Simpson Thacher

Securities Law Alert

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First Circuit: Reverses Dismissal of Action Claiming Investors Were Misled About a New—Allegedly Non-Functional—Product

On December 22, 2021, the First Circuit reversed the dismissal of a securities fraud class action under Section 10(b) alleging that a software company and certain of its officers misled investors by touting a new data-backup product that they knew did not work. *Constr. Indus. & Laborers Joint Pension Tr. v. Carbonite*, 2021 WL 6062622 (1st Cir. 2021) (Kayatta, J.). On the issue of scienter, the court held that the complaint alleged facts raising a strong inference that the CEO and CFO either inquired about the new product before deciding to promote it to investors or were reckless in failing to do so.

Background and Procedural History

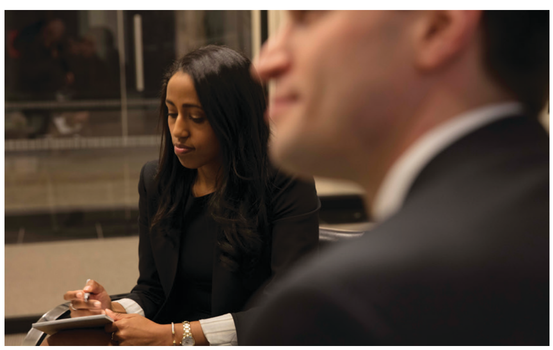
Following the 2018 launch of its new data-backup product, the CEO stated in a call with investors and analysts that the new product "significantly improves our performance for backing up virtual environments and makes us extremely competitive going after that market." Weeks later, the company's CFO stated at an investor conference that "[t]his is a market that we haven't been particularly strong in, in the past, we've been okay. I think we have completely overhauled the product and we have put something out that we think is just completely competitive and just a super strong product[.]" However, plaintiff alleged that throughout this time the new product never worked and the company had set up an internal "tiger team" focused on fixing the product. In July 2019, the company announced reduced 2019 full-year revenue projections and that the product would be withdrawn from the market, after which there was a stock drop.

Plaintiff Alleged Facts Raising a Strong Inference of Scienter

The First Circuit disagreed with the district court that plaintiff failed to successfully plead scienter. The court determined that plaintiff alleged facts raising a strong inference that the CEO and CFO either inquired about the product before deciding to promote it to investors or were reckless in failing to do so. Specifically, plaintiff asserted that defendants must have known that the product did not work because its professed importance to the company strongly implied that senior officers were following it closely and were aware of its failings. Plaintiff alternatively asserted that defendants were at least highly reckless in promoting the product because, if they were not aware of the issues, "then they repeatedly and with apparent premeditation promoted it as important to the company without at least checking that it had ever worked."

Court Rejects Non-Culpable Inference From Efforts to Remedy the Product's Issues

The court also rejected that the company's efforts to remedy the issues with the product suggested "a sincere belief that [the product] could be made operational with enough work, such that [the company] believed [the product] was fixable." The court pointed out that the CEO's and CFO's statements were framed in the present tense and, therefore, "were not projections of hoped-for future performance." The court characterized the statements as "flat-out claims about the product as it then stood."



Seventh Circuit: Reverses Bylaw-Based Dismissal of a Derivative Suit Under Section 14(a) of the Exchange Act

On January 7, 2022, a split Seventh Circuit panel reversed a derivative suit's dismissal based on a company forum-selection bylaw requiring derivative actions be filed in the Court of Chancery of Delaware. *Seafarers Pension Plan v. Bradway*, 2022 WL 70841 (7th Cir. 2022) (Hamilton, J.). The court held that the "forum bylaw cannot be applied to this derivative action asserting a claim that is subject to exclusive federal jurisdiction." The court explained that if the bylaw were so applied then plaintiff's derivative action could not be heard in any forum because the Exchange Act gives federal courts exclusive jurisdiction over actions under it. Further, the court stated that this "result would be contrary to Delaware corporation law, which respects the non-waiver provision in Section 29(a) of the federal Exchange Act, 15 U.S.C. § 78cc(a)."

Background and Procedural History

Following two fatal plane crashes involving the same aircraft model, plaintiff filed this derivative suit in 2019 under Section 14(a) of the Exchange Act in the Northern District of Illinois where the plane manufacturer is headquartered. Plaintiff alleged that the company's officers and directors made materially false and misleading public statements about the development and operation of this model in the company's proxy materials. Without addressing the merits, the district court dismissed on forum non conveniens grounds after applying a company bylaw[1] requiring that any derivative actions be filed in the Delaware Court of Chancery.

Delaware Corporation Law and the Exchange Act Bar Application of the Bylaw

The court began by stating that the "most straightforward resolution of this appeal is under Delaware corporation law, which we read as barring application of the [company's] forum bylaw to this case invoking non-waivable rights under the federal Exchange Act." After noting that plaintiff's chosen forum in the federal district where the company is headquartered "seems appropriate" the court pointed out that if the bylaw is applied, it "will force plaintiff to raise its claims in a Delaware state court, which is not authorized to exercise jurisdiction over Exchange Act claims." The court observed that it would be difficult to reconcile this

1. The bylaw provided in relevant part, "With respect to any action arising out of any act or omission occurring after the adoption of this By-Law, unless the Corporation consents in writing to the selection of an alternative forum, the Court of Chancery of the State of Delaware shall be the sole and exclusive forum for . . . any derivative action or proceeding brought on behalf of the Corporation . . . ."

result with Section 29(a) of the Exchange Act, which deems void contractual waivers of compliance with the requirements of the Act.

After parsing the statutory text of Section 115[2] of the Delaware General Corporation Law, which addresses bylaws that impose choices of forum for litigation involving derivative claims, the court stated that "we conclude that Section 115 does not authorize use of a forum-selection bylaw to avoid what should be exclusive federal jurisdiction over a case, particularly under the Exchange Act." In particular, the court focused on the "consistent with applicable jurisdictional requirements" phrase in Section 115. The court concluded that as applied here, the company's forum bylaw violates Section 115 because it is inconsistent with the jurisdictional requirements of the Exchange Act.

Judge Easterbrook Dissents

While agreeing that Section 27(a) of the Exchange Act provides for exclusive jurisdiction of claims arising under it and the SEC's rules, Judge Easterbrook stated that, however, "a derivative suit arises under state law even if a federal issue may come to the fore eventually." He also pointed out that in *Shearson/American Express v. McMahon*, 482 U.S. 220 (1987), the Supreme Court treated exclusivity under Section 27(a) as a right that may be waived. Writing in support of the bylaw's application, Judge Easterbrook described it "just another forum-selection clause." In response to concerns that plaintiff would be denied relief, Judge Easterbrook responded that "Delaware will provide whatever substantive relief is appropriate[.]"

Judge Easterbrook concluded that "if there is no such thing as a derivative § 14(a) claim divorced from state corporate law, if derivative suits are proper in state courts, and if exclusivity under § 27(a) is waivable—indeed, if any one of these three propositions holds—then there is no problem with litigating plaintiff's claim in the courts of Delaware."

Court of Chancery of Delaware: Applies Entire Fairness Standard to De-SPAC Merger

On January 3, 2022, the Court of Chancery of Delaware largely denied motions to dismiss in a class action for breach of fiduciary duties alleging that the directors, officers, and controlling stockholder of a SPAC (special purpose acquisition company) withheld material information from the public stockholders, which allegedly impaired their right to redeem their shares before the de-SPAC merger. *In re MultiPlan S'holders Litig.*, 2022 WL 24060 (Del. Ch. Ct. 2022) (Will, V.C.).[3] The court held that: (i) plaintiffs pleaded direct claims centering around the purported impairment of their redemption right; (ii) the entire fairness standard of review applied at the pleading stage; and (iii) plaintiffs had pleaded a non-exculpated disclosure claim against the SPAC's controlling stockholder and former directors.

Background

The SPAC's initial public stockholders purchased IPO units consisting of one common share and a fractional warrant for $10 per unit. The sponsor of the SPAC was ultimately controlled by a sole stockholder (the "Controlling Stockholder"), who had previously sponsored several SPACs. The sponsor's primary form of compensation was "founder" shares. If the SPAC entered into a business combination within two years, the founder shares would convert into common

2. Section 115 provides that "bylaws may require, consistent with applicable jurisdictional requirements, that any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State." 8 Del. C. § 115.

3. Simpson Thacher represents defendant MultiPlan Corp. f/k/a Churchill Capital Corp. III in this action.

shares. If no transaction was completed, the SPAC would liquidate, the public stockholders would receive their investment back plus interest and the founder shares would have no value.

The SPAC entered into a merger with a healthcare data analytics firm and, in September 2020, the SPAC issued a proxy statement that solicited stockholder votes on the deal. The SPAC's certificate of incorporation established that the public stockholders could either exercise their redemption right (then equal to $10.04) held by the SPAC trust or remain as investors in the post-combination entity. In October 2020, the SPAC's stockholders "overwhelmingly" voted to approve the business combination and the de-SPAC merger was completed. In November 2020, a short-seller published a negative report alleging that the target's largest customer was building a competing in-house product. The post-merger company's stock fell to a then-closing low of $6.27 the following day.

Procedural History

Plaintiffs alleged that the SPAC's fiduciaries omitted material information in the proxy. Counts I, II, and III of the complaint were direct claims for breach of fiduciary duty against certain SPAC directors, officers, and the Controlling Stockholder. Plaintiffs alleged that defendants, putting their own financial interests ahead of the public stockholders' interests, failed to disclose facts that impaired the public stockholders' informed exercise of their redemption and voting rights. Defendants moved to dismiss.

Plaintiffs Pleaded Facts Supporting a Reasonable Inference That Entire Fairness Applies

An issue before the court was whether to apply the business judgment rule, which is Delaware's "default standard of review" or entire fairness, which is Delaware's "most onerous standard of review" to the de-SPAC merger. The court determined that plaintiffs pleaded facts supporting a reasonable inference that entire fairness applied on two independent bases. First, plaintiff alleged that the de-SPAC merger was a conflicted controller transaction. Second, plaintiff alleged that a majority of the SPAC board was conflicted either because the directors were self-interested or because they lacked independence from the Controlling Stockholder.

Noting that entire fairness was not triggered by the mere presence of a controlling stockholder, the court explained that plaintiffs must also adequately plead that the Controlling Stockholder engaged in a conflicted transaction. Delaware courts place conflicted controller transactions implicating entire fairness into one of two categories: "where the controller stands on both sides"[4] and "where the controller competes with the common stockholders for consideration." As to the second category, the court explained that a controller competes with common stockholders when he "receives a unique benefit by extracting something uniquely valuable to the controller, even if the controller nominally receives the same consideration as all other stockholders to the detriment of the minority."[5] *IRA Tr. FBO Bobbie Ahmed v. Crane*, 2017 WL 7053964 (Del. Ch. 2017, revised 2018).

Plaintiffs Pleaded Facts Supporting a Reasonable Inference That the Controlling Stockholder Received a Unique Benefit

Focusing on the period before the de-SPAC merger when the public stockholders held redemption rights backed by the trust, the court determined that the allegations pleaded facts supporting a reasonable inference that

4. The court found that the Controlling Stockholder did not stand on both sides of the de-SPAC merger as this was an arms-length transaction between two unaffiliated parties.

5. A controller also competes with common stockholders when the controller "receives greater monetary consideration for its shares than the minority stockholders" or "takes a different form of consideration than the minority stockholders[.]"

there was a unique benefit to the Controlling Stockholder. The court pointed out that the merger had a value to the common stockholders if shares of the post-merger entity were worth $10.04, but that the merger was valuable to the Controlling Stockholder "well below" $10.04 because the value of the Controlling Stockholder's compensation would drop to zero if no merger occurred. The court determined that "[t]he potential conflict between [the Controlling Stockholder] and public stockholders resulting from their different incentives in a bad deal versus no deal is sufficient to pass the 'reasonably conceivable' threshold[ ]" found in Rule 12(b)(6).

Plaintiffs Pleaded Facts Supporting a Reasonable Inference That the Stockholders' Redemption Rights Were Impaired Through Failure to Disclose Material Information

The court finally found that plaintiffs' breach of fiduciary duty claims were reasonably conceivable because they alleged that the directors "failed, disloyally, to disclose information necessary for the plaintiffs to knowledgeably exercise their redemption rights." The court emphasized that "plaintiffs' claims are [not] viable [ ] simply because of the nature of the transaction or resulting conflicts[ ]" and that the court's "conclusion does not address the validity of a hypothetical claim where the disclosure is adequate and the allegations rest solely on the premise that fiduciaries were necessarily interested given the SPAC's structure." Indeed, the court stated that "[i]f public stockholders, in possession of all material information about the target, had chosen to invest rather than redeem, one can imagine a different outcome."

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