GIBSON DUNN

January 21, 2015

2014 YEAR-END SECURITIES LITIGATION UPDATE

To Our Clients and Friends:

As with the past several years, 2014 once again proved to be a significant year of developments for securities litigation. As the "case to watch" in 2014, *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014) ("*Halliburton II*") lived up to the hype. In upholding the decades-old fraud-on-the-market doctrine, the Supreme Court simultaneously breathed new life into the strategy of using "price impact" evidence--or lack thereof--to defeat class certification. The next big thing in securities litigation is decidedly the *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund* case, in which the Court is expected to issue its opinion in the spring of 2015. In *Omnicare*, the Supreme Court will resolve a circuit split concerning the scope of liability for so-called "false opinions" under Section 11 of the Securities Act of 1933, as discussed further below.

These developments in the case law appear to have had little impact on the rate at which new cases are filed. The number of new cases filed in 2014 remained fairly steady compared to past years. But one thing changed dramatically in 2014: settlement values. The average settlement value in securities cases declined by approximately 40% in 2014, while the median settlement value declined by 25%. We discuss the possible reasons below.

The year also saw several developments in Delaware and derivative case trends. December brought a Delaware Supreme Court opinion that reaffirmed longstanding principles under Delaware law regarding a board's *Revlon* duties, and the preceding months brought a variety of notable decisions summarized below. And in a well-timed decision given growing concerns over cyber security and related shareholder litigation risk, a federal court dismissed a derivative action, and though now on appeal, the decision provides a helpful roadmap for boards contending with cybersecurity issues. These and other significant developments of 2014 are discussed in detail below.

For other developments, including those related to SEC Enforcement and trends in foreign corrupt practices investigations and litigation, we encourage you to read our 2014 Year-End Securities Enforcement Update, 2014 Year-End FCPA Update, and other updates.

I. Filing and Settlement Trends

In 2014, the rate of new securities case filings continued to reflect a "steady state" of over 200 cases a year, notwithstanding the virtual disappearance of credit crisis class actions filed in federal court in 2013 (from an all-time high of over 100 class actions in 2008). According to a new study by NERA Economic Consulting ("NERA"), a marked increase in cases against issuers in other industry sectors, particularly the technology and healthcare sectors, has filled that void. Somewhat counter-intuitively, however, the number of "merger objection" cases (including breach of fiduciary duty cases)--at least in federal court--has been on a multi-year decline, and significantly so in 2014. In part, this trend represents a flight to state courts; nevertheless, it is perhaps the most prominent area where the particular subject matter of new case filings has declined year-over-year.

Although the rate of new case filings remained constant in 2014, most notable is the enormous decline in settlement values in 2014, both average settlements and median settlements. Median settlement values plummeted from $9.1 million in 2013 to just $6.6 million in 2014. Over half of the 2014 settlements were less than $10 million, while only 14% of all settlements in 2014 exceeded $50 million. Average settlement values also dropped dramatically in 2014, from $55 million in 2013 to $33 million in 2014. Settlements under $10 million represented almost 60% of the totals, while only 20% were over $20 million. 2014 settlements also continued the trend that the larger the investor losses, the lower the settlement represents as a percentage of such losses. Indeed, over the last four years, settlements as a percentage of investor losses did not exceed 2%. But despite it all, plaintiffs' lawyers continue to rack up large fees--in 2014, the total haul was over $600 million, and the four year average was over $770 million.

A few new factors potentially could reverse the downward trend in these settlement statistics. First, the SEC's whistleblower program is building a head of steam, with "bounties" paid to individuals in 2014 of up to $30 million, and more to come. These awards are likely to stimulate more whistleblower activity, and along with it, more spill-over effects for private securities litigation. Second, the SEC's new emphasis on pursuing financial fraud cases represents a decided shift in focus for the Enforcement Division, and potentially will lead to more accounting/financial fraud cases being brought by private civil litigants.

Finally, the Supreme Court's recent decision in *Halliburton II* may have a dampening effect on securities class actions going forward. As discussed below, although *Halliburton II* upheld the "fraud on the market" theory, it also raised the bar on the proof required at the class certification stage to establish that allegedly misleading statements caused any "price impact." While the early returns on cases applying *Halliburton II* in 2014 are inconclusive, defense counsel continue to monitor whether the Court's newly-adopted "price impact" test will have a material effect on filing and settlement trends in the future.

A. Class Action Case Filing Trends

Overall filing rates are reflected in Figure 1 below (all charts courtesy of NERA). A total of 221 cases were filed in 2014. This figure does not include the many class suits filed in state courts or the increasing number of state court derivative suits. These state court cases represent a "force multiplier" of sorts in the dynamics of securities litigation in the United States today.

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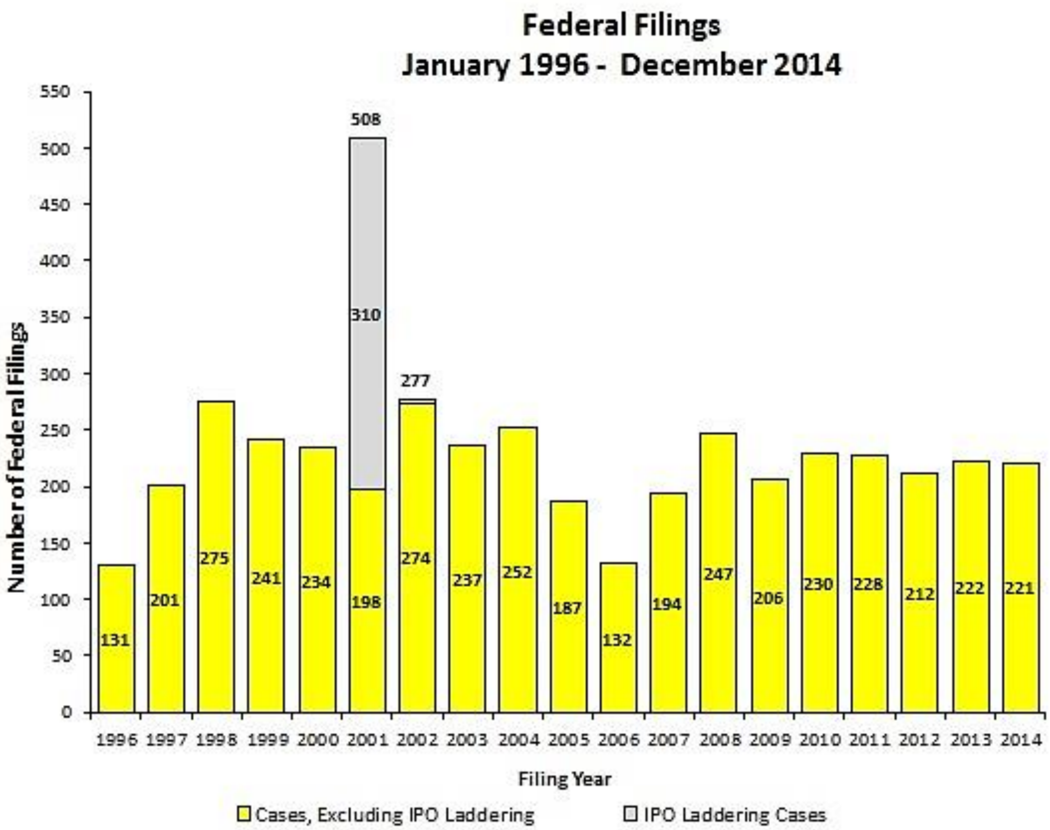
Figure 1:



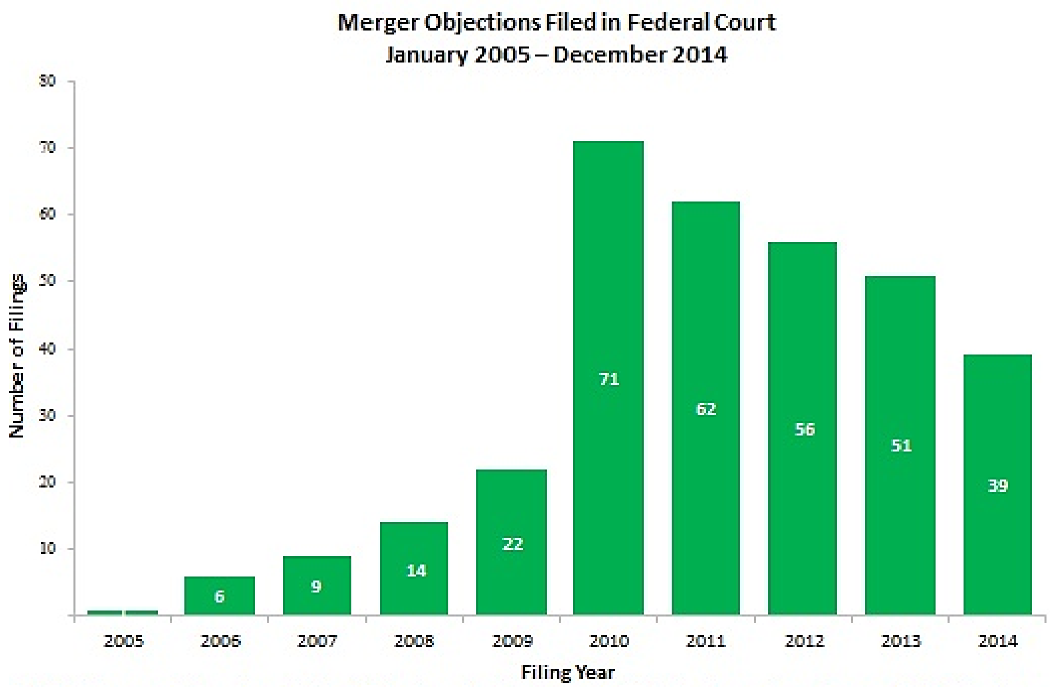
B. Mix of Cases Filed in 2014

Credit Crisis Cases. Almost no new federal court class actions were filed against financial institutions in the first few months of 2014, reflecting the dramatic decline of "credit crisis" class actions since 2008. While a number of major credit crisis cases are still pending, the trend is expected to continue: like stock option "backdating" cases, credit crisis class actions will soon be consigned to history. That said, while credit crisis *class actions* are on the wane, a new generation of cases have replaced them: single-plaintiff suits by government agencies (such as the Federal Housing Finance Agency on behalf of Fannie Mae and Freddie Mac), monoline insurers (such as MBIA), and institutional and pension fund investors. A few have already resulted in settlements in excess of $100 million.

Merger Cases. As shown in Figure 2, "merger objection" cases represented a declining portion of new federal court securities class action filings over the last several years, with a notable drop last year. NERA reports only 39 merger-related cases filed in federal courts in 2014, down from a high of 71 filed in 2010. As discussed below in our discussion of "Another Eventful Year in Delaware Courts," corporate exposure to M&A litigation continues to persist.

Return of "Traditional" Securities Class Actions. With the capital markets enjoying what appears to be a longer-term recovery, the capital markets improved markedly in 2014, which brought a number of major IPO's along with it. As has been true for decades, along with more robust capital markets activity comes more shareholder class actions of the more traditional sort: cases challenging earnings, accounting, internal controls, and failed forecasts. As discussed below, these cases tend to be brought against issuers in hot markets such as technology and healthcare.

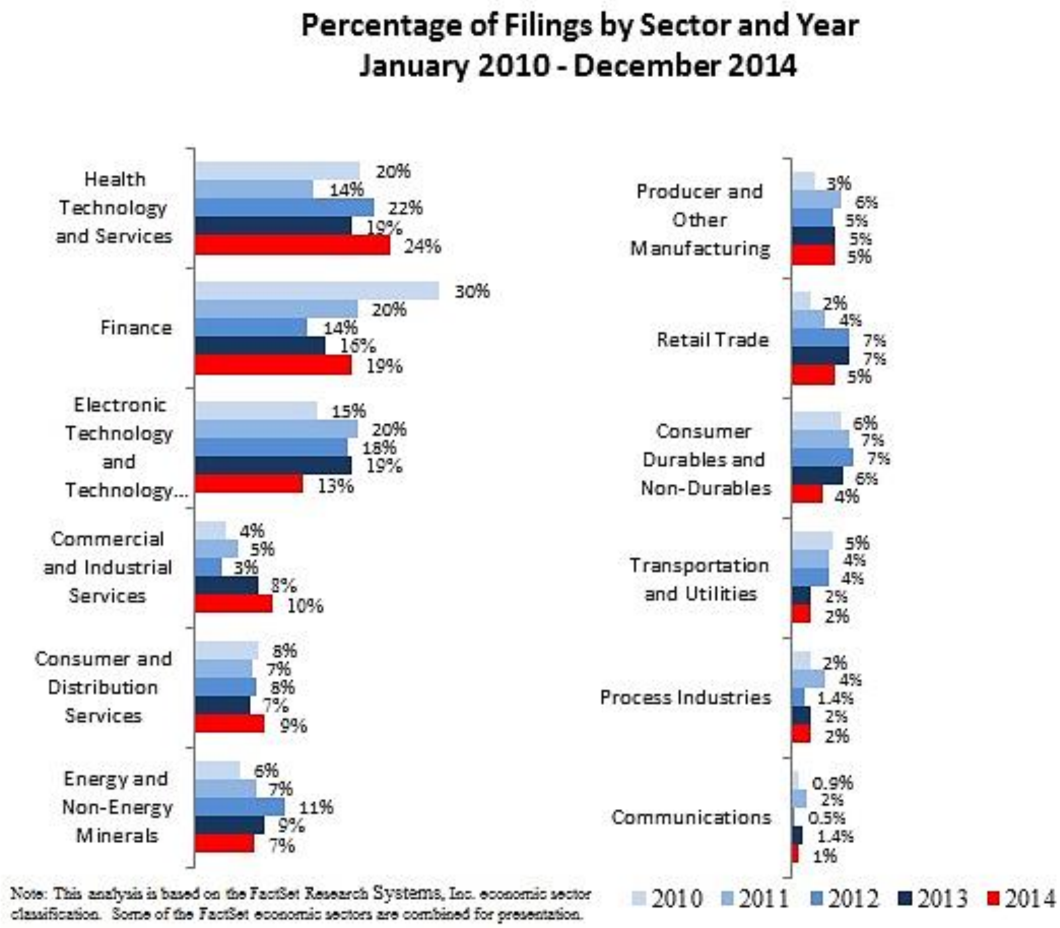
Figure 2:



Note: Includes cases alleging either a violation of federal securities laws or a breach of fiduciary duty, as long as they were filed in federal court.

Filings by Industry Sector. The trends in new case filings against particular industry sectors reflect the decline in "credit crisis" cases, as new suits against financial institutions have dropped from record-shattering levels in 2009 to second place in 2014 (19% of all new case filings), behind the healthcare sector (24% of new case filings). The technology sector ranked third (13%). The biggest year-over-year percentage increase in new case filings was in the healthcare sector, where new filings grew from 19% in 2013 to 24% in 2014. By contrast, eight out of twelve sectors remained flat or down from the prior year. *See* Figure 3 below.

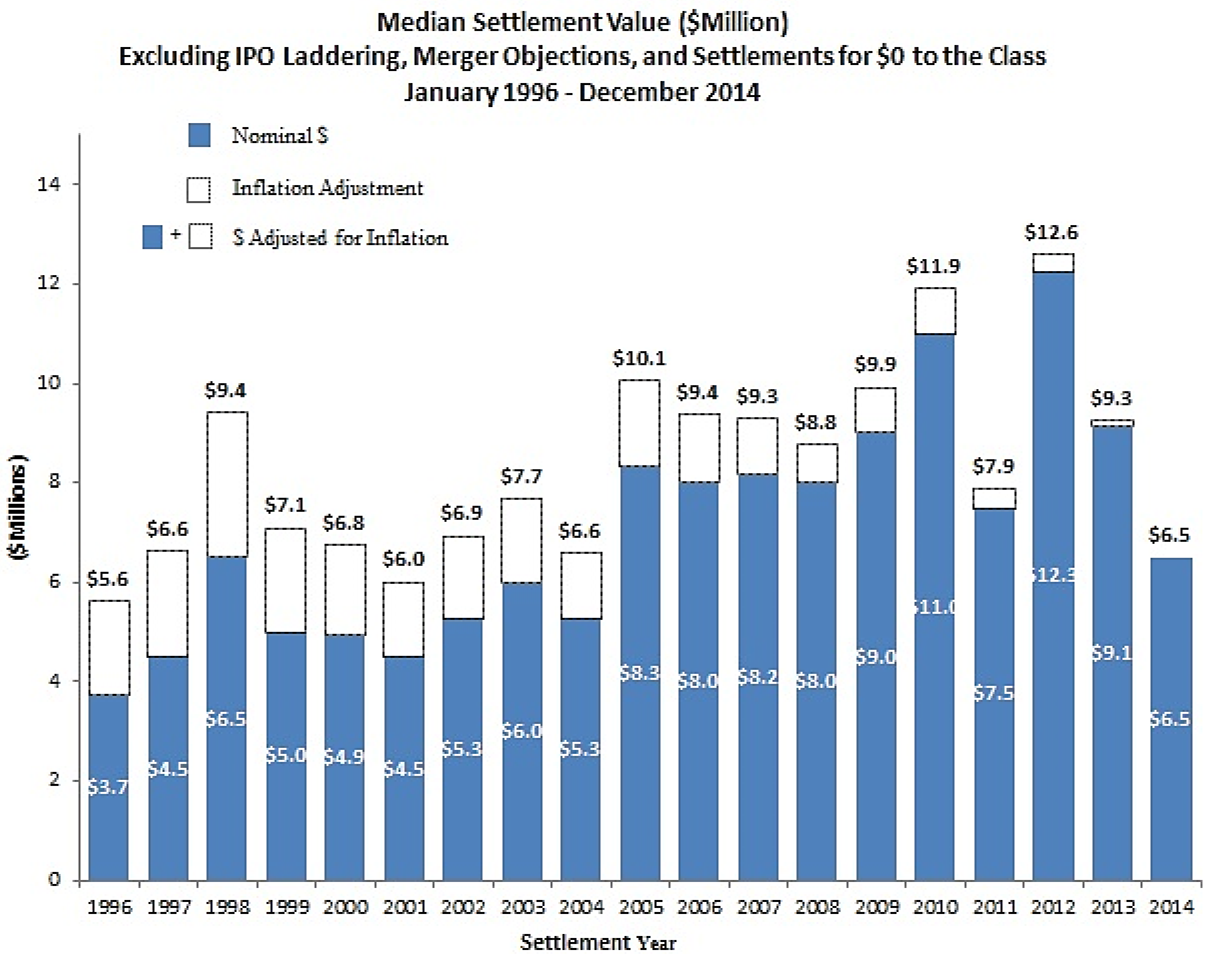
***Figure 3*:**



C. Class Action Settlements

As Figure 4 shows, median settlement values--generally a better barometer of settlement trends than average settlement values, which can be significantly impacted by outlier settlements--was *hugely* down in 2014, from $9.1 million in 2013 to $6.6 million in 2014--the lowest level in a decade.

***Figure 4*:**



One can speculate about what may account for the pronounced declines in both median and average settlement values over the last two years. In any given year, of course, the statistics can mask a number of important factors that contribute to settlement value, such as (i) the amount of D&O insurance; (ii) the presence of parallel proceedings, including government investigations and enforcement actions; (iii) the nature of the events that triggered the suit, such as the announcement of a major restatement; (iv) the range of provable damages in the case; and (v) whether the suit is brought under Section 10(b) of the Exchange Act or Section 11 of the Securities Act. The period 2009–2012 also included the settlement of several of the major credit crisis cases totaling several billion dollars. Whatever the variables, median and average settlement values over the last two years should not be viewed as a barometer of either a long-term increase or decline in settlement values.

II. *Omnicare*: U.S. Supreme Court Hears Oral Argument on Whether a Section 11 "False Opinion" Claim Requires Proof That the Opinion Was Not Genuinely Held

On November 3, 2014, the Supreme Court heard oral argument in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, No. 13-435, a case expected to resolve an important circuit split concerning the scope of liability for so-called "false opinions" under Section 11 of the Securities Act of 1933. Section 11 provides a private right of action for investors to recover damages based on "an untrue statement of a material fact" in, or omission of a material fact from a securities registration statement. As explained in our 2014 Mid-Year Securities Litigation Update, the question in *Omnicare* is whether plaintiffs alleging an untrue statement of opinion--in contrast to a statement of "hard fact"--must plead and prove not just objective falsity, but also subjective falsity, *i.e.*, that the person offering the opinion believed it to be false.

At issue in *Omnicare* is a registration statement in which the company stated a belief that it was in compliance with applicable laws. The plaintiffs allege that belief was "untrue" under Section 11 largely because of pending lawsuits asserting that the issuer violated federal law through its contracts with business partners. The *Omnicare* plaintiffs' complaint does not allege that the defendants did not honestly believe that the company was complying with applicable laws when the registration statement was filed. Instead, they contend that Section 11 does not require proof of subjective falsity for statements of opinion. The Sixth Circuit agreed, parting ways with the Second, Third, and Ninth Circuits.

A dozen groups--including industry organizations, public interest groups, institutional investors, and legal scholars--filed amicus briefs. Omnicare supporters argued that the Sixth Circuit's approach improperly expands liability under Section 11, imposes an unclear duty to investigate with respect to any opinion offered in a registration statement, and creates hindsight-based liability for inherently subjective opinions. Supporters of the Sixth Circuit's position contended that an objective falsity standard is the best way to promote transparency, protect investors, and maintain the integrity of securities markets. Still other amici promoted more nuanced positions, rejecting both the pure objective falsity standard and the position that mere subjective belief in the truth of a statement, without reasonable foundation, is sufficient to avoid liability.

The Securities and Exchange Commission and Department of Justice together submitted an amicus brief arguing for the middle ground, namely that a statement of opinion included in a registration statement should be actionable if "the maker of the statement did not actually hold the opinion stated or [if] the statement lacked a basis that was reasonable under the circumstances in which the statement was made." Brief for United States as *Amicus Curiae* at 10, *Omnicare*, No. 13-435, 2014 WL 2703331, at *10 (U.S. June 12, 2014). According to the government, investors expect that an issuer has undertaken "significant investigation" of an opinion in a registration statement to ensure it "has a solid foundation." *Id.* at *12. The government argued, however, that the Sixth Circuit went a step too far and erred "in suggesting that a statement of opinion is actionable whenever it is ultimately proved incorrect." *Id.* at *6. The Office of the Solicitor General participated in oral argument to support this position.

At oral argument, several justices appeared to support the government's "middle-ground" position that a statement of opinion should be actionable if the speaker did not affirmatively believe the statement to be true or lacked a reasonable basis for that belief, even if it was sincerely held. Some justices appeared to suggest that a registration statement carries with it an implied warranty that any included statements have a reasonable basis. But, the justices also expressed concern with the implication of the Sixth Circuit's holding that, even if an opinion had a reasonable basis, it could still be actionable if it ultimately turned out to be objectively false. Observers of the oral argument are split on how the Court is likely to rule. Some contend that the justices' questions demonstrated skepticism of Omnicare's position, and predict that the Court will affirm the Sixth Circuit and/or adopt some version of the government's position. *See e.g.*, Richard Booth, *Argument Analysis: Justices Seem Likely to Affirm* Omnicare, SCOTUSblog (Nov. 4, 2014, 12:35 PM), http://www.scotusblog.com/2014/11/argument-analysis-justices-seem-likely-to-affirm-omnicare/ (predicting "a nine-to-zero decision essentially affirming the decision of the Sixth Circuit but with plenty of guidance--or at least verbiage--as to what constitutes reasonable basis"). Others assert that the questioning foreshadows reversal of the Sixth Circuit decision. *See e.g.*, Lawrence Hurley, *To Tell the Truth: U.S. Top Court Mulls* Omnicare *Securities Case*, Reuters (Nov. 3, 2014 3:13 PM), http://www.reuters.com/article/2014/11/03/usa-court-omnicare-idUSL1N0ST0SC20141103 ("Judging from questions posed during an hour of oral arguments, the most likely outcome is that the nine justices will throw out the appeals court decision.").

As discussed in our 2014 Mid-Year Securities Litigation Update, the Court's opinion will likely have wide-ranging consequences. A Supreme Court decision affirming the Sixth Circuit might expand liability--or at least not lessen the exposure--for statements of opinion and subjective judgment and could leave issuers with little guidance as to what constitutes an acceptable basis for a statement of opinion. On the other hand, a decision adopting the view held by the majority of circuits would provide some assurance that officers, directors, underwriters, accountants, and others cannot be subject to liability for opinions and professional judgments that were offered in good faith, but later prove to be inaccurate. In addition, although the *Omnicare* case concerns only a Section 11 claim, given the similar language in Section 11 to other federal securities law provisions, the Court's decision also could impact other securities law claims, such as claims under Section 10 of the Securities Exchange Act and Rule 10b-5, to which circuit courts also have applied the subjective falsity standard. *See, e.g.*, *City of Omaha, Neb. Civilian Emps.' Ret. Sys. v. CBS Corp.*, 679 F.3d 64, 67-68 (2d Cir. 2012).

A decision in *Omnicare* is expected by June 2015.

III. Class Actions Post-*Halliburton II*: Probing Market Efficiency and "Price Impact"

As discussed in our June 2014 Client Alert, the Supreme Court issued its ruling in *Halliburton II*, 134 S. Ct. 2398, this summer. The ramifications of *Halliburton II*--where the Court upheld the presumption of reliance but made clear it is rebuttable at the class certification stage--will not be fully known for years, as district courts are only beginning to grapple with the decision. A bellwether decision anticipated to be issued shortly is in the *Halliburton II* case itself. On remand to the U.S. District Court for the Northern District of Texas, the district court held a one-day hearing in early December to consider the issue of price impact as it relates to the fraud on the market presumption. *See* Minute Entry, *Eric P. John Fund, Inc. v. Halliburton Co.*, No. 02-cv-1152-M, (N.D. Tex. Dec. 1, 2014). This appears to have been just the sort of mini-trial that many predicted would occur in the wake of *Halliburton II*, with a "battle of the experts" on the issue of price impact, and the judge noted as much: "[I]f I buy what either one of the experts are saying to the exclusion of the other, then whoever is offering that expert has met the burden of persuasion. . . . This is a pretty stark choice that I have here."

While we will have to wait for the ruling on remand in *Halliburton II*, the second half of 2014 provided a few decisions addressing evidence of price impact in a post-*Halliburton II* world. Based on the small set of reported cases, courts naturally are focused on the "price impact" standard articulated by the Court. For example, in a case decided less than two months after *Halliburton II*, the Eleventh Circuit vacated and remanded in part a district court's decision granting class certification so the court could consider the defendants' evidence of price impact in light of *Halliburton II*. *Local 703, I.B. of T. Grocery & Food Emps. Welfare Fund v. Regions Fin. Corp.*, 762 F.3d 1248 (11th Cir. 2014). In stating that the district court's task on remand would "be limited in scope," the Eleventh Circuit noted that *Halliburton II* "only said that defendants '*may* seek to defeat the *Basic* presumption' with evidence that the misrepresentations did not impact the price. *Halliburton II* by no means holds that in every case in which such evidence is presented, the presumption will always be defeated." *Id*. at 1259 (emphasis in original) (citation omitted).

On remand in the *Regions* case, the district court heeded that message, finding that little had changed since its last ruling on the issue of reliance and class certification. *See Local 703, I.B. of T. Grocery & Food Emps. Welfare Fund v. Regions Fin. Corp.*, No. 10-cv-2847-IPJ, 2014 WL 6661918 (N.D. Ala. Nov. 19, 2014). The district court held that its previous ruling had already considered defendants' rebuttal evidence showing a lack of price impact, and that renewed consideration did not change its analysis. *Id.* at *4. The court declined to engage in any *Daubert*-style examination of the experts at this stage of the proceeding and further stated that "nothing in *Halliburton II* requires the plaintiffs to produce an event study in opposition to defendants' event study on a class certification motion." *Id.* at *4 n.3, *8. The court also appeared disinclined to take issues away from the jury, finding that the cause of the stock decline was "so tied to the merits of this case that it is reserved for the trier of fact" and otherwise rejecting defendants' interpretation of *Halliburton II* as an attempt to "turn the class certification stage of securities litigation into a trial on the merits." *Id.* at *8-10. Defendants again sought to appeal the class certification decision, but the Eleventh Circuit denied the Rule 23(f) petition. Order, *Regions Fin. Corp. v. Local 703, I.B. of T. Grocery & Food Emps. Welfare Fund*, No. 14-90022 (11th Cir. Jan. 14, 2015).

Halliburton II similarly provided no relief to defendants in a class certification dispute in the U.S. District Court for the District of Minnesota. In *IBEW Local 98 Pension Fund v. Best Buy Co.*, the court took into account the Supreme Court ruling (filed as supplemental authority by the parties), but found the defendants failed to submit evidence sufficient to rebut the presumption of reliance. No. 11-cv-429-DWF, 2014 WL 4746195, at *6 (D. Minn. Aug. 6, 2014). Despite this loss in the district court, defendants persuaded the Eighth Circuit to accept an interlocutory appeal from the district court's class certification ruling. *See IBEW Local 98 Pension Fund v. Best Buy Co.*, Nos. 14-8020, 14-3178 (8th Cir. Sept. 24, 2014). Defendants, supported on appeal by amicus briefs from interested business organizations and groups, including the U.S. Chamber of Commerce, argue that the lower court misapplied *Halliburton II*. Specifically, defendants argue that in finding that alleged misrepresentations *could* have affected the stock price, in part on a theory of price maintenance--despite defendants' unrebutted evidence of lack of price impact--the district court may have disregarded a significant requirement of *Halliburton II* by failing to place the ultimate burden of persuasion on the issue of reliance on the plaintiffs.

Another case worth watching is *In re Vivendi Universal, S.A. Securities Litigation*, where the Southern District of New York rejected the defendant's request to move for judgment as a matter of law based on an intervening change in the law resulting from *Halliburton II*. No. 02-cv-5571-SAS, 2014 WL 4080950, at *1-2 (S.D.N.Y. Aug. 18, 2014). The court noted that while *Halliburton II* permits consideration of price impact at the class certification stage, it "made no mention of how a plaintiff can prove price impact," which was the key issue in *Vivendi*. *Id.* at *2. The court stated that the company would have to challenge plaintiffs' theory of price impact on appeal. *Id.* In December, the court entered a judgment of nearly $50 million against the company, which has indicated it will appeal to the Second Circuit. Judgment, *In re Vivendi*, No. 02-cv-5571-SAS (S.D.N.Y. Dec. 22, 2014).

A fourth case, from the U.S. District Court for the Southern District of Florida, also granted plaintiffs' class certification motion despite defendants' rebuttal evidence on price impact. *See Aranaz v. Catalyst Pharm. Partners Inc.*, 302 F.R.D. 657 (S.D. Fla. 2014). Finding that plaintiffs were entitled to the presumption of reliance, the court then referred to the defendants' "daunting task of proving that the publicly known statement had no price impact," and citing Justice Ginsburg's concurrence in *Halliburton II* that the decision "should impose no heavy toll on securities-fraud plaintiffs with tenable claims." *Id.* at 673. The court first considered defendants' truth-on-the-market argument, but held that such a defense cannot be used to prove an absence of price impact at the class certification stage because it actually goes to materiality. *Id.* at 671. The court then rejected defendants' alternative evidence as insufficient to show no negative impact on price from the alleged misrepresentation. *Id.* at 672-73. Subsequent to this decision, the parties entered mediation and reached a court-approved settlement agreement. *See* Order, *Aranaz*, No. 13-cv-23878-UU (S.D. Fla. Dec. 3, 2014).

While these cases are not necessarily a sign of things to come, it remains to be seen whether other courts will be as resistant as the *Regions* court was to delving into *Daubert* challenges and issues touching upon the merits at the class certification stage. Most importantly, however, the *Halliburton II* district court's impending ruling on class certification is likely to be a bellwether decision on the "price impact" test, and is likely to influence how other courts approach this critical class certification issue. Ultimately, court rulings on the price impact issue will have to work their way through the appellate courts before any definitive conclusions about the import of *Halliburton II* can be reached.

IV. *Comcast*'s Continued Relevance in Class Certification Challenges

In a similar vein, the aftermath of the Supreme Court's decision in *Comcast Corp. v. Behrend*, 133 S. Ct. 1426 (2013), continues to play out in securities class actions as lower courts apply the heightened predominance requirement of Rule 23(b)(3) articulated by the Court. As we noted in our 2014 Mid-Year Securities Litigation Update, this increased scrutiny at the class certification stage, particularly as to allegations of class-wide damages, has resulted in a more fact-intensive inquiry. Both plaintiffs and defendants are increasingly using experts to explain or undermine a proposed damages model, leading courts to resolve the "battle of the experts" earlier in the litigation. Additionally, courts seem more willing to bifurcate securities class actions, certifying as to liability but leaving the damages determination to individual class members. Overall, *Comcast* continues to assist defendants challenging class certification in securities cases, though it is far from settled that a plaintiff's failure to demonstrate a class-wide damages model will operate as an absolute bar to certification.

Three recent decisions illustrate these developments. First, in *Fort Worth Employees' Retirement Fund v. J.P. Morgan Chase & Co.*, 301 F.R.D. 116 (S.D.N.Y. 2014), the court denied class certification in a Section 11 class action, noting that *Comcast* placed "emphasis on the importance of damages calculations to the analysis of predominance at the class certification stage." *Id.* at 140. While the court found that the plaintiffs' damages model appeared to be "sufficiently linked with the theory of liability," it concluded that the plaintiffs could not show "that damages can be calculated on a classwide basis." *Id.* at 141. The plaintiffs' expert proposed three methods to calculate damages and stated that in his opinion, "class-wide damages can be calculated in a formulaic manner." *Id.* (internal quotation mark omitted). Nevertheless, the court emphasized that "a more precise specification of the damages calculation method is necessary to assure that the model is in fact linked with the theory of liability." *Id.* Although the expert was "confident" in his ability to apply a class-wide damages model, the court refused to rely on his "say-so" because he had not in fact created such a model. *Id.* at 141-42 (internal quotation marks omitted). The court went on to certify the class for liability purposes only. *Id.* at 142. A status conference in the case was scheduled for January 16, 2015. Order, *Fort Worth Emps.' Ret. Fund*, No. 09-cv-3701-JPO (S.D.N.Y. Jan. 7, 2015).

IBEW Local 98 Pension Fund v. Best Buy Co.--the same case discussed above as to the *Halliburton II* "price impact" issue currently on appeal to the Eighth Circuit--also addresses class-wide proof of damages. In *Best Buy*, the district court ultimately held that damages were capable of measurement on a class-wide basis, but only after a fairly extensive analysis of the evidence presented by the plaintiffs' expert. No. 11-cv-429-DWF, 2014 WL 4746195, at *7-8. The plaintiffs alleged that the defendant's false and misleading statements artificially inflated its stock price until the defendant revealed its true financial condition at a later date, resulting in a 14% decline in the stock price. *Id.* at *2. The court noted that the expert performed an event study using methodology for the quantification of damages to show that damages were capable of calculation on a class-wide basis. *Id.* at *7. The expert focused on the two disclosure dates to ascertain "whether new, material information was quickly incorporated into [the defendant's] stock price," and concluded that the first disclosure positively impacted the stock price, while the second negatively impacted the stock price. *Id.* The *Best Buy* court recognized the "potential gap in damages" from the time of the opening of the market until the time of the first disclosure, but concluded that this gap would not "make the calculation of damages difficult or improper." *Id.* Although there would likely be "issues regarding the timing of a particular investor's purchase in relation to the fraudulent statements," the court found that these individual issues would not predominate over common ones and certified the class. *Id.* at *7-8.

In a final decision, *Cromeans v. Morgan Keegan & Co.*, the court certified the class for claims of violation of the Missouri Blue Sky law and negligent underwriting in the defendant's sale of bonds, even though the plaintiffs did not present any measure of damages. No. 12-cv-4269-NKL, 2014 WL 4722217, at *13-14, *16 (W.D. Mo. Sept. 23, 2014). The court observed that other courts have not read *Comcast* broadly enough to decertify classes based solely on individual differences in class members' damages, "instead holding that [*Comcast*] simply requires a plaintiff to show a linkage between its theory of liability and theory of damages." *Id.* at *13. Applying this requirement to the facts at hand, the court found a "straightforward" linkage because the "Plaintiffs claim that they paid valuable consideration for the bonds and the bonds are now worthless." *Id.* at *14. The court reasoned that the variation in the amounts gained by resale of the bonds by each plaintiff "does not defeat the common issue of liability," and the damages calculation is based on the "mechanical" application of "a single model [] to all members of the class." *Id.*

Defendants challenging certification in securities class actions are likely to continue relying on *Comcast*, and as with price impact challenges, expert testimony regarding the method of proving damages will continue to play an important role. But cases litigating *Halliburton II*'s "price impact" test are likely to overshadow *Comcast* in the near term.

V. Limits on Named Plaintiff's Standing to Sue

In our 2013 Mid-Year Securities Litigation Update, we reported that the Supreme Court denied a petition for certiorari in *Goldman, Sachs & Co. v. NECA-IBEW Health & Welfare Fund*, 133 S. Ct. 1624 (2013), following a well-publicized decision from the Second Circuit, holding that a named plaintiff may assert claims on behalf of a putative class that the named plaintiff would not have standing to raise itself. *See NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, 693 F.3d 145, 164 (2d Cir. 2012). However, even the Second Circuit's expansive holding was not entirely without limit. The court permitted the named plaintiff to assert class claims related to mortgage-backed certificates that were all backed by mortgages from a defined set of common lenders that had originated mortgages backing the plaintiff's certificates, because those claims "raise[d] a sufficiently similar set of concerns to permit [the plaintiff] to purport to represent Certificate-holders from those Offerings." *Id.* But, to the extent the named plaintiff sought to assert claims on behalf of purchasers of Certificates from other, non-common lenders, the Second Circuit held that the plaintiff lacked standing to assert those claims, because they involved "alleged injuries [with] the potential to be very different [from the plaintiff's alleged injuries]--and could turn on very different proof." *Id.* at 163-64. Essentially, the Second Circuit's holding limited the plaintiff's standing to assert claims on behalf of other putative class members if the defendants' conduct as to the plaintiff and others implicates "the same set of concerns." *Id.* at 162.

On remand, the plaintiff filed a Fourth Amended Complaint that included claims pertaining to seven offerings as to which the Second Circuit had expressly denied standing to the plaintiff. *See* No. 08-cv-10783-MGC (S.D.N.Y. Nov. 5, 2012). In June 2014, defendants moved to dismiss these claims on the grounds that, among other things, they "violate[d] the Second Circuit's mandate by asserting claims that that court held that NECA lacked standing to bring." No. 08-cv-10783-MGC (S.D.N.Y. June 10, 2014). The plaintiff argued that the claims should not be dismissed because the new Second Circuit standard nonetheless required the district court to examine whether the new claims involved common loan originators. In July 2014, the district court granted the defendants' motion to dismiss those claims. *See* Memo Endorsement, No. 08-cv-10783-MGC (S.D.N.Y. July 10, 2014).

The plaintiff moved for interlocutory appeal, seeking immediate Second Circuit review of the district court's dismissal of the seven claims, arguing that the offerings involved in those claims did, in fact, involve a common loan originator because the offerings at issue were backed by mortgages originated by Goldman, which also originated mortgage loans the plaintiff bought. Motion to Amend, No. 08-cv-10783-MGC (S.D.N.Y. July 28, 2014). Last week, the district court denied the plaintiff's motion, holding that the Second Circuit explicitly dismissed and "gave no instruction regarding an opportunity to restore" the dismissed claims, and that "[e]ven if [the Second Circuit] had not mandated dismissal . . . the decision to allow repleading would be left to [the district court's] discretion." Opinion at 6, No. 08-cv-10783-MGC (S.D.N.Y. Jan. 6, 2015).

VI. *American Pipe* Tolling Split Remains Unresolved

In our 2014 Mid-Year Securities Litigation Update, we reported that the Supreme Court had granted certiorari in *Public Employees' Retirement System of Mississippi v. IndyMac MBS, Inc.*, 134 S. Ct. 1515 (2014), to resolve whether the class action tolling doctrine of *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974), applies to the three-year statute of repose for claims under the Securities Act of 1933. However, in late September, days before the case was scheduled to be argued, the Court dismissed the writ of certiorari as improvidently granted, following the plaintiffs' partial settlement with many of the defendants. 135 S. Ct. 42 (2014). Dismissal of the writ left the circuit split unsolved and let stand the Second Circuit's holding that the filing of a class action does not toll the 1933 Act's statute of repose, rendering the proposed individual claims untimely.

Notably, the Second Circuit's decision contrasted with the Tenth Circuit's prior holding in *Joseph v. Wiles*, which concluded that *American Pipe* is not actually a "tolling" doctrine or even an equitable rule at all, but rather a legal rule that treats the filing of a class action as a pre-filing of all covered individual claims within the limitations and repose periods, preserving those claims as timely. 223 F.3d 1155, 1166-68 (10th Cir. 2000). The contrasting Second and Tenth Circuit approaches were recently examined by the U.S. District Court for the Southern District of Texas, which ultimately followed the Tenth Circuit's holding in *Joseph* that a previously-filed class action preserved subsequent individual claims notwithstanding the statute of repose. *In re BP P.L.C. Secs. Litig.*, No. 13-cv-1393, 2014 WL 4923749, at *5 (S.D. Tex. Sept. 30, 2014).

This past June, the Supreme Court emphasized that statutes of repose "effect a legislative judgment that a defendant should 'be free from liability after the legislatively determined period of time'" and are "in essence an 'absolute bar' on a defendant's temporal liability." *CTS Corp. v. Waldburger*, 134 S. Ct. 2175, 2183 (2014) (alteration omitted). The *Waldburger* Court emphasized--as the Court previously had done--that "[s]tatutes of repose . . . generally may not be tolled." *Id.* at 2183 (citing *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 363 (1991)). Although *Waldburger* concerned preemption of a state statute of repose and did not conclusively resolve the circuit split that the Court appeared poised to address in *IndyMac*, *Waldburger* may suggest that when the Supreme

Court ultimately resolves the circuit split, it will find that the *American Pipe* doctrine does not apply to statutes of repose.

VII. Restricting Extraterritorial Suits: Courts Continue to Define Which Transactions Qualify as "Domestic" Under *Morrison*

In 2014, courts continued to explore which transactions with extraterritorial elements qualify as domestic following *Morrison v. National Australia Bank Ltd.*, which held that Section 10(b) of the Securities Exchange Act applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities." 561 U.S. 247, 267 (2010). Following the Second Circuit's decision in *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 68 (2d Cir. 2012)--holding that a plaintiff could establish a "domestic" transaction if irrevocable liability in relation to a security was incurred, or title to the security was transferred, within the United States--a number of district courts have continued to apply Section 10(b) based on the location of the transaction at issue. *See, e.g.*, *Alpha Capital Anstalt v. New Gen. Biofuels, Inc*., No. 13-cv-5586-VEC, 2014 WL 6466994, at *13 (S.D.N.Y. Nov. 18, 2014) (denying defendants' motion to dismiss where relevant security agreements were executed in the United States); *SEC v. Funinaga*, No. 13-cv-1658 JCM-CWH, 2014 WL 4977334, at *8 (D. Nev. Oct. 3, 2014) (denying defendants' motion to dismiss where defendants transferred title to relevant securities in the United States by "transmitt[ing] application forms, money, and investment certificates to and from Las Vegas offices and bank accounts"); *Takiguchi v. MRI Int'l, Inc.*, No. 13-cv-01183-JAD-VCF, 2014 WL 4663851, at *2 (D. Nev. Sept. 18, 2014) (denying defendants' motion to dismiss where plaintiffs were required to mail applications to purchase securities to defendants' Las Vegas headquarters and wire investment funds to defendants' bank in Las Vegas).

A. Redefining *Morrison*: Second Circuit Adds to the "Domestic Transaction" Test

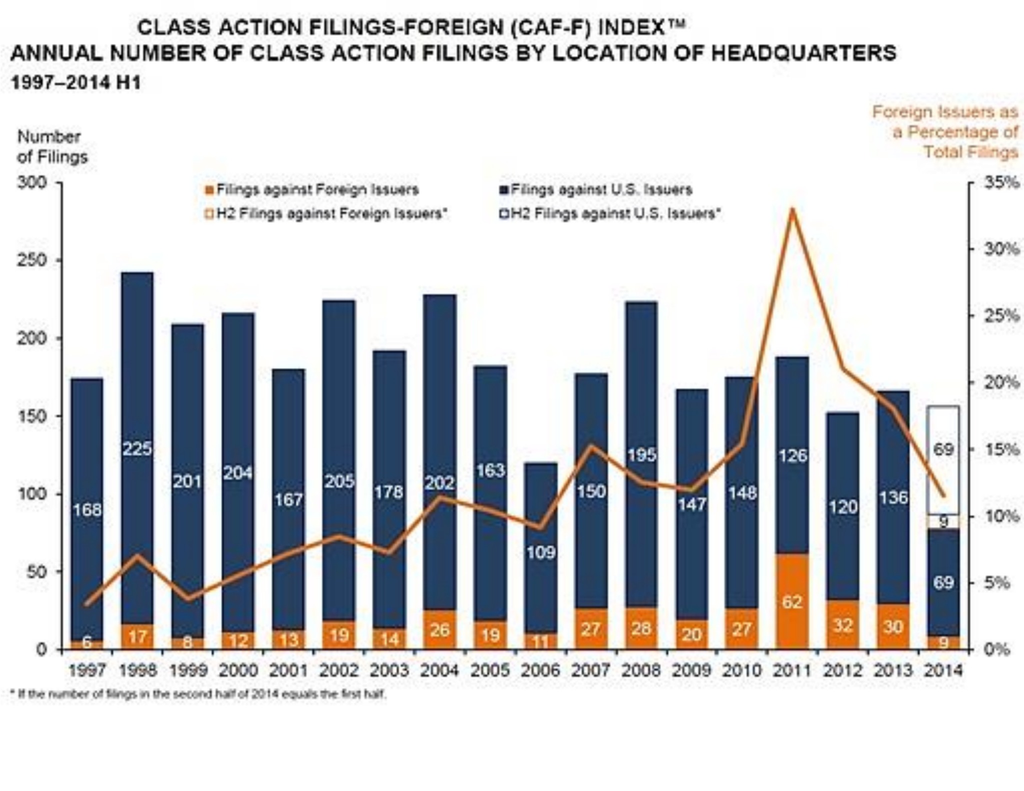
In what might signal a reversal of the trend, the Second Circuit recently held in *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*, that "a domestic transaction is *necessary but not necessarily sufficient* to make § 10(b) applicable" to claims with extraterritorial elements. 763 F.3d 198, 216 (2d Cir. 2014) (emphasis added). In *Parkcentral*, plaintiff hedge funds entered into private securities-based swap agreements in the United States, under which the amount of gain or loss depended on the value of Volkswagen stock, which was only traded on foreign exchanges. *Id*. at 201. Although defendant Porsche was not involved in plaintiffs' swap agreements, plaintiffs alleged that they sustained losses as a result of Porsche's misrepresentations about its intention to acquire shares in Volkswagen. *Id*. at 202-03, 207. The district court granted defendants' motion to dismiss, finding the claims did not involve domestic transactions because that designation applied only to "purchases and sales of securities explicitly solicited by the issuer in the U.S., rather than transactions in foreign-traded securities--or swap agreements that reference them--where only the purchaser is located in the United States." *Id*. at 213 (internal quotation marks omitted).

The Second Circuit affirmed the dismissal on different grounds, holding that "while a domestic transaction or listing is *necessary* to state a claim under § 10(b), a finding that these transactions were domestic would not *suffice* to compel the conclusion that the plaintiffs' invocation of § 10(b) was appropriately domestic." *Id.* at 216 (emphasis in original). In other words, the Second Circuit adopted a "domestic transaction plus" test. Because plaintiffs' claims concerned statements made by an essentially uninvolved defendant in Germany with respect to stock in a German company traded only on European exchanges, the court found the plaintiffs' claims were impermissibly extra-territorial despite the existence of swap agreements entered into domestically with a party other than the defendant. *Id.* Although the Second Circuit held that a domestic transaction by itself may be insufficient to justify the extraterritorial application of Section 10(b), the court did not specify what additional factors are required to permit such an application.

B. Trends in Suits Against Foreign Issuers

In line with the trend limiting extraterritorial application of U.S. securities laws, the number of class action filings against foreign issuers (*i.e.*, companies headquartered outside the United States) declined for the third consecutive year. According to Cornerstone Research, the percentage of filings against foreign issuers declined to pre-2010 levels in 2014. Specifically, the number of federal securities class action filings against foreign issuers decreased to 12% of all filings in the first half of 2014, down from 18% in 2013, 21% in 2012, and 33% in 2011. Figure 5 below, courtesy of Cornerstone Research, shows this trend.

Figure 5:



VIII. Another Eventful Year in Delaware Courts

While the news that merger objection case filings are in decline in the federal courts, several Delaware state court decisions last year provide important new guidance on a range of issues confronting companies involved in M&A transactions.

A. Delaware Supreme Court *C&J Energy* Opinion Offers Guidance in Change-in-Control Transactions

In a December 2014 decision reaffirming the longstanding principle under Delaware law that "there is no single blueprint that a board must follow to fulfill its [*Revlon*] duties," the Delaware Supreme Court issued a ruling reversing an order of the Court of Chancery granting a preliminary injunction that would have enjoined an agreed-to merger and required a mandatory post-signing 30-day go-shop period. *See C&J Energy Servs., Inc. v. City of Miami Gen. Emps.' and Sanitation Emps.' Ret. Trust*, No. 655/657, 2014 WL 7243153, at *14 (Del. Dec. 19, 2014) (internal quotation marks omitted). As reported in our recent Client Alert, the Delaware Supreme Court in *C&J Energy* held that the Court of Chancery had imposed a non-existent requirement that a selling company must engage in an active market process as a matter of law. *Id.* at *17.

The transaction that gave rise to the lawsuit was a proposed merger between a Delaware corporation, C&J Energy Services, and a Bermuda subsidiary of Nabors Industries. *Id.* at *1. The Court of Chancery determined that the C&J board was informed of the company's value and was not conflicted, but nevertheless concluded that it was "plausible" that the board transgressed *Revlon*'s requirement that it seek the highest immediate value reasonably available because the board did not have "impeccable" knowledge of the assets of the company acquiring it. *Id.* at *1, *15 (internal quotation marks omitted). Thus, the Court of Chancery enjoined the stockholder vote for 30 days and instructed C&J to actively shop itself during that 30-day period. *Id.* at *1.

The Delaware Supreme Court, *en banc*, unanimously reversed the lower court and held that enjoining the merger was not proper. *Id.* at *2. First, the Supreme Court held that the lower court applied the wrong legal standard for the issuance of a preliminary injunction. *Id.* at *13. Rather than requiring plaintiffs to demonstrate a reasonable probability of success on the merits in order to secure preliminary injunctive relief, the lower court granted relief based on the mere "plausible" ability to succeed on the merits. *Id.* Second, the Supreme Court held that, in determining success on the merits was "plausible," the lower court erred in holding that an affirmative go-shop period was required in order to satisfy the *Revlon* doctrine. *Id.* at *14-15. *Revlon* imposed no such requirement; it only required a process that would ensure a bidder willing to pay more for a company had a meaningful opportunity to submit a viable bid. *Id.* at *14. The question under *Revlon*, the court noted, is "whether the directors made a *reasonable* decision, not a *perfect* decision." *Id.* (emphasis in original) (internal quotation marks omitted).

As noted in our Client Alert, the key takeaway is the opinion's reinforcement of the *Revlon* principle that the central question is "'whether the directors made a *reasonable* decision, not a *perfect* decision.'" *Id.* *C&J Energy* reinforces that the *Revlon* standard gives a board significant discretion to "pursue the transaction it reasonably views as the most valuable to stockholders"--provided that decision is accompanied by at least a market check. *Id.* However, while "an *effective* market check" is mandatory, an *active* market checks is not always necessary. *Id.* (emphasis added). The requirement is intended to be flexible, and may be "effective" so long as it gives "any bidder interested in paying more for a company an opportunity to do so." *Id.* Hence, a passive market check, when employed with other safeguards, can satisfy *Revlon* duties. *Id.* Finally, while several recent decisions have left the strong impression that the Court of Chancery's equitable authority is remarkably broad, the court held in *C&J Energy* that it nonetheless has its limits, and "it is not uncabined." *Id.* at *18. According to the Delaware Supreme Court, the lower court's exercise of its equitable authority was overly broad where its use of a preliminary injunction would have "divest[ed] third parties of their contractual rights." *Id.*

B. Delaware Chancery Court Addresses Alleged "Control" by Stockholders Holding Less Than 50% of a Corporation's Stock

The Delaware Court of Chancery issued two recent decisions on the important question of what constitutes "control" by a stockholder holding less than 50% of a corporation's stock. In *In re Zhongpin Inc. Stockholders Litigation*, No. 7393-VCN, 2014 WL 6735457 (Del. Ch. Nov. 26, 2014), and *In re KKR Financial Holdings LLC Shareholder Litigation*, 101 A.3d 980 (Del. Ch. 2014), plaintiffs sought to challenge deals involving minority stockholders purportedly acting on both sides of transactions. In both cases, plaintiffs argued that the transactions involved "controlling stockholders," and thus should be analyzed under the entire fairness standard rather than the more deferential business judgment standard. While Chancellor Bouchard (in *KKR*) and Vice Chancellor Noble (in *Zhongpin*) reached opposite conclusions about the control of the stockholder in question in these cases, which involved very different facts, the decisions provide important guidance to companies and significant stockholders considering transactions that may be challenged as controlling stockholder transactions.

As a general rule, a stockholder who owns less than 50% of a corporation's outstanding stock presumptively is not a controlling stockholder. *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 70 (Del. 1989). To rebut this presumption, "a plaintiff must allege domination by [the] minority shareholder through actual control of corporate conduct." *Id.*

In *In re KKR*, plaintiffs sought entire fairness review of a merger between KKR & Co. L.P. ("KKR") and KKR Financial Holdings LLC ("KFN"). 101 A.3d at 983. Plaintiffs sought to rebut the business judgment presumption by arguing that (1) KKR, while an owner of less than 1% of KKN stock, was a "controlling" stockholder of KKN and (2) at least half of the directors who approved the transaction were not disinterested or independent. *Id.*

Plaintiffs contended that KKR controlled KKN--despite the minimal stockholdings--because a management agreement ceded almost all of KKN's day-to-day operational control to KKR. *Id.* The court acknowledged KKR's operational control of KKN, but found that KKR was not a controlling stockholder because the complaint failed to "support a reasonable inference that KKR *controlled the KFN board* . . . such that the directors of KFN could not freely exercise their judgment." *Id.* at 993 (emphasis in original). Plaintiffs' allegations, the court concluded, did not give rise to a reasonable inference that the directors lacked disinterestedness or independence. *Id.* at 998-99. Thus, the board's decision was protected under the business judgment rule. *Id*.

In *In re Zhongpin*, Vice Chancellor Noble reached the opposite conclusion: that plaintiffs sufficiently pled facts raising an inference that Xianfu Zhu--Zhongpin Inc.'s founder, Chairman of the Board, and CEO--was a controlling stockholder, despite Zhu owning only 17.3% of the company's stock. 2014 WL 6735457, at *7, *12. Plaintiffs challenged the directors' decision to approve Zhu's going-private bid. *Id.* at *1. Plaintiffs argued that, rather than being subject to the business judgment rule, the merger was subject only to the entire fairness standard because of Zhu's control. *Id.* at *5-6.

The court looked to the language of the company's 10-K, which acknowledged that Zhu was the "largest shareholder" and had "significant influence over [the company's] management and affairs and could exercise this influence against your best interests." *Id.* at *7. It further noted that Zhu could "exercise significant influence over [the] company, including, but not limited to, any shareholder approvals for the election of [company] directors . . . the selection of [company] senior management . . . [and] mergers and acquisitions." *Id.* The court discussed Zhu's power to control the day-to-day operations of the company and noted that Zhu's departure from the company would have had a materially adverse impact on the company. *Id.* at *9. Plaintiffs pled that another bidder was only interested in the transaction if Zhu were to remain at the company, *id.* at *3, and the court found it noteworthy that the company did not receive any other bids during the go-shop period, implying that Zhu's power over the company discouraged any other potential acquirers from attempting to gain control over the company, *id.* at *9. All of these facts, the court concluded, were sufficient to support a finding that Zhu possessed both latent and active control of Zhongpin. *Id.*

Thus, while the "actual control" test to determine a minority shareholder's control of an organization "is not an easy one to satisfy," it is possible where there is evidence that the stockholder can or does control the board and the board's decision making process. *In re PNB Holding Co. S'holders Litig.*, No. Civ. A. 28-N, 2006 WL 2403999, at *9 (Del. Ch. Aug. 18, 2006).

C. Delaware Court of Chancery Continues to Uphold Forum-Shifting Bylaws

As discussed in our prior updates, courts across the country have upheld the facial validity of corporate bylaws that select the Delaware Court of Chancery as the exclusive forum for litigation relating to the company's internal affairs, including stockholder derivative suits. *See Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013); *see also Hemg Inc. v. Aspen Univ.*, No. 650457/13, 2013 WL 5958388 (N.Y. Sup. Ct. Nov. 4, 2013); *In re MetroPCS Commc'ns, Inc.*, 391 S.W.3d 329 (Tex. App. 2013). Case law in Delaware and beyond has continued to uphold these provisions, signaling that forum-selection bylaws are here to stay. In the first half of 2014, courts in Illinois and California dismissed actions based on such forum-selection provisions. *Miller v. Beam Inc.*, No. 2014 CH 00932, 2014 WL 2727089 (Ill. Cir. Ct. Mar. 5, 2014); *Groen v. Safeway Inc.*, No. RG14716641, 2014 WL 3405752 (Cal. Super. Ct. May 14, 2014). And in September 2014, the Delaware Court of Chancery addressed an issue of first impression concerning Delaware corporations' use of forum-selection bylaws. In *City of Providence v. First Citizens Bancshares, Inc.*, Chancellor Bouchard granted a motion to dismiss lawsuits challenging a forum-selection bylaw requiring that stockholder suits be adjudicated not in Delaware, but in another jurisdiction--North Carolina. 99 A.3d 229, 230-31 (Del. Ch. 2014).

At issue in the *First Citizens Bancshares* case was the adoption by the board of a bylaw containing a forum-selection provision, which was adopted on the same day the company announced the merger that would become the subject of the litigation. *Id.* The bylaw made North Carolina state and federal courts the sole and exclusive forums for any (1) derivative claim, (2) any claim for breach of fiduciary duty by a director, officer, or employee of the corporation, (3) any action pursuant to any Delaware state corporation statutes, and (4) any claims governed by the internal affairs doctrine. *Id.* at 234.

A stockholder of the company challenged the validity of the bylaw and merger, claiming that (1) it was invalid as a matter of Delaware law or public policy, (2) the adoption of the bylaw was *ultra vires* and a breach of fiduciary duty, and (3) the defendant board breached various fiduciary duties in connection with the merger. *See id.* at 232. Chancellor Bouchard rejected each of plaintiff's arguments and dismissed the action.

First, Chancellor Bouchard found the forum-selection bylaw to be facially valid. *Id.* at 236. The bylaw was identical to a forum-selection bylaw upheld by the court in *Boilermakers*, except that it selected North Carolina as the preferred forum instead of Delaware. Following the "logic and reasoning" of the *Chevron* decision, Chancellor Bouchard found the bylaw was valid and noted that "nothing in the text or reasoning" of the *Chevron* decision prohibited a Delaware corporation "from designating an exclusive forum other than Delaware in its bylaws." *Bancshares*, 99 A.3d at 231, 235.

The Chancery Court also rejected plaintiff's argument that the defendant board breached its fiduciary duties through the "self-interested adoption of the Forum Selection Bylaw." *Id.* at 236-37 (internal quotation mark omitted). While one of the companies executing the merger was headquartered in North Carolina, the court rejected plaintiff's arguments that the defendant board was "motivated by a desire" to protect its own interests and "insulate itself from the jurisdiction of Delaware courts" as wholly conclusory. *Id.* at 237 (internal quotation mark omitted).

Having found the forum-selection bylaw and its adoption to be facially valid, the Chancery Court dismissed plaintiff's claims regarding the merger for lack of proper venue. *Id.* at 242. In concluding the opinion, Chancellor Bouchard also discussed the important interests of judicial comity with regard to forum-selection bylaws, noting: "If Delaware corporations are to expect, after *Chevron*, that foreign courts will enforce valid bylaws that designate Delaware as the exclusive forum for intra-corporate disputes . . . so too should this Court enforce a Delaware corporation's bylaw that does not designate Delaware as the exclusive forum." *Id.*

D. Delaware Chancery Court Refuses to Imply Fiduciary Duties Where Properly Eliminated From Master Limited Partnership Agreements

In two recent decisions, also discussed in a recent Client Alert, Vice Chancellor Travis Laster of the Delaware Court of Chancery made clear that when dealing with limited partnerships, contractual terms control and that, once fiduciary duties are contractually eliminated as permitted by Delaware law, courts should not imply terms that would alter the contractual arrangement.

These decisions, *In re El Paso Pipeline Partners, L.P. Derivative Litigation*, No. 7141-VCL, 2014 WL 2768782 (Del. Ch. June 12, 2014) and *Allen v. El Paso Pipeline GP Co.*, No. 7520-VCL, 2014 WL 2819005 (Del. Ch. June 20, 2014), address both the express and implied duties of good faith owed in the context of master limited partnership ("MLP") conflict transactions. In both cases, the partnership agreement at issue was that of El Paso Pipeline Partners, L.P. ("El Paso"). As permitted under the Delaware Limited Partnership Act, the El Paso MLP agreement eliminated common law fiduciary duties. *In re El Paso*, 2014 WL 2768782, at *21. In the place of such duties, the partnership agreement created a contractual structure that included processes for handling conflict transactions. *Id.* at *9-12. The process employed in both cases is the use of a special conflicts committee, comprising of independent directors assigned the task of evaluating the fairness and reasonableness of the proposed conflict transaction. *See id.* For such committee approval to be properly granted, the partnership agreement required that the conflict-of-interest transaction receive "approval by a majority of the members of the Conflicts Committee *acting in good faith*." *Id.* at *3 (emphasis added) (internal quotation marks omitted). Both *Allen* and *In re El Paso* featured a group of holders of limited partnership common units claiming that the directors of the general partner and the general partner itself violated their express and implied duties of good faith in engaging in conflict transactions. *Id.* at *7.

The Chancery Court examined the subjective good faith standard. *Id.* at *12. The express duty of good faith was defined in the partnership agreement as the belief that the transaction is in the best interests of the partnership. *Id.* at *10. In both cases, the court clarified that such belief is a subjective test. *Id.* at *12. In *Allen*, the court further explained that the "best interests of the partnership" standard allowed the Conflicts Committee to subjectively judge the transaction from the perspectives of all partnership constituencies, whereas under normal corporate fiduciary duties the interests of the stockholders would have been of primary importance. 2014 WL 2819005, at *8-9. In *In re El Paso*, the court also held that subjective good faith cannot be challenged based on information that the plaintiffs admitted the members of the Conflicts Committee did not have. 2014 WL 2768782, at *14. In both cases, Vice Chancellor Laster emphasized the importance and primacy of contract principles when fiduciary duties have been eliminated.

As to the implied duty of good faith, the Chancery Court carefully explained that implying a term must never rewrite a contract but must only fill gaps as the parties would have done had they considered the issue when drafting. For example, in *Allen*, the court concluded that it would conflict fundamentally with the plain language and structure of the partnership agreement to invoke the implied covenant to require that the Conflicts Committee follow a particular course of obtaining an opinion from a financial advisor that addressed the fairness of a drop-down to the limited partners in a judicially prescribed manner, as advocated by plaintiffs. 2014 WL 2819005, at *16-17. In *In re El Paso*, the Chancery Court declined to imply in the partnership agreement an affirmative obligation on the part of the general partner to disclose material information about other transactions to the Conflicts Committee. 2014 WL 2768782, at *21. The Chancery Court also emphasized that the concepts of good faith and fair dealing, when applied to a contract such as the partnership agreement, are not moral concepts but are instead relative to the contract. *Allen*, 2014 WL 2819005, at *10. Finding no relevant gaps in the partnership agreement, the Chancery Court dismissed, in each case, the claim that the implied covenant of good faith had been violated. *E.g.*, *id.* at *18; *El Paso*, 2014 WL 2768782, at *23.

IX. Developments in Derivative Litigation

Shareholder derivative suits continue to yield notable developments and represent an area of continued focus and significant filings by plaintiffs across the country. The following trends in derivative litigation in the latter half of 2014 deserve close attention by potential targets of such claims.

A. Court Examines Fundamental Fairness of Settlement Agreement to Shareholders

The last weeks of the year brought a notable opinion regarding court review of a proposed resolution of derivative shareholder claims. In *In re Hewlett-Packard Co. Shareholder Derivative Litigation*, the United States District Court for the Northern District of California rejected a proposed settlement agreement between Hewlett-Packard and its shareholders due to its "unresolved vagueness" and the massive "breadth of the releases." No. 12-cv-06003-CRB, 2014 WL 7240144, at *6 (N.D. Cal. Dec. 19, 2014). Shareholders brought derivative actions after HP's acquisition of Autonomy, a U.K.-based software company, "resulted in a writedown of 85 percent of the $11.7 billion purchase price," leading to a significant drop in its stock price. *Id*. at *1-2. Hewlett-Packard concluded that it was a victim of fraud, as Autonomy had improperly recorded its pre-acquisition revenue, and that it had overpaid for the Autonomy acquisition. *Id*. at *2.

The derivative action plaintiffs and Hewlett-Packard reached a proposed settlement and sought the court's approval. The proposed settlement agreement barred shareholders from pursuing "all Autonomy-Related claims" and "all Known Claims arising from the allegations in the Complaints, that Settling Plaintiffs or any other Securities Holder asserted or could have asserted derivatively on behalf of the Company." *Id*. at *1 (internal quotation marks omitted). The court found cause for concern with the second release, explaining that its ambiguity could "only spawn further litigation about the scope of a settlement intended to quiet future legal action." *Id*. Specifically, the court reasoned that the shareholders seemed "to be relinquishing a whole universe of potential claims regarding HP governance and practices with no factual predicates that overlap the Autonomy acquisition." *Id*. at *5. The court consequently rejected the proposed agreement as it concluded the broad scope of the release left the court unable to assess its fairness and reasonableness. *Id*.

Though derived from an entirely different legal context and set of facts, the *Hewlett-Packard* opinion is somewhat reminiscent of Judge Rakoff's rejection in 2011 of the parties' settlement in *U.S. Securities and Exchange Commission v. Citigroup Global Markets, Inc*. That decision--later overturned by the Second Circuit as an abuse of discretion, No. 11-5227 (2d Cir. June 4, 2014)--spurred a number of other federal court judges at the time to scrutinize closely and even reject other settlements.

B. Is Cybersecurity the Next Big Thing in Derivative Litigation?

A notable development in derivative litigation is the uptick in claims seeking damages related to cyber security breaches. With news-grabbing breaches on the rise, it would be unsurprising to see this trend continue. But the news is not all bad: in what appears to be the first published decision regarding such a claim, a federal court dismissed a cyber breach-related derivative complaint. In *Palkon v. Holmes*, the U.S. District Court for the District of New Jersey granted defendants' motion to dismiss a shareholder derivative action seeking damages from members of the board of directors of Wyndham Worldwide Corp. in the wake of three cyber attacks between April 2008 and January 2010, in which the personal information of over 600,000 customers was compromised. No. 14-cv-01234-SRC, 2014 WL 5341880, at *1-2, *7 (D.N.J. Oct. 20, 2014). The widely-reported breaches became the subject of a Federal Trade Commission ("FTC") action against the company. *Id.* at *1. The derivative action alleged that the board failed "to implement adequate data-security mechanisms" and disclose the breaches timely, and wrongfully rejected the shareholder's demand to bring an action for those failures. *Id.* at *2. The court dismissed the complaint, finding that the board exercised its business judgment in refusing the shareholder demand. *Id.* at *5-7.

The opinion provides some insight into what circumstances the court found adequate to provide the board an adequate basis to reject the demand. The board's record in actively engaging on the relevant cyber security issues proved extremely useful in its defense. The court noted that the board discussed the cyber attacks, the company's security policies, and proposed security enhancements at fourteen meetings during the relevant period. *Id.* at *2, *5. The Audit Committee investigated both shareholder demands, and discussed them and the other cyber security issues in at least sixteen meetings as well. *Id.* at *5. The company also hired technology firms to investigate the breaches and implemented their recommendations on improving security. *Id* .at *2. According to the court, that these facts showed the board had a "firm grasp" of the demand when it declined to pursue claims. *Id.* at *6; *see also* Eduardo Gallardo & Andrew Kaplan, *Board of Directors Duty of Oversight & Cybersecurity*, Delaware Business Court Insider (Aug. 20, 2014), http://www.gibsondunn.com/publications/Documents/GallardoKaplan--Board-of-Directors-Duty-of-Oversight-Aug2014.pdf.

It is too early to tell yet whether the *Wyndham* opinion will stand as a framework for evaluating demand in other cybersecurity derivative cases, as the decision is currently on appeal to the Third Circuit. *See Palkon v. Holmes*, No. 14-4528 (3d Cir. Nov. 19, 2014). But there can be little doubt that as the number and reach of cyber breaches continues to grow, focus will be further brought to bear on directors' and officers' role in addressing such security risks. We will continue to report on derivative case developments in this area.

C. Delaware Court Discretion and Section 220 Requests

Several recent so-called "books and records" demand cases have highlighted the Court of Chancery's broad discretion under Section 220 of the Delaware General Corporation Law ("DGCL") to order a company to produce documents for shareholder-plaintiff inspection. For example, in *Oklahoma Firefighters Pension & Retirement System v. Citigroup Inc.*, the Delaware Court of Chancery granted a Section 220 demand, holding that the shareholder met "the low burden of proof required of a stockholder under Section 220" where the demanded books and records were "necessary and essential" to the shareholder's proper purpose--even where only the company's foreign subsidiary was accused of wrongdoing. No. 9587-ML, 2014 WL 5351345, at *1, *4, *7-8 (Del. Ct. Ch. Sept. 30, 2014) (ordering production of a subset of documents requested by the plaintiff).

But a late December opinion from the Delaware Supreme Court offers companies a ray of hope in defending Section 220 demands. In *United Technologies Corp. v. Treppel*, the court reversed a decision by the Court of Chancery and remanded to determine whether, under the circumstances, the court should impose restrictions on the books and records request. No. 127, 2014 Del. Lexis 608, at *17-21 (Del. Dec. 23, 2014). The shareholder made a demand on the board to, among other things, bring claims against certain officers and directors related to a Department of Justice investigation of the company's exportation of software to the Chinese government for military use (charges that ultimately led to a Deferred Prosecution Agreement and payment of fines by the company). *Id.* at *2-3. The board ultimately rejected the shareholder's demand, and the shareholder asserted his Section 220 inspection rights into documents related to the demand rejection. *Id.* at *4-5. The company by in large permitted the inspection but required a confidentiality agreement that contained a forum selection clause in favor of Delaware for any claims relating to the inspection. *Id.* at *5. The Court of Chancery rejected the clause, concluding that it lacked authority under Section 220(c) to impose a forum selection proposed by the recipient of a books and records request. *Id.* at 9.

The Delaware Supreme Court reversed. It held that "Section 220(c) of the DGCL gives broad discretion to the Court of Chancery to condition a books and records inspection," allowing it to, "in its discretion, prescribe *any limitations or conditions* with reference to the inspection, or award such other or further relief as the Court may deem just and proper." *Id.* at *10-11 (emphasis in original) (internal quotation mark omitted). The opinion provided the Court of Chancery guidance in the exercise of that discretion:

> [G]ive weight to factors such as: (i) the fact that [the plaintiff] seeks to file claims arising out of the same corporate conduct that was already the subject of derivative litigation in the Court of Chancery and this Court; (ii) [the company's] legitimate interest in having consistent rulings on related issues of Delaware law, and having those rulings made by the courts of this state; (iii) [the company's] adoption of a forum selection bylaw that represents a non-case-specific determination by its board of directors that internal affairs litigation involving the company should proceed in a single forum; and (iv) the investment the corporation has already made (which comes at a cost to its stockholders) in defending not only the prior derivative litigation in the Court of Chancery, but also this § 220 action.

Id. at *17-18.

In another Section 220 dispute, between shareholder Ravenswood Investment Co. and Winmill & Co., the Court of Chancery ruled that a books and records inspection could not be conditioned upon the shareholder's indemnification of the company against losses from any related federal and state securities laws claims. Opinion, *Ravenswood Inv. Co. v. Winmill & Co.*, No. 7048-VCN, 2014 WL 7451505 (Del. Ch. Dec. 31, 2014). Earlier, in a May 30, 2014 opinion, the court ruled that the company could not condition the inspection upon the shareholder's agreement to not trade in the company's stock based on the nonpublic information received. Opinion, *Ravenswood Inv. Co.*, 2014 WL 2445776, at *2, *4 (Del. Ch. May 30, 2014). And it reasoned in December that it was "not willing to presume that [the shareholder] would violate its duties as prescribed by [relevant] laws," and that "[m]ore fundamentally, conditioning a right provided by [Section 220] upon an unlimited and unrestricted indemnification obligation unduly impairs a shareholder's rights." 2014 WL 7451505, at *1. The December ruling, however, contained no reference to the Delaware Supreme Court's ruling just one week earlier in *United Technologies*. *See id.*

In light of the *United Technologies* decision, it should now be "best practice" for companies to insist on reasonable limits on the scope of permitted access, and reasonable restrictions on the use of the discovered material in related litigation.

D. Ninth Circuit Weighs in on Demand Futility

In *Rosenbloom v. Pyott*, 765 F.3d 1137 (9th Cir. 2014), the Ninth Circuit allowed a derivative suit to proceed against Allergan's current and former directors without requiring shareholders to first demand action from the board of directors. *Id*. at 1159. The claims centered on the board's alleged role in Allergan's purported off-label promotions of Botox. *Id*. at 1141-42. The district court had dismissed the complaint on the ground that plaintiffs had failed adequately to plead demand futility. *Id.* at 1157. The Ninth Circuit ruled that "demand is excused if Plaintiffs' particularized allegations create a reasonable doubt as to whether a majority of [a] board faces a substantial likelihood of liability for failing to act in the face of a known duty to act." *Id.* at 1151. According to the Ninth Circuit, "the district court essentially insisted on a smoking gun of Board knowledge, even though precedent holds that plaintiffs can show demand futility by alleging particular facts that support an *inference* of conscious inaction." *Id.* at 1156 (emphasis in original). The court of appeals thus reversed the district court's dismissal order, ruling that the allegations of demand futility in the complaint were sufficient. *Id.* at 1159.

X. Stockholder Proposal/Proxy Disclosure Litigation Trends

If the number of shareholder proposals on proxy access rights submitted in 2014 are any indication, proxy disclosure litigation will continue to be a focus in the upcoming year. According to a recent report by The Conference Board, Inc., a record number of proxy access proposals were submitted, voted on, and approved in 2014.[1]

As we reported in our 2014 Mid-Year Securities Litigation Update, the 2014 proxy season was marked by an increase in litigation brought not by stockholders, but by issuers bypassing the SEC no-action process and going directly to courts, seeking declaratory rulings on whether the issuer may properly exclude stockholder proposals. The second half of the year served as a reminder that stockholders, too, may seek relief from federal courts without regard to the SEC's view as to whether an issuer may properly exclude a proposal from the issuer's proxy materials.

The case-to-watch in this area is *Trinity Wall Street v. Wal-Mart Stores, Inc.*,[2] currently on appeal to the Third Circuit where the appellate court granted Wal-Mart's unopposed motion for expedited briefing. *Trinity Wall St. v. Wal-Mart Stores, Inc.*, No. 14-4764 (3d Cir. Dec. 29, 2014). In the *Trinity* case, the U.S. District Court for the District of Delaware granted summary judgment in favor of a stockholder challenging Wal-Mart's decision to exclude--with the approval of the SEC staff--the stockholder's proposal from its 2014 proxy materials. No. 14-405-LPS, 2014 WL 6790928, at *1-2 (D.

Del. Nov. 26, 2014). The court's decision, including its decision to decide the case at all, has generated substantial debate.

Trinity's proposal requested that Wal-Mart create a committee of its board to oversee and report on the formulation and implementation of policies. *Id.* at *2. Specifically, the proposal sought to amend Wal-Mart's Compensation, Nominating and Governance Committee's charter to provide for "oversight" concerning the "formulation and implementation" of "policies and standards that determine whether or not the Company [] should sell a product" that has "the substantial potential to impair the reputation of the Company," including products that endanger "public safety and well-being," or that could be considered "offensive" to "family and community values." *Id.* The narrative portion of the proposal stated that the oversight and reporting duties extended to determining "whether or not the company should sell guns equipped with magazines holding more than ten rounds of ammunition ('high capacity magazines') and to balancing the benefits of selling such guns against the risks that these sales pose to the public and to the Company's reputation and brand value." *Id.* (internal quotation marks omitted). Wal-Mart filed a letter with the SEC explaining its intent to exclude the proposal because, in the company's view, it addressed ordinary business operations and thus could be excluded under SEC Rule 14a-8(i)(7). *Id.* The SEC staff issued a no-action letter concurring with exclusion of the proposal under Rule 14a-8(i)(7) on March 20, 2014. *Id.*

Trinity filed its suit against Wal-Mart on April 1, 2014, and shortly thereafter lost its motion for a preliminary injunction. *Id.* at *2-3. Wal-Mart distributed its proxy materials, without the proposal, on April 23, and held its annual meeting on June 6, 2014. *Id.* at *1, *4. After distributing the proxy materials, Wal-Mart filed a motion to dismiss for lack of subject matter jurisdiction. *Id.* at *4. In response, Trinity amended its complaint to seek declaratory relief as to the omission of its proposal from the 2014 materials and prospective relief based on Trinity's intent to submit the proposal again for inclusion in the 2015 materials. *Id.* Shortly thereafter, both parties filed cross motions for summary judgment. *Id.*

The district court's November 26, 2014 decision granted summary judgment in Trinity's favor, giving the stockholder the declaratory relief it sought as well as an injunction requiring Wal-Mart to include Trinity's re-submitted proposal in its 2015 proxy materials. *Id.* at *12-13. The district court's decision involved two controversial holdings, one relating to the exercise of jurisdiction and the other relating to the interpretation and application of the rule allowing companies to exclude shareholder proposals that address ordinary business operations. Both aspects of the district court's decision--which is currently on appeal to the Third Circuit--are discussed below.

Wal-Mart argued that, because the 2014 stockholder meeting had already passed, Trinity's claim based on exclusion of the proposal from the 2014 proxy materials was moot. *Id.* at *4. Noting the short duration of the proxy season, the court applied the "capable of repetition, yet evading review" exception to the mootness doctrine, so that it could rule on the merits. *Id.* at *5-8.

In so holding, the court recognized that its decision was in conflict with decisions from other courts declining to exercise jurisdiction under similar circumstances. *See id.* at *6. For example, in *New York City Employees' Retirement System v. Dole Food Co.*, the Second Circuit opined that the exception did not apply because the proposal and no action process generally leaves "ample time for a full review of the case while it remains a live controversy." 969 F.2d 1430, 1435 (2d Cir. 1992). Similarly, in *Lindner v. American Express Co.*, the court declined to apply the exception because the stockholder could obtain review of the issue by submitting a similar proposal and filing a similar lawsuit the next proxy season. No. 10-civ-2228-JSR, 2011 WL 2581745, at *5 (S.D.N.Y. June 27, 2011).

The district court was also unpersuaded by decisions in several jurisdictions suggesting that a plaintiff must file an interlocutory appeal from the court's denial of a preliminary injunction to benefit from the "capable of repetition but evading review" exception, which Trinity failed to do. *See, e.g.*, *ProtectMarriage.com--Yes on 8 v. Bowen*, 752 F.3d 827, 837 (9th Cir. 2014); *Newdow v. Roberts*, 603 F.3d 1002, 1009 (D.C. Cir. 2010); *Minn. Humane Soc'y v. Clark*, 184 F.3d 795, 797 (8th Cir. 1999).

The district court's ruling on the merits was also controversial. The SEC's proxy rules do not require issuers to include in their proxy materials stockholder proposals relating to the company's ordinary business operations. Although Trinity's proposal related to the products that Wal-Mart sells, the court held that it was "best viewed as dealing with matters that are not related to Wal-Mart's ordinary business operations" because it does not dictate to management, but instead "seeks to have Wal-Mart's *Board* oversee the development and effectuation of a Wal-Mart policy." *Trinity*, 2014 WL 6790928, at *8-9 (emphasis in original). Previously, however, the SEC had rejected a proposed standard under which stockholder proposals involving "matters that would be handled by management personnel without referral to the board of directors generally would be excludable," while proposals involving "matters that would require action by the board would not be." SEC Rel. No. 34-12598, 1976 WL 160410, at *8 (July 7, 1976); SEC Release No. 34-12999, 1976 WL 160347, at *11 (Nov. 22, 1976).

Wal-Mart filed its opening appellate brief on January 14, 2015. There, Wal-Mart argued that SEC Rule 14a-8(i)(7) authorizes exclusion from a company's proxy materials any shareholder proposal that "deals with a matter relating to the company's ordinary business operations." Appellant's Opening Brief, No. 14-4764, at 20 (3d Cir. Jan. 14, 2015) (quoting 17 C.F.R. § 240.14a-8(i)(7)). To avoid exclusion under the rule, a shareholder proposal must focus on a significant policy issue, not merely implicate it. *Id.* at 30-32. The district court's interpretation of the rule, Wal-Mart argued, "will leave the Rule 14a-8(i)(7) ordinary business exclusion in tatters." *Id.* at 6. Wal-Mart also argued that the proposal was properly excluded under Rule 14a-8(i)(3) as vague and indefinite, in that key terms in the proposal were undefined, subjective, and ambiguous. *Id.* at 41-43.

Briefing before the Third Circuit should be complete in February, and a decision is expected this April.

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[1] The Conference Board, Inc.'s full report is available at the organization's website.

[2] Gibson Dunn represented Wal-Mart before the district court, and continues to represent the company on appeal.

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Gibson, Dunn & Crutcher lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work, or any of the following members of the Securities Litigation Practice Group Steering Committee:

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