous" to Plaintiffs' Theory of Liability
- Second Circuit Affirms Dismissal of a Securities Fraud Action Against the Royal Bank of Scotland, Finding Optimistic Statements Concerning the ABN Amro Acquisition to Be Inactionable Puffery
- Eleventh Circuit Dismisses Securities Fraud Action Against Jiangbo Pharmaceuticals' CFO and Auditor on Scienter Grounds Based on Plaintiffs' Failure to Allege a Sufficiently Specific Theory of Fraud
- Southern District of New York Holds (1) *Newman*'s "Personal Benefit" Requirement Applies in Misappropriation Cases; and (2) a Tippee May Be Civilly Liable for Recklessly Disregarding the Tipper's Receipt of a Personal Benefit
- Delaware Chancery Court Finds Breach of Master Limited Partnership Agreement by General Partner for Failure to Evaluate Related Party Transaction Properly

April 2015

Simpson Thacher "[d]emonstrates considerable expertise in the current multitude of RMBS-related cases, while also continuing to impress highly in M&A litigation."

–Chambers USA 2014

Second Circuit Finds *Janus*'s Definition of What It Means to "Make" a Misstatement Under Rule 10b-5 Does Not Apply to Section 17(a)(2)

In *Janus Capital Group v. First Derivative Traders*, 131 S. Ct. 2296 (2011), the Supreme Court defined what it means to "make" a statement for purposes of Rule 10b-5. The *Janus* Court held that "the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."[1]

On April 9, 2015, the Second Circuit held the *Janus* "Court's definition of 'to make' in Rule 10b-5 does not apply to [Section] 17(a)(2)" of the Securities Act of 1933. *U.S. Sec. & Exch. Comm'n v. Big Apple Consulting USA,* 2015 WL 1566925 (2d Cir. 2015) (Siler, Jr., J.). Section 17(a)(2) renders it unlawful "for any person in the offer or sale of any securities ... to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact." The Second Circuit found that the phrase "*by means of* any untrue statement" in Section 17(a)(2) "encompasses a broader range of conduct than 'mak[ing]' such a statement as defined in SEC Rule 10b-5(b)" (emphasis added by the court).

1. Please click here to read our prior discussion of the *Janus* decision.

Background

The SEC brought suit against Big Apple Consulting and its wholly owned subsidiary, MJMM (collectively, "defendants") in connection with their provision of public relations and investor relations services to CyberKey Solutions, a company that sold customizable USB drives. CyberKey allegedly falsely represented in press releases that it had received a $25 million purchase order from the Department of Homeland Security. The SEC contended that defendants either "knew, or were severely reckless in not knowing, that CyberKey" had no purchase orders from the federal government and in fact "had very little legitimate revenue at all." Nevertheless, defendants allegedly "persisted in promoting CyberKey and selling hundreds of millions of unregistered CyberKey shares to unsuspecting investors."

Following a trial, a jury found that defendants had violated Section 17(a). Defendants appealed. Among other arguments, defendants asserted that the district court had erred in submitting the Section 17(a) claims to the jury in light of the Supreme Court's decision in *Janus*. Defendants argued that "because they did not have ultimate authority over the content of CyberKey's press releases, they could not be considered 'makers' of any material misstatements and thus could not be liable under the provisions of Section 17(a)," which defendants characterized as "largely coextensive in scope" to the provisions of Rule 10b-5.

Second Circuit Determines *Janus*'s "Maker" Definition Is Inapplicable to Section 17(a)(2) Because Section 17(a)(2) Is Broader Than Rule 10b-5(b)

On appeal, the Second Circuit rejected defendants' contention that the *Janus* Court's definition of "make" "extends to claims brought under [Section] 17(a) of the Securities Act."

First, the Second Circuit found "untenable" defendants' attempt "to import the [*Janus*] Court's narrow holding to the *entirety* of [Section 17(a)]" because subsections (1) and (3) of Section 17(a)—like subsections (a) and (c) of Rule 10b-5—"do not use the word 'make' or even address misstatements." The Second Circuit found the *Janus* Court "did not alter the potential for liability under Rule 10b-5(a) and (c)." Even after *Janus*, a defendant "who is not the 'maker' of an untrue statement of material fact" could "nonetheless ... be liable as a primary violator of Rule 10b-5(a) and (c)." The Second Circuit explained it would be "incongruous" to apply *Janus* "to remove the potential for liability under" Sections 17(a)(1) and (3) given that "Rule 10b-5(a) and (c) [were] modeled" after those provisions.

The Second Circuit also deemed meritless defendants' contention that "the Court's holding in *Janus* should apply to [Section] 17(a)(2)" because "[Section] 17(a)(2) is the analogue to Rule 10b-5(b)." The court explained that the text of Rule 10b-5(b) differs from "the expansive language of [S]ection 17(a)(2)." Under Rule 10b-5(b), a defendant may not "make any untrue statement of a material fact or [ ] omit to state a material fact" in connection with the purchase or sale of securities. Section 17(a)(2), however, prohibits defendants from "obtain[ing] money or property" in connection with "the offer or sale of any securities" "*by means of* any untrue statement of a material fact or any omission to state a material fact" (emphasis added by the court). While a defendant can only be held liable under Rule 10b-5(b) for "mak[ing]" a material misstatement, the Second Circuit found that a defendant may be liable under Section 17(a)(2) regardless of whether the defendant "use[d] his own false statement or one made by another individual" (quoting *SEC v. Tambone*, 550 F.3d 106 (1st Cir. 2008)). The Second Circuit "decline[d] ... defendants' invitation to supplant the language of [Section] 17(a)(2) with words taken from" Rule 10b-5(b).

Finally, the Second Circuit found *Janus* inapplicable to Section 17(a)(2) for the additional reason that the *Janus* Court addressed the implied private right of action under Rule 10b-5. The *Janus* Court stated that it was "mindful" of the need to "give narrow dimensions ... to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law" *Janus*, 131 S. Ct. 2296. The Second Circuit explained that "the same concern regarding the expansion of a judicially-created private cause of action" does not apply with respect to claims under Section 17(a)(2) because "there is no private right of action under [Section] 17(a)."

Second Circuit Holds SLUSA Only Precludes Claims Based on Allegations of Fraudulent Conduct (1) by the Defendant (2) That Are Not "Extraneous" to Plaintiffs' Theory of Liability

In its April 23, 2015 decision, the Second Circuit addressed "the scope of the Securities Litigation Uniform Standards Act of 1998 ('SLUSA'), … which bars the maintenance of certain state-law-based class actions alleging falsity in connection with transactions in … 'covered securities.'" *In re Kingate Mgmt. Ltd. Litig.*, 2015 WL 1839874 (2d Cir. 2015) (Leval, J.). The Second Circuit determined that "SLUSA requires courts … to inquire whether an allegation is of [fraudulent] conduct by the defendant, or by a third party." The court held that "claims of false conduct in which the defendant is *not* alleged to have had any complicity are not" "subject to SLUSA's prohibition"(emphasis in the original). The Second Circuit also held that "[i]f the allegation [of fraudulent conduct by the defendant] is extraneous to the complaint's theory of liability, it cannot be the basis for SLUSA preclusion."

Background

Plaintiffs brought suit in the Southern District of New York alleging a multitude of state law-based claims against various defendants affiliated with Kingate Global Fund and Kingate Euro Fund (the "Funds"), two "feeder funds" for Bernard L. Madoff Investment Securities. In March 2011, the Southern District of New York dismissed plaintiffs' claims on SLUSA grounds. The court "concluded that because some allegations in the complaint involved material misstatements in connection with the purchase or sale of a covered security, the [c]omplaint should be dismissed in its entirety." Plaintiffs appealed.

Second Circuit Finds Plaintiffs' Claims Satisfy SLUSA's "in Connection with" Requirement

The Second Circuit began its analysis by determining whether plaintiffs' claims satisfied "SLUSA's requirement that the false conduct be 'in connection with' a transaction in 'covered securities.'" The court explained that in *In re Herald*, 753 F.3d 110 (2d Cir. 2014), it had previously interpreted the Supreme Court's decision in *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058 (2014),[2] to find that SLUSA precluded claims brought by plaintiffs who had invested in offshore funds based on the expectation that the funds would then invest the proceeds in S&P 100 stocks. The *Herald* court distinguished *Troice* because there, plaintiffs "were not seeking, directly or indirectly, to purchase covered securities." *Herald*, 753 F.3d 110. The *Herald* plaintiffs, however, had made "attempted investments in covered securities, albeit through feeder funds."

The Second Circuit found that the *Kingate* plaintiffs, "like the *Herald* plaintiffs, [had] purchased the uncovered shares of the offshore Funds, expecting that the Funds were investing the proceeds in S&P 100 stocks, which are covered securities." *Kingate*, 2015 WL 1839874. The court therefore determined that SLUSA's "in connection with" requirement was met.

Second Circuit Holds SLUSA Preclusion Applies Only to Claims Alleging False Conduct by the Defendant

The Second Circuit then considered "the meaning of SLUSA's ambiguous use of the word 'alleging'" insofar as SLUSA precludes covered class actions "alleging … [false conduct] in connection with the purchase or sale of a covered security." The court found that "the history and the purposes of this provision all favor interpreting it to apply to state law claims predicated on conduct *by the defendant* that is specified in SLUSA's operative provisions referencing the anti-falsity proscriptions of the 1933 and 1934 Acts" (emphasis in the original). The court reasoned that "[s]uch allegations would be subject to the [Private Securities Litigation Reform Act ('PSLRA')] if pleaded as a private securities claim," and therefore "[c]ouching [those claims] as state law claims would escape the PSLRA's limitations." The Second Circuit explained that "[i]nterpreting SLUSA to apply" "whenever a falsity in connection with a transaction in a covered security is a necessary predicate of the plaintiffs' claim,

2. Please click here to read our prior discussion of the *Troice* decision.

even where the falsity is not chargeable to the defendant and the claim could not have been brought under the federal securities laws … would bar state law claims in a manner unrelated to SLUSA's purposes."

The Second Circuit clarified that there were "two caveats and a limitation" to its holding that SLUSA only precludes claims alleging fraudulent conduct *by the defendant* in connection with transactions in covered securities. First, the court found that plaintiffs cannot "evade SLUSA by camouflaging allegations that satisfy this standard in the guise of allegations that do not." The court explained that "[w]hen the success of a class action claim depends on a showing that the defendant committed false conduct conforming to SLUSA's specifications, the claim will be subject to SLUSA, notwithstanding that the claim asserts liability on the part of the defendant under a state law theory that does not include false conduct *as an essential element*—such as breach of a contractual right to fair dealing" (emphasis in the original). The court further stated that "if the success of a claim depends on conduct specified in SLUSA, and the defendant was complicit in that conduct, the claim is covered by SLUSA even though plaintiffs … artfully avoided using SLUSA's terms."

Second, the court ruled that "SLUSA may apply even though there is no private claim … for that violation under the 1933 and 1934 Acts." The court reasoned that while SLUSA "requires an allegation of conduct prohibited by the anti-falsity provisions of the 1933 and 1934 Acts that are referenced in SLUSA," the statute "does not require an allegation of conduct for which the 1933 and 1934 Acts *authorize a private right of action*" (emphasis in the original).

Finally, the court recognized that certain "[s]tate law fraud prohibitions … are not defined in a manner that refers explicitly to securities transactions, much less to transactions in 'covered' securities." The Second Circuit held that "where a state law class-action claim charges the defendant with liability based on conduct violative of the anti-falsity provisions of the 1933 and 1934 Acts as referenced in SLUSA but does not allege the supplemental status-based elements specified in SLUSA, such as the 'covered' status of the relevant security, the court may nonetheless ascertain those facts independently of [ ] plaintiffs' allegations and apply SLUSA when those facts are present."

Second Circuit Rules "Peripheral" Allegations of False Conduct Cannot Serve as the Basis for SLUSA Preclusion

The Second Circuit also considered whether "the falsity of the conduct alleged in the complaint" must "be essential to the state law theory of liability" in order for SLUSA preclusion to apply. The court recognized that under "the broadest of interpretations, [the term] 'alleging' could mean that SLUSA applies to any claim that includes any reference whatsoever to the false conduct specified in SLUSA, even if the false conduct is completely irrelevant to the state law theory of [ ] defendants' liability."

Rejecting this approach, the Second Circuit held that an allegation of fraud "cannot be the basis for SLUSA preclusion" if it is "extraneous to the complaint's theory of liability." The court explained that "[a]ny factual assertion in a complaint can be considered an 'allegation,' regardless of whether the asserted fact pertains in any way to the defendant or has any role in establishing the defendants' liability." Because "[c]omplaints are drafted not only to comply with the legal requirements for setting forth an actionable claim, but also at times for public relations purposes," they may "include assertions intended for the eyes of the press" that are "unrelated to the legal theory of the complaint." The Second Circuit therefore found that "SLUSA requires courts to inquire whether [an] allegation is necessary to or extraneous to liability under the state law claims" before determining whether that allegation can serve as the basis for SLUSA preclusion.

Second Circuit Holds Dismissal of the Entire Action Is Not Warranted If SLUSA Precludes Some (But Not All) of Plaintiffs' Claims

The Second Circuit determined that the district court had erred in dismissing plaintiffs' entire action after finding that SLUSA precluded some (but not all) of plaintiffs' claims. The court explained that "[t]he district court was required to conduct [its SLUSA] analysis on a claim-by-claim basis."

The court found that under longstanding Second Circuit precedent, "only the claims covered by SLUSA's terms should [have] be[en] dismissed" (citing *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25 (2d Cir. 2005), *rev'd on other grounds by Dabit*, 547 U.S. 71)). The court stated that this position is "clearly correct" because "SLUSA does not say that a class action containing a claim that falls within the statute's terms 'must be dismissed.'" Rather, SLUSA "asserts the very different command—that no covered class action based on the law of any state and including the necessary allegations '*may be maintained* in any State or Federal court by any private party'" (emphasis added by the court). The Second Circuit observed that "[i]f the court dismisses the claims that come within SLUSA's terms and allows the other claims to proceed," then "the surviving action which is 'maintained' does not include allegations precluded by SLUSA."

The Second Circuit vacated the district court's decision, and remanded the action for further proceedings consistent with its opinion.

Second Circuit Affirms Dismissal of a Securities Fraud Action Against the Royal Bank of Scotland, Finding Optimistic Statements Concerning the ABN Amro Acquisition to Be Inactionable Puffery

On April 15, 2015, the Second Circuit affirmed dismissal of a securities fraud action against the Royal Bank of Scotland ("RBS"). *IBEW Local Union No. 58 Pension Trust Fund & Annuity Fund v. Royal Bank of Scotland Grp.*, 2015 WL 1653788 (2d Cir. 2015) (Chin, J.). The court determined that RBS's positive statements concerning its acquisition of ABN Amro were inactionable expressions of "general corporate optimism." In addition, the court held that RBS's alleged understatement of its subprime exposure by less than 5% was immaterial pursuant to the guidance set forth in the SEC's Staff Accounting Bulletin ("SAB") No. 99. Finally, the Second Circuit also found immaterial RBS's representation that the United Kingdom's Financial Services Authority ("FSA") had "encouraged," rather than "required," RBS to raise additional capital in April 2008.

Second Circuit Holds Optimistic Statements Concerning the ABN Amro Acquisition Were Not Actionable Because Those Statements Were Not Worded as Guarantees, Nor Was There Any Allegation That RBS Did Not Believe the Statements at the Time They Were Made

Plaintiffs contended that RBS had "made [a number of] false statements" regarding its April 2007 acquisition of ABN Amro, a Dutch bank. For example, RBS had stated that "[t]he integration of ABN Amro [was] off to a promising start" and that RBS's "positive view" of the transaction had "been confirmed." Plaintiffs claimed that these statements "were misleading" because, in plaintiffs view, "ABN Amro was suffering significant losses and the acquisition [had been] 'an unmitigated disaster for RBS.'"

The Second Circuit found that RBS's positive statements concerning the ABN Amro acquisition were nothing more than "inactionable puffery." The court explained that "[s]tatements of general corporate optimism, such as these, do not give rise to securities violations." The Second Circuit recognized that "[s]tatements of corporate optimism may be actionable if 'they are worded as guarantees or are supported by specific statements of fact, or if the speaker does not genuinely or reasonably believe them." Here, however, the court determined that RBS's statements were "not worded as guarantees" and "there [were] no allegations that defendants did not reasonably believe" the statements at the time they were made.

Second Circuit Finds RBS's Alleged Understatement of Its Subprime Exposure Immaterial Under SAB No. 99

With respect to plaintiffs' claims that had "RBS [had] understated its [subprime] exposure in its December 2007 press release," the Second Circuit found that the "allegedly undisclosed" amount "constitute[d] less than 4% of RBS's total asset backed securities exposure, and less than 1% of its total assets." The Second Circuit explained that this alleged understatement was "presumptively immaterial" under SAB No. 99, which "provides that a misstatement related to less than 5% of a financial statement carries a preliminary presumption of immateriality." The court further found that the "qualitative factors" enumerated in SAB No. 99 did "not favor treating [RBS's] presumptively immaterial statements as material statements." The Second Circuit noted that plaintiffs did "not allege that the amount of exposure could have been calculated precisely, mask[ed] a change in earnings, change[d] a loss into income or vice versa, or involve[d] an unlawful transaction, or that the misstatements resulted in a significant positive market reaction."

Second Circuit Determines RBS's Representation That the FSA "Encouraged" Rather Than "Required" RBS to Raise Additional Capital Was Not a Material Misstatement

Plaintiffs alleged that RBS had misrepresented the reasons for its £12 billion Rights Issue in April 2008. According to RBS, the FSA had "encouraged" RBS to raise capital. However, RBS made it clear that RBS had not been "'asked to raise capital by anyone,' including the FSA." Plaintiffs claimed that RBS's "statements were false" because the FSA's CEO had in fact "'specifically required' [RBS] to conduct a Rights Issue to 'raise as much capital as possible.'"

Following a review of "[t]he timeline of events leading up to RBS's allegedly false statement," the Second Circuit determined that plaintiffs had "fail[ed] to plead the basis for a securities fraud claim." First, the court found that RBS "had already started preparations for the Rights Issue" five days before the FSA's CEO "purportedly 'specifically required' RBS to conduct a Rights Issue." Second, the court explained that "critical facts were already known to the investing market: RBS needed an infusion of capital; it was taking additional write-downs; the FSA was closely monitoring RBS's situation and encouraging a Rights Issue; and there was generally a steep deterioration in market conditions and credit market outlooks." Finally, the court found it significant that there was no determination that RBS had "violated [the] FSA's minimum capital guidelines." Given "these contexts," the Second Circuit held that "a reasonable investor would have deemed the difference between 'encouraged' and 'required' to be immaterial."

Judge Leval issued an opinion concurring in part, but dissenting from the majority's decision with respect to RBS's alleged misstatements concerning the Rights Issue. In Judge Leval's view, "[t]he fact that RBS had decided to raise capital before being told by the FSA that it had to do so [did] not change the fact that it was required to raise capital." Moreover, Judge Leval disagreed with the majority's view that "a reasonable investor would see no material difference between the acknowledged fact that RBS had been 'encouraged' by the FSA to raise capital and a further statement that it had been 'required' by the FSA to do so." Judge Leval opined that "the difference is substantial" and found that a "reasonable investor would [have] want[ed] to know" that the FSA had "required" RBS to raise capital.

Eleventh Circuit Dismisses Securities Fraud Action Against Jiangbo Pharmaceuticals' Former CFO and Auditor on Scienter Grounds Based on Plaintiffs' Failure to Allege a Sufficiently Specific Theory of Fraud

On March 25, 2015, the Eleventh Circuit affirmed dismissal of a securities fraud action against Jiango Pharmaceuticals' CFO and auditor on scienter grounds. *Brophy v. Jiangbo Pharm.*, 781 F.3d 1296 (11th Cir. 2015) (Pryor, J.). The court found that plaintiffs had "fail[ed] to allege a theory

of fraud that [was] specific enough in its scope or [its] connection to [either the company's CFO or its auditor] to support a strong inference of scienter." Notably, the court rejected plaintiffs' contention that the company's former CFO "must have known" of the alleged fraud given her position at the company.

Background

In May 2011, less than a year after Jiango Pharmaceuticals became a publicly traded company, the company disclosed that the SEC had formally launched an investigation into the company's reported cash balances, and also disclosed that it had defaulted on a debt payment. The company's share price quickly plummeted in the days and months that followed. Plaintiffs subsequently brought a securities fraud action against Jiangbo, its principal officers, as well as its audit firm, Frazer LLP.

Plaintiffs alleged that Elsa Sung, Jiangbo's former CFO, and Frazer, Jiangbo's auditor, had "misrepresented the company's cash balances and failed to disclose a material related-party transaction." The district court dismissed plaintiffs' claims against both Ms. Sung and Frazer for failure to allege fraud with the specificity required under the Private Securities Litigation Reform Act ("PSLRA"). Plaintiffs appealed.

Eleventh Circuit Rejects Plaintiffs' Contention That Jiangbo's Former CFO "Must Have Known" About the Alleged Fraud Given Her Role at the Company

On appeal, the Eleventh Circuit rejected plaintiffs' attempt to establish scienter by claiming that "the disparity between Jiangbo's actual and reported cash balances" was so large "that it would have been difficult or impossible for Ms. Sung not to have known about it in her capacity as CFO." The court noted that plaintiffs' "fail[ure] to allege any particular amount or even a range" by which Jiangbo's cash balances were overstated "weaken[ed] any inference of scienter to be drawn from the magnitude of the alleged overstatements." The Eleventh Circuit also found meritless plaintiffs' claim that "a number of red flags," including the SEC investigation and the company's allegedly "dysfunctional internal controls," "should have put Ms. Sung on notice of the fraud." The court explained that "the complaint provide[d] no explanation as to how these red flags should have alerted her to the fraud." The court stated that since plaintiffs did not describe "how these vaguely defined problems would have affected financial reporting or how Ms. Sung would have known about them," it could not "rely" on those allegations "to add much weight to an inference of scienter."

The Eleventh Circuit found that plaintiffs essentially wanted the court to "rely solely on Ms. Sung's position as CFO to overlook [the] omissions and ambiguities in the complaint." In support of this argument, plaintiffs "cite[d] cases in which courts [have] recognized a strong inference of scienter based in part on a senior financial executive's oversight of the processes that produce a company's financial statements." The Eleventh Circuit deemed those cases inapposite because they all "involve[d] particularized allegations that the executives knew or were severely reckless in disregarding how those processes were distorted by fraud." Here, however, plaintiffs had "allege[d] no particularized facts that directly show[ed] [that] Ms. Sung intended to deceive shareholders or knew about or was severely reckless with respect to deficiencies in reporting." For example, plaintiffs "offer[ed] no allegations describing Ms. Sung's day-to-day practices as CFO or identifying any specific misconduct apart from confirming incorrect cash balances within filings and on conference calls."

The Eleventh Circuit held that in the absence of "more particularized allegations," plaintiffs' "claim that Jiangbo's fraud was too large for Ms. Sung not to have noticed [was] unpersuasive." The court determined that "[t]he seriousness of Jiangbo's errors and Ms. Sung's proximity to those errors at most impl[ied] negligence, which is not enough to establish scienter."

Eleventh Circuit Finds the Inference of Scienter as to Jiangbo's Auditor Even Weaker Than the Inference as to Jiangbo's Former CFO Because the Auditor Was "a Step More Removed" From the Alleged Indicators of Fraud

The Eleventh Circuit found that "[i]f the inference of scienter against Ms. Sung [was] tenuous, then the corresponding inference against Frazer [was] even more attenuated." The court explained that "[a]s an external auditor, Frazer was a step more removed than Ms. Sung from any alleged indicators of the fraud." Here, plaintiffs did not specify "in what ways Frazer's audit was deficient," nor was there any "allegation that Frazer had extensive involvement with the company beyond what was required to conduct a single audit."

"Ultimately," the court held that "the investors' allegations against Frazer suffer[ed] from the same overarching deficiency as those against Ms. Sung: they fail[ed] to articulate a theory of the fraud with any particularity." The court observed that "[a]lthough the allegations against Ms. Sung and Frazer might survive motions to dismiss under a less burdensome pleading standard, the PSLRA imposes a high bar." The Eleventh Circuit therefore affirmed dismissal of the complaint as to both Ms. Sung and Frazer.

Southern District of New York Holds (1) *Newman*'s "Personal Benefit" Requirement Applies in Misappropriation Cases; and (2) a Tippee May Be Civilly Liable for Recklessly Disregarding the Tipper's Receipt of a Personal Benefit

In *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), a case brought under the "classical" theory of insider trading, the Second Circuit held that a tippee can only be liable for insider trading if "the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for a personal benefit." On April 6, 2015, the Southern District of New York held that *Newman*'s "personal benefit" requirement also applies in cases brought under the "misappropriation" theory of insider trading. *Sec. & Exch. Comm'n v. Payton*, 2015 WL 1538454 (S.D.N.Y. 2015) (Rakoff, J.). The court also held that a tippee "may be civilly liable" for trading on material nonpublic information if the tippee either "knew or *recklessly disregarded*" the tipper's receipt of a personal benefit in exchange for the disclosure of that information (emphasis added).

Background

At issue were allegations that Michael Dallas, a law firm associate, had disclosed information concerning IBM's pending acquisition of SPSS to his roommate, Trent Martin, who was a registered broker-dealer at the time. The SEC alleged that Martin had "tipped inside information about the SPSS acquisition" to his roommate, Thomas Conradt, a lawyer affiliated with a New York broker. According to the SEC, Martin and Conradt "shared a close, mutually-dependent financial relationship, and had a history of personal favors." For example, "Conradt took the lead in organizing and paying shared expenses for the apartment," and assisted Martin when he ran into legal trouble in connection with a street altercation. Several days after the street altercation incident, Conradt purchased SPSS securities.

Conradt allegedly disclosed information concerning the SPSS acquisition to two of his colleagues. The SEC claimed that Conradt informed his two colleagues that he had obtained the information from his roommate. The two colleagues then purchased SPSS securities. The SEC subsequently brought civil insider trading claims against Conradt's two colleagues ("defendants"), on the grounds that defendants knew that Martin had misappropriated the information concerning the SPSS acquisition and had inappropriately disclosed this information to Conradt.

Court Holds *Newman*'s "Personal Benefit" Requirement Applies Even in Misappropriation Cases Involving Remote Tippees

The SEC contended that *Newman*' s "personal benefit" requirement should not apply in cases brought under the "misappropriation" theory of insider trading, in which "an outsider (i.e., not part of the company

whose stock is to be traded) … embezzles material nonpublic information … and then either trades on it or, in return for a benefit, provides it for trading purposes to a tippee." The SEC argued that "a remote tippee's knowledge that the inside information emanated from an act of misappropriation should be sufficient to charge the remote tippee, for it is the equivalent of knowledge that the tippee is the knowing recipient of stolen property."

The Southern District of New York rejected the SEC's contention. The court explained that in *Newman*, the Second Circuit expressly stated that "[t]he elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory" of insider trading (quoting *Newman*, 773 F.3d 438). While the Second Circuit's statements "were not technically necessary to the resolution of the case," the Southern District of New York found that "these statements seem so clearly intended to give guidance to the lower courts of this Circuit that" the court "[took] them as binding."

Court Finds the SEC Sufficiently Alleged the Tipper's Receipt of a Personal Benefit for Disclosure of the Material Nonpublic Information

The court next considered whether the SEC had "sufficiently alleged that Martin, the tipper, [had] received a personal benefit for disclosing material nonpublic information about the SPSS acquisition to Conradt." The court explained that in *Dirks v. SEC*, 463 U.S. 646 (1983), the Supreme Court stated that a "personal benefit" could be found if there is "a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient." The *Dirks* Court further stated that a personal benefit may "also exist when an insider makes a gift of confidential information to a trading relative or friend." In *Newman*, however, "the Second Circuit held that, to the extent *Dirks* suggests that a benefit may be inferred from a personal relationship, 'such an inference is impermissible in the absence of proof of a meaningfully close relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature'" (quoting *Newman*, 773 F.3d 438).

While the court recognized that it may be difficult "to reconcile the two" decisions, the court found that the SEC's allegations satisfied "any definition of 'benefit' set forth in either *Dirks* or *Newman*." Here, the SEC contended that Martin and Conradt were roommates whose "expenses were 'intertwined.'" The SEC also alleged that Martin had thanked Conradt for his legal assistance, and "told Conradt he was happy that Conradt [had] profited from the SPSS trading because Conradt had helped him." The court found these allegations "indicative [of] Martin's intent to benefit Conradt at the time of the disclosure of the information, as well as evidence of a *quid pro quo* relationship."

Court Determines the SEC Adequately Alleged Defendants Recklessly Disregarded Whether the Tipper Had Received a Personal Benefit for Disclosing the Material Nonpublic Information

The court next considered the SEC's allegations as to whether Conradt's colleagues (the defendants in this action) knew that Martin had personally benefited by disclosing information concerning the SPSS acquisition to Conradt. The court explained that a defendant may be "guilty of criminal insider trading only if that person committed the offense 'willfully,' i.e., knowingly and purposely." However, the court found that a defendant "may be civilly liable if that person committed the offense recklessly, that is, in heedless disregard of the probable consequences." The court stated that in civil cases, it is "inclined to define unlawful insider trading broadly, so as to effectuate the remedial purposes behind the prohibition of such trading."

Turning to the case before it, the court held that the complaint "more than sufficiently allege[d] that defendants knew or recklessly disregarded that Martin [had] received a personal benefit in disclosing information to Conradt, and that Martin in doing so [had] breached a duty of trust and confidence to the owner of the information." The court noted that defendants allegedly "knew that Martin was the source of the tip to Conradt," and "that Conradt and Martin were friends and roommates." One of the two defendants also allegedly knew of "Martin's assault arrest." Moreover, defendants allegedly "took

multiple steps to conceal their own trading in SPSS securities." The court determined that these allegations were "enough to raise the reasonable inference that [ ] defendants knew that Martin's relationship with Conradt involved reciprocal benefits."

Delaware Chancery Court Finds Breach of Master Limited Partnership Agreement by General Partner for Failure to Evaluate Related Party Transaction Properly

In an April 20, 2015 memorandum opinion written by Vice Chancellor Laster, the Delaware Court of Chancery, in *In Re El Paso Pipeline Partners, L.P. Derivative Litigation*, found that the general partner of El Paso Pipeline Partners, L.P. (the "partnership"), a publicly traded master limited partnership ("MLP"), breached the partnership's limited partnership agreement and ordered the general partner to pay $171 million in damages.[3] The court found that the independent directors serving on the conflicts committee of the general partner's board of directors failed to form a subjective belief that a sale of assets from the partnership's parent, El Paso Corporation ("parent") to the partnership (a transaction commonly known as a "dropdown") was in the best interests of the partnership, as required by the limited partnership agreement. Although the opinion is consistent with previous MLP cases in that the court evaluated the conflicts committee's actions under the express contractual provisions of the limited partnership agreement rather than traditional fiduciary duties applicable to directors in the corporate context, the opinion demonstrates that even when directors are subject to contractually limited fiduciary standards, their conduct will not be immune from scrutiny by wary Delaware courts in conflict-of-interest transactions.

Discussion

In 2010, the partnership was a publicly traded MLP. Fifty-two percent of the common units and the entire general partner interest of the partnership were owned by the parent. As owner of the general partner, the parent controlled the partnership and was entitled to appoint all of the directors of the general partner. In the Spring of 2010, the partnership and the parent engaged in a dropdown transaction (the "Spring dropdown") where the parent sold to the partnership a fifty-one percent interest in two subsidiaries that owned a 190-mile natural gas pipeline and a liquefied natural gas terminal. In the Fall of 2010, the parent and the partnership engaged in another dropdown (the "Fall dropdown") where the parent sold to the partnership the remaining forty-nine percent interest in the assets transferred in the Spring dropdown plus a fifteen percent interest in a separate parent subsidiary that owned a 7,600 mile natural gas pipeline.

The limited partnership agreement authorized the general partner to approve interested party transactions such as dropdowns by one of four different paths, one of which was "Special Approval," which required that a conflicts committee consisting of independent board members of the general partner approve a transaction in the good faith belief that the transaction is in the best interests of the partnership. Special Approval was the path taken for both the Spring dropdown and the Fall dropdown.

Delaware courts have previously held that a good faith standard similar to the one in the limited partnership agreement requires only that the conflicts committee have a subjective good faith belief that the proposed transaction is in the best interests of the MLP and does not impose any objective or reasonableness standard with respect to a "belief." To prevail on a claim that the conflicts committee breached its contractual duty of good faith, the plaintiff cannot merely show that a belief was unreasonable or misguided but rather must prove either (1) that the conflicts committee acted in subjective bad faith, meaning that the conflicts committee believed that the dropdowns were not in the best interests of the MLP, or (2) that the conflicts committee consciously disregarded its contractual duty to form a subjective belief that the transaction was in the best interests of the MLP.[4]

3. The partnership's existence as a publicly traded MLP ended in 2014 when the partnership became a wholly owned subsidiary of Kinder Morgan (which also owns the general partner).

4. *Allen v. Encore Energy Partners, L.P.*, 72 A.3d 93, 104-106 (Del. 2013).

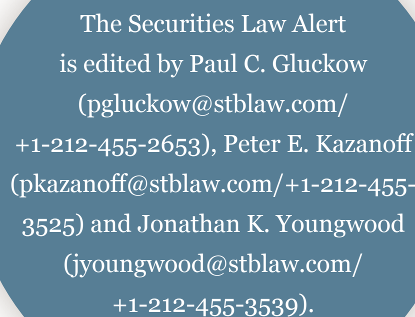
The plaintiff filed suits challenging the Spring dropdown and the Fall dropdown, alleging that the general partner breached the limited partnership agreement. The court granted summary judgment in favor of the defendants with respect to the Spring dropdown in a separate opinion decided on June 12, 2014[5] and partially denied the defendant's motion for summary judgment as to the Fall dropdown in a separate order issued on June 12, 2014.[6]

In a post-trial decision, the court concluded that the general partner had breached the limited partnership agreement with respect to the Fall dropdown. The court made a number of findings which led to its conclusion that the conflicts committee failed to form a subjective good faith belief that the Fall dropdown was in the best interests of the partnership. The court cited communications among the members of the conflicts committee in which they expressed the view that the Fall dropdown would not be in the best interests of the partnership as well as communications discussing their views regarding the values for the Spring dropdown and the Fall dropdown, which were significantly below the amounts eventually paid in both transactions. The court also concluded that the committee members did not view their job as one of evaluating whether the Fall dropdown was in the best interests of the partnership but rather believed they were merely supposed to determine whether the Fall dropdown would be accretive, which the court emphasized is a measure of the short term impact of a transaction on the level of distributions to equity holders rather than an indication of the long term value created by a transaction. The court also criticized the conflicts committee for having fallen into a "comfortable pattern" in approving dropdowns and failing to negotiate seriously with the parent.

Finally, the court was critical of the analysis undertaken by the committee's financial advisor. In particular, the court pointed out a number of inconsistencies between the analysis prepared by the financial advisor for the Spring dropdown and the analysis prepared for the Fall dropdown even though the transactions involved, in part, the same assets. The court criticized both the absence of clearly articulated reasons for the changes in the financial advisor's analyses between the Spring dropdown and the Fall dropdown and the conflicts committee's apparent unawareness of these changes.

5. *In Re El Paso Pipeline Partners, L.P. Derivative Litigation*, 2014 WL 2768782 (Del. Ch. 2014).

6. *In Re El Paso Pipeline Partners, L.P. Derivative Litigation*, 2014 WL 2641304 (Del. Ch. 2014) (Order).



The Securities Law Alert is edited by Paul C. Gluckow (pgluckow@stblaw.com/ +1-212-455-2653), Peter E. Kazanoff (pkazanoff@stblaw.com/+1-212-455-3525) and Jonathan K. Youngwood (jyoungwood@stblaw.com/ +1-212-455-3539).

Simpson Thacher

New York

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

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

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

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

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

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

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

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

Linda H. Martin
+1-212-455-7722
lmartin@stblaw.com

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

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

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

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

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

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

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

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

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

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

Los Angeles

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

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

Palo Alto

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

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

Washington, D.C.

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

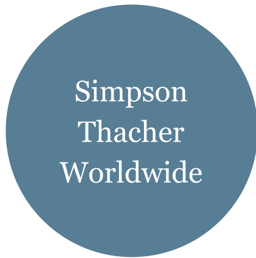
Jeffrey H. Knox
+1-202-636-5532
jeffrey.knox@stblaw.com

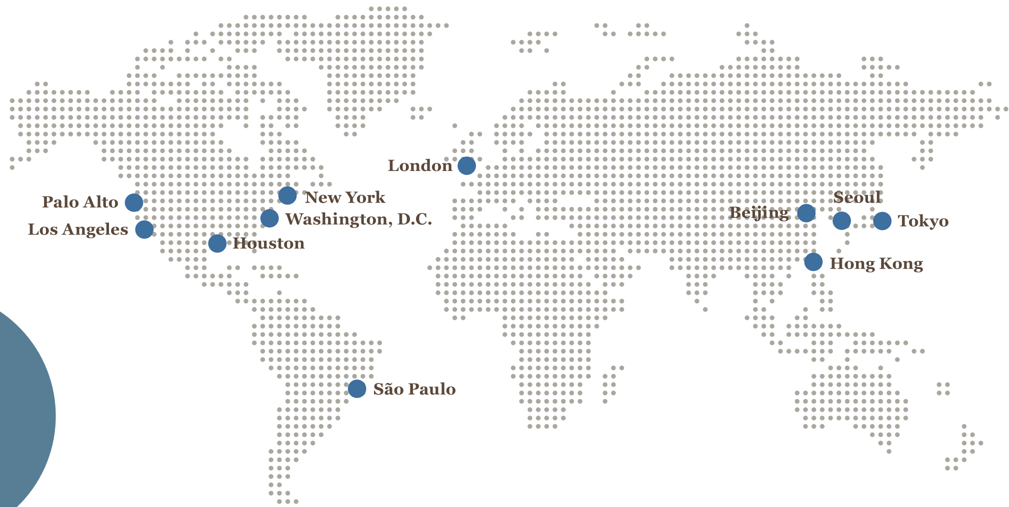
Cheryl J. Scarboro
+1-202-636-5529
cscarboro@stblaw.com

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

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

Simpson
Thacher





UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000