Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Slicing And Dicing The Delaware Carve-Out

Law360, New York (March 13, 2013) -- With the 2013 proxy season started, a new trend of proxy-driven litigation promises to raise blood pressures in the board rooms of America. Plaintiffs' firms — perhaps buoyed by earning fees from the uniform filing of challenges to virtually every merger or go-private transaction in recent years, on price, disclosure or board process or all of the above — are seeking to fashion a new cottage industry through the "Delaware carve-out" to the securities litigation reform acts (PSLRA and SLUSA) of the 1990s, and more of these proxy suits promise to come.

While few have gotten real traction, with 10b-5 filings on the wane, and IPO's of potentially volatile companies still relatively scarce, the plaintiffs' bar appears eager to fill the gap in revenue with a bread and butter diet of smaller fee, M&A and proxy cases. While the "whale" cases still are being brought, certified, litigated and settled, the plaintiffs' bar appears intent on sweeping up minnow-sized fees on a regular basis as well.

This article examines the history of recent reform acts, the effect on securities litigation filings and settlements, and the recent trends in M&A and proxy litigation; and proposes a possible reform framework for the new efforts of the plaintiffs' bar.

(Recent) History of Securities Litigation Reforms

The PSLRA

Congress passed the Private Securities Litigation Reform Act of 1995 (PSLRA) in an attempt to stem the tide of frivolous lawsuits brought against issuers. These so-called "strike suits" left defendants between the proverbial rock and hard place, facing either settling potentially meritless claims at an early stage of the litigation or defending against those claims at a potentially high litigation cost. The PSLRA implemented several procedural obstacles to plaintiffs' private securities-based actions, the most significant of which was a heightened pleading standard.

Under the PSLRA, plaintiffs bringing claims under the Securities Exchange Act of 1934 ("the 1934 Act") alleging that the defendant made an materially false statement or misrepresentation were now required to "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, [and] state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[1] Thus, defendants could now seek to dismiss nuisance lawsuits at an early stage of litigation by showing that a complaint failed to meet the new standards imposed by the PSLRA and consequently were subject to proper dismissal under Federal Rule of Civil Procedure 12(b)(6).

SLUSA

The PSLRA was not entirely successful in its attempt to stem the flow of nuisance litigation, however. Indeed, plaintiffs, seeking to avoid the stricter pleading standards imposed by the PSLRA in federal courts, began to file their lawsuits in state courts. Accordingly, Congress passed the Securities Litigation Uniform Standards Act of 1998 (SLUSA) to address this migration of securities fraud cases to the state courts.

Significantly, SLUSA preempted covered class actions that were based on state law claims alleging fraud or misrepresentation in connection with the purchase or sale of a covered security[2] and made covered class actions, brought in state court and involving a covered security, removable to the federal district court.[3] The SLUSA also included the "Delaware carve-out," however, a savings clause that preserved certain state-law actions based upon the statutory or common law of the state in which the issuer is incorporated or organized.[4] Thus, opportunistic plaintiffs retained some means of accessing the state courts with their creative claims.

The Courts Carry Out the Reform Laws and Resulting Trends in 10b-5 Securities Class Actions — Whale Hunting

Section 10b of the 1934 Act, and its implementing regulation, Rule 10b-5, prohibit the "mak[ing] any untrue statement of a material fact ... in connection with the purchase or sale of any security."[5] As one court has put it, these provisions "serve as the federal securities laws' catchall antifraud provisions,"[6] providing the basis for many-a-plaintiff's attempt to extract a settlement or favorable judgment at the expense of an issuer who has not necessarily engaged in any wrongdoing. The courts, however, have continued to implement the reform acts with relatively consistent applications which, along with the recent tightening of pleading standards in all federal civil actions, combine to create a relatively rigorous gauntlet of tests for a would be 10b-5 plaintiff.

For example, in Stoneridge Inv. Partners LLC v. Scientific-Atlanta Inc., the Supreme Court stated that there is no private right of action against purported aiders and abettors of securities fraud, and that in order to hold a secondary actor liable for misconduct, it is necessary for plaintiffs properly to plead reliance on the alleged misconduct.[7] The court then concluded that where there was no disclosure of the alleged misconduct to the investing public, there is no cause of action against a secondary actor under Rule 10b-5.[8]

The Supreme Court has also recently sought to clarify who is a proper defendant in a private Rule 10b-5 action, concluding that only the "maker" of the public statement at issue may be held liable in a private action.[9] The court defined a "maker" as "the person or entity with ultimate authority," and concluded that "one who prepares or publishes a statement on behalf of another is not its maker."[10] Thus, the court narrowed the universe of proper defendants in a Rule 10b-5 action.

Supreme Court jurisprudence regarding pleading standards in civil litigation has also generally raised the bar for plaintiffs alleging securities fraud. In Bell Atlantic Corp. v. Twombly, the court stated that in order to survive a Rule 12(b)(6) motion to dismiss for failure to state a claim, plaintiffs must "state a claim to relief that is plausible on its face."[11] Further in Ashcroft v. Iqbal, the court stated that "the plausibility standard is not akin to a probability requirement, but it asks for more than a sheer possibility that a defendant has acted unlawfully."[12] Accordingly, in order to survive dismissal at the complaint stage, a plaintiff alleging securities fraud in a Rule 10b-5 action must plead "sufficient factual matter" to permit the reviewing court "to draw the reasonable inference that the defendant is liable for the misconduct alleged."[13]

Of course, the U.S. Supreme Court has not been uniformly friendly to the defense bar. For example the very recent decision in Amgen Inc. v. Connecticut Retirement Plans and Trust Funds, Docket No. 11-1085, decided Feb. 27, 2013, with Justice Ruth Bader Ginsburg writing the opinion for the 6-3 majority declining to require proof of materiality before certifying a plaintiff class based on the fraud-on-the-market theory.

The Backdating Scandals

The mid-2000s saw the onset of the backdating scandal in which literally hundreds of issuers, and their directors and officers, were accused of changing the date of stock options grants in order to maximize their profitability to the grantee, without employing proper accounting procedures and without making proper tax disclosures. One study concluded that the practice of backdating was widespread[14], yet it has recently been suggested that the scandal has amounted to little as a regulatory matter due to the relative lack of resultant criminal prosecutions or SEC suits.[15]

Nonetheless, the plaintiffs' bar took advantage of the scandal, which spawned a total of 39 backdating-based securities class actions and more than 150 similar shareholder derivative suits.[16] Interestingly, even faced with relatively clear-cut accounting issues and paper trails of actions, and at least theoretical harms from added compensation expense and effects on stock price of revelatory disclosures, the plaintiffs' bar still preferred derivative actions and state courts to facing the music of the reform acts.

M&A Suits Become De Rigueur — A "Tax" on Transactions, Even Transactions with Substantial Premiums

Perhaps buoyed by their experience in the state courts in derivative suits during the backdating bonanza, and faced with the legislative and judicial straits in pleading securities fraud, recent years have seen a significant rise in M&A-based litigation. In these cases, plaintiffs generally allege a breach of fiduciary duty related to the terms of a merger or acquisition and cite purported disclosure deficiencies and other procedural deficiencies. These cases are often filed shortly after the announcement of a significant transaction, suggesting little, if any, prefiling investigation of the transaction at issue and, as a consequence, little meaningful analysis by the plaintiffs' bar of the merit of the claims prior to the initiation of the litigation.

The relative success of these actions, however — indeed in certain instances, plaintiffs' counsel have been awarded millions of dollars in attorneys' fees — promises to incentivize the continued filing of such cases. To that end, one study reveals in that in 2012 alone, 53 M&A-based class actions were filed in federal court, while in Delaware, in 2011, M&A-based lawsuits were filed in connection with 96 percent of deals with acquisitions valued at or above $500 million.[17]

The Current Wave of Proxy Suits and Abuses

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, enacted in part as a means of "improving accountability and transparency in the financial system,"[18] has also provided fodder for the plaintiffs' bar. Section 951 and its implementing regulations require that issuers hold an advisory vote on executive compensation at least once every three years.[19] Two new trends in proxy-driven litigation have emerged from this so-called "say-on-pay" provision.

In the first related trend, although under Dodd-Frank, "say-on pay" votes are nonbinding on compensation committees, plaintiffs sought to challenge the decision of compensation committees in the wake of a negative say-on-pay vote. These suits have largely targeted Delaware-incorporated issuers, yet have largely been brought in states other than Delaware. Plaintiffs have generally made several allegations including that boards breached their fiduciary duty of loyalty under Delaware law by approving the compensation package notwithstanding the negative say-on-pay vote, but have not met with much success. Indeed, courts have declined to extend Delaware's fiduciary duty law to conclude that a negative say-on-pay vote by itself is enough to rebut the business judgment rule as recognized under Delaware law.[20]

In the second related trend, and perhaps in the wake of the apparent lack of success in basing legal challenges on negative say-on-pay votes, plaintiffs have targeted issuers after the filing of a proxy statement, but in advance of annual meetings and their scheduled say-on-pay vote. Plaintiffs have sought to enjoin the scheduled shareholder vote on the theory that say-on-pay proxy disclosures are deficient. In so doing, plaintiffs' counsel have asked courts to extend (oft-times Delaware) state law-based fiduciary duties to include additional say-on-pay disclosure requirements even though issuers have fully complied with the requirements set out in Dodd-Frank.

After a few initial high-profile successes, in which courts have granted the injunction or defendants have elected to settle the claims so as not to delay the impending vote[21], plaintiffs are increasingly being met with some push-back. Several courts have recently denied similar plaintiffs' motions for injunctive relief, declining to extend Delaware fiduciary duty law to include a duty to make disclosures beyond what Dodd-Frank requires.[22] Moreover, even though yielding to the pressure to settle by entering into a stipulation of settlement, some defendants nonetheless are opposing plaintiffs' counsel fees refusing to yield to the opportunistic behavior of the plaintiffs' bar.[23]

Possible Reforms

One truth is evident in this review of the history: the plaintiffs' bar is adaptable, entrepreneurial and opportunistic. Like water carving a canyon over decades, they rush to fill gaps, crevices and weaknesses. And like water, they avoid flowing "uphill," avoiding obstacles and impediments to their march.

Faced with this, and the downward economic pressure and downdraft from excessive strike suits, the time may be ripe to refine the avenue for the M&A and proxy suits. This could be achieved through a requirement of direct, material economic harm, plead with specificity, as pre-condition to class-based or derivative claims. A related reform might include capping attorney fees in absence of such pleading and preventing injunctive relief in absence of such pleading. These sorts of reforms could still provide truly concerned plaintiff counsel the ability to seek relief, while reducing the holdup factor or extortion effect of the suits, as well as the distractions to managers pursuing transactions or dealing with disclosure issues in a challenging economic climate. The same data that supported the PSLRA and SLUSA reform acts would apply here.[24]

Moreover, reforms of this nature could be accomplished in a way that balances federal and state interests. The Class Action Fairness Act of 2005 (CAFA) is an example of a reform measure whose provisions seek to balance both federal and state interests in the adjudication of class action claims. A principle goal of CAFA was to address the practice of forum shopping wherein for strategic reasons, plaintiffs would seek to keep their class actions in state court, and out of federal court, even though the class itself was composed of a national group and the adjudication of the action itself was of national import.[25]

Prior to CAFA, defendants seeking to remove these types of state-filed class actions to federal court were hard pressed to meet the diversity of citizenship required to support federal jurisdiction. CAFA expanded federal jurisdiction over class actions by granting to the federal district court original jurisdiction over class actions in which the amount in controversy is over $5,000,000 in the aggregate, and in which there is minimal diversity (where at least any class member was a citizen of a state different from any defendant.)[26]

Yet, CAFA reform also paid heed to the interests that individual states might have in adjudicating class actions that are of significant impact to any given state in which such an action is originally filed. To that end, CAFA provides for certain exceptions to federal removal in favor of adjudication in the state court. For example, the home-state exception requires the district court to decline to exercise jurisdiction over class actions where two-thirds or more of the class and the primary defendants are citizens of the state in which the action was originally filed.[27]

There is also the local-controversy exception, which requires the district court to exercise jurisdiction over class actions where two-thirds or more of the class are citizens of the state in which the action was originally filed, at least one defendant, from whom significant relief is sought and whose alleged conduct forms a significant basis for the claims asserted, is a citizen of the state in which the action was originally filed and the principle injury alleged were incurred in the state in which the action was originally filed.[28]

Framing CAFA reform in terms of 1934 Act securities class action litigation, by relaxing federal jurisdictional standards CAFA improved the prospects for targets for securities fraud lawsuits by facilitating removal to the district court, arguably a more favorable environment for defendants to address nonsense suits at an early stage of the litigation. CAFA’s state-centered provisions, however, in certain instances limit such removal thus preserving the state forum, arguably a more favorable environment for plaintiffs with meritorious claims. In other words, CAFA exemplifies how federal reforms addressing abuses in class action litigation can be accomplished with appropriate balancing of legitimate interests.

The United States economy, while still weak in many respects, is showing strong signs of life in the deal markets. This shaking out process of moving assets to their highest value use could presage a robust economic era for the economy. Potential legal reforms to streamline the “tax” imposed by plaintiff suits in the M&A and proxy contexts could only aid in this economic upswing.

--By Thad A. Davis and Abbye Atkinson, Gibson Dunn & Crutcher LLP

Thad Davis is a partner with Gibson Dunn & Crutcher in the firm's New York office and a co-chairman of the firm's national securities litigation practice. Abbye Atkinson is an associate in the firm's San Francisco office.

[1] 15 U.S.C. § 78u–4(b)(1)(B), (2).

[2] See 15 U.S.C. § 78bb(f)(1).

[3] Id. § 78bb(f)(2).

[4] See 15 U.S.C. § 77p(d).

[5] 17 C.F.R. § 240.10b-5(b); 15 U.S.C. § 78j(b).

[6] Madden v. Cowen & Co., 556 F.3d 786, 790 (9th Cir. 2009), superseded on other grounds by Madden v. Cowen & Co., 579 F.3d 957(9th Cir. 2009).

[7] 552 U.S. 148 (2008).

[8] Id. at 159.

[9] See Janus Capital Group Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2299(2011).

[10] Id. at 2302.

[11] 550 U.S. 544, 570 (2007).

[12] 556 U.S. 662, 678 (2009).

[13] Id.

[14] See Mark Maremont, Backdating Likely More Widespread, WALL STREET JOURNAL, August 18, 2009.

[15] See Peter Lattman, Backdating Scandal Ends with a Whimper, NEW YORK TIMES, November 11, 2010.

[16] See http://blog.issgovernance.com/slw/options-backdating/; http://www.gibsondunn.com/publications/Documents/Farhang-BNABackdating-Directors.pdf

[17] See Gibson, Dunn & Crutcher, 2012 Year-End Securities Litigation Update, January 24, 2013, available at http://www.gibsondunn.com/publications/pages/2012-Year-End-Securities-Litigation-Update.aspx.

[18] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[19] 15 U.S.C. § 78n-1.

[20] See, e.g., Laborer's Local v. Intersil, 868 F.Supp. 838, 847-49 (N.D.Cal., 2012).

[21] See, e.g., Knee v. Brocade Communications Systems, Inc., No. 1-12-CV-220249 (Cal. Sup. Ct. Santa Clara, April 10, 2012), in which the court granted plaintiffs' motion for a preliminary injunction, and

Brocade subsequently settled the claim, agreeing to supplement its proxy statements and to reimburse plaintiff's' counsel up to $625,000. Other companies targeted in 2012 by similar lawsuits that also entered in settlement agreements include WebMD Health Corp. and Martha Stewart Living Omnimedia Inc.

[22] For example, in Wenz v. Globecomm Systems, Inc., No. 31747–12 (N.Y. Sup. Ct. Suffolk County, Nov. 14, 2012), the New York Supreme Court of Suffolk County denied plaintiffs' motion to enjoin the upcoming shareholder vote because of purported proxy deficiencies, stating that "a review of the record before the Court . . . leads to the conclusion that the disclosure claims alleged by the plaintiffs fail to show that any of the omitted information complained of significantly would have altered the 'total mix' of information available to shareholders." See also Gordon v. Symantec Corp., No. 1-12-CV-231541 (Cal. Sup. Ct. Santa Clara, Oct. 17, 2012) and Mancuso v. The Clorox Co., No. RG12-65165 (Cal. Sup. Ct. Alameda County, Nov. 13, 2012).

[23] See, e.g., Hutt v. Martha Stewart Omnimedia, No. 651249–12 (N.Y. Sup. Ct. N.Y. County, Apr. 17, 2012).

[24] See, e.g., H.R. Rep. No. 104-50 (1995) (noting abuses in securities litigation prompting the need for the enactment of the PSLRA).

[25] 28 U.S.C. § 1711 note.

[26] Id. at § 1332 (a)(2).

[27] Id. at § 1332(d)(4)(B).

[28] Id. at § 1332(d)(4)(A).