CLEARY GOTTLIEB

2019 Mid-Year Developments in Securities and M&A Litigation

August 2019

Overview

The most significant securities decision to be handed down in the first half of 2019 came from the Supreme Court in *Lorenzo v. SEC*, which clarified the scope of "scheme liability" under Rule 10b-5(a) and (c). Another significant ruling came from the Tenth Circuit in *SEC v. Scoville*, which held that the Dodd-Frank Act permits the SEC to bring fraud claims or claims under Section 17 of the Securities Act based on sales of securities that do not constitute domestic transactions within the meaning of *Morrison v. National Australia Bank Ltd.*

The second half of the Supreme Court's 2018-2019 term was noteworthy more for the cases the Court declined to decide than for the cases it did decide. The Court declined to rule on several significant issues arising from the Ninth Circuit, including whether plaintiffs must show that the defendant acted with scienter when bringing claims under Section 14(e), whether *Morrison* extends to unsponsored American Depositary Receipts, and the standard for establishing loss causation. Indeed, the Supreme Court has yet to grant certiorari in a securities case for the next term.

With respect to M&A litigation, the Delaware Supreme Court continued to clarify its jurisprudence with respect to appraisal methodology as well as the protection *MFW* affords to controlled transactions. The Court also released important opinions pertaining to oversight duties for boards of directors and the fiduciary duties of activist investors. The Delaware Court of Chancery continued to see a rise in litigation pertaining to books and records demands under Section 220. It also issued decisions reflecting its continued strict enforcement of the plain language provisions in merger agreements.

Securities Litigation

Supreme Court Rules On "Scheme Liability" Under Rule 10b-5(a) And (c)

In March, the Supreme Court issued a 6-to-2 decision in *Lorenzo v. SEC* holding that an investment banker could be primarily liable under Rule 10b-5(a) and (c) for circulating misleading emails to investors, even though the investment banker did not personally author the content of the emails.[1] The case arose out of allegations that Francis Lorenzo, the director of investment banking at a broker-dealer, sent investors emails containing false statements that were drafted by his supervisor. The D.C. Circuit concluded that Lorenzo was not a "maker" of a misleading statement for the purposes of 10b-5(b) liability, but held that he could be liable for deceptive practices in violation of Rules 10b-5(a) and (c).[2]

The Supreme Court previously held in *Janus Capital Group, Inc. v. First Derivative Traders* that only a "maker" of a misleading statement—*i.e.* someone with ultimate authority over the statement—could be held liable under Rule 10b-5(b) for making an untrue statement of a material fact.[3] In *Lorenzo*, the Supreme Court focused on the distinction between "making" a false statement under Rule 10b-5(b) and engaging in deceptive conduct—so-called "scheme liability"—under Rule 10b-5(a) and (c). The Court clarified that the scheme liability provisions reach a defendant who disseminates a false statement with intent to defraud, even if the defendant does not qualify as the "maker" of the statement and therefore could not be held liable under Rule 10b-5(b). The Court rejected Lorenzo's argument that the scheme liability provisions of Rule 10b-5 should apply only to conduct other than misstatements, and instead explained that the three subsections of Rule 10b-5 overlap rather than apply to mutually exclusive conduct.

The *Lorenzo* decision shows that cases involving misstatements are not exclusively the province of Rule 10b-5(b). But the decision does not precisely define the reach of "scheme liability" with respect to false statements, and it seems likely to lead to questions in SEC enforcement actions and private litigation about when exactly defendants can be held primarily liable for statements that they did not themselves make.

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1 *Lorenzo v. Sec. & Exch. Comm'n*, 139 S. Ct. 1094 (2019).

2 *Lorenzo v. Sec. & Exch. Comm'n*, 872 F.3d 578 (D.C. Cir. 2017).

3 *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135 (2011).

Tenth Circuit Rules On SEC's Authority To Bring Securities Fraud Claims Over Certain Foreign Transactions

In January, in *SEC v. Scoville*, the Court of Appeals for the Tenth Circuit held that the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") allows the SEC to bring fraud claims and claims under Section 17 of the Securities Act based on sales of securities that do not qualify as domestic transactions, where defendants engage in fraudulent conduct within the United States.[4]

Scoville arose out of an SEC civil enforcement action against Traffic Monsoon, LLC and its founder, alleging that the defendants operated a Ponzi scheme in violation of various securities laws. Traffic Monsoon sold online advertising packages, which the Tenth Circuit concluded qualified as investment contracts under the *Howey* test. Many of the advertising packages were purchased by individuals located outside the United States in transactions that may not have been domestic under the Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*[5]

The Tenth Circuit held that the antifraud provisions of the securities laws reached the sales of advertising packages to those individuals outside the United States. In reaching this holding, the Tenth Circuit concluded that the Dodd-Frank Act abrogated in part the Supreme Court's rule in *Morrison* that fraud claims under the federal securities laws can only be brought with respect to transactions in securities listed on a U.S. exchange or transactions in other securities in the United States. The Tenth Circuit found that the Dodd-Frank Act's jurisdictional amendments with respect to enforcement actions brought by the SEC were intended to codify the conduct-and-effects test for evaluating the extraterritorial application of the securities laws, which was the test universally applied prior to *Morrison*. Under the conduct-and-effects test, courts apply the securities laws to foreign transactions if the wrongful conduct occurred in the United States or had a substantial effect in the United States.

The Tenth Circuit reached this decision even though *Morrison* (which was decided about one month before the Dodd-Frank Act was enacted) had held that the extraterritorial application of the securities laws is a merits issue, not a jurisdictional issue. The Court explained that "[n]otwithstanding the placement of the Dodd-Frank amendments in the jurisdictional provisions of the securities acts, given the context and historical background surrounding Congress's enactment of those amendments, it is clear to us that Congress undoubtedly intended that the substantive antifraud provisions should apply extraterritorially when the statutory conduct-and-effects test is satisfied."[6]

Scoville provides a strong precedent for the SEC and DOJ to continue to bring securities fraud actions or for the SEC to bring an action under Section 17 of the Securities Act concerning certain foreign transactions. This decision also portends a potential increase in the risk of liability for companies with significant U.S. operations or companies that engage in investor relations related activities in the United States, but that have no securities listed or sold here, or for companies located abroad but whose activities result in injury to investors in the U.S. market. A petition for *certiorari* was filed in June.

Second Circuit Rules On Statements Of Regulatory Compliance Forming Basis For Securities Fraud Claim

In March, in *Singh v. Cigna Corp.*, the Second Circuit held that plaintiffs failed to identify a materially false statement as a matter of law when they alleged that Cigna's statements about its commitment to regulatory compliance procedures were materially misleading in light of an undisclosed history of non-compliance with Medicare regulations.[7] The Second Circuit affirmed the district court's decision dismissing the plaintiffs' case, finding that Cigna's statements with respect to its policies and

4 *Sec. & Exch. Comm'n v. Scoville*, 913 F.3d 1204 (10th Cir. 2019).

5 *Morrison v. Nat'l Australia Bank Ltd.*, 561 U.S. 247 (2010).

6 *Scoville*, 913 F.3d at 1218.

7 *Singh v. Cigna Corp.*, 918 F.3d 57 (2d Cir. 2019).

procedures in its Code of Ethics were plainly an example of "puffery." The Second Circuit's decision provides a strong defense for companies accused of securities fraud following the revelation of corporate mismanagement or regulatory violations. The decision is also a reminder that a company's disclosure of its Code of Ethics and description of its compliance efforts cannot alone provide the basis for an investor suit in the event that the company or its employees violate ethical policies.

Third Circuit Addresses Defendants' Burden To Rebut Presumption Of Reliance Under *Halliburton II*

In May, in *Vizirgianakis v. Aeterna Zentaris, Inc.*, the Third Circuit affirmed a district court order granting class certification to a group of shareholders who alleged that Aeterna Zentaris, Inc., a biopharmaceutical company, violated Section 10(b) of the Exchange Act and Rule 10b-5 by misrepresenting the efficacy of a particular drug.[8] The district court found that the plaintiffs properly alleged a "fraud-on-the-market" theory of reliance, which provides plaintiffs a rebuttable presumption of class-wide reliance when plaintiffs traded securities in an efficient market. On appeal, Aeterna did not contest that plaintiffs raised the presumption of an efficient market, and instead argued that the district court erred in finding that it had not rebutted the presumption of reliance by proving that the alleged misstatements did not have a price impact under *Halliburton Co. v. Erica P. John Fund, Inc.* ("*Halliburton II*").[9] In particular, Aeterna argued that it had rebutted the presumption by presenting an expert declaration "pointing out that [plaintiffs' expert] had not proven—to a 95% confidence level—that the alleged misrepresentations … impacted the price of Aeterna's common stock."[10] But the Third Circuit held that the plaintiffs' "failure to do so is not necessarily proof of the opposite,"[11] and otherwise deferred to the district court's competency in weighing conflicting testimony and making factual findings with respect to market efficiency. This decision is another example of the difficulties that defendants have faced rebutting the presumption of reliance under *Halliburton II*.

Jury Returns Mixed Verdict In Rare Securities Class Action Trial

In February 2019, a rare jury trial in a securities class action resulted in a mixed verdict in *Hsingching Hsu v. Puma Biotechnology, Inc.* in the Central District of California.[12] A class of plaintiffs alleged that the pharmaceutical company and certain of its directors made misrepresentations about the results of a clinical trial. The jury rendered a verdict in favor of the defendants with respect to three of four allegedly misleading statements and one of the two stock price drops, but the jury found in favor of the plaintiff class with respect to a fourth misleading statement about a drug's efficacy and decline in the stock price following disclosure. As a result, shareholders who purchased stock between 2014 and 2015 may recover up to $4.50 per share in damages, an amount that the company has claimed represented 5% or less of the claimed damages. This case is noteworthy because of the infrequency of jury trials in securities class actions. Commentators have noted that since Congress enacted the Private Securities Litigation Reform Act (PSLRA) in December 2005, only 25 securities class action suits have resulted in a verdict, with 12 of these 25 in favor of defendants.

Noteworthy Dismissal And Denials Of Certiorari From Ninth Circuit Decisions

The Supreme Court denied certiorari petitions from three Ninth Circuit decisions. In another case, where the Court had previously granted certiorari of a decision from the Ninth Circuit, the Court dismissed the writ as improvidently granted following oral argument. The Court thereby let stand four Ninth Circuit rulings that serve to expand the scope of liability under the securities laws.

8 *Vizirgianakis v. Aeterna Zentaris, Inc.*, 2019 WL 2305491 (3d Cir. May 30, 2019).

9 *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258 (2014).

10 *Vizirgianakis*, 2019 WL 2305491, at *2.

11 *Id.*

12 Verdict Form, *Hsingching Hsu v. Puma Biotechnology, Inc.*, 8:15–cv–00865–AG (C.D. Cal. Feb. 4, 2019), ECF No. 718.

The Supreme Court Dismissed Writ Of Certiorari From Decision Holding That Plaintiffs Need Only Show That Defendants Acted Negligently To Bring Claims Under Section 14(e)

In January 2019, the Supreme Court granted certiorari to review a Ninth Circuit decision in *Varjabedian v. Emulex Corp.*, which held that plaintiffs bringing claims under Section 14(e) of the Exchange Act need only show that defendants acted negligently, rather than with scienter.[13] Section 14(e) prohibits misstatements, omissions or fraudulent conduct in connection with a tender offer. The Ninth Circuit's holding split with decisions from the Second, Third, Fifth, Sixth and Eleventh Circuits, which all held that Section 14(e) claims require a plaintiff to demonstrate that defendants acted knowingly or with a reckless disregard of the truth—a significantly higher burden than negligence.[14] In addition to creating a circuit split, the Ninth Circuit's decision also set the stage for a potential uptick in tender offer litigation brought in the Ninth Circuit, given that the more lenient negligence standard will make it more difficult to dismiss Section 14(e) claims at the motion-to-dismiss stage.

In its merits brief before the Supreme Court, Emulex argued that the Ninth Circuit erred in using negligence as the standard, and that, more fundamentally, Section 14(e) does not provide a private right of action.[15] At the Court's invitation, the Solicitor General filed an amicus brief arguing that, although the Ninth Circuit correctly held that Section 14(e) does not require a showing of scienter, the provision does not contain an implied private right of action.[16] The question whether Section 14(e) contains a private right of action was a primary focus during oral argument, with Chief Justice Roberts and Justice Kavanaugh expressing the view that it was beyond the authority of the Court to permit a private suit under this provision when the right is absent from the text.[17] Justices Ginsburg and Sotomayor, on the other hand, indicated that they preferred not to consider this issue because it had not been preserved below.[18]

On April 23, the Supreme Court dismissed the grant of certiorari without explanation. Thus, a private right of action under Section 14(e) remains available for now. However, for decades, the Court has been reluctant to infer private rights of action unless they are explicit in the text of a statute, which they are not in Section 14(e). Going forward, we expect to see defendants challenge the existence of a private right of action under Section 14(e) in hopes that the Court will take the next case in which this issue is properly preserved.

The Supreme Court Declined To Address Application Of *Morrison* To Unsponsored ADRs

In June, the Supreme Court denied a petition for certiorari from the Ninth Circuit's decision in *Stoyas v. Toshiba Corp.*, which held that plaintiffs were not precluded from asserting claims under the Exchange Act against foreign issuers with respect to domestic transactions in unsponsored American Depositary Receipts ("ADRs"), transactions in which the foreign issuer may not have played any role.[19] The Ninth Circuit held that if "irrevocable liability" for the purchase and sale of ADRs is incurred in the United States, the transaction qualifies as domestic and the Exchange Act applies. The Ninth Circuit explicitly declined to follow the Second Circuit's decision in *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*, which held that a domestic transaction is necessary, but not sufficient, for the Exchange Act to apply.[20] The Ninth Circuit further held that the issue of whether the Exchange Act applies is distinct from the issue of whether Toshiba could be held liable. Even if the Exchange Act applies, Toshiba could be liable only if the plaintiffs show a connection between Toshiba's fraud and the domestic purchase or sale of an ADR.

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13 *Varjabedian v. Emulex Corp.*, 888 F.3d 399 (9th Cir. 2018). In the Supreme Court, the case was captioned *Emulex Corp. v. Varjabedian*, No. 18-459.

14 *See Connecticut Nat'l Bank v. Fluor Corp.*, 808 F.2d 957 (2d Cir. 1987); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir. 1974); *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir. 1980); *In re Digital Island Sec. Litig.*, 357 F.3d 322 (3d Cir. 2004); *U.S. Sec. & Exch. Comm'n v. Ginsburg*, 362 F.3d 1292 (11th Cir. 2004).

15 Brief for Petitioners, *Emulex Corp. v. Varjabedian*, No. 18-459 (Feb. 19, 2019).

16 Brief for the United States as Amicus Curiae in Support of Neither Party, *Emulex Corp. v. Varjabedian*, No. 18-459 (Feb. 26, 2019).

17 *See* Tr. of Oral Arg., *Emulex Corp. v. Varjabedian*, 2019 WL 1598075, at *43-44, (Apr. 15, 2019) (No. 18-459).

18 *Id.* at *3-4, 7-8.

19 *Stoyas v. Toshiba Corp.*, 896 F.3d 933 (9th Cir. 2018). In the Supreme Court, the case was captioned *Toshiba Corp. v. Auto. Industries Pension Trust Fund*, No. 18-486.

20 *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*, 763 F.3d 198 (2d Cir. 2014).

In January, the Supreme Court invited the Solicitor General to file an amicus brief. The Solicitor General's brief argued that certiorari should be denied and that the Ninth Circuit correctly held that the plaintiffs' claims involve a permissible domestic application of the Exchange Act.[21] Specifically, the Solicitor General agreed with the Ninth Circuit that the issue of whether the Exchange Act applies is distinct from the question of whether it has been violated.

The Supreme Court's denial of certiorari leaves intact a potential split between the Ninth Circuit's holding that a domestic transaction is sufficient for the Exchange Act to apply, and the Second Circuit's holding that a domestic transaction is necessary but not sufficient if the transaction and alleged fraud at issue are "predominantly foreign."

The Supreme Court Declined To Address The Standard For Establishing Loss Causation

Also in June, the Supreme Court denied a petition for certiorari from the Ninth Circuit's decision in *Mineworkers' Pension Scheme v. First Solar Inc.*, which held the element of loss causation can be based on an event or disclosure that causes a decline in stock price, even when the event or disclosure does not reveal the underlying fraud.[22] The Ninth Circuit permitted plaintiffs to recover based on the drop in the stock's value before the fraud was revealed to the market because "the underlying facts concealed by fraud… affect[ed] the stock price."[23] The Ninth Circuit held that the revelation of fraud to the market is just one of many theories on which a plaintiff may establish proximate cause in a securities fraud claim. At the Court's invitation, the Solicitor General filed an amicus brief and argued that the Ninth Circuit's decision was correct.[24]

[21] Brief for the United States as Amicus Curiae, *Toshiba Corp. v. Auto. Industries Pension Trust Fund*, No. 18-486 (May 20, 2019).

[22] *Mineworkers' Pension Scheme v. First Solar Inc.*, 881 F.3d 750 (9th Cir. 2018). In the Supreme Court, the case was captioned *First Solar Inc. v. Mineworkers' Pension Scheme*, No. 18-164.

[23] *Id.* at 754.

[24] Brief for the United States as Amicus Curiae, *First Solar Inc. v. Mineworkers' Pension Scheme*, No. 18-164 (May, 15, 2019).

The Court's denial of *certiorari* leaves intact a decision that could be highly consequential for securities fraud defendants, because it may enable plaintiffs to establish loss causation based on facts that were not disclosed to the market.

The Supreme Court Declined To Address An Issuer's Duty To Update A Statement Of Historical Fact Under Rule 10b-5(b)

In May, the Supreme Court denied a petition for certiorari from the Ninth Circuit's decision in *Khoja v. Orexigen Therapeutics, Inc.*, which held that a company had a duty to disclose information making clear that a historical statement of fact was no longer accurate.[25] In 2015, Orexigen published results of an "interim analysis" reporting that its new obesity drug reduced the risk of cardiovascular events by 41%. A few weeks later, results from a new study showed the drug did not offer such benefits, but the company failed to disclose these result in its subsequent SEC filings. The Ninth Circuit held that although the statements about the results of the interim analysis were technically still accurate, "having learned new information that diminished the weight of those results, [the company] was obligated to share that information."[26]

The company's petition for certiorari argued that the Ninth Circuit had created a new standard of a "duty to update" when the "weight" of an historical fact has been "diminished" by subsequent events.[27] The company claimed this standard articulated by the Ninth Circuit was at odds with other Circuits, which may recognize a duty to update in narrow circumstances, but do not require an issuer to update a statement of historical fact that was accurate when made. The Supreme Court's denial of certiorari leaves this potential circuit split in place. It also fails to offer guidance on other ambiguities in the Ninth Circuit's decision, including what it means for an historical fact to be "diminished."

[25] *Khoja v. Orexigen Therapeutics, Inc.*, 899 F.3d 988 (9th Cir. 2018). In the Supreme Court, the case was captioned *Hagan v. Khoja*, No. 18-1010.

[26] *Id.* at 1015.

[27] Petition for Writ of Certiorari, *Hagan v. Khoja*, No. 18-1010 (Jan. 31, 2019).

M&A Litigation

Delaware Supreme Court Clarifies Fair Value Appraisal Methodology

In April 2019, the Delaware Supreme Court in *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.* clarified the extent to which the Court of Chancery may rely on stock trading prices when determining fair value in an appraisal action.[28] In two previous opinions, the Delaware Supreme Court had emphasized that the deal price will often be the best evidence of fair value in appraisal actions involving open, competitive, and arm's-length mergers of publicly-traded targets.[29] However, neither prior case involved a merger where the transaction resulted in significant synergies, which are excluded statutorily from the determination of fair value. In the opinion below, Vice Chancellor Laster sidestepped the need to precisely calculate deal synergies by finding that the fair value was the thirty-day average market price at which the shares traded before the transaction was publicly reported.[30]

In a strongly-worded per curiam opinion, the Delaware Supreme Court reversed. The Delaware Supreme Court criticized the selection of the average market price prior to public announcement, and held that the proper approach was to start with the deal price and then subtract the synergies resulting from the deal. The Delaware Supreme Court selected the company's calculation of deal synergies to arrive at the fair value calculation. The decision likely will further reduce the volume of appraisal arbitrage litigation in Delaware.

Delaware Supreme Court Clarifies Timing Requirements To Trigger "Dual Protections" Under *MFW*

Also in April, in *Olenik v. Lodzinski*,[31] the Delaware Supreme Court further clarified when the "dual protections" outlined in *Kahn v. M&F Worldwide Corp.* ("*MFW*")[32] must be put in place in order to qualify a take-private transaction for deferential business judgment review.

Under *MFW*, business judgment review applies to a take-private transaction proposed by a controlling stockholder when the transaction is conditioned "*ab initio*" on two procedural protections: (1) the approval of an independent, adequately-empowered special

[28] *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*, 2019 WL 1614026 (Del. Apr. 16, 2019) (Per Curiam).

[29] *DFC Global Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346 (Del. 2017); *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd*, 177 A.3d 1 (Del. 2017).

[30] *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*, 2018 WL 922139 (Del. Ch. Feb. 15, 2018).

[31] *Olenik v. Lodzinski*, 208 A.3d 704 (Del. 2019).

[32] *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

committee that fulfills its duty of care; and (2) the uncoerced, informed vote of a majority of the minority stockholders. If the controlling stockholder does not commit to these dual protections from the beginning of negotiations, then the traditional entire fairness standard applies instead. Recently, the Delaware Supreme Court explained in *Flood v. Synutra International, Inc.*, a case argued by Cleary Gottlieb, that the dual protections must be put in place "early in the process and before there has been any economic horse trading."[33] *Synutra* clarified that the controlling stockholder is not required to include the dual protections in its initial written offer to receive protection under *MFW*.

The *Olenik* decision provides further guidance about the application of *MFW*. The transaction at issue was a stock-for-stock merger between two companies both controlled by the same stockholder, which was alleged to have actively participated in the conception and negotiation of the transaction. Minority stockholders of one of the companies challenged the transaction post-closing seeking damages. Although the Court of Chancery dismissed the claims, the Delaware Supreme Court reversed, holding that the complaint pled facts "support[ing] a reasonable inference" that the controlled companies and the controlling stockholder had effectively engaged in "substantive economic negotiations" before the dual protections were in place, and thus the complaint "should not have been dismissed on *MFW* grounds."[34]

The implication of the Court's holding in *Olenik*, along with its recent holding in *Synutra* on the "*ab initio*" requirement, clarifies the line between "preliminary discussions" (which are permissible before *MFW's* dual protections are put in place) and "substantive economic discussions" (which are not). For example, exploratory meetings and initial exchanges of information may be sufficiently "preliminary" for protection under *MFW*, but a discussion of valuation or significant deal terms is likely to preclude business judgement review.

33 *Flood v. Synutra International, Inc.*, 195 A.3d 754, 756 (Del. 2018).

34 *Olenik*, 208 A.3d at 718.

Delaware Supreme Court Rules On Directors' Oversight Duties

In *Marchand v. Barnhill*, the Delaware Supreme Court reversed the Court of Chancery's dismissal of a *Caremark* claim, providing guidance on the role of the board of directors in overseeing risk management.[35]

The case arose out of a listeria outbreak at Blue Bell Creameries USA in 2015, which resulted in the death of three customers, a complete product recall, a liquidity crisis, and a temporary closure of manufacturing facilities. The plaintiffs brought claims against key executives, alleging that they breached their duties of care and loyalty—specifically that deficiencies in food safety controls were uncovered, yet the board failed to discuss any problems. The Court of Chancery dismissed the claims, but in June 2019, the Delaware Supreme Court reversed, holding that the plaintiffs had plausibly alleged that the board breached its duties by failing to make a good-faith effort to establish a board-level system to monitor food safety and compliance—a key risk facing the company. The "utter failure" to attempt to develop a reporting system constituted an act of bad faith and a breach of the duty of loyalty.

The case is a reminder that *Caremark* claims still have teeth, especially on facts as striking and consequential as those in this case. By the same token, boards can protect themselves from such claims by taking steps to design a functional risk management and oversight system. Boards should ensure that protocols for regular reporting on key risks are in place and that these procedures are properly documented. The Court offered concrete suggestions, advising that boards should consider risk management efforts on quarterly or biannual bases.

35 *Marchand v. Barnhill*, 2019 WL 2509617 (Del. June 18, 2019).

Delaware Supreme Court Affirms Finding Of A Breach Of Fiduciary Duty By Activist Investor

In May 2019, the Delaware Supreme Court in *In re PLX Technology Inc. Stockholders Litigation* affirmed on narrow grounds a decision that involved issues of both a controlling stockholder's aiding and abetting a board's breaches of fiduciary duty and proof of damages.[36]

The case arose after activist investor Potomac Capital Partners II, L.P. ("Potomac") acquired a stake in PLX Technology Inc. ("PLX") for the purpose of inducing (ultimately successfully) PLX to sell itself to a company called Avago. A co-managing member of Potomac named Eric Singer attained a position on the PLX board of directors. Singer received a tip that disclosed significant information about Avago's interest in acquiring PLX. Singer failed to disclose this tip to the rest of the PLX board, and the tip was also not disclosed to PLX stockholders. The Court of Chancery found after a trial that failing to disclose the tip to stockholders was a material omission that amounted to a breach of the PLX directors' duty of disclosure, and that Potomac had aided and abetted the breach through Singer's actions as an agent of Potomac.[37]

However, the Court of Chancery also found that the plaintiffs had failed to prove any damages. The plaintiffs argued that the company should not have been sold at all and that they had suffered damages in the amount of the difference between the merger consideration and the company's "fair" or "intrinsic" value. The Court of Chancery disagreed. Relying on recent decisions from the Delaware Supreme Court in the context of appraisal actions, it found that the deal price was sufficiently reliable notwithstanding the flaws in the sale process. On appeal, the Delaware Supreme Court affirmed the finding on damages, and therefore declined to reach the issue of breach of fiduciary duties.

This decision underscores the importance of full disclosure of material facts in cases involving potential conflicts at the board level and at the stockholder level. And it demonstrates the Delaware Supreme Court's comfort with expanding its recent appraisal jurisprudence, which gives substantial deference to deal price in arm's length transactions, into other contexts.

Delaware Court Of Chancery Strictly Enforces "End Date" Of Merger Agreement

In *Vintage Rodeo Parent, LLC v. Rent-a-Center, Inc.*, the Delaware Court of Chancery found that a target company properly terminated a merger agreement following the passage of the specified "end date" where the buyer failed to exercise its right under the agreement to give notice that it wished to extend the end date.[38] The Court further determined that there was no implied duty to warn a counterparty of the mistake, and that an obligation to use commercially reasonable efforts to consummate a merger does not preclude exercise of an express right to terminate the merger agreement. The court, however, requested additional briefing regarding the enforceability in this context of the $126.5 million reverse termination fee to which the target claimed to be entitled, which constituted 15.75% of the equity value of the transaction. The case settled before that issue was decided, but the decision is a stark reminder that courts will strictly enforce the terms of a merger agreement as written, and that the failure to comply with seemingly ministerial formalities can have potentially severe consequences.

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36 *In re PLX Tech. Inc. Stockholders Litig.*, 2019 WL 2144476 (Del. May 16, 2019).

37 *In re PLX Tech. Inc. Stockholders Litig.*, 2018 WL 5018535 (Del. Ch. Oct. 16, 2018).

38 *Vintage Rodeo Parent, LLC v. Rent-a-Center, Inc.*, 2019 WL 1223026 (Del. Ch. Mar. 14, 2019).

Delaware Court Of Chancery Rules On Privilege Of Pre-Merger Attorney-Client Communications

In *Shareholder Representative Services LLC v. RSI Holdco, LLC*, the Court of Chancery upheld a provision in a merger agreement that precluded the buyer from using the seller's pre-merger attorney-client privileged communications in a post-closing dispute.[39] The Court had previously addressed the issue in *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP*, which held that privileges over attorney-client communications transfer to the surviving company unless the seller takes affirmative action to prevent it.[40]

In *RSI Holdco*, the seller negotiated for a provision in the merger agreement that allowed the seller to continue asserting privilege over pre-merger attorney-client communications and prohibited the buyer from using these communications in post-closing litigation. The Court held that the plain language of the contractual provision prevented the buyer from using or relying on the seller's pre-merger privileged communications in the post-closing litigation. The Court disagreed with the buyer's contention that the seller's failure to excise or segregate the privileged communications from the computers that were transferred as part of the deal constituted a waiver of the privilege, reasoning that such an argument would undermine the policy behind *Great Hill*, which encourages "parties to negotiate for contractual protections."[41]

Continued Rise Of Books And Records Demands Under Section 220 Of The DGCL

In recent years, the Delaware courts have encouraged stockholders to seek books and records under Section 220 of the Delaware General Corporation Law before filing stockholder derivative or post-merger damages suits—in part in reaction to decisions like *Corwin* that have raised the pleading standard for stockholder plaintiffs. In response, each year more stockholders have done so, and this trend continued in 2019 with several important decisions addressing books and records demands. These decisions show that Delaware courts are increasingly willing to permit stockholders to gain access to electronic records (even, in some cases, personal emails and text messages) where there are gaps in the board's minutes and other formal materials, although such stockholders must continue to make a threshold showing that they have a proper purpose and legitimate need before the court will order such records turned over.

In *KT4 Partners LLC v. Palantir Technologies Inc.*, the Delaware Supreme Court clarified when emails may be available as part of a Section 220 demand.[42] The stockholder in the case had demonstrated that the company corresponded via email in relation to the potential wrongdoing the stockholder was investigating, and the company conceded that it did not maintain traditional records related to the issue, such as board resolutions or minutes. The Court explained that "if a company … decides to conduct formal corporate business largely through informal electronic communications [rather than through formal minutes and resolutions], it cannot use its own choice of medium to keep shareholders in the dark about the substantive information to which § 220 entitles them."[43] But the Court emphasized that this "does not leave a respondent corporation … defenseless and presumptively required to produce e-mails and other electronic communications. If a corporation has traditional, non-electronic documents sufficient to satisfy the petitioner's needs, the corporation should not have to produce electronic documents."[44]

In *Schnatter v. Papa John's International, Inc.*, Chancellor Bouchard approved a director's Section 220 request that sought, among other things, certain text messages and emails from his fellow directors' personal accounts and

[39] *Shareholder Representative Servs. LLC v. RSI Holdco, LLC*, 2019 WL 2290916 (Del. Ch. May 29, 2019).

[40] *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP*, 80 A.3d 155 (Del. Ch. 2013).

[41] *RSI Holdco, LLC*, 2019 WL 2290916, at *4.

[42] *KT4 Partners LLC v. Palantir Tech. Inc.*, 203 A.3d 738 (Del. 2019).

[43] *Id.* at 742.

[44] *Id.* at 756.

devices.[45] The court explained that "[a]lthough some methods of communication (*e.g.*, text messages) present greater challenges for collection and review than others, and thus may impose more expense on the company to produce, the utility of Section 220 as a means of investigating mismanagement would be undermined if the court categorically were to rule out the need to produce communications in these formats."[46]

In *Inter-Local Pension Fund GCC/IBT v. Calgon Carbon Corp.*, Vice Chancellor Zurn ruled that a company was not entitled to reject a Section 220 demand on the basis that it was an impermissibly lawyer-driven effort.[47] The investment fund had certain agreements (to monitor the fund's investments, identify potential mismanagement or wrongdoing, and pursue appropriate legal action) with the outside law firm that drafted and sent the Section 220 demand. Vice Chancellor Zurn found as a factual matter that the fund's purpose was not different from its counsel's purpose, and thus permitted a limited inspection to go forward. But the case is a helpful reminder that books and records actions may be dismissed if discovery shows that there are differences between the aims of the stockholder and its counsel in issuing the demand.

Finally, two additional Court of Chancery decisions, both by Vice Chancellor Slights, illustrate what a stockholder must show to present a "credible basis" from which to infer corporate wrongdoing, as required to demonstrate a proper purpose for a Section 220 request. In *Hoeller v. Tempur Sealy International, Inc.*, the Court found that termination of a supply contract by the company's largest customer was not, by itself, a "credible basis" from which to infer wrongdoing.[48] The Court emphasized that "the stockholder's burden [is not] a mere speed bump."[49] By contrast, in *In re Facebook, Inc. Section 220 Litigation*, the Court found that a Facebook stockholder had succeeded in showing a credible basis for wrongdoing in connection with Facebook's data privacy breaches.[50] The Court emphasized that it was not appropriate to assess the merits of the stockholder's *Caremark* claim when adjudicating the Section 220 demand.

[45] *Schnatter v. Papa John's Int'l, Inc.*, 2019 WL 194634 (Del. Ch. Jan. 15, 2019).

[46] *Id.* at *16.

[47] *Inter-Local Pension Fund GCC/IBT v. Calgon Carbon Corp.*, 2019 WL 479082 (Del. Ch. Jan. 25, 2019).

[48] *Hoeller v. Tempur Sealy Int'l, Inc.*, 2019 WL 551318 (Del. Ch. Feb. 12, 2019).

[49] *Id.* at *1.

[50] *In re Facebook, Inc. Section 220 Litig.*, 2019 WL 2320842 (Del. Ch. May 31, 2019).

Looking Ahead

In the coming months, we will be watching for:

— a decision on the certiorari petition in *SEC v. Scoville*;

— developments in the Courts of Appeals on the application of *Morrison* to cases involving foreign transactions;

— a ruling confirming that syndicated loans are not securities subject to state and federal securities laws; and

— developments in appraisal jurisprudence in the Delaware courts.

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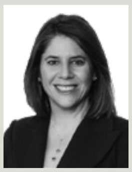

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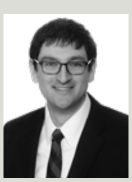

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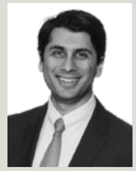

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We'd like to recognize that **Emily Morrow** contributed to Cleary's *2019 Mid-Year Developments in Securities and M&A Litigation* publication.

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