Simpson Thacher

Securities Law Alert

Year in Review:

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2023

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Supreme Court Decisions and Developments

Supreme Court: Constitutional Challenges to Agency Proceedings Can Be Brought Directly in Federal District Court

On April 14, 2023, the Supreme Court issued a unanimous opinion settling a circuit split concerning whether a party to an administrative enforcement action can sue directly in federal district court to challenge the agency's constitutional authority to proceed, or whether the party must first complete the administrative process before seeking review in a federal court of appeals. *Axon Enter. v. FTC*, 598 U.S. 175 (2023) (Kagan, J.). Affirming *Cochran v. SEC*, 20 F.4th 194 (5th Cir. 2021) and reversing *Axon Enterprise v. FTC*, 986 F.3d 1173 (9th Cir. 2021), the Court held that federal district courts have jurisdiction to hear lawsuits challenging the constitutionality of agency proceedings and to resolve such constitutional challenges. In both cases, the parties challenged the agency's administrative enforcement action on the theory that the administrative law judges' dual-layer tenure protection unconstitutionally insulates them from presidential removal.

Justice Kagan, writing for the Court, concluded that "each of the three *Thunder Basin* factors signals that a district court has jurisdiction to adjudicate [these] sweeping constitutional claims." In *Thunder Basin Coal v. Reich*, 510 U.S. 200 (1994), the Court set forth three factors designed to determine whether a claim was "of the type" that Congress intended to be reviewed within a statutory review scheme. A court should consider whether: (i) precluding district court jurisdiction "could foreclose all meaningful judicial review" of the claim; (ii) the claim is "wholly collateral to the statute's review provisions"; and (iii) the claim is "outside the agency's expertise." If the answer to all three questions is yes, it is presumed that Congress did not intend to limit jurisdiction.

Analyzing the first factor, Justice Kagan contrasted situations where an appellate court could undo an agency action (such as by revoking a fine) with situations where a party faces allegedly unconstitutional agency authority that "is impossible to remedy once the proceeding is over, which is when appellate review kicks in." The Court concluded that "[j]udicial review of [these] structural constitutional claims would come too late to be meaningful." As to the second factor, the Court concluded that the constitutional claims were "collateral" to any orders or rules from which review might be sought because the constitutional claims have nothing to do with either the enforcement-related matters the Commissions regularly adjudicate or those they would adjudicate in assessing the charges against the parties. Regarding the third factor, the Court determined that the parties' claims were outside the agencies' expertise noting that these tenure protection claims "raise standard questions of administrative and constitutional law, detached from considerations of agency policy." Thus, the claims were not "of the type" that the statutory review schemes reach and a district court could review them.

Supreme Court: Section 11 Requires Purchasers of Shares in a Direct Listing to Plead and Prove That They Purchased Traceable Shares

On June 1, 2023, the Supreme Court issued a unanimous opinion settling a circuit split concerning whether Section 11 of the Securities Act requires a plaintiff who purchased shares through a direct listing to trace his shares to a false or misleading registration statement. *Slack Techs. v. Pirani*, 598 U.S. 759 (2023) (Gorsuch, J.). The Court held that to state a claim under Section 11 "requires a plaintiff to plead and prove that he purchased shares traceable to the allegedly defective registration statement[.]" The Court remanded the case to the Ninth Circuit to consider whether plaintiff's pleadings could satisfy Section 11 in light of its decision.[1]

Plaintiff purchased shares on the day the company went public through a direct listing, by filing a registration statement relating to a certain number, but not all, of the shares sold into the market on that date. Following a stock price drop, plaintiff filed a putative class action alleging that the company had violated Sections 11 and 12 of the Securities Act by filing a materially misleading registration statement. The company moved to dismiss arguing that Sections 11 and 12 authorized suit only for those who held shares issued pursuant to a false or misleading registration statement and plaintiff did not allege that he purchased shares traceable to the allegedly misleading registration statement. The district court denied the motion to dismiss but certified its ruling for interlocutory appeal and a divided panel of the Ninth Circuit affirmed. The Supreme Court subsequently granted certiorari.

Writing for the Court, Justice Gorsuch explained that Section 11 authorizes an individual to sue for a material misstatement or omission in a registration statement when he has acquired "such security." Viewing this as a matter of statutory interpretation, the Court focused its analysis on the meaning of the term "such security" in Section 11. Noting that there is no clear referent in Section 11 to indicate what "such" means in the phrase "such security" the Court looked to other sections of the Securities Act for context. In particular, the Court observed that "the statute repeatedly uses the word 'such' to narrow the law's focus." The Court reasoned that as to "'such security,' the statute is limited to a security registered under the particular registration statement alleged to contain a falsehood or misleading omission." The Court also noted that Section 11(e) caps damages against an underwriter at the total price at which the securities were offered to the public, thereby tying the maximum available recovery to the value of the registered shares alone. The Court observed that this provision would make "little sense" under plaintiff's interpretation because if Section 11 liability "extended beyond registered shares then presumably available damages would too." The Court concluded that "[c]ollectively, these contextual clues persuade us that [the company's] reading of the law is the better one."

Supreme Court: The Court Hears Oral Argument on Whether the SEC's In-House Courts Are Unconstitutional

On November 29, 2023, the Supreme Court heard oral argument concerning whether statutory provisions that empower the SEC to initiate and adjudicate administrative enforcement proceedings seeking civil penalties in its own in-house courts violate the Seventh Amendment right to a jury trial. *SEC v. Jarkesy*, No. 22-859. In the case, the SEC brought an administrative proceeding

1. The Court also vacated the Ninth Circuit's judgment determining that plaintiff had standing under Section 12 (on the ground that Section 12 paralleled Section 11) for reconsideration in light of the Court's interpretation of Section 11. The Court declined to express a view as to the proper interpretation of Section 12 or its application to the case, but cautioned "that the two provisions contain distinct language that warrants careful consideration."

against a hedge fund owner and his advisory firm for allegedly making misrepresentations to investors. After an SEC administrative law judge determined that respondents had violated the Securities Act, Exchange Act, and Advisers Act, a divided panel of the Fifth Circuit vacated and remanded. In its petition for a writ of certiorari, the SEC asserted that the Fifth Circuit's holdings were "incorrect" and "highly consequential."

During oral argument, the attorney appearing on behalf of the SEC emphasized that in-house adjudications are a "longstanding and entrenched practice" and asserted that the Supreme Court's decision in *Atlas Roofing v. Occupat'l Safety & Health Rev. Comm'n*, 430 U.S. 442 (1977) considered many of the same arguments and "reaffirmed that Congress does not violate the Seventh Amendment when it authorizes an agency to impose civil penalties in administrative proceedings to enforce a federal statute." In *Atlas Roofing*, the Court stated "in cases in which 'public rights' are being litigated - *e.g.*, cases in which the Government sues in its sovereign capacity to enforce public rights created by statutes within the power of Congress to enact - the Seventh Amendment does not prohibit Congress from assigning the factfinding function and initial adjudication to an administrative forum with which the jury would be incompatible."

Justice Thomas asked if the rights being litigated were categorized as private rights rather than public rights if that would determine whether the case should be adjudicated before an Article III court. Justice Sotomayor noted that Justice Thomas's writings have broadly defined a private right as any right that involves property, life, or liberty. The SEC attorney acknowledged that the definition of public rights is contested but pointed out that when an agency is enforcing a federal statute in exercise of its sovereign powers, that it is a matter involving public rights under *Atlas Roofing*, even if private property was involved. The SEC attorney asserted that this case involves public rights because the SEC is seeking to vindicate is the public's right to fair and honest markets.

Justice Gorsuch commented that the SEC has changed over the years and stated that "Congress has a lot more problems on its plate today than it -- than it did a hundred years ago or even 50 years ago. But that doesn't mean that the constraints of the Constitution somehow evaporate[.]" Similarly, Chief Justice Roberts noted that "the extent of impact of government agencies on daily life today is enormously more significant than it was 50 years ago." Chief Justice Roberts further pointed out that when an administrative agency can decide whether to proceed against a defendant before its own in-house court or in federal court, that "it does seem to me to be curious that and unlike most constitutional rights that you have that right until the government decides that they don't want you to have it. That doesn't seem to me the way the Constitution normally works."

Addressing respondents' counsel, Justice Kagan pointed out that *Atlas Roofing* stated that "the Seventh Amendment is no bar to the creation of new rights or to their enforcement outside the regular courts of law." Comparing the statutory scheme at issue with the OSH Act at issue in *Atlas Roofing,* Justice Kagan

stated that both served a prophylactic purpose allowing the government to take action before harm occurs. Respondents' counsel countered that a new statutory public right had not been created here because the elements of a 10b-5 action are "substantially the same and certainly serve the same essential function as a traditional common law fraud claim." Respondents' counsel continued that if a common law claim or something "approximating" such a claim is thrown into a statutory scheme that it still requires the right to trial by jury.

The Court's decision in this case is highly anticipated as its outcome may affect how the SEC litigates certain cases.

Significant Circuit Court Decisions

Third Circuit: A District Court Must Impose "Some Form" of Rule 11 Sanctions When It Finds Rule 11 Violations in Proceedings Governed by the PSLRA

On April 5, 2023, the Third Circuit resolved whether a district court erred in failing to award attorneys' fees or impose any other sanctions in connection with determining that plaintiffs violated Rule 11 in bringing three federal securities claims following their purchase of unregistered securities in a company's stock offering. *Scott v. Vantage Corp.*, 64 F.4th 462 (3d Cir. 2023) (Smith, J.). The Third Circuit affirmed the district court's determination that certain of plaintiffs' claims violated Rule 11 and that the company's founder (the only defendant party to the appeal) was not entitled to attorneys' fees. The court held, however, that the PSLRA "mandates the imposition of some form of sanctions when parties violate Rule 11 in bringing federal securities claims."

After plaintiffs purchased stock in the company's 2016 stock offering under SEC Rule 506(b), they brought an unregistered securities claim, a misrepresentation claim, and a Rule 10b-5 securities fraud claim against the defendant company, its president, and the company's founder. In 2019, the district court granted summary judgment for the company's founder and the company's president on the three federal securities law claims. On appeal, the Third Circuit affirmed the district court's determination that plaintiffs' unregistered securities claim and their misrepresentation claim against the company's founder violated Rule 11. The Third Circuit also held that the district court did not abuse its discretion in determining that these claims lacked factual support in violation of Rule 11(b)(3).

Noting that under *Mary Ann Pensiero, Inc. v. Lingle*, 847 F.2d 90 (3d Cir. 1988), courts should assess Rule 11 compliance by assessing a party's or attorneys' conduct based on what was reasonable to believe at the time of the complaint the Third Circuit stated that plaintiffs made only general unregistered securities allegations in the complaint and failed to identify any specific individuals as unaccredited investors. Similarly, as to the misrepresentation claim, the Third Circuit pointed to the district court's determination that plaintiffs' pre-filing investigation should have revealed the lack of factual support for their allegation that the offering was public. The Third Circuit also affirmed the district court's determination that plaintiffs' 10b-5 securities fraud claim did not violate Rule 11. The Third Circuit concluded that there was no abuse of discretion in the district court's determination that plaintiffs had a reasonable basis to allege securities fraud. The Third Circuit also noted that while the district court did summarily dismiss the 10b-5 claim, "courts must ensure that Rule 11 'not be used as an automatic penalty against an attorney or a party advocating the losing side of a dispute.'" (quoting *Gaiardo v. Ethyl Corp.*, 835 F.2d 479 (3d Cir. 1987)).

Ultimately, the Third Circuit concluded that the district court did abuse its discretion in declining to impose any form of sanctions and vacated the portion of the order that declined to impose sanctions because the text of the PSLRA makes the imposition of sanctions mandatory after a court determines that a party has violated Rule 11. On remand, the Third Circuit instructed the district court to impose "some form of sanction" against plaintiffs in accordance with Rule 11, but took no position on what sanction to impose acknowledging that the district court was better situated to make that determination.

Fourth Circuit: Proxy Statement Need Not Have Included Cash-Flow Projections Given the Array of Other Metrics

On June 1, 2023, the Fourth Circuit affirmed a district court's grant of summary judgment in favor of a defendant bank holding company, which was alleged to have violated Section 14(a) of the Exchange Act by misleading shareholders about the true value of their shares ahead of a stock-for-stock merger. *Karp v. First Conn. Bancorp*, 69 F.4th 223 (4th Cir. 2023) (Diaz, J.). Affirming the district court's ruling, the Fourth Circuit held that no reasonable jury could find the omission from the proxy statement of certain cash-flow projections prepared by the defendant's financial advisor was material.

In 2018, defendant and another bank holding company proposed a merger. After defendant's shareholders voted to approve the merger, plaintiff commenced a putative class action alleging that defendant's proxy statement did not disclose either the specific cash-flow projections used in its financial advisor's discounted cash flow analysis or a set of "more optimistic" cash-flow projections that defendant's financial advisor prepared in connection with a previous potential merger. Plaintiff claimed this led shareholders to undervalue their shares and approve the merger. Both parties moved for summary judgment, the district court denied plaintiff's motion and granted the defendant's.

On appeal, the Fourth Circuit agreed with the district court that there was no genuine dispute of material fact regarding any of the elements of plaintiff's Section 14(a) claim. The court explained that to prevail under Section 14(a) "plaintiff must show that (1) the proxy statement contained a material misrepresentation or omission (2) that caused the plaintiff injury and that (3) the proxy solicitation was an essential link in the accomplishment of the transaction." Rejecting plaintiff's argument that a reasonable investor would have found the omitted cash flow projections would have been material because they would have shown that the merger consideration was inadequate and that the financial advisor's valuation was skewed, the Fourth Circuit held that no reasonable jury could find the omission of the cash-flow projections material. The Fourth Circuit agreed with defendant that it was "not enough to speculate that shareholders might have found the projections helpful to the deliberations, so long as the merger proxy 'provided a thorough and accurate summary' of the financial advisor's work." The Fourth Circuit noted that, "as other courts have held, shareholders aren't entitled to double-check every aspect of the advisor's math so long as the proxy statement contains an adequate and fair statement of their work." The Fourth Circuit concluded that based on "the array of metrics in the proxy statement," it was unlikely that the more optimistic cash-flow projections "would have significantly altered the total mix of information."

Fourth Circuit: Affirms Dismissal of Securities Fraud Class Action Alleging Misrepresentations or Omissions Regarding a Clinical Trial Drug

On March 2, 2023, the Fourth Circuit affirmed the dismissal of a putative securities fraud class action alleging that a drug company, its president/CEO and its CFO made material misrepresentations or omissions concerning a new drug, in violation of Section 10(b) of the Exchange Act and Rule 10b-5. *Emps. Ret. Sys. v. MacroGenics*, 61 F.4th 369 (4th Cir. 2023) (Gregory, J.). The court held that plaintiffs failed to sufficiently allege any actionable misrepresentations or omissions that would give rise to a duty to disclose.

In June 2019 the company presented clinical trial data for its new drug at a scientific conference, including a graph that provided a visual depiction of the interim overall survival data. An analyst described this data as "underwhelming." Subsequently, the company experienced a stock price drop and plaintiffs sued asserting violations of Section 10(b) and Rule 10b-5 and Sections 11 and 12(a)(2) of the Securities Act. Plaintiffs alleged that the graph depicting interim overall survival data should have been disclosed earlier and showed that the overall survival data was not on track to generate a statistically significant result when the data fully matured.

The Fourth Circuit noted that while a company must disclose information when "necessary to make statements made, in light of the circumstances under which they were made, not misleading," under *Matrixx Initiatives v. Siracusano*, 563 U.S. 27 (2011), the Fourth Circuit determined that defendants did not have a duty to disclose the interim overall survival results because their written and oral statements prior to a May 2019 press release—where the company discussed the overall survival data for the first time in detail—"did not 'speak' about the [overall survival] data." Instead, these prior statements had "primarily focused" on the clinical trial's success in reaching its first endpoint and "[a]ny language concerning the [overall survival] endpoint was preliminary and focused on the ongoing nature of the [overall survival] data's accumulation."

Seventh Circuit: Specifies the Correct Pleading Standard for a Breach of the Duty of Prudence Under ERISA in the Wake of *Hughes*

On March 23, 2023, on remand from the Supreme Court's decision last year in *Hughes v. Northwestern*, 595 U.S. 170 (2022), the Seventh Circuit reexamined plaintiffs' allegations that the defendant plan fiduciary breached its duty of prudence under ERISA. [*Hughes v. Northwestern*, 63 F.4th 615 (7th Cir. 2023) (Brennan, J.)](). Under the Supreme Court's decision in *Hughes*, to plead a breach of the duty of prudence under ERISA, a plaintiff must plausibly allege fiduciary decisions outside a range of reasonableness. The plan fiduciary argued that plaintiffs must plead that a prudent alternative action was "actually available." Rejecting this, the Seventh Circuit held that "[a]t the pleadings stage, a plaintiff must provide enough facts to show that a prudent alternative action was plausibly available, rather than actually available."

The Seventh Circuit noted that *Hughes* directed it "to reevaluate plaintiffs' allegations based on the duty of prudence articulated in *Tibble v. Edison International*, 575 U.S. 523 (2015), applying the pleading standard discussed in *Ashcroft v. Iqbal*, 556 U.S. 662 (2009), and *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007)." *Iqbal* and *Twombly* establish that an obvious alternative explanation for a defendant's conduct that precludes liability can undermine the claim's plausibility. The court stated that "[o]nly obvious alternative explanations must be overcome at the pleadings stage, and only by a plausible showing that such alternative explanations may not account for the defendant's conduct." The court then concluded that "whether a claim survives dismissal necessarily depends on the strength or obviousness of the alternative explanation that the defendant provides."

In applying this standard, the Seventh Circuit concluded that plaintiffs plausibly alleged that the plan fiduciary violated its duty of prudence by incurring unreasonable recordkeeping fees. The court noted that plaintiffs alleged that recordkeeping services are fungible, that the market for such services is highly competitive and that the fees were excessive relative to the recordkeeping services rendered. The Seventh Circuit also denied dismissal of plaintiffs' second claim that the plan fiduciary failed to swap out retail shares for identical, lower-cost institutional shares of the same funds. The court noted plaintiffs' allegations that the plan fiduciary retained more expensive retail-class shares of 129 mutual funds, when less expensive but otherwise identical institutional-class shares were available.

Ninth Circuit: Affirms Dismissal of Derivative Suit Based on a Forum-Selection Clause in the Defendant Company's Bylaws

On June 1, 2023, a majority of the Ninth Circuit sitting en banc affirmed the dismissal of a putative derivative action that plaintiff brought in California district court against a retail clothing company incorporated in Delaware in light of a forum-selection clause[2] in the company's bylaws requiring any derivative action or proceeding to be brought in Delaware Chancery Court. [*Lee v. Fisher*, 70 F.4th 1129 (9th Cir. 2023) (Ikuta, J.)]. The Ninth Circuit held that enforcement of the forum-selection clause did not violate the Exchange Act's antiwaiver provision, Section 29(a), and was not contrary to Section 115 of the Delaware General Corporation Law ("DGCL").

Plaintiff alleged that the company and certain directors violated Section 14(a) of the Exchange Act by making false or misleading statements to shareholders about the company's commitment to diversity. After the district court dismissed on forum non conveniens grounds, a three-judge panel of the Ninth Circuit affirmed in 2022. The instant Ninth Circuit opinion follows its decision to rehear the case en banc to consider whether a forum-selection clause can require that all derivative actions be brought in a state court in the state of incorporation.

As to the Exchange Act's antiwaiver provision, the court began its analysis with the text of Section 29(a), which provides that "any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder . . . shall be void." In *Shearson/Am. Exp. v. McMahon*, 482 U.S. 220 (1987), the Supreme Court interpreted Section 29(a) as prohibiting "only . . . waiver of the substantive obligations imposed by the Exchange Act." The Ninth Circuit then framed the issue as whether the forum-selection clause authorized the company to waive compliance with the substantive obligation of Section 14(a) and Rule 14a-9 (*i.e.*, to not to make a false or misleading statement in a proxy statement). While plaintiff argued that enforcing the forum-selection clause would allow the company to waive such compliance by precluding her from bringing a derivative Section 14(a) action in any forum (because the Chancery Court would dismiss her action based on federal courts' exclusive jurisdiction of Exchange Act violations), the Ninth Circuit explained that plaintiff could still enforce the company's compliance with the substantive obligations of Section 14(a) by bringing a direct action in federal court. The court noted that the forum-selection clause does not impose any limitation on direct actions.

The Ninth Circuit also concluded that the forum-selection clause was valid under Delaware law because in *Salzberg v. Sciabacucchi*, 227 A.3d 102 (Del. 2020), the Delaware Supreme Court indicated that federal claims like plaintiff's derivative Section 14(a) action are not "internal corporate claims" as defined in Section 115[3] of the DGCL, and because no language in Section 115, the official synopsis, or *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013)—which Section 115 was intended to codify—"operates to limit the scope of what constitutes a permissible forum-selection bylaw under Section 109(b)[.]"

2. The forum-selection clause states that "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 . . . ."

3. Section 115 of the DGCL, states that a corporation's "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." Section 115 defines "internal corporate claims" as those "that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity," and claims "as to which the DGCL confers jurisdiction."

Ninth Circuit: Complaint Timely Where Plaintiff Could Not Have Discovered Necessary Facts Until an SEC Order Revealed That a Company's Statements Were Misleading

On April 11, 2023, the Ninth Circuit reversed and remanded a district court's dismissal of a securities fraud class action on the ground that it was untimely. [*York Cnty. v. HP, Inc.*, 65 F.4th 459 (9th Cir. 2023) (Bybee, J.)]. The Ninth Circuit determined that the defendant printing supply company's "allegedly fraudulent statements, on their own, were insufficient to start the clock on the statute of limitations." The Ninth Circuit held that the complaint was timely, concluding that plaintiff could not have discovered the facts necessary to plead an adequate complaint until after the issuance of an SEC order that revealed the misleading nature of defendants' statements.

During 2015 and 2016 investor calls the defendant company made statements about whether it was meeting its inventory target ranges. Subsequently, an SEC investigation uncovered that the company had allegedly engaged in sales practices that led to short term gains but harmed overall profits. The SEC issued an order in 2020 ("SEC Order") instituting cease-and-desist proceedings. The company agreed to pay a fine without admitting or denying the allegations contained in the SEC Order. Within weeks of the SEC Order, plaintiff sued alleging that the company violated Section 10(b) and Rule 10b-5. The company moved to dismiss asserting that plaintiff's claims were time-barred by the statute of limitations in 28 U.S.C. § 1658(b)(1), which provides "that private actions alleging securities fraud must be brought no more than '2 years after the discovery of the facts constituting the violation' of securities laws." The district court dismissed the complaint as time-barred.

Relying on *Merck & Co. v. Reynolds*, 559 U.S. 633 (2010), the Ninth Circuit held that "a defendant establishes that a complaint is time-barred under § 1658(b)(1) if it conclusively shows that either (1) the plaintiff could have pleaded an adequate complaint based on facts discovered prior to the critical date and failed to do so, or (2) the complaint does not include any facts necessary to plead an adequate complaint that were discovered following the critical date." Under *Merck*, "the critical date" is defined as the date "two years before the complaint was filed." Adopting the reasoning of *City of Pontiac General Employees' Retirement System v. MBIA, Inc.*, 637 F.3d 169 (2d Cir. 2011), the Ninth Circuit further held that a "reasonably diligent plaintiff has not 'discovered' one of the facts constituting a securities fraud violation until he can plead that fact with sufficient detail and particularity to survive a 12(b)(6) motion to dismiss."

In this case, the critical date was April 21, 2019, based on the fact that the complaint was filed on April 21, 2021. The Ninth Circuit noted the allegation that the false statements and misrepresentations were made approximately three years before the critical date. The court then noted plaintiff's assertion that it did not "discover the facts constituting the violation" until after the critical date because "the SEC Order put [the company's] prior statements in a new context, revealing that ostensibly innocuous statements were actually intentional misrepresentations." Because plaintiff pleaded facts that post-dated the critical date, the court explained that the company could still show the claim was time-barred by either showing that: (i) plaintiff "could have pleaded its claim based solely on things that it knew or should have known prior to the critical date"; or (ii) "the SEC Order provided no information necessary" to plaintiff's claim. The court stated that the company failed to make this showing.

Tenth Circuit: Rejects Motion to Compel Arbitration of ESOP Claims, Holding That the Effective Vindication Exception Applies

On February 9, 2023, the Tenth Circuit affirmed a district court's denial of a motion to compel arbitration in a lawsuit brought by an ESOP (Employee Stock Ownership Plan) participant alleging that the plan fiduciaries breached their fiduciary duties to the plan under ERISA. [*Harrison v. Envision Mgmt. Holding*, 59 F.4th 1090 (10th Cir. 2023) (Briscoe, J.)](). On appeal, the Tenth Circuit held that enforcing the arbitration provisions in the plan document would prevent plaintiff from vindicating the statutory causes of action listed in his complaint, and concluded "that the effective vindication exception applies in this case."

The Tenth Circuit stated that under *American Express v. Italian Colors Restaurant*, 570 U.S. 228 (2013), the "key question is whether 'the prospective litigant effectively may vindicate its statutory cause of action in the arbitral forum.'" The court explained that, to determine whether the effective vindication exception applies, it "must first identify the statutory remedies [plaintiff] is seeking" and "then determine whether the arbitration provisions contained in the Plan Document effectively prevent [plaintiff] from obtaining those statutory remedies in the arbitral forum." The court noted that the statutory remedies plaintiff sought were under ERISA subsections 502(a)(2) and (a)(3), and included a declaration that defendants breached their fiduciary duties under ERISA, among other things.[4]

As to whether the arbitration provisions effectively prevented plaintiff from vindicating the statutory remedies, the court focused on the language in the plan document stating that "each arbitration shall be limited solely to one Claimant's Covered Claims, *and that Claimant may not seek or receive any remedy which has the purpose or effect of providing additional benefits or monetary or other relief to any Eligible employee, Participant or Beneficiary other than the Claimant*." (emphasis in original). The court found that "this sentence would clearly prevent [plaintiff] from obtaining at least some of the forms of relief that he seeks in his complaint pursuant to [Section 502(a)(2)]," including, among other things, a declaration that all defendants breached their fiduciary duties under ERISA. The court explained that these forms of relief would provide additional benefits to the plan as a whole or to all of the plan participants and beneficiaries and would thus be barred by the arbitration provisions. The court concluded that "Section 21(b) is not problematic because it requires [plaintiff] to arbitrate his claims, but rather because it purports to foreclose a number of remedies that were specifically authorized by Congress[.]"

4. These included an injunction of further fiduciary duty violations, the appointment of a new fiduciary to manage the ESOP, removal of the ESOP trustee, and an order directing the ESOP trustee to restore all losses to the plan that resulted from the fiduciary breaches and to disgorge all profits made through use of the ESOP's assets.

Significant Delaware Decisions

Delaware Supreme Court: Refines the Standards for Reviewing Board Action That Interferes With Director Elections or Stockholder Voting Rights in Control Contests

On June 28, 2023, the Delaware Supreme Court affirmed a Chancery Court decision finding that the board of a real estate services company had not acted for "inequitable purposes" and had "compelling justifications" for a stock sale, which diluted plaintiff's 50% ownership interest in the company, broke a director election deadlock, and mooted plaintiff's petition to appoint a corporate custodian. *Coster v. UIP Cos.*, 300 A.3d 656 (Del. 2023) (Seitz, C.J.). The Supreme Court held that the Chancery Court did not err as a legal matter, and its factual findings were not clearly wrong. As to the proper standard of review for stockholder challenges to board action that interferes with director elections or stockholder voting rights in control contests, the Supreme Court folded the three standards of review in this area into a unified standard.

In her suit seeking to cancel the board's stock sale, plaintiff alleged that the sale had been effectuated to dilute her voting power in violation of the company co-owner's fiduciary duties. In a post-trial opinion, the Chancery

Court upheld the stock sale under the entire fairness standard of review and dismissed the action. In the first appeal, the Supreme Court did not disturb the Court of Chancery's entire fairness decision but remanded with instructions to review the stock sale under *Schnell v. Chris Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971)[5] and *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988)[6] because entire fairness "is not a substitute for further equitable review under *Schnell* or *Blasius* when the board interferes with director elections."

On remand, the Chancery Court found that the board had not acted for inequitable purposes under *Schnell* and had compelling justifications for the stock sale under *Blasius* (because the custodian appointment would harm the company and the stock sale had been previously planned). Notably, the Chancery Court's compelling justification analysis largely borrowed from the reasonableness and proportionality test in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), for defensive measures adopted by a board in response to a takeover threat. In *Unocal*, "the Supreme Court used an enhanced standard of review to decide whether the directors had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and that the board's response was reasonable in relation to the threat posed."

On appeal from the remand decision, the Supreme Court sought to reconcile *Schnell*, *Blasius* and *Unocal*. The Court explained that "[w]hen a stockholder challenges board action that interferes with the election of directors or a stockholder vote in a contest for corporate control, the board bears the burden of proof." The Court stated that a court should review whether: (1) "the board faced a threat to an important corporate interest or to the achievement of a significant corporate benefit. The threat must be real and not pretextual, and the board's motivations must be proper and not selfish or disloyal"; and (2) "the board's response to the threat was reasonable in relation to the threat posed and was not preclusive or coercive to the stockholder franchise. To guard against unwarranted interference with corporate elections or stockholder votes in contests for corporate control, a board that is properly motivated and has identified a legitimate threat must tailor its response to only what is necessary to counter the threat."

5. *Schnell* stands for the proposition that "inequitable action does not become permissible simply because it is legally possible and management cannot inequitably manipulate corporate machinery to perpetuate itself in office and disenfranchise the stockholders." Under *Schnell*, board actions are "twice tested." First for legal authorization, and second to determine whether the board action was equitable. In *Schnell*, the Delaware Supreme Court determined that a board's compliance with legal technicalities was insufficient because the board's actions in response to a proxy fight (moving up the annual meeting's date and switching it to a remote location) were intended to prevent the dissidents from being able to wage an effective campaign and motivated by a desire to entrench themselves.

6. *Blasius* has applied in cases where directors allegedly took steps for the primary purpose of interfering with a stockholder vote and established that "directors who interfere with board elections, even if in good faith, must have a compelling justification for their actions." In *Blasius*, Chancellor Allen voided the board's creation and filling of two new board positions in response to an unaffiliated majority of stockholders seeking to expand the board and elect a new majority, despite finding that the directors had acted on their view of the corporation's interest and not selfishly because the directors' action "constituted an unintended violation of the duty of loyalty that the board owed to the shareholders."

Delaware Court of Chancery: Denying Dismissal, Court Could Not Conclude That De-SPAC Merger Was the Product of Fair Dealing

On January 4, 2023, the Court of Chancery of Delaware denied dismissal of a putative class action alleging breach of fiduciary duty claims against the sponsor and directors of a SPAC who allegedly undertook a value destructive merger and impaired the public stockholders' ability to decide whether to redeem or to invest in the post-merger company. [*Delman v. GigAcquisitions3*, 288 A.3d 692 (Del. Ch. 2023) (Will, V.C.)](). The court determined that it could not conclude that the de-SPAC merger was the product of fair dealing because plaintiff sufficiently pleaded that the proxy contained material misstatements and omitted material, reasonably available information.

Citing *In re MultiPlan Shareholders Litigation*, 268 A.3d 784 (Del. Ch. 2022)[7] the court determined that entire fairness applied here "due to inherent conflicts between the SPAC's fiduciaries and public stockholders in the context of a value-decreasing transaction." In essence, plaintiff alleged that defendants undertook the transaction to obtain "colossal" returns on the sponsor's investment but that the public stockholders would have been better served by liquidation. Defendants also allegedly provided inadequate disclosures to discourage redemptions and ensure greater deal certainty.

The court rejected defendants' contention that the proxy contained all material information, explaining that compliance with the duty of disclosure is included within the fair dealing facet of the fairness test under *Weinberger v. UOP*, 457 A.2d 701 (Del. 1983). The court stated that the public stockholders' redemption decisions were compromised because defendants failed to disclose the cash per share that the SPAC would invest in the combined company, and made an incomplete disclosure of the value that the SPAC and its non-redeeming stockholders could expect to receive in exchange. The court noted that "[b]oth pieces of information would be essential to a stockholder deciding whether it was preferable to redeem her funds from the trust or to invest them in [the combined company]." The court concluded that "[b]ecause the Proxy allegedly misstated and obfuscated the net cash—and thus the value—underlying [the SPAC's] shares, public stockholders could not make an informed choice about whether to redeem or invest."

Plaintiff also alleged that defendants overstated the target's value. The court noted that the target's value would be highly relevant to the public stockholders' investment decisions and concluded that the "lofty projections were not counterbalanced by impartial information." The court "inferred that the defendants knew (and should have disclosed) or should have known (but failed to investigate)" that the target's production would be difficult to scale as predicted. Therefore, the court concluded that it was reasonably conceivable that the board deprived the public stockholders of an accurate portrayal of the target's financial health, and consequently the public stockholders could not fairly decide whether it was preferable to redeem or invest.

Delaware Court of Chancery: Clarifies for the First Time That Corporate Officers, Not Just Directors, Have a Duty of Oversight

On January 26, 2023, the Court of Chancery of Delaware denied dismissal of a derivative action alleging that the defendant former head of human resources for a global fast food company breached his fiduciary duties by: (i) consciously ignoring red flags regarding sexual harassment and misconduct at the company (duty of oversight); and (ii) personally engaging in sexual harassment (duty of loyalty). [*In re McDonald's S'holder Derivative Litig.*, 289 A.3d 343 (Del. Ch. 2023) (Laster, V.C.)](). Rejecting defendant's argument that

7. In *MultiPlan*, Vice Chancellor Will applied the entire fairness standard in the SPAC context for the first time.

Delaware law does not impose any obligation on officers that are comparable to the duty of oversight for directors established by *In re Caremark International Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), the court announced for the first time that "[t]his decision clarifies that corporate officers owe a duty of oversight."

Concluding "that oversight liability for officers requires a showing of bad faith[,]" the court explained that "[t]he officer must consciously fail to make a good faith effort to establish information systems, or the officer must consciously ignore red flags." The court stated that the duty of oversight is context-driven and its application will differ depending on the officer's role. However, "a particularly egregious red flag might require an officer to say something even if it fell outside the officer's domain." The court stated that: "To plead a Red-Flags Claim that will survive a Rule 12(b)(6) motion, a plaintiff must plead facts supporting an inference that the fiduciary knew of evidence of corporate misconduct. The plaintiff also must plead facts supporting an inference that the fiduciary consciously failed to take action in response. The pled facts must support an inference that the failure to take action was sufficiently sustained, systematic, or striking to constitute action in bad faith. A claim that a fiduciary had notice of serious misconduct and simply brushed it off or otherwise failed to investigate states a claim for breach of duty."

The court found that plaintiffs asserted a red-flags claim because they described that defendant: (i) knew about evidence of sexual misconduct; and (ii) acted in bad faith by consciously disregarding his duty to address the misconduct. The court found that plaintiffs alleged a number of red flags, including coordinated EEOC complaints, employee strikes and Congressional inquiries, indicating for pleading purposes that sexual harassment occurred at the company and supporting a reasonable inference that defendant knew about the red flags. The court observed that defendant was the executive officer with day-to-day responsibility for overseeing the human resources function and promoting a safe and respectful environment, and was thus "supposed to have his ear to the ground and be knowledgeable about the Company's employees." As to bad faith, the court explained that Delaware law presumes that directors and officers act in good faith, and a complaint must plead facts sufficient to support an inference of bad faith intent. The court stated that several factors support an inference of scienter, including plaintiffs' allegations that defendant engaged in multiple acts of sexual harassment and concluded that "[w]hen a corporate officer himself engages in acts of sexual harassment, it is reasonable to infer that the officer consciously ignored red flags about similar behavior by others."

The court also denied dismissal of plaintiffs' claim that defendant's own acts of sexual harassment constituted a breach of the duty of loyalty. The court explained that an alleged harasser acts in bad faith and breaches the duty of loyalty because a harasser engages in sexual harassment for selfish reasons. The court concluded by noting: "Sexual harassment is bad faith conduct. Bad faith conduct is disloyal conduct. Disloyal conduct is actionable."

Notably, on March 1, 2023, the court issued a Rule 23.1 order dismissing the breach of fiduciary duty claims against defendant because plaintiffs had not made a demand on the company's board before commencing their lawsuit. The court explained that plaintiffs' claims against defendant were subject to dismissal unless they could plead demand futility under the three-part test in *UFCW Union & Participating Food Industry Employers Tri-State Pension Fund v. Zuckerberg*, 262 A.3d 1034 (Del. 2021). Plaintiffs asserted that demand on the board was futile because the board faced a "substantial risk of liability" from plaintiffs' claims. However—as discussed below—the court dismissed plaintiffs' claims against the board on March 1, therefore demand on the board was not excused.

Delaware Court of Chancery: Allegations on Board's Response to Red Flags Fell Short Where Board Took Responsive Action

On March 1, 2023, in the same litigation discussed immediately above, the Delaware Court of Chancery dismissed two breach of fiduciary duty claims against the board of a global fast food company: (i) for failing to take action to address red flags indicating that sexual harassment and misconduct were occurring at the company; and (ii) in connection with various executive employment decisions. [*In re McDonald's S'holder Derivative Litig.*, 291 A.3d 652 (Del. Ch. Mar. 1, 2023) (Laster, V.C.)]. The court held that plaintiffs failed to state a claim against the board for breach of the duty of oversight under *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), for failing to take action to address red flags indicating that sexual harassment and misconduct were occurring at the company. The court also held that plaintiffs failed to state a claim against the board for breach of fiduciary duty in connection with three executive employment decisions.

The court explained that "[a]lthough they have pled facts supporting an inference that red flags came to the attention of the Director Defendants, they have not alleged facts supporting a reasonable inference that the Director Defendants acted in bad faith in response to those red flags." The court determined that plaintiffs' allegations fell short regarding the board's response to the red flags, noting that at the end of 2018 the board began taking various responsive steps that included, among other things, hiring outside consultants, revising the company's policies, implementing new training programs, providing new levels of support to franchisees, and setting up an employee hotline.

The court also held that plaintiffs failed to state a claim against the board for breach of fiduciary duty in connection with three executive employment decisions because the business judgment rule protected these decisions to: (i) hire the CEO based on his assurance that a consultant with whom he was in an intimate relationship would be removed from the company's account, (ii) discipline rather than terminate the head of human resources following a sexual harassment incident, and (iii) terminate the CEO without cause rather than with cause after learning that he had engaged in an inappropriate relationship with an employee. The court determined that plaintiffs failed to plead facts sufficient to rebut any of the business judgment rule's presumptions, which are that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

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