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Securities Law Alert

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–*Chambers USA*

Second Circuit: Factual Issues Remain as to Whether a Hedge Fund Is a Beneficial Owner That Must Disgorge Short-Swing Profits

On November 23, 2020, the Second Circuit vacated a grant of summary judgment against a hedge fund and remanded, concluding that factual issues remained as to whether the hedge fund was the beneficial owner of more than 10% of a retail company's shares such that it must disgorge short-swing profits under section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b). *Packer v. Raging Cap. Mgmt.*, 981 F.3d 148 (2d Cir. 2020) (Newman, J.). Defendants claimed that the hedge fund was not the beneficial owner by virtue of an agreement in which the hedge fund delegated to its registered investment advisor investment and voting authority for the shares. In its opinion, the Second Circuit rejected each of the district court's reasons for ruling that the delegation was not effective.

Background

The hedge fund at the center of this case is the customer of a registered investment advisor, Raging Capital Management ("RCM"). Investments from the public were funneled to the hedge fund by two feeder funds. The relationship between the hedge fund, RCM and the two feeder funds was governed by an investment management agreement ("IMA"), which Defendant William Martin signed on behalf of all four parties. Martin holds positions in RCM, the hedge fund and one of the feeder funds, and has an indirect role with the other feeder fund.

Litigation Commences

In 2015, plaintiff brought a derivative lawsuit on behalf of a retail company against RCM, the hedge fund, and Martin, "to obtain disgorgement of profits resulting from a short-swing sale of [the retail company's] stock." Initially, the complaint "alleged that the three defendants were a group for purposes of determining beneficial ownership and that the group had beneficial ownership of more than ten percent of [the retail company's] Class A common stock." However, discovery showed that the hedge fund held more than 10% of the outstanding shares during the relevant trading period. The district court granted plaintiff's motion for summary judgment and ordered the hedge fund to disgorge nearly $5 million in short-swing profits for violating section 16(b). Defendants appealed.

Beneficial Ownership Under Section 16(b)

The Second Circuit began its discussion by stating that section 16(b) of the Exchange Act "requires a 'beneficial owner' of more than ten percent of a company's shares to disgorge profits obtained from a short-swing sale." Under the relevant rules, "a beneficial owner of a security includes any person who . . . has or shares: (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or (2) Investment power which includes the power to dispose, or direct the disposition, of such security." Additionally, "a person is deemed to be a beneficial owner of a security if that person has the right to acquire beneficial ownership of such security within sixty days." However, as is relevant to this case, the SEC has also advised "that if a security holder has delegated all authority to vote and dispose of its stock to an investment advisor and lacks the right under the contract to rescind the authority granted . . . within 60 days, the security holder does not need to report beneficial ownership of the securities."

Defendants sought to avoid the hedge fund's beneficial ownership by virtue of the IMA through which the hedge fund delegated to RCM investment and voting authority for the shares. The district court ruled that the delegation was not effective. The Second Circuit vacated the grant of summary judgment, rejecting each of the district court's three reasons for ruling that the delegation was not effective.

Rejecting Delegation on the Basis of an Intertwined Relationship Impermissibly Extends Section 16(b)

As to the district court's first reason, the Second Circuit set forth what it termed "basic principles concerning section 16(b)[,]" explaining that section 16(b) "imposes a form of strict liability," and is a remedy which should be "applied narrowly." The court then stated that it would "not be consistent with these principles" to accept the district court's reason for concluding that delegation failed because of "the intertwined relationship of these parties[.]" The Second Circuit concluded that "using generalized wording such as 'intertwined' or 'not unaffiliated' to bring a person within the coverage of Rule 13d-3(a) would extend the reach of section 16(b) beyond the text of both the statute and the rule."

Acting as a Customer's Agent for One Purpose Does Not Make an Investment Advisor an Agent for All Purposes

The district court based its second reason for rejecting the delegation on Second Circuit precedent that included *Analytical Surveys v. Tonga Partners*, 684 F.3d 46 (2d Cir. 2012), where as "a result of these state-law-based agency relationships, both the limited partnership and the limited partner's agent were liable for a violation of section 16(b) by the managing member of the general partner." However, the Second Circuit stated that in the "pending case, there is no comparable state-law-based agency relationship between [the hedge fund] and RCM. They are both distinct corporations, and the [d]istrict [c]ourt did not rule that the corporate veil could be pierced." The Second Circuit pointed out that "making an investment advisor a customer's agent for the specified purpose of carrying out the advisor's traditional functions for a customer does not make the advisor an agent for all purposes." Further, the court stated that "[n]either *Tonga* nor *Huppe*, nor anything in SEC statutes, rules, or guidance, supports such a result."

Signing Authority Is Not Necessarily Authority to Amend or Terminate

The district court's third reason for rejecting delegation was its view that Martin had the power to amend the IMA, allowing him to eliminate the notice requirement in the IMA's termination provision, ending the delegation within 60 days of acquiring shares which would trigger application of section 16(b). The Second Circuit explained that the district court "based its view of Martin's authority to *amend* the IMA on the fact that he had *signed* it on behalf of all four parties to the agreement." The Second Circuit quickly dispatched this reasoning stating that "[a]uthority for an individual to sign a document on behalf of an entity, however, does not necessarily carry with it authority to commit those entities to making changes in, or terminating, that document."

The Second Circuit stated that it was "not clear at this point" whether Martin could amend the IMA on behalf of the hedge fund and the feeder funds. The Second Circuit held that the district court "could not, on a motion for summary judgment, determine that Martin could alter the IMA on behalf of all four entities with strokes of a pen." The court continued that "[i]t remains to be determined as a factual matter whether, under all the relevant circumstances, Martin is in control of [the hedge fund] and the feeder funds with authority to commit these entities to altering or terminating the IMA." The court explained that whether such a "determination can be made on a renewed motion for summary judgment, after the record has been expanded, or will require a trial is a matter initially for the [d]istrict [c]ourt on remand."

District of Colorado: Complex, Technical and Not Obvious Tax-Accounting Error Failed to Create a Strong Inference of Scienter

On December 2, 2020, the District of Colorado dismissed with prejudice securities fraud claims against Molson Coors Beverage Company and certain of its officers and directors, which alleged that defendants knowingly or recklessly misstated Molson's financial statements in the wake of Molson's announcement that it had made a tax-accounting error causing it to significantly understate its tax liabilities. *In re Molson Coors Beverage Sec. Litig.*, No. 1:19-cv-00455 (D. Colo. 2020) (Ebel, J.). The court explained that "[a]t bottom, [plaintiffs'] argument is that the existence of a $400 million accounting error in a critical corporate acquisition is too meaty not to be the result of fraud." Under these circumstances, the court stated that it "would only find a strong inference of scienter if the error was so obvious that it would be absurd to conclude that [d]efendants did not know about it." Instead, the court found "that the tax-accounting error was technical and non-obvious."

Background

In 2019, Molson filed a Form 8-K announcing that it had made a tax-accounting error in connection with a 2016 acquisition (the "Restatement"). Specifically, Molson announced that its "consolidated financial statements for 2016 and 2017 should be restated and should no longer be relied upon[.]" The error caused Molson to understate its deferred tax liabilities in its 2016 and 2017 financial statements by nearly $400 million. After the announcement, Molson's share price fell by 9%. Subsequently, plaintiff stockholders commenced a securities fraud class action alleging that various Molson officers and directors knowingly or recklessly misstated Molson's financial statements in order to inflate share prices.

Plaintiffs claimed that they were injured due to Molson's false financial statements, because they purchased stock "at artificially inflated levels and were damaged when the truth was revealed" and Molson's stock price subsequently declined. Defendants moved to dismiss, arguing that plaintiffs failed adequately to plead scienter.

Strong Inference of Scienter Not Created by Complex, Technical and Non-Obvious Error

The court began its analysis "by addressing each allegation of scienter or its absence, reviewing the merits of each." Plaintiffs alleged scienter based on Molson's erroneous financial statements alone. However, citing

In re Sun Healthcare Securities Litigation, 181 F. Supp. 2d 1283 (D.N.M. 2002), the court stated that "the mere existence of an error warranting restatement does not necessarily reflect on the scienter behind that error." Further citing *Sun Healthcare*, the court quoted "[t]o hold otherwise would subject every financial restatement to liability." The court explained that "[w]hether the Restatement and the underlying tax-accounting error imply scienter depends on what exactly the error entailed." The court continued that "[h]ere, as described in the 2018 Form 10-K, the error was Molson's failure to reconcile[] its outside basis for its investment in the partnership to the book-tax differences in the underlying assets and liabilities within the partnership."

In response to plaintiffs' claim that it was an "Accounting 101 text book type of reconciliation" such that "the error was intentional or deliberately reckless[,]" the court evaluated the complexity of the error. The court stated that "[t]o determine the complexity of the error, the [c]ourt looks to Molson's Form 10-K for its description of the error[.]" The court then announced that it "agrees with [d]efendants that this involves a technical tax-accounting error[.]" The court then stated "[t]hat the error was indeed complex, technical, and not obvious is confirmed by the fact that [Molson's independent accounting firm] conducted annual audits of Molson's financial reporting for both 2016 and 2017 and failed to identify the error." Further, that Molson's accounting firm "failed to identify the error until the Restatement strongly suggests that it was not a simple and obvious error indicative of scienter." The court further found "that the [accounting firm] audits do not categorically insulate [d]efendants from liability, but they do weigh against an inference of scienter." Additionally, the court found "that the Restatement error itself does not lend to a strong inference of scienter and that [the accounting firm's] involvement weighs against an inference of scienter."

Plaintiffs additionally argued that a number of other allegations supported scienter, including the magnitude of the error, weakness in Molson's internal controls over financial reporting, and defendants' motive, among others. The court analyzed each allegation under existing precedent, finding that they did little to support an inference of scienter.

Holistic Analysis of Allegations Gives Rise to Only a Weak Inference of Scienter

Beginning its holistic analysis, the court explained that it must "consider these allegations together and decide if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." The court noted that "[p]laintiffs' inference of scienter relies primarily on the mere existence of a $400 million tax liability understatement in Molson's financial statements relating to a critical, costly acquisition." The court "conclude[d] that, considering [p]laintiffs' allegations together, they give rise to only a weak inference of scienter." The court also "conclude[d] that [p]laintiffs have failed adequately to plead scienter, forestalling their claims under § 10(b) and Rule 10b–5." The court dismissed the complaint in its entirety with prejudice.

Delaware Supreme Court: Plaintiff Need Not Explain Strategy in Section 220 Document Demand

On December 10, 2020, the Delaware Supreme Court held that when a Section 220 books and records inspection demand states a proper investigatory purpose it need not identify the particular course of action the stockholder will take if the books and records confirm the stockholder's suspicion of wrongdoing. *AmerisourceBergen v. Leb. Cnty. Emps.' Ret. Fund*, 2020 WL 7266362 (Del. 2020) (Traynor, J.). The court further held that, although the actionability of wrongdoing can be a relevant factor to consider when assessing the legitimacy of a stockholder's stated purpose, an investigating stockholder is not required in all cases to establish that the wrongdoing under investigation is actionable.

Background

Defendant AmerisourceBergen is one of the largest opioid distributors in the United States. Federal regulations require opioid distributors to take steps to maintain effective controls and reporting systems to make certain that drug shipments stay within "legitimate medical, scientific, and industrial channels." Since 2012, AmerisourceBergen has been subject to a number of government investigations and lawsuits relating to its opioid practices. In 2019, plaintiff stockholders served a demand under Section 220 of the Delaware General Corporation Law on AmerisourceBergen that requested inspection of board materials "related to AmerisourceBergen's operations and its potential involvement in the opioid crisis." The demand listed four investigatory purposes: (i) to investigate possible breaches of fiduciary duty, mismanagement, and other violations of law by AmerisourceBergen's directors and its management in connection with its distribution of opioid medications; (ii) to consider any remedies with respect to the aforementioned conduct; (iii) to evaluate director independence and disinterestedness; and (iv) to use the information obtained to evaluate possible litigation or other corrective measures.

AmerisourceBergen rejected the demand, claiming that it "did not state a proper purpose and that, even if [p]laintiffs' purpose were proper, the scope of the inspection was overbroad." Plaintiffs subsequently filed an action in the Court of Chancery, seeking to compel production of the requested documents.

In its memorandum opinion, the Court of Chancery found that plaintiffs had demonstrated a proper purpose sufficient to warrant the inspection of formal board materials. The Court of Chancery further found that plaintiffs "had established a credible basis, through strong circumstantial evidence, to suspect that AmerisourceBergen's situation did not result from any ordinary business decision that, in hindsight, simply turned out poorly, but instead may have been the product of [its] violation of positive law." The Court of Chancery also rejected AmerisourceBergen's contention that plaintiffs' sole purpose was to investigate a potential *Caremark* claim, noting that plaintiffs' demand "reserved the ability to consider all courses of action that their investigation might warrant pursuing." The Court of Chancery additionally rejected AmerisourceBergen's contention that plaintiffs were required to show that the wrongdoing they sought to investigate was "actionable" wrongdoing. AmerisourceBergen moved for, and the Court of Chancery granted, certification of an interlocutory appeal.

On appeal, AmerisourceBergen argued that the lower court erroneously found that plaintiffs had stated "a proper purpose and need not identify the objectives of the investigation." AmerisourceBergen also asserted that the court erroneously determined that plaintiffs "had established a credible basis from which the court could suspect wrongdoing and that such wrongdoing need not be *actionable*."

Plaintiff Need Not Specify the Ends to Which It Might Use Books and Records

The court began its analysis by noting that Section 220 provides that stockholders who seek to inspect a corporation's books and records must establish that they have a "proper purpose for the inspection" and that a proper purpose is a "purpose reasonably related to such person's interest as a stockholder." The court cautioned that "a stockholder seeking to investigate wrongdoing must show, by a preponderance of the evidence, a credible basis from which the court can infer there is possible mismanagement as would warrant further investigation." The court further explained that a "stockholder need not show that corporate wrongdoing or mismanagement has occurred in fact, but rather the threshold may be satisfied by a credible showing . . . that there are legitimate issues of wrongdoing."

Agreeing with the Court of Chancery, the court "reject[ed] AmerisourceBergen's characterization of [p]laintiffs' [d]emand as solely limited to pursuing derivative litigation." The court held that "when the purpose of an inspection of books and records under Section 220 is to investigate corporate wrongdoing, the stockholder seeking inspection is not required to specify the ends to which it might use the books and records."

AmerisourceBergen contended that unless the objectives of the investigation "are explicitly disclosed in the stockholder's demand, the corporation will be impaired, if not entirely thwarted in its efforts to evaluate the propriety of the demand's purpose without resorting to litigation." The court distinguished AmerisourceBergen's reliance on *Northwest Industries v. B.F. Goodrich*, 260 A.2d 428 (Del. 1969), which involved a stockholder's request to inspect the company's list of stockholders. The court stated that "a request to inspect a list of stockholders is fundamentally different than a request to inspect books and records in furtherance of an investigation of corporate wrongdoing." The court explained that "[a] corporation cannot discern whether the inspection of its list of stockholders for the purpose of communicating with other stockholders is related to the stockholder's interest as a stockholder without a disclosure of the substance of the intended communication." The court stated that "[b]y contrast, corporate wrongdoing is, as the Court of Chancery noted, in and of itself a legitimate matter of concern that is reasonably related to a stockholder's interest as a stockholder."

The court further held that when a stockholder can present a credible basis from which a court can infer possible wrongdoing or mismanagement, a stockholder's purpose will be deemed proper under Delaware law. However, the court cautioned that "a corporation may challenge the *bona fides* of a stockholder's stated purpose and present evidence from which the court can infer that the stockholder's stated purpose is not its actual purpose." Further, the court explained that "when assessing the propriety of a stockholder's purpose," the court can imply "what the stockholders' intended use of the books and records will be."

Credible Basis Test Reaffirmed, Plaintiff Need Not Show Alleged Wrongdoing Is Actionable

AmerisourceBergen additionally argued that merits-based attacks on the lawsuit that it expected plaintiffs to file someday were justified because plaintiffs "must establish that the wrongdoing they seek to investigate is *actionable* wrongdoing." AmerisourceBergen asserted that plaintiffs' claims were not actionable because they were legally barred by a Section 102(b)(7) exculpatory provision and by laches. The court held that it agreed with the Court of Chancery's grounds for rejecting AmerisourceBergen's argument.

The court explained that "the Court of Chancery's determination that [p]laintiffs contemplated purposes *other than* litigation is supported by a fair reading of the [d]emand." The court then announced that "[w]e need go no further than that to dispose of AmerisourceBergen's 'actionability' argument." Nevertheless, the court seized the opportunity "to dispel the notion that a stockholder who demonstrates a credible basis from which the court can infer wrongdoing or mismanagement must demonstrate that the wrongdoing or mismanagement is actionable." The court explained that "[i]f litigation is the stockholder's sole objective but an insurmountable procedural obstacle unrelated to the suspected corporate wrongdoing bars the stockholder's path, it cannot be said the stockholder's stated purpose is its actual purpose." The court continued that "[g]iven the obvious futility of the litigation the stockholder claims to have in mind, the investigation can only be seen as assuaging the stockholder's idle curiosity or a fishing expedition."

The court stated that "[a]s the Court of Chancery has noted, a Section 220 proceeding is not the time for a merits assessment of Plaintiffs' potential claims against [the corporation's] fiduciaries." The court then held that "[w]e therefore reaffirm the 'credible basis' test as the standard by which investigative inspections under Section

220 are to be judged." The court held that "[t]o obtain books and records, a stockholder must show, by a preponderance of the evidence, a credible basis from which the Court of Chancery can infer there is possible mismanagement or wrongdoing warranting further investigation." The court further held that a "stockholder need not demonstrate that the alleged mismanagement or wrongdoing is actionable."

The court noted that a court may be justified in denying inspection in "the rare case in which the stockholder's sole reason for investigating mismanagement or wrongdoing is to pursue litigation and a purely procedural obstacle, such as standing or the statute of limitations, stands in the stockholder's way such that the court can determine, without adjudicating merits-based defenses, that the anticipated litigation will be dead on arrival," but "in all other cases, the court . . . should defer the consideration of defenses that do not directly bear on the stockholder's inspection rights, but only on the likelihood that the stockholder might prevail in another action."

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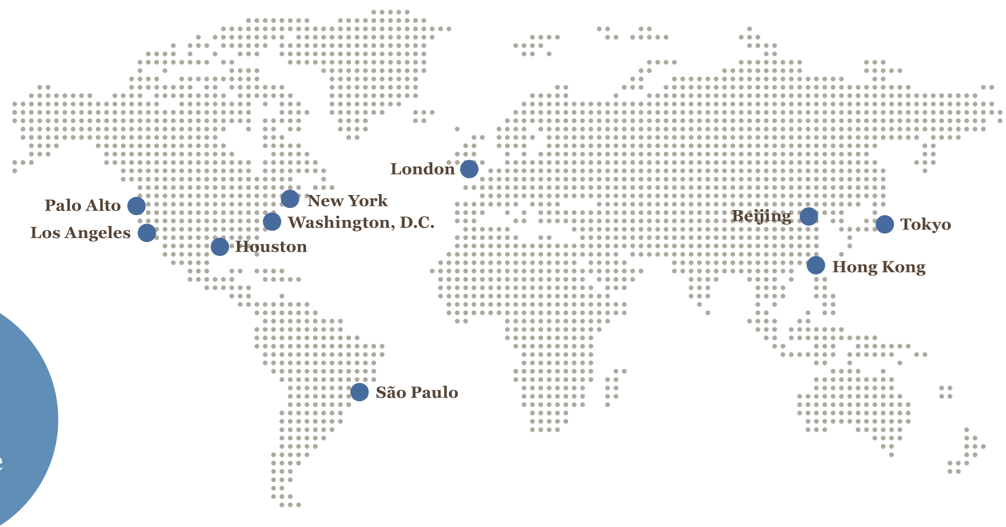

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