CLEARY GOTTLIEB

2020 Developments in Securities and M&A Litigation

January 2021

Overview

Securities Litigation

M&A and Corporate Governance Litigation

Looking Ahead

Overview

The year 2020 contained several significant developments in securities litigation. Perhaps most notably, the Supreme Court handed down its decision in *Liu v. SEC*, which cemented but limited the SEC's authority to seek disgorgement as "equitable relief" for a securities law violation. The Circuit courts also issued opinions that impact shareholder suits alleging violations of the securities laws. In *Arkansas Teacher Retirement System v. Goldman Sachs Grp., Inc.* and *Carpenters Pension Trust Fund et al. v. Allstate Corp. et al.*, the Second and Seventh Circuits addressed both the standards district courts must use in considering defendants' efforts to rebut the fraud-on-the-market presumption of reliance by showing a lack of price impact, as well as the validity of the "price maintenance" theory of inflation. In December, the Supreme Court granted *certiorari* in the *Arkansas Teacher* matter, and a decision is expected this year.

In 2020, the Second Circuit also provided helpful guidance concerning the requirements for pleading scienter in securities actions in *Jackson v. Abernathy* and *In re Omega Healthcare Investors, Inc. Securities Litigation*. The Ninth Circuit weighed in on whether unproven allegations in whistleblower lawsuits and short-seller reports may constitute corrective disclosures in fraud-on-the-market securities cases in *In re BofI Holding, Inc. Securities Litigation*.

In addition, the COVID-19 pandemic raised the specter of securities litigation arising from losses related to the pandemic and the economic uncertainty it caused. These issues are just beginning to be litigated, but recent decisions from the prior financial crisis may provide strong defenses against these claims.

With respect to M&A and corporate governance litigation, COVID-19 was again a catalyst for a number of lawsuits. Most notably, in a number of mergers that had been announced before the pandemic but had not yet closed, buyers sought to avoid their obligation to consummate the transaction by invoking Material Adverse Effect clauses or claiming breaches of interim operating covenants by the seller. Most of these cases settled, usually with an adjustment to the purchase price, but in November 2020, the Delaware Court of Chancery held in *AB Stable v. MAPS Hotels* that the buyer was excused from closing and permitted to terminate the merger agreement because the seller's response to the pandemic constituted a breach of the covenant to operate the target's business "in the ordinary course consistent with past practice."

In other developments, the Delaware Supreme Court issued an important decision green-lighting federal-forum charter provisions for claims under the federal Securities Act, and other decisions providing meaningful guidance regarding the demand futility requirement of shareholder derivative actions and the grounds on which dissident slates may be excluded in a proxy contest. The Delaware Court of Chancery also issued important decisions concerning aiding and abetting claims, the proper purpose requirement and scope of a Section 220 request for books and records, the validity of contractual terms adopted in a spin-off, the materiality of certain proxy statement disclosures, and the scope of attorney-client privilege as between company counsel and a board of directors. Meanwhile, while most public company mergers continued to attract federal complaints challenging proxy disclosures under Section 14 of the Exchange Act, in a rare case in which such claims were actually litigated, the court dismissed the complaint on grounds that would apply to most such complaints.

Securities Litigation

Supreme Court Upholds Authority of SEC to Seek Disgorgement

In June, the Supreme Court issued an 8-to-1 decision in *Liu v. SEC* holding that the SEC may seek disgorgement as "equitable relief" for a securities law violation, provided the disgorgement (1) does not exceed the wrongdoer's net profits and (2) is awarded for the benefit of victims of the acts that underlie the enforcement action.[1] The case arose out of the construction of a cancer treatment center for which defendants Charles Liu and Xin Wang solicited investments. Liu and Wang allegedly misappropriated much of the funds they had raised, in violation of the terms of a private offering memorandum. The SEC initiated a civil action and sought disgorgement of the full amount of money raised from investors, which the district court ordered and the Ninth Circuit affirmed.

The Supreme Court granted *certiorari* to consider whether the full disgorgement sought by the SEC was a proper equitable remedy under 15 U.S.C. § 78u(d)(5), or a penalty, as the Court had determined disgorgement to be for statute of limitations purposes in *Kokesh v. SEC*.[2] Examining longstanding principles of equitable relief underlying the SEC's authority pursuant to Section 78u(d)(5), the Court noted that as a general matter wrongdoers should not be permitted to retain their ill-gotten gains, but that courts have occasionally awarded disgorgement in ways that test the bounds of equity practice. Rejecting petitioners' interpretation of *Kokesh* that would render any relief described as "disgorgement" a penalty, the Court held that disgorgement is proper where the award does not exceed the profits of the unlawful conduct. The Court, however, left more specific questions about how net profits should be calculated for the lower court on remand. The Court also held that the award must be for the benefit of the victims of the unlawful conduct in order to constitute equitable relief, but similarly left to the lower court the question of whether depositing gains with the U.S. Treasury is indeed for the victims' benefit.

The *Liu* decision allows the SEC to continue its practice of seeking disgorgement awards, but leaves open a door for defendants to dispute the terms of those awards, particularly pertaining to calculation of net profits. The open questions sent down for consideration on remand leave the precise parameters of appropriate disgorgement unsettled, but the Supreme Court has made clear that the scope of the SEC's equitable powers are not unlimited.

---

1 *Liu v. Sec. & Exch. Comm'n*, 140 S.Ct. 1936 (2020).

2 *Kokesh v. Sec. & Exch. Comm'n*, 137 S.Ct. 1635 (2017).

Moreover, the National Defense Authorization Act, which survived a presidential veto in December 2020, includes Section 6501, "Investigations and Prosecution of Offenses for Violations of the Securities Laws," which amends the Exchange Act to explicitly allow the SEC to seek disgorgement as a result of a securities law violation. The provision establishes a 10-year statute of limitations for disgorgement and equitable remedies, but does not define "disgorgement" or address the limitations that the Supreme Court set forth in *Liu*.

Supreme Court Grants Certiorari in Case Concerning Price Impact

In April, a divided panel of the Second Circuit issued its second decision in *Arkansas Teacher Retirement System v. Goldman Sachs Grp., Inc.* ("*ATRS II*"), affirming class certification and holding that the district court did not abuse its discretion in finding that defendants failed to prove that the alleged misstatements had no price impact.[3]

In *ATRS II*, the Second Circuit first considered the scope and applicability of the "price-maintenance theory" of securities fraud, under which misleading statements can purportedly "have price impact not because they introduce inflation into a share price, but because they 'maintain' it."[4] The Second Circuit rejected defendants' effort to narrow the price-maintenance theory by arguing that the price inflation prior to the allegedly price-maintaining misstatements must have been "fraud-induced." The court held instead that the company need not have "led the market" to the inflated price; the price-maintenance claim could also be viable where the market "originally arrived at [the] misconception" on its own.[5] The Second Circuit then rejected defendants' argument that "general statements" cannot maintain price inflation as a matter of law. Defendants argued that the price-maintenance theory had previously only been applied to statements conveying "specific, material financial or operational information" to "stop a stock price from declining" or to "statements falsely conveying that the company has met market expectations about a specific, material financial metric, product, or event."[6] By contrast, defendants argued, the misstatements at issue were "general" and fell into neither narrow category. The court, however, characterized defendants' proposed test as a "means for smuggling materiality into Rule 23," which is an issue that cannot be considered at the class certification stage under the Supreme Court's decision in *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*.[7]

The Second Circuit also affirmed the district court's finding that defendants failed to rebut the *Basic* presumption by showing a lack of back-end price impact.[8] Defendants attempted to do so by, among other things, offering expert testimony that there was no price reaction on dozens of days when corrective information was released before the plaintiff's alleged corrective disclosure. However, the court found that the district court did not abuse its discretion in holding that the subsequent corrective disclosures alleged by the plaintiff contained additional information not previously released in the prior disclosures identified by defendants. The Second Circuit did not foreclose the possibility, however, that some portion of the losses associated with the announcements of the enforcement actions identified by the plaintiff would be unrecoverable as damages.

In dissent, Judge Richard J. Sullivan opined that the district court misapplied the *Basic* presumption and that defendants had sufficiently demonstrated during an evidentiary hearing that the alleged misstatement had no impact on price. He noted that if a plaintiff could point to an alleged corrective disclosure that merely "repackag[ed]" the earlier disclosures identified by a defendant that had no price impact, "then the *Basic* presumption is truly irrebuttable and class certification is all but a certainty in every case."

3 *Arkansas Tchr. Ret. Sys. v. Goldman Sachs Grp., Inc.*, 955 F.3d 254 (2d Cir. 2020).

4 *Id.* at 264.

5 *Id.* at 265.

6 *Id.* at 266.

7 *Amgen Inc. v. Conn. Ret. Plans & Tr. Funds*, 568 U.S. 455 (2013).

8 *Basic v. Levinson*, 485 U.S. 224 (1988).

In December, the Supreme Court granted defendants' petition for *certiorari*, which raised questions concerning (1) whether a defendant in a securities class action can rebut the *Basic* presumption by pointing to the generic nature of alleged misstatements in showing a lack of price impact even where that evidence is also relevant to materiality and (2) whether in rebutting the *Basic* presumption, the defendant carries the burden of persuasion, as well as the burden of production. A decision, which could provide significant guidance on how defendants can rebut the fraud-on-the-market presumption of reliance, is expected later this year.

Seventh Circuit Addresses Rebuttal of *Basic* Presumption and Permits Tolling to Add New Class Representative at Class Certification Stage

On July 16, 2020, in *Carpenters Pension Trust Fund et al. v. Allstate Corp. et al.*, the Seventh Circuit vacated a decision certifying a class of investors in a securities fraud class action against Allstate, finding that the lower court did not adequately consider the evidence concerning price impact that Allstate had presented in an attempt to rebut the *Basic* presumption.[9] In particular, the Seventh Circuit held that the district court was required to consider evidence with respect to price impact, even if it was also relevant to other elements that are not properly considered at the class certification stage. While the court noted several recent Supreme Court cases that grappled with when and how to evaluate evidence bearing on materiality, loss causation, and price impact at the class certification stage, it ultimately recognized that the Supreme Court's holding in *Halliburton Co. v. Erica P. John Fund, Inc.* ("*Halliburton II*")[10] established that lower courts must be willing to consider a defendant's price impact evidence even where such evidence overlaps with other defenses and arguments that are more properly suited for resolution at subsequent merits stages (e.g., materiality and loss causation).[11]

In finding that the district court had erred when it failed to evaluate Allstate's price impact evidence, the Seventh Circuit also adopted the Second Circuit's holding in *ARTS II*, that, to successfully rebut the *Basic* presumption, a defendant carries the burden of persuasion on the issue, which it must satisfy by a preponderance of the evidence.[12] While litigants and scholars have argued the Second Circuit's holding is in tension with a decision from the Eighth Circuit in *Pension Fund v. Best Buy Co.*,[13] the Seventh Circuit disagreed, stating that no fundamental inconsistency exists between the holdings.

On remand, the district court subsequently re-certified the class, again characterizing Allstate's arguments as an inappropriate truth-on-the-market defense and otherwise rejecting its price impact arguments.[14] Significantly, the decision reflects considerable confusion about the requirements for rebutting the fraud-on-the-market presumption at the class certification stage, including characterizing *Halliburton II* as precluding defendants from directly rebutting the *Basic* presumption and criticizing Allstate's expert for assuming that the market for Allstate's securities was efficient.

The Seventh Circuit's *Allstate* decision is notable because it reaffirms that defendants must be provided with an opportunity to rebut the fraud-on-the-market presumption at the class certification stage by demonstrating that the alleged misstatements had no price impact, even where such evidence is also relevant to other merits issues, such as materiality and loss causation. Further, it reflects a growing view among circuit courts that the burden a defendant needs to carry to rebut the *Basic* presumption of reliance is one

9 *Carpenters Pension Tr. Fund et al. v. Allstate Corp. et al. (In re Allstate Corp. Sec. Litig.)*, 966 F.3d 595 (7th Cir. 2020).

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

11 *In re Allstate Corp. Sec. Litig.*, 966 F.3d at 606-07 (citing *Halliburton II*, 573 U.S. 258).

12 *In re Allstate Corp. Sec. Litig.*, 966 F.3d at 610-11 (citing *Arkansas Tchr. Ret. Sys.*, 879 F.3d at 485).

13 *Pension Fund v. Best Buy Co.*, 818 F.3d 775 (8th Cir. 2016).

14 *In re Allstate Corp. Sec. Litig.*, No. 16 C 10510, 2020 WL 7490280 (N.D. Ill. Dec. 21, 2020).

of persuasion, and not merely one of production, and that a defendant must do so by a preponderance of the evidence. However, the Seventh Circuit decision – as well as the district court's subsequent decision on remand – demonstrates the confusion that courts have faced in considering price impact issues at the class certification stage, as well as the high burden that has been placed on defendants to rebut the fraud-on-the-market presumption.

In the same decision, the Seventh Circuit separately affirmed the addition of a new class representative at the class certification stage, even though it had not asserted claims on behalf of a class within the two-year statute of limitations. The Seventh Circuit did so by finding that the new plaintiff's claims were tolled by the filing of the class action, notwithstanding the Supreme Court's recent ruling in *China Agritech, Inc. v. Resh* that such class-action tolling only "allow[s] unnamed class members to join the action individually or file individual claims if the class fails," rather than pursuing claims on behalf of a class.[15] It remains to be seen whether other courts will follow the Seventh Circuit's approach.

COVID-19 Crisis and Response Affects Numerous Aspects of Securities Litigation

Particularly during the first half of 2020, the COVID-19 pandemic disrupted nearly all facets of business operations around the world, leaving both companies and investors facing the specter of severe losses. Various efforts to address the medical and financial consequences of the pandemic have in turn given rise to their own complexities and led to disputes. As the impacts of COVID-19 continue to unfold, these early cases are likely to set precedent for further securities litigation in the future.

Proving Causation During a Crisis: A decision in mid-2020 in a case long predating COVID-19 shows that plaintiffs in pandemic-era securities litigations may face an uphill battle proving loss causation. In May, the New York Supreme Court Commercial Division granted summary judgment to the defendants in *Loreley Financing (Jersey) No. 3 Ltd. v. Lynch*, a fraud case arising from collateralized debt obligation ("CDO") investments in the mid-2000s.[16] The plaintiff investor alleged that Merrill Lynch and others misled it in 2006 about the selection of collateral for a CDO, which was purportedly selected by an undisclosed third party. The subsequent financial crisis caused market-wide losses, and defendants showed that the collateral at issue performed no worse than in comparable instruments, and that the financial crisis thus caused plaintiff's loss. Rather than putting on any evidence showing that the alleged fraud was the cause of the CDO's performance, plaintiff argued it only needed to show it overpaid at the time of investment to prove loss causation. The court rejected that argument, holding that the plaintiff therefore failed to raise a triable issue of fact demonstrating that its investment losses in the CDO were caused by Merrill Lynch's alleged misrepresentations or omissions, as opposed to the broader financial crisis that affected the entire CDO market.

In light of the steep COVID-19-related market decline beginning in February and March 2020 and the accompanying multi-sector slowdown, there has been much speculation of a looming rise in related securities litigation. Similarly, some have speculated that collateralized loan obligations ("CLOs") or commercial mortgage-back securities ("CMBS") in particular are at heightened risk of underperformance and default, suggesting they might experience a similar fate as CDOs during the earlier financial crisis.[17] *Loreley* is a strong reminder that investors who suffer losses on their investment in the wake of the COVID-19 crisis may face the significant challenge of pleading and ultimately proving that their loss was caused by an alleged fraud or some other misconduct, and not the result of the broader market downturn. This task will likely be even

[15] *China Agritech, Inc. v. Resh*, 138 S.Ct. 1800, 1804 (2018).

[16] *Loreley Fin. (Jersey) No. 3 Ltd. v. Lynch*, No. 652732/2011, 2020 WL 2302989 (N.Y. Sup. Ct. Apr. 2, 2020). Cleary Gottlieb represented Merrill Lynch in this action.

[17] *See* Joe Rennison & Robert Smith, *CLOs: Ground Zero for the Next Stage of the Financial Crisis?*, Financial Times, (May 13, 2020), https://www.ft.com/content/f10eaaac-0f4e-46bc-8f78-0754028da46a.

more difficult for CLO, CMBS and other structured finance investments than in the prior financial crisis, especially considering that it is a virus this time that was at the heart of the downturn, and not the structured finance products themselves.

Companies Facing Significant Disruption: Plaintiffs have brought several securities claims against companies for statements made concerning their COVID-19-related business risks. For example, in *Atachbarian v. Norwegian Cruise Lines*, plaintiff alleges that Norwegian knew as early as February 20, 2020 that COVID-19 would have a devastating impact on the cruise industry, but instead of disclosing that risk, "took steps to falsely induce potential customers to book trips" by downplaying the threat of COVID-19.[18] Norwegian's share price dropped after news reports leaked Norwegian sales scripts that encouraged the sales team to downplay COVID-19; however, around the same time, Norwegian and three other major cruise lines had also announced that it would suspend all of its U.S. voyages for at least one month.

Similarly, in *Service Lamp Corp. v. Carnival Corp.*, plaintiffs allege that Carnival failed to disclose increasing cases of COVID-19 on its ships, violations of port of call regulations and its own health and safety protocols, and its role in the resulting spread of the virus throughout the world.[19] *Elmensdorp v. Carnival Corp.* asserts claims over an even longer class period, alleging that Carnival has continuously made misleading statements about "prioritizing" health and safety, as evidenced by Norovirus and Coronavirus outbreaks on its cruise ships.[20]

Outside of the cruise line industry, at least one case was filed in the first half of 2020 alleging a failure to disclose risks associated with the earliest COVID-19 outbreak in Wuhan, China. Plaintiffs in *Wandel v. Gao* allege that a Chinese apartment management company prepared defective offering materials in connection with its IPO by failing to disclose business risks associated with the onset of COVID-19.[21]

Overly Optimistic Statements by Healthcare Companies: While plaintiffs have alleged that cruise companies have understated their risks due to COVID-19, some companies in the healthcare industry have faced claims that they overstated their opportunities, thereby inflating share prices. For example, in litigation against Inovio, a biotechnology company, plaintiffs allege that the company falsely claimed that it had developed a COVID-19 vaccine "in a matter of about three hours once [it] had the DNA sequence from the virus," and announced its plan to start human trials in April 2020.[22]

A similar case was brought against SCWorx, which "provides data content and services related to the repair, normalization, and interoperability of information for healthcare providers."[23] Plaintiff alleges that SCWorx's share price artificially increased after the company announced it received a purchase order for two million COVID-19 rapid testing kits. The share price subsequently dropped after an analyst report suggested that SCWorx's potential supplier has a history of fraud, and, moreover, that the purchaser was unlikely to be able to handle such a large order. Plaintiff alleges that SCWorx failed to disclose these facts, and that SCWorx's positive statements regarding the purchase order were materially misleading and lacked a reasonable basis.

Use of Payment Protection Program Funds: Litigation has also arisen out of COVID-19 relief efforts, including shareholder claims based on the use of funds received under the U.S. government's

18 Class Action Complaint, *Atachbarian v. Norwegian Cruise Lines*, No. 1:20-cv-21386-CMA (S.D. Fla. Mar. 31, 2020), ECF No. 1.

19 Class Action Complaint, *Service Lamp Corp. v. Carnival Corp.*, No. 1:20-cv-22202 (S.D. Fla. May 27, 2020), ECF No. 1.

20 Class Action Complaint, *Elmensdorp v. Carnival Corp.*, No. 1:20-cv-22319-MGC (S.D. Fla. June 6, 2020), ECF No. 1.

21 Complaint, *Wandel v. Gao*, No. 1:20-cv-03259 (S.D.N.Y. Apr. 24, 2020), ECF No. 1.

22 Class Action Complaint, *McDermid v. Inovio Pharms, Inc.*, No. 2:20-cv-01402-GJP (E.D. Pa. Mar. 12, 2020), ECF No. 1, ¶¶ 4-5 (emphasis omitted); *see also* Verified Shareholder Derivative Complaint, *Beheshti v. Kim*, No. 2:20-cv-01962 (E.D. Pa. Apr. 20, 2020), ECF No. 1.

23 Class Action Complaint, *Yannes v. SCWorx Corp.*, No. 1:20-cv-03349 (S.D.N.Y. Apr. 29, 2020), ECF No. 1, ¶ 2.

Paycheck Protection Program ("PPP"). In *Ma v. Wells Fargo*, plaintiff alleges that Wells Fargo planned to, and did, improperly allocate government-backed loans under the PPP, and/or had inadequate controls in place to prevent such misallocation, and failed to disclose the litigation and regulatory risks posed by its PPP allocation.[24]

Second Circuit Rules on Pleading Standards for Corporate Scienter

Pleading Standards for Corporate Scienter: In May, the Second Circuit decided *Jackson v. Abernathy*, a securities fraud action arising from a health product manufacturing company's allegedly false and misleading statements about the quality standards of its protective surgical gowns.[25] The Second Circuit affirmed the district court's dismissal of claims against the company, holding that plaintiffs had failed to meet the stringent standards for pleading scienter on the part of a corporation.

The Second Circuit held that to plead scienter by a corporation, a plaintiff must plead facts giving rise to a strong inference that someone whose intent could be imputed to the corporation acted with scienter, and that only in exceedingly rare circumstances could collective corporate scienter be inferred without alleging individual scienter. The court found that the plaintiff's "general" allegations about three employees who testified in a related consumer class action – in particular, that they warned "unidentified senior executives" about the protective gown's defects – were not sufficiently particularized to impute scienter to the corporate defendants.[26] The court also gave no credence to the plaintiff's suggestion that the corporate defendants should be precluded from contesting scienter because the jury in the consumer fraud class action found that the companies had intentionally defrauded consumers, stating that the plaintiff had not demonstrated that the issues in the two proceedings were identical or that the same individuals' states of mind were relevant. Finally, the Second Circuit rejected the plaintiff's invocation of the "core operations" doctrine. The plaintiff argued that the manufacture of the surgical gown in question was of such core importance to the company's operations that the "senior officers must have known that the challenged statements were false."[27] The court held that more than this "naked assertion" was required to raise a strong inference of collective corporate scienter.[28]

The *Jackson* decision provides significant guidance to courts resolving whether a plaintiff has adequately pleaded corporate scienter, a task that the Second Circuit referred to as "difficult and sometimes confusing."[29] Under *Jackson*, it is not sufficient to allege that someone – or even multiple people – at the company knew about an underlying issue, without providing any "connective tissue between those employees and the alleged misstatements."[30] Further, the Second Circuit's rejection of the suggestion that scienter could be established in the securities class action based solely on the related consumer class action, which resulted in a jury verdict that the companies had defrauded consumers, serves as an important reminder that the scienter inquiry in securities class actions is narrowly focused on whether the defendants intentionally or recklessly misled investors. Increasingly, securities class actions are filed as follow-on actions after a company has been found liable for some other underlying misconduct. The *Jackson* decision confirms that, in such cases, merely alleging that the company was found liable for engaging in such misconduct is not sufficient to plead a strong inference of scienter with respect to their securities disclosures, even where the underlying misconduct itself involved a culpable state of mind.

---

24 Class Action Complaint, *Ma v. Wells Fargo*, No. 3:20-cv-03697 (N.D. Cal. June 4, 2020), ECF No. 1.

25 *Jackson v. Abernathy et al.*, 960 F.3d 94 (2d Cir. 2020).

26 *Id.* at 99.

27 *Id.*

28 *Id.*

29 *Id.* at 98.

30 *Id.* at 99.

Second Circuit Reverses the Dismissal of Class Action Alleging Material Misstatements With Respect to Efficacy of Cancer Drug

In July, the Second Circuit in *Abramson v. NewLink Genetics Corp.* reversed the dismissal of a securities class action against the pharmaceutical company NewLink Genetics Corporation and its leadership, alleging they materially misrepresented the efficacy of their pancreatic cancer drug and the design of the Phase 3 clinical trial.[31] In distinguishing the alleged misstatements that were actionable from those that were "puffery," the court focused on the timing and the context of those statements. First, the court held that generic positive statements made regarding the efficacy of the drug after successful Phase 2 clinical trials were mere puffery and were not actionable under Rule 10b-5. In contrast, statements made at an industry conference regarding pancreatic cancer survival rates framed as fact rather than opinion, without qualifying language such as "I believe" or "in my estimation," and made with specificity, provided a reasonable basis for a court to find such statements could be materially false or misleading.[32] Similarly, the Second Circuit held that another statement made by the company President and Chief Marketing Officer on an investor call in response to a question regarding survival rates in the Phase 3 clinical trial was adequately alleged to be false. In providing a categorical response to a specific question, and despite prefacing the statement with "it is our belief," the court found that the company had implied there were no conflicting facts on survival rates while allegedly aware of competing evidence to the contrary. Conversely, the court found that a response regarding the intended design of the Phase 3 trial was accurate and not actionable.

In addition, the Second Circuit held that plaintiffs adequately alleged loss causation. In reaching this conclusion, the court first rejected as insufficient the plaintiffs' reliance on an analyst report, which it concluded "did not alert the public to the falsity" of the challenged statement because it did not mention the allegedly misrepresented issue.[33] However, the court accepted the plaintiffs' alternative argument that the allegedly concealed risk "materialized when the Phase 3 trial failed," and that "at this early pleading stage" such an allegation was sufficient because courts "do not require 'conclusive proof' of the causal link between the fraud and plaintiffs' loss."[34]

Ninth Circuit Addresses Loss Causation Pleading Requirements

In October, the Ninth Circuit addressed the pleading of loss causation, and joined the Sixth Circuit in rejecting a categorical rule that allegations in a lawsuit alone cannot qualify as corrective disclosures. The case, *In re BofI Holding, Inc. Securities Litigation*, involved allegations that executives of BofI falsely portrayed the company as a safer investment than it actually was by touting the bank's conservative loan underwriting standards, strong internal controls, and robust compliance structure.[35]

In its decision, the Ninth Circuit addressed the adequacy of two potential corrective disclosures: a whistleblower lawsuit and a series of anonymous blog posts discussing negative reports about the company's operations. With respect to the whistleblower lawsuit, the Ninth Circuit held that a former employee's allegations of fraud may qualify as a corrective disclosure and be used to plead loss causation, as long as the allegations are plausible, and even if there is no additional evidence corroborating the allegations. In reaching this ruling, the court held that plaintiffs do not have to establish that allegations in the whistleblower complaint are true to plead loss causation – just that the market perceived the allegations in the suit as true in a way that affected the share price. Analyzing each of the blog posts in turn, the court held that even though they relied on public information, that

31 *Abramson v. Newlink Genetics Corp.*, 965 F.3d 165 (2d Cir. 2020).

32 *Id.* at 176.

33 *Id.* at 180.

34 *Id.*

35 *Houston Mun. Emps. Pension Sys. v. BofI Holding, Inc. (In re BofI Holding, Inc. Sec. Litig.)*, 977 F.3d 781 (9th Cir. 2020).

alone did not disqualify them from being corrective disclosures, as the authors of the posts had conducted "extensive and tedious research" to arrive at their conclusions.[36] However, the court held that the plaintiffs had not plausibly alleged that the market reasonably perceived the posts to reveal the falsity of misstatement by BofI and thus cause a price drop on the day the posts were released. In this respect, the court relied on the anonymity of the posts, disclaimers made by the authors of the posts as to the accuracy of the reported information, and the fact that the posts were authored by short-sellers who had a financial incentive to convince other investors to sell, which the court noted a reasonable investor reading the posts would "have taken their contents with a healthy grain of salt."[37]

In dissent, Judge Kenneth K. Lee took issue with the majority's holding with respect to the whistleblower lawsuit, positing that the decision would have "the unintended effect of giving the greenlight for securities fraud lawsuits based on unsubstantiated assertions that may turn out to be nothing more than wisps of innuendo and speculation."[38] He noted the significant cost to companies in defending against these cases and stated that he believed additional external confirmation of fraud allegations in a whistleblower lawsuit were necessary in order for them to count as corrective disclosures.

Plaintiffs Survive Motion to Dismiss Claims Against Foreign Issuer in Latest on Unsponsored ADRs

In January, following remand from the Ninth Circuit, the Central District of California denied a motion to dismiss the plaintiffs' amended complaint in *Stoyas v. Toshiba Corp.*[39] In this latest decision in a long-running dispute as to whether companies whose shares are traded in the United States as unsponsored American Depositary Receipts ("ADRs") can be subject to claims under the federal securities laws, the district court found that the amended complaint successfully pled both a domestic transaction and Toshiba's involvement in the issuance of the securities.

Considering the newly amended complaint in light of guidance previously provided by the Ninth Circuit, the district court concluded that the plaintiffs sufficiently pleaded that irrevocable liability was incurred in the United States with respect to their transactions in the unsponsored ADRs, as required to allege a domestic transaction. The court further rejected Toshiba's contention that it should draw the inference that transactions in Toshiba's unsponsored ADRs were not "domestic" because those shares were first purchased by a depositary institution in a foreign transaction and subsequently converted to an unsponsored ADR, because drawing such an inference against the plaintiffs was improper at the pleading stage. In addressing the "in connection with" requirement, the district court held that the plaintiffs properly conformed their complaint to the Ninth Circuit's order, by sufficiently alleging Toshiba's plausible consent to the sale of its stock in the United States as ADRs.

This decision raises important questions about the extent of domestic activity necessary to subject a foreign issuer to potential securities litigation in the United States.

District Court Allows Securities Act Claims to Proceed Against Direct Listing of Shares

In April, the Northern District of California held in *Pirani v. Slack Technologies* that investors who had purchased shares of Slack through its direct listing could pursue claims under the Securities Act.[40] Slack had entered the public market through a direct listing of its stock on the New York Stock Exchange by insiders and early investors, without issuing new shares in a traditional IPO.

[36] *Id.* at 796-97.

[37] *Id.* at 797.

[38] *Id.* at 798-99 (Lee, J., dissenting).

[39] *Stoyas v. Toshiba Corp.*, No. 15-cv-4194 DDP (JCx), 2020 WL 466629 (C.D. Cal. Jan. 28, 2020).

[40] *Pirani v. Slack Techs. Inc. et al.*, 445 F.Supp.3d 367 (N.D. Cal. 2020).

In a case of first impression, the court declined to dismiss Securities Act claims concerning the direct listing, holding: (1) that a direct listing exempted plaintiffs from the well-established requirement that a plaintiff trace its shares to a registration statement in order to establish a claim under Section 11; (2) that damages could be established under Section 11 even in the absence of a public offering price; and (3) that Slack's signing of the offering materials and soliciting sales at an Investor Day were sufficient to constitute active solicitation by a statutory seller as required for a claim under Section 12(a)(2).

The *Slack* decision is significant because it is the first case to address the potential application of the civil liability provisions of the Securities Act to direct listings. While commentators had expected the risk of such liability to be limited in light of Section 11's tracing requirement and Section 12(a)(2)'s statutory seller requirement, *Slack* shows that courts may be willing to relax those requirements in order not to insulate direct listings from liability under the Securities Act. Accordingly, if the *Slack* decision stands and is followed by other courts, it raises a risk companies should consider in deciding whether to go public through a direct listing, particularly where they have no need for new equity capital. Defendants were granted permission to file an interlocutory appeal on July 24, 2020.

Courts Rule on the Scope of "Securities" in Cryptocurrency and Syndicated Loan Cases

Cryptocurrency: Decisions from the Southern District of New York this year lent support to the SEC's characterization of some cryptocurrencies as securities. In March, the Southern District of New York granted the SEC's request for a preliminary injunction in *SEC v. Telegram Grp.*, finding that the SEC was likely to be able to prove that Telegram's distribution of cryptocurrency was part of an unregistered offering of a security.[41] Telegram had entered into purchase agreements with a group of sophisticated entities and high net-worth investors, agreeing to distribute its cryptocurrency, called Grams, once they were launched, and anticipating that these initial investors would then resell the Grams in the secondary market. While Telegram viewed these secondary sales as separate from the purchase agreement transactions, the SEC took the position that the initial sales and planned resales were part of a single securities offering in which the initial investors assumed the role of underwriters. Applying the *Howey* test for interpreting an investment contract,[42] the court granted the SEC's request for an injunction, preventing Telegram from delivering the Grams to the initial purchasers.

In May, the SEC then brought charges against blockchain services company BitClave for conducting an unregistered initial coin offering of digital asset securities called Consumer Activity Tokens.[43] BitClave agreed to settle the charges by returning proceeds from the offering and paying additional monetary relief to be distributed to investors, and it has also since discontinued its operations.

In September, the Southern District of New York issued a decision in *SEC v. Kik Interactive, Inc.*, holding that Kik offered and sold unregistered securities in violation of Section 5 of the Securities Act.[44] Kik created its cryptocurrency Kin and advertised it through a multi-city "roadshow" and other public events. Kin was sold in both a private and public offering and as part of pre-sale agreements called Simple Agreements for Future Tokens ("SAFTs"), in which buyers acknowledged that they were acquiring a right to purchase a security that was unregistered with the SEC. Relying on the *Howey* test and referencing the court's decision in *Telegram Grp.* (though noting it was factually distinct), the court held that both the private and public sale of Kin constituted an unregistered securities offering that did not qualify for an exemption and granted the SEC's motion for summary judgment.

[41] *Sec. & Exch. Comm'n v. Telegram Grp. Inc.*, 448 F.Supp.3d 352 (S.D.N.Y. 2020).

[42] *Sec. & Exch. Comm'n v. W. J. Howey Co.*, 328 U.S. 293 (1946).

[43] Complaint, *In the Matter of BitClave PTE Ltd.*, No. 3-19816 (S.E.C. May 28, 2020).

[44] *Sec. & Exch. Comm'n v. Kik Interactive, Inc.*, No. 19-cv-5244, 2020 WL 5819770 (S.D.N.Y. Sept. 30, 2020).

Syndicated Loans: By contrast, in a decision issued in the first half of 2020, a court refused to characterize a syndicated loan as a security. In May, the Southern District of New York dismissed state securities law and common law claims in *Kirschner v. J.P. Morgan Chase* concerning a syndicated term loan.[45] In keeping with settled market expectations, the court held that syndicated loans were not securities and did not bear a sufficient "family resemblance" to the types of securities subject to the applicable laws. A contrary decision would have threatened to upend the trillion-dollar market for syndicated loans.

Cases Highlight Ongoing Risks Related to #MeToo Disclosures in the Workplace

In January, the Southern District of New York allowed certain securities fraud claims related to the #MeToo movement to move forward in *Construction Laborers Pension Trust for Southern California v. CBS Corp.*[46] The case arises from a number of allegedly misleading statements made by CBS concerning alleged misconduct by its former Chief Executive Officer Leslie Moonves. Investors brought a securities fraud action against CBS alleging that the concealed sexual misconduct posed a material business risk in light of the #MeToo movement, and identifying a wide variety of potentially misleading statements. However, the court dismissed the plaintiffs' claims regarding the majority of the statements, finding them immaterial or not misleading. The only claims that survived the motion to dismiss were Moonves' own statements to news media – suggesting that pervasive workplace sexual harassment was new and shocking information to him.

In March, another court in the Southern District of New York dismissed all claims without prejudice in a similar securities fraud action against Papa John's in *Oklahoma Law Enforcement Retirement System v. Papa John's*.[47] Plaintiffs alleged that current and former Papa John's Chief Executive Officers made public statements about company culture that misled investors about an allegedly pervasive, toxic culture of harassment. The court held that the executives' statements were mere puffery, comparing the claims to the one dismissed in *CBS*. An amended complaint was filed and is still pending.

Though these cases are still in progress, they show that viable claims based on misrepresentation of #MeToo risks may be possible, but that most statements generally lauding company culture and employee satisfaction are not actionable.

---

[45] *Kirschner v. J.P. Morgan Chase Bank, et al.*, No. 17-cv-06334-PGG, 2020 WL 2614765 (S.D.N.Y. May 22, 2020). Cleary Gottlieb submitted an amicus brief in this action on behalf of The Bank Policy Institute.

[46] *Constr. Lab. Pension Tr. for S. Cal. v. CBS Corp.*, No. 18-cv-7796, 2020 WL 248729 (S.D.N.Y. Jan. 15, 2020). Cleary Gottlieb represented CBS directors Shari Redstone, David R. Adelman, and Robert N. Klieger in this action.

[47] *Okla. Law Enf't Ret. Sys. v. Papa John's Inc.*, 444 F.Supp.3d 550 (S.D.N.Y. 2020).

M&A and Corporate Governance Litigation

"Busted Deal" Litigation Related to COVID-19

In many deals signed before the onset of COVID-19 that had not yet closed by March 2020, when much of the economy shut down, buyers were faced with the unpleasant prospect of acquiring a company whose value proposition was dramatically less favorable than had been expected at signing. Not surprisingly, many such buyers attempted to terminate, or otherwise delayed or refused performance, by invoking various rights under the merger agreement. In some cases, that led to litigation brought by the seller to compel the buyer to close.

Material Adverse Effect Claims: Many buyers argued that the COVID-19 pandemic or its effects constituted a Material Adverse Effect ("MAE") permitting the buyer to refuse to close. The determination of whether an MAE clause is triggered necessarily depends on the language of each merger agreement and the specific facts of each case. But generally speaking, in order to successfully invoke an MAE, a buyer would need to show that the impact of COVID-19 on the target is durationally and economically significant (i.e., a dramatic loss of value that persists, or is expected to persist, for more than a year),[48] and that the target business was disproportionally impacted by the pandemic compared to other companies in the target's industry (i.e., a MAE that impacts the industry as a whole is typically carved out and not considered an MAE permitting the buyer to terminate).

In *Snow Phipps v. KCAKE Acquisition*, the owner of DecoPac holdings (the world's largest supplier of cake decorations) agreed in March to sell the company to a private equity buyer.[49] In April, the buyer refused to close, arguing that the COVID-19 pandemic had resulted in an MAE and that the target had been disproportionally affected in comparison to its competitors. The seller sued in the Delaware Court of Chancery, seeking specific performance compelling the buyer to close. Similarly, in *Realogy Holdings v. Sirva Worldwide*, the seller filed suit in Delaware to enforce an agreement to sell a corporate relocation business against the buyer, which refused to close on the basis of an alleged MAE.[50]

[48] *Akorn, Inc. v. Fresenius Kabi AG et al.*, C.A. No. 2018-0300-JTL, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018); *see also Akorn v. Fresenius: A MAC in Delaware*, Cleary M&A and Corporate Governance Watch (Oct. 11, 2018), https://www.clearymawatch.com/2018/10/akorn-v-fresenius-mac-delaware/.

[49] *Snow Phipps Grp., LLC v. KCAKE Acquisition, Inc. et al.*, C.A. No. 2020-0282 (Del. Ch. 2020).

[50] *Realogy Holdings v. Sirva Worldwide*, C.A. No. 2020-0311 (Del. Ch. 2020).

In both of these cases, the seller sought expedited proceedings in order to allow the seller to obtain a specific performance remedy before the termination of previously arranged acquisition financing. In June, the Delaware Court of Chancery declined to expedite *Snow Phipps*, citing the burden and expense of preparing for a trial on the extremely truncated timetable proposed by the seller. In October, however, the court delivered a bench ruling largely denying the buyer's motion to dismiss the specific performance claim. The court held that despite the passage of time, the buyer could not avoid specific performance under the "prevention doctrine," which may excuse the nonoccurrence of a contractual condition if a party's breach materially contributed to the nonoccurrence. In this case, the court found it reasonably conceivable that the buyer's alleged breaches materially contributed to the termination of financing. Conversely, in *Realogy Holdings v. Sirva Worldwide*, the court granted the motion to expedite on a more reasonable timetable, and a motion to dismiss was heard in late July. At oral argument on the motion to dismiss, the court dismissed the claim for specific performance, holding that the seller had caused the termination of the buyer's acquisition financing by naming one of the buyer's guarantors as a co-defendant (in violation of the terms of the financing commitment letter) and therefore could no longer be entitled to specific performance. In *Forescout Technologies v. Ferrari Grp. Holdings L.P.*, the parties agreed to an expedited schedule culminating in a trial scheduled for the end of July, when the buyer would otherwise have been permitted to terminate the merger agreement (although seller claimed it was already too late to compel specific performance).[51] Interestingly, in that case, the seller offered to provide (or obtain) financing for the buyer, arguing that such offer precluded the buyer from invoking the lack of available financing as an unsatisfied condition precedent to specific performance in order to avoid being ordered to close. The week before the trial was scheduled to occur, the parties settled the case by agreeing to reduce the purchase price.

[51] *Forescout Techs. Inc., v. Ferrari Grp. Holdings L.P.*, C.A. No. 2020-0385 (Del. Ch. 2020).

Ordinary Course Covenants: Many buyers have additionally alleged that sellers have committed a material breach of interim operating covenants, for example, by failing to continue operating the target company in the ordinary course consistent with past practice (since COVID-19 has necessarily caused many businesses to dramatically alter their business practices).

In November, the Delaware Court of Chancery addressed this issue in a lengthy post-trial opinion in *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC*.[52] In that case, the seller sought to enforce an agreement to sell Strategic Hotels, which owned a portfolio of luxury hotels, that was signed in September 2019 and scheduled to close in April 2020. The buyer refused to close, alleging, among other things, that the seller failed to continue operating the hotels in the ordinary course because, like many if not all of its competitors in the hospitality industry, it took dramatic steps in response to the COVID-19 pandemic, including closing hotels or substantially reducing operations at hotels that nominally remained open. The court ruled that while the buyer failed to prove an MAE had occurred, the buyer was nonetheless excused from closing and permitted to terminate the merger agreement because it proved that the seller's response to the pandemic, even though it was in line with that of comparable companies, breached the ordinary course covenant because those steps were not routine or consistent with its past practices in ordinary times. The court rejected the seller's argument that "ordinary course" encompasses ordinary or reasonable responses to extraordinary events, and noted that the seller could have, but did not, seek the buyer's consent to the steps it was taking in response to the pandemic.

Other Closing Conditions Not Satisfied: In April, in *Khan v. Cinemex Holdings USA, Inc.*, a seller brought suit in the Southern District of Texas to compel the sale of a chain of movie theaters.[53] The buyer relied on, among

[52] *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC*, C.A. No. 2020-0310, 2020 WL 7024929 (Del. Ch. November 30, 2020).

[53] *Khan v. Cinemex Holdings USA, Inc.*, No. 4:20-CV-1178, 2020 WL 2047645 (S.D. Tex. Apr. 27, 2020).

other arguments, the doctrine of impossibility, arguing that it had a right to inspect the theaters before closing, but could not do so due to travel restrictions imposed by the governor as a result of COVID-19. Shortly after the lawsuit was filed, Cinemex filed for bankruptcy and the case remains stayed. In *Realogy Holdings v. Sirva Worldwide*, the buyer argued that one reason it should be excused from closing was that the seller was nearing insolvency and may not have been able to consummate the transaction or perform its transition service obligations.[54] As noted above, this case subsequently settled.

Follow-on Shareholder Suits: In June, in *Arbitrage Fund v. Forescout Technologies, Inc.*, shareholders of Forescout brought suit in the Northern District of California alleging that management failed to adequately disclose foreseen risks that there would be difficulties closing the proposed sale to private equity firm Advent when the deal was announced in May.[55] As noted above, in that case, the buyer initially refused to close, arguing that the COVID-19 pandemic constituted an MAE before ultimately agreeing to close at a reduced purchase price. In the California lawsuit, the plaintiff alleges that defendants violated the Exchange Act by failing to disclose risks associated with the deal until Advent publicly purported to terminate the merger, causing Forescout's share price to decline. The case remains pending.

Delaware Supreme Court Upholds Federal-Forum Charter Provisions

In March, the Delaware Supreme Court issued an opinion in *Sciabacucchi v. Salzberg*,[56] a case involving a stockholder challenge to charter provisions of three Delaware corporations requiring stockholder plaintiffs to litigate claims under the Securities Act of 1933 in federal court. The plaintiffs sought a determination that Securities Act claims are external claims outside the scope of matters that may be regulated by Delaware corporate charters.

The *en banc* Supreme Court unanimously upheld such provisions against the plaintiffs' facial challenge, reversing the Delaware Court of Chancery's prior decision in this case. The court held that the forum selection provisions were permissible under the Delaware General Corporation Law, rejecting the Court of Chancery's binary division between internal and external claims in favor of a more nuanced approach. The court reasoned that, while Securities Act claims brought by investors against the company and/or its directors and officers are not "internal affairs," they are a form of "intra-corporate litigation," which Delaware corporations may regulate as to procedure.[57]

The decision is a significant development for Delaware corporations, particularly those that anticipate going public, or that have gone public within the last three years, which may now wish to consider adopting federal-forum provisions in their charters or bylaws. Such provisions could reduce the burdens and inefficiencies of Securities Act litigation created by the U.S. Supreme Court's 2018 *Cyan Inc. v. Beaver County Employees Retirement Fund* decision, which has led to a marked increase in related securities class actions proceeding simultaneously in multiple federal and state courts.[58] A number of questions remain unresolved, however, including whether other state and federal courts will similarly uphold federal-forum provisions, and under what circumstances (since the Delaware Supreme Court's decision, several state court decisions have enforced federal-forum provisions, but the caselaw in this area is still developing);[59] whether such courts will reach the same conclusion with respect to federal-forum provisions adopted in a corporation's bylaws; and whether courts would similarly uphold a charter or

[54] *Realogy Holdings v. Sirva Worldwide*, C.A. No. 2020-0311 (Del. Ch. 2020).

[55] Complaint, *Arbitrage Fund v. Forescout Techs., Inc.*, No. 3:20-cv-03819, 2020 WL 3254374 (N.D. Cal. Jun. 10, 2020), ECF No. 1.

[56] *Salzberg v. Sciabacucchi*, 227 A.3d 102, (Del. 2020).

[57] *Id.* at 114.

[58] *Cyan Inc. v. Beaver Cty. Emps. Ret. Fund*, 138 S. Ct. 1061 (2018).

[59] *See In re Uber Techs., Inc. Sec. Litig.,* No. CGC-19-579544 (Cal. Super. Ct. Nov. 16, 2020) (dismissing claims against all defendants); *Wong v. Restoration Robotics, Inc. et al.*, No. 18CIV02609 (Cal. Super. Ct. Sept. 1, 2020) (dismissing plaintiff's claims against the issuer, but upholding claims against the underwriters and investors).

bylaw provision mandating *arbitration* of Securities Act (or other federal securities law) claims.

Delaware Court of Chancery Allows More *Caremark* Claims to Proceed

Two decisions in 2019 – *Marchand v. Barnhill*[60] and *In re Clovis Oncology, Inc. Derivative Litigation*[61] – drew significant attention by permitting *Caremark*[62] duty-of-oversight claims to proceed past the motion to dismiss stage, despite the typically high bar for pleading such claims, leading some commentators to speculate whether the bar had been lowered and more such decisions were to come. In April of this year, and again in August, the Delaware Court of Chancery again denied motions to dismiss *Caremark* claims in *Hughes v. Hu*[63] and *Teamsters Local 443 Health Services & Insurance Plan v. Chou*.[64] Both cases involve detailed allegations, driven by plaintiff's pre-suit investigation of books and records pursuant to Section 220, and may signal a trend of stockholder plaintiffs using Section 220 demands to craft more detailed complaints against boards faced with a significant negative event.

The *Hughes* case arose from a number of serious issues that China-based manufacturing company Kandi Technologies faced with its financial reporting, disclosure controls and internal control over financial reporting. After Kandi issued a financial restatement reflecting these many weaknesses, a shareholder brought a derivative suit against the audit committee and several executives, alleging that they breached their *Caremark* duty of oversight. The court allowed the claims to move forward, holding that the plaintiff had alleged sufficiently extreme failures by Kandi's audit committee, which allegedly "met only sporadically and devoted patently inadequate time to its work" and "had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation."[65]

Similarly, in the *Teamsters* case, the court found it was reasonably conceivable that the board had consciously ignored obvious red flags, including a subpoena from the Department of Justice and a *qui tam* complaint filed by a former executive. The court also emphasized the severity of the alleged compliance failures in the context of the highly-regulated pharmaceutical drug industry.

The *Hughes* and *Teamsters* cases illustrate the kinds of systemic troubles – "mission critical" compliance risks – within an organization that, if unaddressed at the board level, may leave directors vulnerable to *Caremark* liability, and the continued importance of boards establishing and maintaining systems of oversight, and properly documenting their exercise of oversight responsibilities.

Delaware Courts Expand the Proper Purpose Requirement for Stockholders' Inspection Rights

In December, the Delaware Supreme Court affirmed the Delaware Court of Chancery's decision in *Lebanon County Employees' Retirement Fund v. AmerisourceBergen Corp.*, clarifying the circumstances in which stockholders are entitled to demand books and records to investigate allegations of mismanagement pursuant to Section 220 of the Delaware General Corporation Law.[66]

The Supreme Court held that when a stockholder seeks to investigate credible allegations of mismanagement, the stockholder is not required to disclose "up-front" the "ultimate objective—that is, what [it] intend[s] to do with the books and records in the event that they confirm[] [its] suspicion of wrongdoing."[67] Emphasizing that the credible basis standard is the "lowest possible burden

[60] *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019).

[61] *In re Clovis Oncology, Inc. Derivative Litig.*, C.A. No. 2017-0222-JRS, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019).

[62] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996)

[63] *Hughes v. Hu*, C.A. No. 2019-0112-JTL, 2020 WL 1987029 (Del. Ch. Apr. 27, 2020).

[64] *Teamsters Local 443 Health Servs. & Ins. Plan v. Chou, et. al.*, C.A. No. 2019-0816-SG, 2020 WL 5028065 (Del. Ch. Aug. 24, 2020).

[65] *Hughes*, 2020 WL 1987029, at *14.

[66] *Lebanon Cty. Emps.' Ret. Fund v. AmerisourceBergen Corp.*, No. 2019-0527-JTL, 2020 WL 7266362 (Del. Ch. Dec. 10, 2020).

[67] *Id.* at *1.

of proof," the Supreme Court also held that where a stockholder does not identify the pursuit of derivative claims as the sole objective of its investigation, it need not show a credible suspicion of *actionable* mismanagement in order to receive access to books and records (e.g., mismanagement that may lead to a complaint that could survive a motion to dismiss), as long as the stockholder can show a credible basis to believe some mismanagement occurred that it seeks to investigate further.[68]

The decision is likely to continue the recent trend of an increasing number of Section 220 demands in the wake of corporate wrongdoing.

In addition, a November decision of the Court of Chancery introduced an additional risk consideration for companies determining how to respond to a Section 220 demand for books and records. In *Pettry v. Gilead Sciences, Inc.*, the court suggested it would consider awarding attorneys' fees to plaintiffs' counsel for costs related to the Section 220 action.[69] In a decision decrying the "massive resistance" by defendant corporations to Section 220 demands and criticizing a "trend" of defendants "increasingly treating Section 220 actions as surrogate proceeding[s] to litigate the possible merits of the suit," the court *sua sponte* granted leave for plaintiffs to seek an order compelling the company to pay their attorneys' fees in pursuing the Section 220 case.[70]

Delaware Court of Chancery Provides Guidance on Aiding and Abetting Breach of Fiduciary Duty Claims

In June, the Delaware Court of Chancery considered claims of aiding and abetting breaches of fiduciary duty and issued an important decision for board advisors and M&A buyers in *Morrison v. Berry*.[71] The case arises from a private equity buyer's acquisition of a grocery chain, and in a previous significant decision, the Delaware Supreme Court found that the target's proxy disclosures were insufficient to "cleanse" merger claims under *Corwin v. KKR Financial Holdings LLC*.[72] On remand, the Court of Chancery concluded that the claims against the target board should be dismissed for failure to plead a non-exculpated claim for breach of fiduciary duty pursuant to the company's Section 102(b)(7) provision. Notwithstanding that finding, in its June decision, the court found the stockholder plaintiff could pursue claims against the target board's financial advisor for allegedly aiding and abetting (the exculpated) breaches of fiduciary duty by the board, finding that it was reasonably conceivable that the financial advisor knew its failure to disclose its alleged back-channeling with the buyer impacted the target board's ability to carry out its duties in conducting the target's sale process. The court, however, dismissed the aiding and abetting claims against the target board's law firm and the private equity buyer, finding it was not reasonably conceivable that they were aware of any material information being withheld from the target board.

These diverging results provide guidance as to when the Delaware courts will (and when they will not) dismiss aiding and abetting claims. In many cases, the determining factor will be whether the complaint pleads facts raising a reasonably conceivable inference that the advisor, buyer, or other third party knew the board was engaging in a breach of its fiduciary duty, including by not being informed of material facts. This has important implications for the way board advisors and M&A buyers should approach a situation in which they become aware that the board of a target company is unaware of some material fact that could conceivably affect its ability to fulfill its fiduciary duties.

[68] *Id.* at *5.

[69] *Pettry v. Gilead Scis., Inc.*, C.A. Nos. 2020-0132-KSJM; 2020-0138-KSJM; 2020-0155-KSJM; 2020-0173-KSJM, 2020 WL 6870461 (Del. Ch. Nov. 24, 2020).

[70] *Id.* at *2, *30.

[71] *Morrison v. Berry et al.*, C.A. No. 12808-VCG, 2020 WL 2843514 (Del. Ch. June 1, 2020).

[72] *Morrison v. Berry*, 191 A.3d 268 (Del. 2018) (citing *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015); *see also "Recent Applications of Corwin v. KKR Fin. Holdings LLC Confirm High Bar to Pleading Post-Closing Damages Actions*," Cleary M&A and Corporate Governance Watch (Sept. 12, 2016), https://www.clearymawatch.com/2016/09/recent-applications-corwin-v-kkr-financial-holdings-llc-confirm-high-bar-pleading-post-closing-damages-actions/.

Delaware Court of Chancery Dismisses Claims Even After *Corwin* Defense Fails

In August, the Delaware Court of Chancery in *In re USG Corporation Shareholder Litigation* found that "*Corwin* cleansing," – which applies business judgment protection to mergers that are not subject to entire fairness review and are approved by a fully informed and uncoerced vote of a majority of disinterested shareholders – did not apply.[73] Nonetheless, the court dismissed all claims against the directors because the complaint failed to adequately allege that the directors acted in bad faith, as required by the company's Section 102(b)(7) exculpation provision. The decision is a reminder that *Corwin* is not the only defense available to directors in M&A litigation at the motion to dismiss stage.

Delaware Supreme Court Clarifies Demand Futility Test in Stockholder Derivative Suits

In January, the Delaware Supreme Court affirmed the Court of Chancery's dismissal of claims in *McElrath v. Kalanick et al.*, a shareholder derivative suit where plaintiff had not made a pre-suit demand on the board.[74] The case arises from Uber's ill-fated acquisition of an autonomous vehicle startup founded by a former Google executive, who was later accused of misappropriating Google's trade secrets. After Uber was forced to settle with Google for $245 million, an Uber stockholder initiated the derivative suit against Uber's former Chief Executive Officer and founder, Travis Kalanick, and the directors who had approved the acquisition. The plaintiff did not make a pre-suit demand on the board, claiming that demand was futile due to the directors' self-interest in avoiding personal liability on plaintiff's claims (or alternatively, due to their lack of independence from Kalanick).

The Delaware Supreme Court held that the directors, other than Kalanick, were not interested, as they were exculpated for breaches of the duty of care, and the facts alleged did not support any reasonable inference that they faced liability for breaches of the duty of loyalty – reiterating the high bar for finding a loyalty breach resulting from director bad faith. The court reaffirmed that bad faith requires scienter, and explained that the facts as alleged in this case indicated that, although the directors perhaps should have done more to learn of the transaction's flaws, they had not consciously disregarded them in bad faith.

The court also held that a majority of the directors were independent of Kalanick, rejecting plaintiff's general contention that Kalanick's ability to appoint or remove the directors precluded a finding of their independence. The court further rejected plaintiff's claim about a specific director who was appointed by Kalanick during a board contest, holding that without alleging a personal or financial connection to Kalanick, or the material importance of the board position to the director, plaintiff had not shown that the relationship was of a "bias-producing nature."[75]

Delaware Court of Chancery Examines *MFW* Framework for Controlling Shareholder Transactions

In a series of decisions this past year, the Delaware Court of Chancery further interpreted the framework first articulated in the Delaware Supreme Court's decision in *Kahn v. M&F Worldwide Corp.* ("*MFW*") in 2014, which held that the business judgment rule (as opposed to the stricter entire fairness standard) will apply if the controlling stockholder buyout is expressly conditioned *ab initio* on the approval of a special committee of the independent directors and approval of a majority of the disinterested stockholders.[76]

In *Salladay v. Lev*, the Court of Chancery found that indication from the target as to a satisfactory price range, after a confidentiality agreement was executed and due diligence had commenced (but before a

[73] *In re USG Corp. S'holder Litig.*, C.A. No. 2018-0602-SG, 2020 WL 5126671 (Del. Ch. Aug. 31, 2020).

[74] *McElrath v. Kalanick et al.*, 224 A.3d 982 (Del. Jan. 13, 2020).

[75] *Id.* at 996.

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

special committee had been formed), defeated the *ab initio* requirement, as it "set the stage for future economic negotiations."[77] Likewise, in *In re Homefed Corp. Stockholder Litigation*, pre-special committee discussions of an acceptable deal structure between the controller and a large stockholder led the court to conclude that the *MFW* protections, and therefore the business judgment rule, did not apply.[78] In both of these cases, the court found these discussions, which occurred before the *MFW* protections were agreed to, effectively prevented the special committee from doing its work. Finally, in *In re Dell Technologies Inc. Class V Stockholders Litigation*, the court rejected the application of the *MFW* protections because it found the complaint reasonably alleged that the special committee and minority faced coercion in deciding whether to approve the transaction.[79] The court specifically credited the allegation that the controller maintained the right to force an alternative transaction if the proposed transaction was rejected.

Delaware Court of Chancery Confirms Directors' Right to Access Privileged Communications Between Management and Company Counsel

In August, the Delaware Court of Chancery addressed the previously unresolved question of whether management may withhold as privileged its communications with company counsel from members of the board of directors. In the ongoing *In re WeWork Litigation*, the court clarified that directors are always entitled to communications between management and company counsel unless there is a formal board process to wall off such directors (such as the formation of a special committee) or other actions at the board level demonstrating "manifest adversity" between the company and those directors.[80] In other words, management cannot unilaterally decide to withhold its communications with company counsel from the board (or specified directors management deems to have a conflict).

In Rare Decision, Federal Court Dismisses Section 14 Claims Challenging Proxy Disclosures in Connection with Merger

In April, the District of Connecticut dismissed claims under Section 14 of the Securities Exchange Act in *Karp v. SI Financial Grp., Inc.*[81] The case arises from a preliminary proxy statement issued by the target in connection with a merger of two financial services companies. As has become common, shortly after the preliminary proxy was filed, a plaintiff stockholder filed a claim in federal court under Section 14, alleging that information material to the stockholders' decision whether to approve the merger had been omitted, rendering the proxy misleading. Although defendants in this type of case typically issue supplemental disclosures to "moot" plaintiffs' claims and settle by paying so-called "mootness fees" to the plaintiffs' lawyers, SI Financial refused to make any supplemental disclosures and instead chose to litigate.

The court granted the defendants' motion to dismiss, holding that omission of information from the proxy statement only violates Section 14 if it is among the disclosures required by SEC regulations, or if the omitted information renders specific other statements in the proxy materially false or misleading. As *Karp* shows, in the typical case, plaintiffs (who in most cases do not know what the omitted facts are) will not be able to plead a viable Section 14 claim. *Karp* should encourage more companies to consider litigating rather than settling these claims, but given the relative ease of issuing supplementary disclosures in order to moot the claims and avoid any perceived execution risk affecting the deal at issue, many may still choose to continue settling even in light of the high bar set by *Karp*.

77 *Salladay v. Lev,* C.A. No. 2019-0048-SG, 2020 WL 954032, at *11 (Del. Ch. Feb. 27, 2020).

78 *In re Homefed Corp. S'holder Litig.*, C.A. No. 2019-0592-AGB, 2020 WL 3960335 (Del. Ch. July 13, 2020).

79 *In re Dell Techs. Inc. Class V S'holders Litig.*, C.A. No. 2018-0816-JTL, 2020 WL 3096748 (Del. Ch. June 11, 2020).

80 *In re WeWork Litig.*, C.A. No. 2020-0258-AGB, 2020 WL 4917593 (Del. Ch. Aug. 21, 2020).

81 *Karp v. SI Fin. Grp., Inc.*, No. 3:19-cv-001099 (MPS), 2020 WL 1891629 (D. Conn. Apr. 16, 2020).

Delaware Court of Chancery Finds Valid Subsidiary Consent to Spin-Off Terms

In *Chemours Co. v. DowDupont, Inc.*, the Delaware Court of Chancery upheld the terms of a spin-off agreement requiring arbitration in the face of a challenge from the spun-off entity.[82] Chemours was formed as a performance chemicals company spin-off from DuPont to be a wholly owned subsidiary, and subsequently challenged the terms of its separation. DuPont sought to enforce an arbitration provision of the separation agreement, which Chemours resisted, claiming it had not validly consented to any portion of the separation agreement, including the arbitration clause, because pre-spin Chemours had no will of its own and was controlled by its parent company.

The court found that the approval of the spin-off and the separation agreement by a duly appointed board of directors, and the execution of the separation agreement by a duly appointed executive, sufficed to evidence Chemours' consent. The court rejected claims that the terms of the agreement were unconscionable, reaffirming the long-standing principles that a wholly owned subsidiary exists to benefit its parent and that contracts between a parent and subsidiary will be enforced. The Delaware Supreme Court subsequently affirmed.[83]

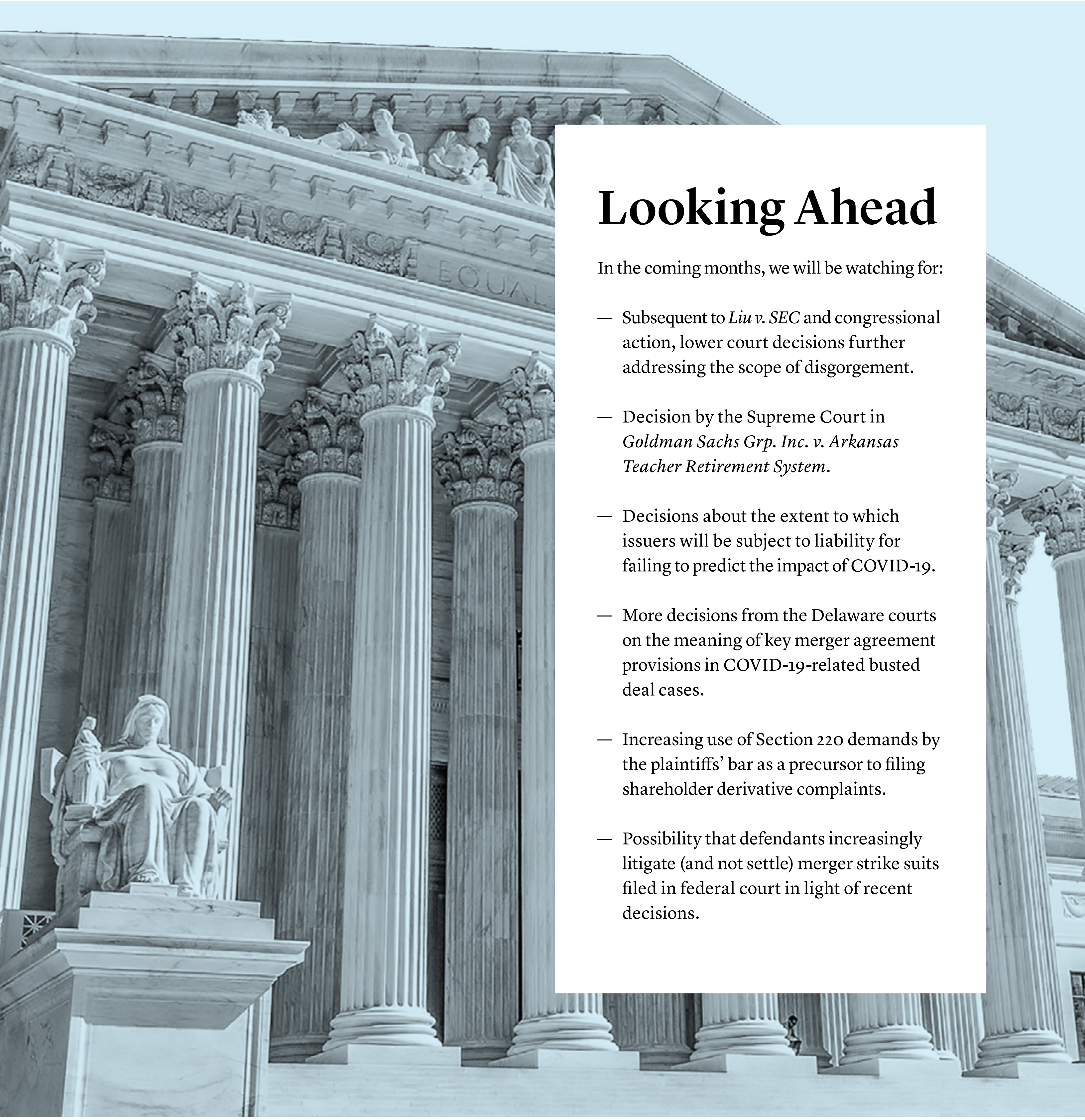
Delaware Supreme Court Upholds Bylaws Governing Proxy Contests

In *BlackRock Credit Allocation Income Trust v. Saba Capital Master Fund, Ltd.*, the Delaware Supreme Court held that it was permissible for an incumbent board to enforce a strict bylaw deadline to exclude a dissident slate in a proxy contest.[84] Saba, a dissident stockholder of two BlackRock closed-end funds, timely submitted its trustee nominations, but failed to respond or object to supplemental information requests regarding its nominees within a five-business-day deadline imposed by the trusts' bylaws, and the trusts therefore refused to consider Saba's nominees. Saba challenged this strict application of the bylaws, alleging that the supplemental requests were overbroad. The Supreme Court held that the bylaws' timing requirements were unambiguous, and rejected the Court of Chancery's finding below that the requests had been unreasonable. The Delaware Supreme Court cited concerns about uncertainty and rewarding after-the-fact excuses if it adopted a rule that a dissident is free to ignore bylaw-imposed deadlines in a proxy contest if it considers them to be unreasonable.

[82] *The Chemours Co. v. DowDupont Inc., et al.*, C.A. No. 2019-0351, 2020 WL 1527783 (Del. Ch. Mar. 30, 2020).

[83] *The Chemours Co. v. DowDupont Inc., et al.*, C.A. No. 147, 2020, 2020 WL 7378829 (Del. Dec. 15, 2020).

[84] *BlackRock Credit Allocation Income Tr. v. Saba Cap. Master Fund, Ltd.*, 224 A.3d 964 (Del. 2020).



Looking Ahead

In the coming months, we will be watching for:

- Subsequent to *Liu v. SEC* and congressional action, lower court decisions further addressing the scope of disgorgement.
- Decision by the Supreme Court in *Goldman Sachs Grp. Inc. v. Arkansas Teacher Retirement System*.
- Decisions about the extent to which issuers will be subject to liability for failing to predict the impact of COVID-19.
- More decisions from the Delaware courts on the meaning of key merger agreement provisions in COVID-19-related busted deal cases.
- Increasing use of Section 220 demands by the plaintiffs' bar as a precursor to filing shareholder derivative complaints.
- Possibility that defendants increasingly litigate (and not settle) merger strike suits filed in federal court in light of recent decisions.

Contacts

Joon H. Kim
Partner
New York
T: +1 212 225 2950
jkim@cgsh.com

Rishi N. Zutshi
Partner
New York
+1 212 225 2085
rzutshi@cgsh.com

Breon S. Peace
Partner
New York
T: +1 212 225 2059
bpeace@cgsh.com

Nowell D. Bamberger
Partner
Washington, D.C.
+1 202 974 1752
nbamberger@cgsh.com

Matthew C. Solomon
Partner
Washington, D.C.
+1 202 974 1680
msolomon@cgsh.com

Abena Mainoo
Partner
New York
+1 212 225 2785
amainoo@cgsh.com

Victor L. Hou
Partner
New York
+1 212 225 2609
vhou@cgsh.com

Rahul Mukhi
Partner
New York
+1 212 225 2912
rmukhi@cgsh.com

Roger A. Cooper
Partner
New York
+1 212 225 2283
racooper@cgsh.com

Lina Bensman
Partner
New York
+1 212 225 2069
lbensman@cgsh.com

Lisa Vicens
Partner
New York
+1 212 225 2524
evicens@cgsh.com

Mark E. McDonald
Partner
New York
+1 212 225 2333
memcdonald@cgsh.com

Jared Gerber
Partner
New York
+1 212 225 2507
jgerber@cgsh.com

Alexander Janghorbani
Senior Attorney
New York
+1 212 225 2149
ajanghorbani@cgsh.com


London


São Paulo


Milan


Rome


Washington, D.C.

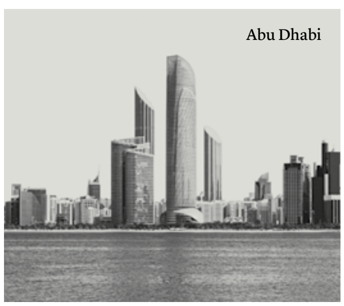

Hong Kong


Beijing

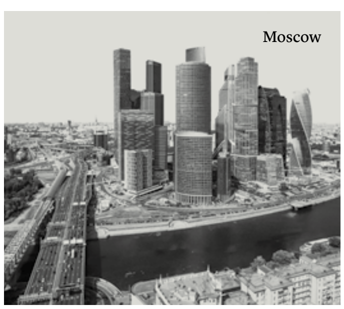
CLEARY GOTTLIEB


Brussels


Buenos Aires


Abu Dhabi

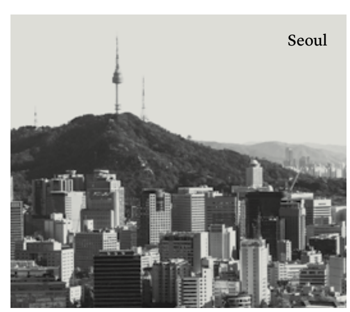

Cologne


Moscow


New York


Frankfurt


Paris


Seoul

clearygottlieb.com

Founded in 1946 by lawyers committed to legal excellence, internationalism, and diversity, Cleary Gottlieb Steen & Hamilton LLP is a leading international law firm with approximately 1,300 lawyers around the world. The firm has 16 closely integrated offices in New York, Washington, D.C., Paris, Brussels, London, Moscow, Frankfurt, Cologne, Rome, Milan, Hong Kong, Beijing, Buenos Aires, São Paulo, Abu Dhabi, and Seoul.

Throughout this brochure, "Cleary Gottlieb", "Cleary" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

21.0105.11_011521