Securities Reform Act Litigation Reporter

A Monthly Reporter Featuring Expert Analysis and Prompt Publication of Oral and Written Decisions

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Highlights

The most noteworthy decisions this month are the following:

- In *Gamco Investors v. Vivendi*, Nos. 13-194, 13-1377 (2nd Cir. Sep. 27, 2016), in a case brought by a value investor Gamco against Vivendi for damages suffered because of failure to disclose liquidity risk, the Second Circuit affirmed a District Court bench trial summary judgment ruling that Gamco could not assert the rebuttable presumption of reliance and would have invested in Vivendi despite the liquidity risk.

- In *Torres v. S.G.E. Management, LLC,* No. 14-20128 (5th Cir. Sep. 30, 2016) (en banc), plaintiffs allegedly defrauded into joining a sales system that in reality was a pyramid scheme were entitled to class certification for their RICO claims, even though some members of the class who knew it was a pyramid scheme voluntarily participated to try to win. In reaching the opposite conclusion of a prior panel decision, an *en banc* Fifth Circuit held that the predominance requirement of Rule 23(b)(3) was satisfied because the proximate cause element of the RICO claims could be established through common proof such that individualized issues would not predominate at trial. The court determined that common questions concerning causation would predominate, regardless of whether the plaintiffs relied on a theory of foreseeability or an inference of reliance in establishing causation.

- In *Lee v. Verizon Communications, Inc.,* No. 14-10553 (5th Cir. Aug. 17, 2015) (unpub.), current retirees failed to establish that their former employer had violated the Employee Retirement Income Security Act of 1974 (ERISA) when it amended its pension plan and transferred obligations from the

(continued on page 4)

Contents

Page

ROUND TABLE ON *IN RE VIVENDI* 11

SEC CHAIR MARY JO WHITE
SEPT. 21, 2016 KEYNOTE REMARKS
INTERNATIONAL BAR ASSOCIATION
ANNUAL CONFERENCE 30

RECENT DECISIONS 44

BEST OF THE BLOGS 142

DOCUMENTS

Opinion, *Gamco Investors v. Vivendi*

Opinion, *Lee v. Verizon Communications, Inc.*

Opinion, *Cobalt Partners, LP v. SunEdison, Inc.*

Opinion, *Feola v. Cameron*

Opinion, *City of Pontiac General Employees' Retirement System v. Dell Inc.*

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ongoing plan by purchasing an annuity. Upholding dismissal of ERISA claims, the Fifth Circuit held that the former employer's decision to partially transfer pension obligations from an ongoing plan was not a breach of fiduciary duty under ERISA Section 404 because the decision by a plan sponsor to amend a plan was not a fiduciary act.

- In *Cobalt Partners, LP v. SunEdison, Inc.,* No. 16-cv-02263-WHA; No. 16-cv-02264-WHA; No. 16-cv-02265-WHA; No. 16-cv-02268-WHA (N.D. Cal. Aug. 26, 2016), Judge William Alsup, United States District Judge for the Northern District of California, denied Plaintiffs' motion to remand four related matters while granting Defendants' motion to transfer the matters to the Southern District of New York. He concurrently certified the issue for interlocutory review and stayed the actions while Plaintiffs decide whether or not to seek appellate review.

- In *Feola v. Cameron,* No. 15-cv-01654-JAK (C.D. Cal. Aug. 25, 2016), Judge John A. Kronstadt of the United States District Court for the Central District of California granted defendants' motion to dismiss plaintiffs' putative class action in connection with statements made in the Company's financial reports regarding unpaid taxes. Despite the plaintiff's confidential witness testimony, director resignations, GAP violations and alleged competitive advantages the court did not find a strong inference of scienter as to any defendants. The court allowed plaintiffs an opportunity to amend.

- In *Pirnik v. Fiat Chrysler Automobiles, N.V.*, No. 15-CV-7199 (JMF) (S.D. N.Y. Oct. 5, 2016), the Court denied a motion to dismiss claims that Fiat Chrysler Automobile (Chrysler) misrepresented its degree of compliance with regulatory requirements in the months before it entered into a consent decree admitting to violations of the National Traffic and Motor Vehicle Safety Act of 1996 (the "Safety Act"), including delayed notification to vehicle owners of 23 recalls, and agreeing to pay a record $105 million fine. In the months leading up to the consent decree, Chrysler executives received letters from the U.S. regulator criticizing its slow progress on notifying customers and replacing parts in connection with the Takata airbag recall and the recall of Jeeps with fuel tanks that could catch fire in low-impact collisions. Chrysler acknowledged in a reply letter to the regulator that its response to the recalls had not been satisfactory yet, around the same time, told the Senate that the regulator viewed its "customer-notification protocols as 'industry-best.'"

- In *City of Pontiac General Employees' Retirement System v. Dell Inc*., No. A-15-CV-374-LY (W.D. Tex. Sep 16, 2016), plaintiffs alleged that Defendants misleadingly informed investors to expect results "in-line" with prior quarters while in possession of contrary information. Defendants argued that Plaintiffs failed to adequately plead two essential

elements of a Section 10(b) securities-fraud claim: (1) material misrepresentation or omission, and (2) *scienter*.

- In *Rihn v. Acadia Pharmaceuticals Inc.,* No. 15cv00575 BTM(DHB) (S.D.Cal. Sept. 19, 2016), a putative class action asserting that the defendants had made material misrepresentations concerning a drug maker's preparedness to submit an application for a new drug crucial to the company adequately alleged claims of securities fraud. Chief District Judge Moskowitz held that the plaintiff had adequately alleged that the defendants' public assurances that the application remained "on track" for submission by a deadline—when in fact the company had not assessed its manufacturing and quality assurance systems, a critical step in the FDA process, resulting in a five-month delay—were materially misleading.

- In *Washtenaw County Employees' Retirement System v. Walgreen Co.,* No. 15-cv-3187 (N.D. Ill. Sep. 30, 2016), investors claiming that a pharmacy chain and its CEO and CFO falsely misrepresented the reasons why protected 2016 earnings goals, set as part of an earlier merger with another pharmacy chain, might not be met, were able to adequately allege that only three statements were false and misleading. Denying in part the defendants' motions to dismiss, District Judge Coleman held that the plaintiff had adequately alleged the falsity of statements concerning the existence and nature of generic drug price inflation and reimbursement pressures.

- In *City of Pontiac Gen. Employees' Ret. Sys. v. Wal-Mart Stores, Inc.*, No. 5:12-cv-5162 (W.D. Ark. Sept. 20, 2016), the Western District Court of Arkansas certified a class of Wal-Mart shareholders who alleged losses after the *New York Times* reported on a bribery scheme involving Wal-Mart's Mexican subsidiary, causing the stock price to fall nearly 10% over three days. The court ruled that the Last in First Out Method (LIFO) of computing damages was preferable to the First in First Out (FIFO) method and that defendant's objection to the "build-up" method of computing damages was premature.

- In *In re Appraisal of Dell Inc.*, Consol. C.A. No. 9322-VCL (Del. Ch. Oct. 17, 2016), Vice Chancellor Laster granted in full the fee application of lead counsel for the appraisal class following a Dell merger, rejecting the objections raised by two groups of appraisal claimants who had hired separate counsel to represent their interests. Lead counsel Grant & Eisenhofer P.A. (G&E) benefitted the appraisal class to the tune of $25,225,145.08 after their efforts through trial resulted in a determination that the fair value of Dell at the effective time was $17.62 per share, or $3.87 per share more than the merger consideration. The court deducted the requested expenses—$4,007,462.08—from the aggregate benefit achieved for the class, and then invoked *Sugarland* for an estimate of a reasonable award of attorneys fees based upon a percentage of the benefit, which here, could have been as

high as $7 million (or 33% of the benefit) since G&E had litigated the case through trial. The lodestar calculation based on hours worked also amounted to over $7 million in fees. G&E, however, requested a lower amount, based on its contingency agreement with its own appraisal clients. The requested fees of $4,043,705.42, representing 19.06% of the net benefit, were "reasonable" in light of the benefit achieved and the complexity of the case, and were to be allocated *pro rata* among the appraisal class.

- In *In re BofI Holding, Inc. Securities Litigation,* Case No. 3:15-CV-02324-GPC-KSC (S.D. Cal. Sept. 27, 2016), in a securities fraud case where investors sued a federally-chartered "Internet bank" (which provides consumer and commercial services wholly on-line) and several senior executives, a federal district court granted in part and denied in part a motion to dismiss, holding that Section 10(b) claims will proceed against the bank and its CEO because only they have the requisite scienter for material misrepresentations about the bank's sketchy lending practices, insufficient internal controls, and overall financial health. While the CEO was complicit in the scheme, the complaint failed to identify specific misrepresentations or omissions by the other individual defendants. The court declined to infer scienter for these defendants based on their alleged motive to defraud, their positions on the audit committee, or their failure to recognize the bank's accounting missteps.

- In *Vanguard Specialized Funds v. VEREIT Inc*., No. CV-15-02157 (D. Ariz. Oct. 3, 2016), the District Court of Arizona declined to dismiss the bulk of plaintiffs' claims against one of the world's largest real-estate investment trusts, American Realty Capital Properties, Inc. (ARCP), and some of its former executives, holding that plaintiffs had adequately pled securities fraud claims under state and federal statutes for the defendants' overstatements of an evaluation metric provided to investors that artificially inflated its stock price. The court also denied a motion to transfer the case to the Southern District of New York because the plaintiffs could not have brought their case there without sacrificing their state law claims to a Securities Litigation Uniform Standards Act challenge.

- In *Luis v. RBC Capital Markets, LLC*, No. 16-cv-00175 (D. Minn. Oct. 13, 2016), the District Court of Minnesota agreed with defendants and dismissed the plaintiffs' putative class action, holding their fraud claims were barred by the Securities Litigation Uniform Standard Act (SLUSA). The plaintiffs' complaint alleged misrepresentations and omissions of material fact by the defendant in connection with the sale of reverse convertible notes (RCNs), a high-risk investment product. The plaintiffs claimed RCNs were not a "covered security" under SLUSA but the court disagreed despite a paucity of precedent on the issue. The court dismissed the case without prejudice, leaving plaintiffs with the opportunity to restate their claims under state law.

- In *In re CommVault Systems, Inc. Sec. Litig.,* No. 14-cv-5628 (D. N.J. Sep. 30, 2016), an investment fund acting as lead plaintiff adequately alleged claims under Section 10(b) and Rule 10b-5 that the defendants had materially misrepresented the consequences of the loss of a business partner and the use of cookie jar accounting to mask decelerating growth. Denying the defendants' motion to dismiss, District Judge Sheridan held, first, that the plaintiff had met the heightened pleading standards of Rule 9(b) and the PSLRA in alleging false or misleading statements.

- In *Hsu v. Puma Biotechnology, Inc.,* No. SACV 15-0865 (JCGx) (C.D. Cal. Sep. 30, 2016), in connection with a public offering, investors were able to adequately allege securities fraud claims against a drug maker and two of its top executives. Denying the defendants' motion to dismiss, District Judge Guilford held that the plaintiffs had pled both falsity and scienter well enough to allow the case to proceed. Finding that the allegations were sufficient to "allow this case to get out of the starting gate," the court observed that "[m]any of [the defendants'] arguments to the contrary are really a better measure of whether [the plaintiffs'] case will be victorious past the eighth pole and down to the finish line."

- In *SEC v. Mapp,* No. 4:16-CV-246 (E.D. Tex. Oct. 7, 2016), a state politician offered compensation to promote a company's stock came close to obtaining dismissal of securities law claims against him. Conditionally granting the defendant's motion to dismiss, District Judge Mazzant ruled that the SEC had not alleged facts sufficient to support plausible claims under Sections 17(a) and (b) of the Securities Act or Sections 10(b) and 15(a) of the Exchange Act. While the SEC's request to amend its complaint did not satisfy Rule 15, the court said it was inclined to allow the SEC to plead additional facts before dismissing the claims against the moving defendant.

- In *In re OM Group, Inc. Stockholders Litig.,* No. 11216-VCS (Del. Ch. Oct. 12, 2016), in a challenge to a merger, disgruntled shareholders claiming that board members had breached their fiduciary duties in a merger transaction failed to show that the overwhelming shareholder vote approving the merger was due to inadequate disclosure. Granting the defendants' motion to dismiss, Vice Chancellor Slights held that the shareholders' fully informed, disinterested and uncoerced approval of the merger agreement cleansed any failure of the board to act reasonably to seek the transaction offering the best value reasonably available. Because of the approval of the transaction by a majority of shareholders, the standard of review of the transaction shifted from enhanced scrutiny to the business judgment rule. Since the plaintiffs did not allege that the merger amounted to waste, they could not overcome the presumption of the business judgment rule.

- In *Chester County Employees' Retirement Fund v. New Residential Investment Corp.*, C.A. No. 11058-VCMR (Del. Ch. Oct. 7, 2016), in a case where a stockholder brought direct claims against New Residential Investment Corp., a Real Estate Investment Trust (REIT), and affiliated entities based on allegations that it overpaid for a third party's assets with stock in a self-interested transaction, the Court of Chancery held that demand was not excused as all of plaintiff's claims were derivative rather than direct, even if the stock issuance had caused a dilution in plaintiff's shares. It further held that plaintiff had not pled particularized facts sufficient to infer a defendant's material interest in the challenged transactions, so demand was not excused under Rule 23.1. Since the plaintiff pled potentially viable claims, however, dismissal was with leave to replead.

- In *In re Receptos, Inc. Stockholder Litigation,* Civil Action No. 11316-CB (Del. Ch. July 21, 2016, in a consolidated stockholder class action suit challenging the high-profile acquisition of one biopharmaceutical company by another, where the case settled quickly leaving only the question of attorneys' fees for plaintiffs' counsel, the Delaware Chancery Court awarded the modest sum of $100,000 under the *Trulia* standard (as compared with the $350,000 sought). This bench ruling signals the continuing demise of disclosure-only settlements in the absence of material supplemental disclosures. The only benefit to the class was Receptos' management's estimate of likelihood for securing regulatory approval of a drug because this information enabled stockholders to gain some understanding about the confidence of management in getting regulatory approval.

- In *Local No. 8 IBEW Ret. Plan & Trust v. Vertex Pharmaceuticals*, No. 15-2250 (1st Cir. Oct. 3, 2016), the First Circuit affirmed dismissal of a securities fraud action alleging that Vertex Pharmaceuticals and several of its executives "turned a blind eye" to "study results that seemed too good to be true" in order to reap "a windfall on the sale of their stock." The First Circuit found no allegations to support plaintiffs' contention that defendants knowingly or recklessly "announced interim results that overstated the improvement in lung function" of patients taking an experimental drug combination for the treatment of cystic fibrosis.

- In *Whitley v. BP*, No. 15-20282 (5th Cir. Sep. 26, 2016), the Fifth Circuit held the Southern District of Texas applied the wrong pleading standard in determining whether an amended ERISA complaint brought by the beneficiaries of BP's employee stock ownership plan passed muster under the Supreme Court's decision in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014). In *Whitley*, the Fifth Circuit stated that "[u]nder the Supreme Court's formulation," a plaintiff asserting an ERISA breach of the duty of prudence claim based on inside information "bears the significant burden of proposing an alternative course of action so clearly beneficial that a prudent fiduciary *could not conclude*

that it would be more likely to harm the fund than to help it." The Fifth Circuit determined the district court had instead erroneously considered whether "no prudent fiduciary would have concluded that" the alternative actions "would do more good than harm."

- In *North Collier Fire Control and Rescue Dist. Firefighter Pension Plan v. MDC Partners*, No. 15 Civ. 6034 (RJS) (S.D. N.Y. Sep. 30, 2016), the Southern District of New York dismissed with prejudice a securities fraud action against MDC Partners and certain of its officers and directors for failure to allege either material misstatements or scienter. The court held plaintiffs' goodwill-related allegations were insufficient to meet the standard for pleading a securities fraud claim based on a misstatement of opinion. As to plaintiffs' claim that defendants used a "misleading version of EBITDA," the court found that companies are free to calculate EBITDA as they deem appropriate, provided they disclose their methodology. With respect to plaintiffs' contention that the company failed to disclose the full amount of compensation paid to its CEO, the court found the allegedly underreported amount was neither quantitatively nor qualitatively material. Finally, the court held plaintiffs' allegations of insider stock sales did not support an inference of scienter "because the vast majority [of those] trades occurred a year or more before the alleged revelation of the fraud."

- In *Nguyen v. Barrett,* C.A. No. 11511-VCG (Del. Ch. Sep. 28, 2016), the Delaware Court of Chancery dismissed post-closing claims that the board acted disloyally or in bad faith by failing to make the challenged disclosures. The Court also reiterated Delaware's strong preference that plaintiffs assert and pursue disclosure claims pre-closing so there is an opportunity to remedy these concerns prior to the stockholder vote.

- In *Judy v. Preferred Communication Systems, Inc*., C.A. No. 4662-VCL (Del. Ch. Sept. 19, 2016), the Court of Chancery denied a fee award to a litigation funding firm in the decision of *Judy v. Preferred Communication Systems, Inc*., C.A. No. 4662-VCL (Del. Ch. Sept. 19, 2016).

- In *Chrome Systems, Inc. v. Autodata Solutions, Inc., et al*., C.A. No. 11808-VCG (Del. Ch. Sept. 21, 2016), the Court of Chancery ruled on a request for interlocutory appeal as it related to the Court's rulings on spoliation issues. In the decision of *Chrome Systems, Inc. v. Autodata Solutions, Inc., et al*., C.A. No. 11808-VCG (Del. Ch. Sept. 21, 2016), Vice Chancellor Glasscock declined to certify the interlocutory appeal.

- In *Geier v. Mozido, LLC*, C.A. No. 10931-VCS (Del. Ch., Sept. 29, 2016), the Court of Chancery granted Mozido, LLC ("LLC") and Mozido, Inc.'s ("Inc.") motion to dismiss claims by plaintiff Philip Geier ("Geier") because Geier released his claims against the entities in a previous settlement agreement.

- In *Jay Frechter v. Cryo-Cell International, Inc.,* Civil Action No. 11915-VCG (Del. Ch. Oct. 7, 2016), the Court of Chancery granted a mootness fee in connection with a lawsuit brought by a stockholder challenging a bylaw provision. The bylaw provision at issue indicated that directors could be removed "for cause" at a "special meeting" of stockholders. The plaintiff asserted that under Section 141(k) of the Delaware General Corporation Law, stockholders have the right to remove directors without cause, and thus the provision was unlawful.

- In *In re Books-A-Million, Inc. Stockholders Litigation*, C.A. No. 11343-VCL (Del. Ch. Oct. 10, 2016), Vice Chancellor Laster of the Delaware Court of Chancery clarified certain issues related to the obligations of a controlling stockholder that often arise in connection with going private and similar transactions. The case involved a relatively conventional proposal by a controlling stockholder (the Anderson family) to acquire the remaining shares of Books-A-Million, Inc. ("BAM") from BAM's minority stockholders. The family structured the proposal with the goal of satisfying the conditions of the MFW decision so that any challenge to the transaction would benefit from the favorable "business judgment" level of judicial review.

- In *Reiter v. Fairbank*, C.A. No. 11693-CB (Del. Ch. Oct. 18, 2016), the Delaware Court of Chancery recently provided an exemplary explanation of Delaware law on the requirements that must be met before directors can be found liable for breaching their duty of oversight.

- In *The Huff Energy Fund, L.P. v. Gershen*, C.A. No. 11116-VCS (Del. Ch. Sept. 29, 2016), the Delaware Court of Chancery recently dismissed a stockholder's breach of contract and fiduciary claims against a dissolving company. This action stems from Defendant Longview Energy Company's ("Longview") decision to dissolve Longview after the company sold a significant portion of its assets. Plaintiff, The Huff Energy Fund ("Huff"), was the largest Longview stockholder, holding approximately 40% of Longview's common stock. Huff brought suit to challenge the dissolution.

Round Table on *In re Vivendi*

Summary of Opinion 11

Publisher's Commentary 20

Commentary by Topol & Williams 23

Commentary by Tu & Foley 26

CLASS ACTION; 10b-5; SECURITIES FRAUD;

PUFFERY; FORWARD-LOOKING STATEMENTS; LIQUIDITY CRISIS; INFLATION MAINTENANCE; EXPERT TESTIMONY; EVENT STUDY;

PRICE IMPACT; JURY VERDICT;

LOSS CAUSATION; FOREIGN SHAREHOLDERS

In re Vivendi, S.A. Sec. Litigation, Nos. 15-180-cv(L), 12-208-cv(XAP) (2d Cir. Sept. 27, 2016)

Second Circuit Upholds Jury Verdict of Securities Fraud Based on Misstatements of Financial Health When Company Faced a Liquidity Crisis; Loss Causation Held Established by "Inflation Maintenance" Despite the Lack of a Corrective Disclosure or the "Materialization" of a Bankruptcy

Sana Hamelin

The Second Circuit affirmed a jury verdict for plaintiffs in a class action against Vivendi Universal, S.A., holding that Vivendi's optimistic assurances about its fiscal state were "half-truths" sufficient for a finding of securities fraud in light of Vivendi's internal knowledge of its liquidity risk. The Court embraced "inflation maintenance" to find liability where a company's affirmative misstatements preserved an inflated stock price regardless of the initial cause of the inflation. It further held that the district court properly admitted expert testimony even though plaintiff's expert did not offer proof that each of the misrepresentations had specific effects on the stock price. Instead, the expert calculated investor damages by using a proxy to generally correlate declines in the stock price with liquidity risk. It was up to the jury to ultimately decide the extent to which the model was accurate and which extraneous events were responsible for potions of the stock decline.

In so ruling the Court held:

- Loss causation was established even though the risk—bankruptcy—did not materialize and no corrective disclosure was issued because investors still suffered losses when the truth about Vivendi's liquidity leaked out and its stock price declined.
- The plaintiffs were not required to prove that each of fifty-seven alleged misstatements had a price impact when their aggregate effect was to maintain an inflated stock price.
- Defendants whose fraud *prevents* preexisting inflation in a stock price from dissipating are just as liable as defendants whose fraud introduces inflation into the stock price in the first instance.
- Liquidity risk was not "too amorphous" to function as a theory of liability.
- The misstatements were not nonactionable "puffery" because they were specific, and were not "forward-looking statements" because they contained false or misleading present representations.
- The district court did not abuse its discretion in excluding certain foreign shareholders from the class on the basis that the excluded countries might not recognize a judgment from a U.S. court, and did not err in dismissing claims by American purchasers of ordinary shares under *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247 (2010).

Background and Overview

Vivendi Universal grew from being a French utilities company in 1998 to a global media conglomerate in 2001, as it aggressively acquired a diverse array of media and communications businesses in the United States and abroad. Its acquisition spree increased Vivendi's debt from 3 billion euros to 21 billion euros and strapped it for cash. The company faced a liquidity crisis, but Vivendi attempted to put a happy face on its troubles by making optimistic public statements. These assurances stood in sharp contrast to internal communications and memoranda, presented into evidence by plaintiffs as a "Book of Warnings," in which the company's Chief Financial Officer warned the CEO and other employees about Vivendi's financial troubles in stark terms.

Vivendi's liquidity troubles became public after credit-rating agencies downgraded Vivendi's senior debt and Vivendi announced selling off a significant stake in one of its holdings, and eventually, as it replaced its CEO. Although Vivendi never experienced a full-blown liquidity crisis or defaulted on its loans, its stock price plummeted as the market became aware of the company's true liquidity position. Plaintiffs, a global class of investors, brought a securities lawsuit alleging that the company misled shareholders about

Vivendi's liquidity risk and overall growth through various public statements at the same time the company was suffering massive losses and increased debt. Following a three-month trial, a jury found Vivendi liable for securities fraud based on fifty-seven misstatements. Vivendi appealed and the Second Circuit affirmed.

Ultimately persuasive to the Court was the disparity between Vivendi's "inside reality" and its "outside message." The company touted its "very strong . . . results with outstanding growth," "the highest growth rates in the industry," "strong operating results," "free operational cash flow [that was] far above [its] objectives," etc. These and other such representations were best characterized as "half-truths" since they glossed over Vivendi's liquidity situation, described by a member of its finance department as "tense" by the middle of 2001, "dangerous" by late 2001, and "more than dangerous [throughout 2002]." Vivendi's CFO repeatedly raised the alarm about looming cash flow problems, warned of the danger of bankruptcy, and spoke of "humiliating" meetings with ratings agencies threatening a downgrade. Four days after one such warning of a downgrade, Vivendi announced a $10.3 billion transaction and claimed it was "not putting pressure on Vivendi Universal," and that it anticipated maintaining "a very comfortable . . . credit rating."

In addition to concealing liquidity issues, Vivendi was also aware that its purchase accounting method painted a deceptively rosy picture of its fiscal health. As it took credit for "aggressive" EBITDA growth rates, implying high profitability and ample cash flow available to service debt, it was aware that its high EBITDA targets derived in large part from "purchase accounting effects (which are just one-time paper adjustments that cannot readily translate into free cash flow) rather than profits from a company's business operations (which reflect actual earnings that may translate into free cash flow)."

In light of these egregious facts—the sheer scale of the company's debt and its total refusal to come clean about its fiscal state—the Court flexed the law in plaintiffs' favor, probably overruling *In re Bear Stearns Companies, Inc. Sec., Derivative and ERISA Litig.*, Master File No. 08 MDL 1963 (RWS) (S.D.N.Y. July 25, 2016) where the Southern District of New York rejected the "leakage theory" of loss causation (an analysis of the market impact of the dissemination of information over time before and not limited to corrective disclosures). Here, the Court cited *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 342 (2005) to stress that it is enough that the loss caused by the alleged fraud results from the "relevant truth . . . leak[ing] out."

Issues on Appeal

Vivendi contended on appeal that (i) the plaintiffs had failed to properly present a specific set of alleged misstatements earlier in the trial, (ii) the identified misstatements

were inactionable puffery, forward-looking statements, or statements of opinion, (iii) the plaintiffs impermissibly relied on a vague "liquidity risk theory" of liability, (iv) the district court erred by admitting expert testimony on damages that did not establish price impact, and plaintiffs failed to demonstrate loss causation.

Plaintiffs cross-appealed the dismissal of foreign shareholders and American purchasers of ordinary shares.

Vivendi's Appeal

(i) Omissions Versus Half-Truths

Vivendi contended that the plaintiffs failed to identify a specific set of alleged misstatements earlier in the trial, which had the effect of "eliminat[ing] the foundational element of a claim for securities fraud" under Section 10(b) and Rule 10b-5. A pure omission, such as Vivendi's failure to inform the market of its liquidity troubles, is not actionable under the securities laws unless the corporation is subject to a duty to disclose the omitted facts. However, the court distinguished "pure omissions" from "half-truths," which are literally true statements that create a materially misleading impression, and will support a claim for securities fraud.

Although the Court acknowledged that plaintiffs were at times "less than precise" in articulating their theory of liability, and initially proposed a jury verdict form that did not include a list of specific alleged misstatements (later amended upon instruction from the court), the plaintiffs' theory of liability ultimately rested upon fraud through affirmative misstatements by Vivendi, and was not predicated on its silence or "pure omission." The district court judge specifically informed the jury that Vivendi was not required to disclose every piece of material information it possessed, and distinguished between "pure omissions" and statements that are misleading by virtue of what they omit to disclose. The charged theory was not one of "pure omission" and the jury properly entered a verdict based on fifty-seven specific misstatements that perpetuated the central lie that Vivendi was operating on a sound financial footing.

(ii) Statements of Opinion, Puffery, and Forward-Looking Statements

Opinion: The Court refused to consider Vivendi's argument that some of the alleged misstatements were nonactionable statements of opinion because the only time this argument had been raised was in a motion to dismiss six years earlier, which was not sufficient to alert the Court to the existence of the argument. Vivendi claimed that "intervening authority" excused its failure to raise the argument in its Rule 50 motion, but the intervening authority here had merely "sharpened or otherwise elaborated" upon an argument that was

already known to be available, and had not established any new arguments about the actionability of opinion statements.

Puffery: Puffery encompasses "statements [that] are too general to cause a reasonable investor to rely upon them." Statements Vivendi characterized as "puffery" included statements such as: "[Vivendi] posted RECORD-HIGH NET INCOME, and ha[d] cash available for investing," and "[t]he results produced by Vivendi Universal in the second quarter are well ahead of market consensus." The Court held that such statements were not so general that a reasonable investor could not have relied upon them in evaluating whether to purchase Vivendi's stock.

Forward-Looking Statements: Vivendi claimed that certain statements fell under the safe-harbor provision for "forward-looking statements" under the PSLRA whereby a defendant is not liable if (1) the forward-looking statement is identified and accompanied by meaningful cautionary language, (2) the forward-looking statement is immaterial, or (3) the plaintiff fails to prove that the statement was made with actual knowledge that it was false or misleading. Here, it was clear that at least some of the statements that Vivendi identified as forward-looking contained present representations, which removed their entitlement to safe harbor. One such statement that Vivendi claimed was forward-looking stated: "Vivendi Universal enters its first full year of operations with strong growth prospects and a very strong balance sheet. This new company is off to a fast start and we are very confident that we will meet the very aggressive growth targets we have set for ourselves both at the revenues and EBITDA levels." The Court pointed out that there was "nothing prospective about the representation that Vivendi entered 2001 with a "very strong balance sheet."

Further, to the extent certain statements were forward-looking, they were not accompanied by meaningful cautionary language. All Vivendi could point to were vague disclaimers that were more in the nature of "garden-variety business concerns that could affect *any* company's financial well-being." Finally, there was sufficient evidence for the jury to find that Vivendi had actual knowledge that its statements were false or misleading. For example, Vivendi's announcement in October 2000 of a 35% EBITDA growth-rate objective was misleading to a reasonable investor, as recognized by Vivendi's CFO in an internal email that noted "analysts will not have it easy to track the purchase accounting benefits" in EBITDA figures. A reasonable investor would be even less likely to discern the impact of purchase accounting on Vivendi's figures.

(iii) Liquidity Risk Theory

Vivendi broadly attacked all of the misstatements on the ground that the plaintiffs had pegged their case on Vivendi's liquidity risk, which was too "amorphous" and "ephemeral"

a concept for any statement to be false or misleading with respect to it. The Court disagreed, stating that liquidity—even if not a "perfectly defined concept with rigid outer bounds"—related to a company's ability to fund its operations and meet its financial obligations, and thus would have been material to a reasonable investor. The federal securities laws, the Court pointed out, "do not protect against only those false and misleading statements that are false or misleading with respect to very specific material facts." The question then became whether there was sufficient evidence to support the jury's finding that fifty-six of the fifty-seven statements (excluding the statement on which the district court granted Vivendi judgment as a matter of law) were materially false or misleading with respect to liquidity risk.

The test for whether a statement is materially misleading under Section 10(b) is not whether the statement is misleading in and of itself, but "whether the defendants' representations, *taken together and in context*, would have misled a reasonable investor." Even if each of the statements did not repeat the same thing, they either spoke directly to liquidity risk or referred to components that contributed to liquidity risk. It would be perverse, said the Court, if a company could escape liability by "disseminating a network of interrelated lies, each one slightly distinct from the other, but all collectively aimed at perpetuating a broader, material lie." Where a company seeks to hide a particularly large problem with multiple contributing factors, it is likely it will have to lie about a number of related topics to successfully conceal the larger issue. Just so here, as Vivendi's problem was "so vast" that a few scattered misstatements would not have sufficed to mask it. Instead, Vivendi needed to "systematically misrepresent" its ability to satisfy its liquidity demands.

As an example, the Court once again recalled Vivendi's aggressive EBITDA growth rates strategy whose success was predicated on purchase accounting benefits, called "accounting magic" by Vivendi's CFO. To drive the point home, the Court highlighted six of the specific misstatements that spoke of "free cash flow of more than 2 billion euros," "additional war chest of 10 billion euros for 2001-2002," having "cash available for investing," "cash flow [] breaking even," "no hidden risks," and expressed confidence in "its capacity to meet its anticipated obligations over the next 12 months." Alongside each statement, the Court juxtaposed Vivendi's internal knowledge of the impending crisis, such as the CFO's "belie[f] that it is wrong to reason . . . in terms of free cash flow (there won't be any this year)," the results of Goldman Sachs' analysis that informed the board that bankruptcy loomed as one of four possible scenarios in three months' time, and the urgency with which a major stockholder urged that new management be installed, the need to sell assets to avoid bankruptcy, and expressed fears that "[o]ur company may fail, and we have not one minute more to waste." Taken all together, the Court found sufficient evidence for the

jury's finding that a reasonable investor could find each of the alleged misstatements false or misleading in context with respect to Vivendi's liquidity risk, and this risk was not so amorphous as to be categorically inactionable as a theory of liability.

(iv) Expert Testimony, Price Impact, and Loss Causation

The plaintiffs' expert, Dr. Blaine Nye, did not correlate inflated stock price to specific misstatements, prompting defendants to argue that he failed to present a traditional "price impact" analysis.

Nye's Methodology: Nye performed an event study to determine whether, and to what extent, Vivendi's stock price was artificially high (i.e. inflated) during the class period due to the market's misapprehension of Vivendi's true liquidity risk. Nye eliminated the effect on the stock price of market-wide events and isolated the variations in Vivendi's stock price that were specific to Vivendi, charting both statistically significant spikes and drops in the stock price. He reviewed more than 16,000 documents to determine whether the information released on any particular day related to Vivendi's liquidity risk, and came up with a list of days on which there was either a positive or negative impact on the stock price associated with information on Vivendi's liquidity risk. The list included nine "negative residual return days"—days on which negative news about Vivendi's liquidity risk came out and resulted in inflation dissipating from the stock price—and one "positive residual return day" on which positive news pertaining to Vivendi's liquidity came out and inflation in Vivendi's stock price increased. The sum of the nine negative return days, offset by the positive return day, came to €22.52, and Nye concluded this was the maximum loss that investors suffered due to the market's lack of knowledge about Vivendi's true liquidity risk. Early sellers suffered less loss than those who sold later.

Nye pinpointed December 13, 2001 as the date when "the discrepancy between what the market knew and what Vivendi knew was at its widest." However, it was more difficult to determine *when* the inflation entered into Vivendi's stock price. Assuming that the full amount of the inflation reflected the value of the truth about Vivendi's liquidity problem at the *apex* of that problem, Nye posited that inflation in the stock price grew over time in step with the worsening of Vivendi's liquidity issues. Without a direct measure, Nye selected three proxy measures to calculate Vivendi's true liquidity risk at any given time. Noting that all three proxies followed similar paths over time, Nye selected the most conservative of the proxy candidates: the increasing degree to which purchase accounting benefits contributed to Vivendi's EBITDA figures. It is important to note that Nye did not measure inflation actually caused by Vivendi's alleged fraud nor assumed that Vivendi's share price was inflated due to misrepresentations. Although fifteen of the fifty-seven statements

plaintiffs identified at the close of trial did issue on days when inflation increased under Nye's model, Nye's testimony did not depend on this correlation. It was left up to the jury to determine how much, if any, of the artificial inflation identified by Nye was caused by Vivendi's misstatements.

Inflation Introduction Versus Inflation Maintenance: Vivendi contended that the fact that forty-two statements did not directly correlate with specific increases in inflation made Nye's testimony unreliable because no "price impact" existed with respect to these forty-two statements. Vivendi charged that the district court "fabricated" an erroneous inflation "maintenance" theory that posits that statements that merely *maintain* inflation already extant in stock price nonetheless *affect* the stock price. Vivendi distinguished between inflation introduction and inflation maintenance, arguing that statements that introduce new inflation actually affect a company's stock price, while statements that merely maintain inflation have no impact because "the preexisting inflation would have persisted" had the defendant who made those inflation-maintaining statements "simply remained silent" as was the defendant's right in the absence of a duty to disclose.

The Court was not persuaded. It was not necessarily the case that preexisting inflation (however it was introduced) would have remained in the face of silence. Misstatements could perpetuate misconceptions that might otherwise have dissipated over time. Thus, it was more coherent to conclude that Vivendi's misstatements had the effect, if not of maintaining the inflation, then preventing the preexisting inflation in stock price from dissipating, and "[d]efendants whose fraud *prevents* preexisting inflation in a stock price from dissipating are just as liable as defendants whose fraud introduces inflation into the stock price in the first instance." Moreover, "once a company chooses to speak, the proper question for purposes of our inquiry into price impact is not what might have happened had a company remained silent, but what would have happened if it had spoken *truthfully*." To conclude otherwise is to let companies off the hook for actively perpetuating, through affirmative misstatements, inflation already extant in their stock price, as long as they cannot be found liable for whatever originally introduced the inflation. In so holding, the Court joined the Seventh and Eleventh Circuits' conclusion that "theories of 'inflation maintenance' and 'inflation introduction' are not separate legal categories," and securities-fraud defendants cannot avoid liability for an alleged misstatement merely because the misstatement is not associated with an uptick in inflation.

Regardless of the validity of Vivendi's price impact argument, the Court found Dr. Nye's testimony relevant and reliable for purposes of damages calculations. Nye measured "actual inflation"—inflation due to investors not knowing the truth about Vivendi's liquidity risk, even if no false statement was ever made. The total amount of actual inflation that

Nye identified was the maximum amount of loss potentially caused by Vivendi's alleged misstatements. Nye's testimony also provided a model over the course of the class period to calculate each plaintiff's damages. Thus, the district court properly admitted the expert testimony as helpful to the trier of fact.

Loss Causation: Loss causation requires demonstrating that the subject of the fraudulent statement or omission was the cause of the actual loss suffered. Vivendi argued that plaintiffs could not establish loss causation because an "objective event such as bankruptcy, default, or insolvency" never materialized as a result of Vivendi's liquidity risk. The Court acknowledged past holdings that state that plaintiffs can establish loss causation either by showing a "materialization of the risk" or identifying a "corrective disclosure" that reveals the truth behind the alleged fraud, but disagreed that these were distinct and separate pathways to demonstrate loss causation. Instead, the loss causation principle simply requires that the fraud be disclosed and cause investors to lose money as a result. Plaintiffs' theory of loss causation rested on the revelation of the truth, even if that did not come about by way of a corrective disclosure. Specifically, Dr. Nye identified nine events that revealed the truth about Vivendi's liquidity risk, and these events were sufficient for the jury to conclude that concealment of the subject of Vivendi's misstatements (its liquidity risk) was the cause of the actual loss suffered by the plaintiffs.

Plaintiffs' Cross-Appeals

Foreign Shareholders: The district court limited the class to investors in the United States, France, England and the Netherlands on the basis that these countries were likely to recognize a judgment from a U.S. court, but it excluded investors from other countries, including Canada, Germany and Austria. The district court had found that Germany and Austria were unlikely to give preclusive effect to a class judgment, but did not make any findings with respect to Canada or any other excluded country. The plaintiffs contended that doubts about the preclusive effect of a judgment is an insufficient basis to exclude class members where other factors favor inclusion. The Second Circuit deferred to the district court that concerns about foreign recognition of our judgments are reasonably related to superiority, and that the plaintiffs did not carry their burden that the proposed class met the requirements of Rule 23 as they failed to identify any evidence they presented to the district court which suggested that foreign courts in the excluded countries would grant preclusive effect to a class judgment.

Dismissal Under Morrison: The plaintiffs objected to the dismissal of claims by American purchasers of ordinary shares under *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247 (2010) because Vivendi did not bring its motion to dismiss these claims until after

trial, and because the purchasers incurred "irrevocable liability" within the United States under *Absolute Activist Value Master Fund Ltd v. Ficeto*, 677 F.3d 60 (2d Cir. 2012). Upon *de novo* review, the Court affirmed, noting that prior to *Morrison*, Vivendi's motion was foreclosed by controlling precedent and it did not waive its argument by not raising it earlier. *Morrison* held that Section 10(b) applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities." In *Absolute Activist*, the Second Circuit used the concept of "irrevocable liability" to determine what constitutes a "domestic purchase or sale" under *Morrison*, reasoning that if "parties" to a transaction incur irrevocable liability in the United States, defined as "becom[ing] bound to effectuate the transaction" or "entering into a binding contract to purchase or sell securities," the transaction is domestic and Section 10(b) applies. However, Americans who acquired ordinary shares were not "parties" to the transaction at issue (the merger between Vivendi, Canal+, and Seagram), so the *Absolute Activist* exception did not apply to them.

* * *

The Facts Determine the Law

Neil J. Cohen

Publisher

This case put the Second Circuit on the horns of a dilemma. Under *Dura and Halliburton II* plaintiffs should prove proximate causation to avoid unwarranted recoveries. But in an inflation maintenance case, dismissal for lack of proximate causation would allow a defendant to commit securities fraud with impunity. That result is especially unacceptable here because corporate officers disregarded an auditor's repeated warnings of a liquidity crisis and the company advertised earnings increases of 35% per year without disclosing that their purchase accounting system would produce inflated results. Without these malodorous facts, the district or circuit court probably would have decided the case differently, as it did in *IBEW Local 98 Pension Fund v. Best Buy Co*., 818 F.3d 775 (8th Cir. 2016). There the alleged misrepresentation was less offensive: Only 14 days into the quarter an officer said at a press conference that the company was "in line" to meet its quarterly earnings forecast. At the oral argument to the Eighth Circuit on the class certification decision one judge chastised the plaintiff's lawyer for bringing a mere "stock drop case." On these facts, the Court found a way to reject the materialization of the risk claim, concluding that the stock price did not drop as a result of the alleged misstatement.

Opening the Door

The *Vivendi* holding makes it easier for plaintiffs to fashion a securities fraud case because they need not point to a misrepresentation and corrective disclosure by the company. So long as a plaintiff can point to a half-truth and a contradictory news story followed by a price drop, the plaintiff can argue that the statement maintained price inflation or materialized an unanticipated risk.

Thus, the decision provides plaintiffs' lawyers with many incentives to cast their complaints as inflation maintenance cases rather than corrective disclosure cases. For example:

(1) There is no need to prove a defendant made a completely false statement: a half-truth is sufficient;

(2) The starting date of the price inflation can be set by the plaintiff as the first half-truth;

(3) The securities fraud can consist of an aggregation of half-truths;

(4) There is no need to demonstrate whether a price drop was caused by defendant's corrective disclosure because any news story causing a price drop is sufficient;

(5) The plaintiff's expert witness does not need to prove loss causation by relating stock price increases or decreases to each half-truth: the expert only has to estimate the damages related to each leakage of the truth;

(6) At the class certification stage the defendant will not be able to show a lack of price impact because it is allegedly responsible for maintaining price inflation.

Class Certification

The *Vivendi* class was certified in 2007. Because the defendant did not contest the predominance requirement, the *Vivendi* appeal did not even mention class certification. It remains to be seen whether the Second Circuit will apply *Vivendi* to the class certification context. Instead, the Court could follow the Fifth Circuit's decision in the *BP Deepwater Horizon* pre-spill securities litigation, *Ludlow v. BP, P.L.C.*, 800 F.3d 674 (5th Cir. 2015).

In *BP*, the plaintiffs' theory of damages for the pre-spill class was that "BP had understated the risk of catastrophe, and when that risk materialized, they could recover its resulting damages." The Fifth Circuit agreed with the lower court that the pre-spill damages theory could not be applied class-wide because it required an individualized finding "that each plaintiff would not have bought BP stock at all were it not for the alleged misrepresentations." Because class-wide treatment of the pre-spill damages issues was not possible, plaintiffs' pre-spill damages model did not satisfy *Comcast*, 133 S. Ct. at 1433, which said

that plaintiffs could not recover damages other than those "resulting from the particular . . . injury on which [defendant's] liability in this action is premised."

As discussed in the comment by David H. Topol and Jennifer A. Williams:

> The Fifth Circuit rejected a materialization-of-the-risk case at the class certification stage because, although the plaintiffs were not required to prove loss causation at that stage, they failed to set forth a damages model that ultimately would do so. . . .
>
> The court rejected the model and, by way of example, provided a scenario in which the true risk to BP of a major oil spill was 2%, but BP's statements misrepresented the risk as only 0.5%. While some conservative investors would be entitled to the full recovery of the decline because they would not have invested in BP at all had they known the true risk of 2%, other more risk-tolerant investors would still have purchased BP stock and should only be able to recover the price difference between the amount they paid (assuming the 0.5% risk) and a hypothetical price assuming the 2% risk. The court concluded that it could not determine the plaintiffs' claims on a class-wide basis but rather would require individualized inquiry

Because investors tolerate various levels of risk, this analysis could doom certification of the class in every risk materialization case. Whether the *BP* case is followed in other circuits will depend on various factors such as whether the court rules that *Comcast*, an antitrust case, applies to securities fraud; whether the court is willing to delve into loss causation models at the certification stage; whether the court considers it reasonably possible to separate fraud damages from extraneous factors, and most importantly, the perceived gravity of the alleged fraud. At the class certification stage the plaintiff's loss causation model does have to be precise, but *Comcast* provides a cynical court with an opportunity to trash a weak case.

An Ounce of Prevention

This litigation probably could have been avoided if Vivendi had simply disclosed in its Management's Discussion and Analysis (MD&A) that

(1) The borrowing required for its ambitious acquisition program would expose the company to a significant risk that assets might have to be sold to meet its creditor obligations and

(2) Its purchase accounting method tends to artificially inflate its earnings results.

The SEC requires MD&A disclosures on liquidity risk. For example, in 2005 the SEC brought a civil complaint against Kmart officers alleging that "instead of candidly admitting the fact of an ill-advised overbuy of inventory and the significant impact it had on the

company's liquidity, the officers dealt with Kmart's liquidity problem by secretly slowing down payments owed vendors," many of whom stopped shipping their products to Kmart. On June 1, 2009 the SEC obtained a jury verdict against the former CEO of Kmart Corporation for misleading investors about inventory levels and liquidity levels as the company was approaching a January 2002 bankruptcy filing.

* * *

Proof of Damages After *Vivendi*

By David H. Topol & Jennifer A. Williams[1]

Wiley Rein LLP

In its recent decision in *In re Vivendi Universal, S.A. Securities Litigation*, No. 15-180, 2016 WL 5389288 (2d Cir. Sept. 27, 2016), the Second Circuit appears to have opened the door wider for plaintiffs with respect to two major recurring issues impacting damages in securities litigation—the price maintenance theory and materialization of the risk. Although there is uncertainty as to whether the court's holding was limited by the posture of the case, it will at a minimum embolden plaintiffs to pursue cases with more tenuous damages theories.

Price Maintenance Theory

With respect to price maintenance theory, the court concluded that a plaintiff need not prove a specific increase in stock price as the result of a particular misrepresentation by the defendant. Rather, according to the court, so long as a misstatement prevents existing inflation from dissipating, the plaintiff has met his or her burden. The court reasoned that, "[w]ere this not the case, companies could eschew securities-fraud liability whenever they actively perpetuate (*i.e.*, through affirmative misstatements) inflation that is already extant in their stock price, as long as they cannot be found liable for whatever originally introduced the inflation." Op. at 73.

The court's intentions may have been noble, but unintended legal implications may follow from endorsing the price maintenance theory. A plaintiff must present price impact evidence—typically, proof that a misrepresentation in fact increased the stock price—in order to demonstrate transaction causation, or reliance. That is, the plaintiff must establish that he or she purchased or retained the company's stock *because of* the defendant's misrepresentation. Price impact is proof of reliance because the economic theory of fraud-on-the-market

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instructs that the price of a stock in an efficient market reflects all public, material information, including the alleged misstatements of the defendant.

The danger with price maintenance theory—allowing a plaintiff to argue simply that the misrepresentation kept the stock price artificially high—is that plaintiffs may be able to move forward with a case without ever demonstrating that the statements at issue had an impact on stock price. Rather than presenting evidence of inflation when the stock price goes up after a misrepresentation, plaintiffs will be speculating that the price might have gone down absent the misrepresentation.

If plaintiffs need not tie a particular misrepresentation to a specific increase in the defendant's stock price, the pool of statements by defendants on which a Section 10(b) claim could be based will expand significantly. In fact, plaintiffs need not identify the initial source of the stock price inflation at all, and the source need not be anything actionable by the defendant. Instead, plaintiffs can pick and choose among a series of alleged misstatements or half-truths during any period of time before the stock price drop. As in *Vivendi*, pairing this theory with a materialization of the risk theory for proving loss causation (as opposed to requiring specific corrective disclosures) affords even greater latitude for plaintiffs to patch together a securities fraud case based on whatever events come to pass.

We note, however, that the *Vivendi* court considered the issue of price maintenance theory in reviewing the trial court's decision to admit the plaintiffs' expert's testimony for abuse of discretion. The court deemed the expert's testimony relevant, reliable, and helpful to the jury even if it could not establish the element of reliance with respect to all of the misstatements at issue. The Second Circuit was also careful to qualify its holding: "To be clear, we do not hold that all statements unassociated with an increase in inflation necessarily have a 'price impact.' We merely hold that such statements do not, as Vivendi argues, categorically lack a 'price impact.'" Op. at 78 n.20. Thus, the outcome of other cases with other facts and in other procedural postures could be different. One notable contrast was the Eighth Circuit's recent rejection of a price maintenance theory in *IBEW Local 98 Pension Fund v. Best Buy Co*., 818 F.3d 775 (8th Cir. 2016), concluding in the context of class certification that the defendant successfully rebutted the presumption of reliance with front-end evidence that the stock price did not increase upon the alleged misstatement. At minimum, the Second Circuit has entered the fray of the circuit split on the viability of price maintenance theory, and it will continue to be a contentiously litigated issue until there is further guidance or resolution from the Supreme Court.

Materialization of the Risk

In addition to opening the door to plaintiffs on the issue of price maintenance theory, the Second Circuit also embraced materialization of the risk as a valid method of proving loss

causation, even where the risk that materialized was not an adverse development but simply a greater risk of an adverse development than the company had previously disclosed. According to the court: "Whether the truth comes out by way of a corrective disclosure describing the precise fraud inherent in the alleged misstatements, or through events constructively disclosing the fraud, does not alter the basic loss-causation calculus." Op. at 82.

This holding likewise makes it easier for plaintiffs to fashion a securities fraud case because they need not point to a corrective disclosure by the company. So long as a plaintiff can point to some actionable statement on the subject matter of the events that came to pass, the plaintiff can argue that the drop in stock price was a materialization of the risk. The concept of materialization of the risk may not be inherently problematic—it is easy to imagine, for example, a company's filing for bankruptcy being the corrective event that reveals prior misstatements about the company's liquidity. The Second Circuit took this a step further, however, by recognizing not only materialization of subject of the risk (i.e, bankruptcy) but also simply materialization of a greater risk than previously disclosed.

The danger with such an approach, however, is that it threatens to decouple the stock price movement from the alleged misrepresentation. Indeed, other courts have found this to be problematic. For example, in the BP Deepwater Horizon securities litigation, the Fifth Circuit rejected a materialization-of-the-risk case at the class certification stage because, although the plaintiffs were not required to prove loss causation at that stage, they failed to set forth a damages model that ultimately would do so. *Ludlow v. BP, P.L.C.*, 800 F.3d 674 (5th Cir. 2015), *cert. denied*, 136 S. Ct. 1824 (2016). In particular, the plaintiffs sought to recover the bulk of the price decline following the Deepwater Horizon oil spill on the theory that the spill reflected the foreseeable consequences of BP's materially misstated risk of catastrophic failure.

The court rejected this model and, by way of example, provided a scenario in which the true risk to BP of a major oil spill was 2%, but BP's statements misrepresented the risk as only 0.5%. While some conservative investors would be entitled to the full recovery of the decline because they would not have invested in BP at all had they known the true risk of 2%, other more risk-tolerant investors would still have purchased BP stock and should only be able to recover the price difference between the amount they paid (assuming the 0.5% risk) and a hypothetical price assuming the 2% risk. The court concluded that it could not determine the plaintiffs' claims on a class-wide basis but rather would require individualized inquiry. Notably, the court also observed that the plaintiffs' own damages model may in fact have rebutted the presumption of reliance (which, again, is based on the fraud-on-the-market theory that the stock price reflects all material, public information, including the

defendant's misstatements) because it asserted that their investment decision was based on a factor other than price—specifically, BP's risk exposure.

In sum, on the issues of both price maintenance theory and loss causation, the Second Circuit appears to have lessened the burdens of proof for plaintiffs. Although these holdings may have been in part the product of the posture in which the court was conducting its review, and it thus remains to be seen how these issues may arise in other contexts such as class certification, the likely outcome is more securities cases being brought. To the extent that the courts continue to give latitude to plaintiffs on these issues, they will have an easier time proving damages notwithstanding the questionable link between stock price and the alleged misrepresentation.

* * *

The Second Circuit Lowers the Bar for Showing Loss Causation in *In re Vivendi*

Michael Tu & William Foley

Orrick Herrington & Sutcliffe LLP

On September 27, 2016, the Second Circuit Court of Appeals issued a decision affirming a securities fraud judgment against Vivendi Universal, S.A. ("Vivendi"): *In re Vivendi, S.A. Sec. Litig*, No. 15-180, 2016 WL 5389288 (2d Cir. Sept. 27, 2016). *Vivendi* involved claims that the company failed to inform its shareholders of an impending liquidity crisis, and indeed fraudulently represented that nothing was amiss. Unlike most securities fraud class action lawsuits, the *Vivendi* case was tried to a jury verdict before being appealed. The decision was significant in many respects, not least of which is that the Court broadened plaintiffs' ability to prove the required element of loss causation.

Background

In 2002, plaintiff-shareholders brought a class action suit against Vivendi, a global media conglomerate, alleging violations of Section 10(b) of the Securities Exchange Act of 1934. As alleged by plaintiffs, in 2000 and 2001, Vivendi had grown substantially, acquiring a diverse array of media and communications businesses via acquisition. According to plaintiffs' claims, Vivendi's acquisition spree caused the company to run critically low on cash, and by late 2001, Vivendi was in danger of defaulting on its debt obligations and/or becoming insolvent. Plaintiffs claim that during this time period, Vivendi fraudulently made numerous optimistic public representations, omitting any mention of Vivendi's impending liquidity crisis.

In mid-2002, however, several things happened that tipped investors to Vivendi's liquidity struggles: the ratings agencies downgraded Vivendi's debt ratings, the company sold both a significant number of treasuries and stakes in two subsidiaries, and management announced plans to divest billions more in assets over the next nine months. This conflation of events caused Vivendi's stock price to drop precipitously as investors feared a liquidity crisis. Notably, Vivendi never *actually* suffered a liquidity crisis—*i.e.*, the company never became insolvent, declared bankruptcy or defaulted on its debt.

Nearly seven years after plaintiffs initiated suit, the case went to trial before a jury in October 2009. After a three month trial and 14 days of deliberation, the jury found Vivendi liable under Section 10(b) for 57 alleged misstatements. The District Court denied Vivendi's motions for judgment as a matter of law and for new trial. Vivendi appealed to the Second Circuit.

Vivendi's appeal was based on numerous grounds, including that: (i) plaintiffs had failed to offer the required "statement-by-statement" proof of fraud, and had instead argued generally that Vivendi had failed to disclose its liquidity risk; (ii) any alleged misstatements by Vivendi were either opinion or non-actionable "puffery"; (iii) plaintiffs' liquidity risk theory was too "amorphous" or "ephemeral" a concept for any statement to actually be false; (iv) plaintiffs' expert could show no price inflation; and (v) plaintiffs had failed to show "loss causation"—that their losses were actually caused by specific misstatements.

Loss Causation

Loss causation is "the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff."[2] To prevail on a Section 10(b) claim, a plaintiff must allege that the subject of the fraudulent statement or omission was the cause of the actual loss suffered.[3] Under Second Circuit precedent, there are two ways a plaintiff may go about proving loss causation: either he or she must allege that (i) "the market reacted negatively to a corrective disclosure of the fraud"; or (ii) "that the loss was foreseeable and caused by the materialization of the risk concealed by the fraudulent statement."[4]

In Vivendi's case, the company never made a "corrective disclosure" regarding its liquidity risk. Consequently, Vivendi argued that under Second Circuit precedent, plaintiffs could only attempt to show loss causation under the "materialization of the risk" theory. On appeal, Vivendi argued that plaintiffs could not demonstrate loss causation under the "materialization" theory because the "risk" plaintiffs identified—a liquidity crisis—never

[2] *Emergent Capital Inv. Mgmt., LLC v. Stonepath Grp., Inc.*, 343 F.3d 189, 197 (2d Cir. 2003).

[3] *Carpenters Pension Trust Fund of St. Louis v. Barclays PLC*, 750 F.3d 227, 232 (2d Cir. 2014).

[4] *Id.* at 232-33.

actually materialized. Indeed, Vivendi noted that it never declared bankruptcy, defaulted on its debt, or was required to restate its financial results. Without being able to tie their losses to a corrective disclosure or to the materialization of a specific risk, Vivendi argued that plaintiffs could not establish loss causation.

The Second Circuit, however, rejected Vivendi's argument. Citing *Dura Pharm., Inc. Broudo*,[5] the Court held that "to show loss causation, it is enough that the loss caused by the alleged fraud results from the 'relevant truth . . . leak[ing] out."[6] According to the Court, even under the "materialization of the risk" theory, plaintiffs are only required to show that a misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security.[7] In other words, the "constructive disclos[ure]" of the risk itself is sufficient to prove loss causation, even if that risk never actually materializes, as long as that disclosure negatively impacts share price.

The Court found that "Vivendi's conception of loss causation would have the effect of insulating companies from securities-fraud liability whenever the thing concealed in a material misstatement never ripens from a mere risk to an out-and-out disaster—unless a specific corrective disclosure issues."[8] In *Vivendi*, the Court posited, the company was found to have lied about *the risk* of insolvency—not necessarily insolvency itself—and that certain events (including the debt ratings downgrades and asset sales) "constructively disclosed" this risk and caused investors to lose money. This, the Court found, sufficiently demonstrated loss causation.

This finding arguably merges the "corrective disclosure" and "materialization of the risk" theories of loss causation into a third theory.[9] Here, Vivendi made no corrective disclosure and the illiquidity risk never materialized in the form of a bankruptcy or default, yet the Court *still* found that plaintiffs had satisfactorily shown loss causation. This finding is significant because, as Vivendi noted in its appellate briefing, the Second Circuit had never before "upheld a materialization-of-risk theory based on illiquidity where the issuer did not seek bankruptcy protection, restate its financial results, or miss a payment to creditors."[10]

[5] 544 U.S. 336, 342 (2005)

[6] 2016 WL 5389288 at *26.

[7] *Id.*

[8] 2016 WL 5389288 at *26

[9] 2016 WL 5389288 at *26 ("our past holdings do not suggest that 'corrective disclosure' and materialization of risk' create fundamentally different pathways for proving loss causation, such that a specific corrective disclosure is the only method by which a plaintiff may prove losses resulting from the revelation of the truth.").

[10] 15-180, D.I. 70 at 87.

Conclusion

Vivendi makes it easier to prove loss causation within the Second Circuit. Plaintiffs presumably now have three options to prove that their losses were caused by defendants' fraud. First, plaintiffs can point to a defendant's "corrective disclosure" that caused share prices to fall. Second, plaintiffs can demonstrate that a risk unknown to plaintiffs *materialized* (*e.g.*, bankruptcy or a credit default), which in turn caused share prices to fall. Finally, in light of the *Vivendi* decision, plaintiffs can point to some other event or occurrence that "constructively disclosed" a risk unknown to plaintiffs *exists*, which causes a fall in prices, even if that risk never actually materializes.

* * *

SEC Chair Mary Jo White

Sept. 21, 2016

Keynote Remarks

Legal Practice Division Luncheon

International Bar Association Annual Conference

Thank you, Almudena Arpon de Mendivil, for your kind introduction.

It is my pleasure to participate in this year's International Bar Association Annual Conference at the request of your president, David Rivkin, whom I first came to highly admire from our days as very young lawyers. He is a tremendous lawyer and leader. In reviewing your conference program, I was struck by the significant overlap with issues currently on the SEC's agenda.

As the regulator of the world's largest securities markets, and thousands of globally-active firms, the SEC is naturally very engaged in many issues that extend beyond the U.S. border. Indeed, the first speech I gave as Chair—after only three weeks on the job—was about the SEC as an international regulator, having spent a surprising amount of time on international meetings and issues.[1] The centrality of international issues to financial regulation and the SEC has not changed during these last three and a half years.

The world's capital markets are indisputably global and interconnected. A couple of quick metrics make the point: as of 2015, U.S. investors held nearly $9.6 trillion in foreign securities, and foreign holdings of U.S. securities were over $17.1 trillion.[2] Consider as well single-name CDS activity—a truly global market where over $7 trillion dollars in notional value was outstanding at the end of 2015:[3] only 12 percent of global transaction volume was between two counterparties located in the U.S., while 48 percent was between one counterparty located in the U.S. and the other located abroad.[4] Witness also the financial crisis when the collapse of the markets for certain products cascaded throughout the global financial system, gravely impacting many interconnected financial institutions, and then all of the ensuing efforts to take measures, both domestically and internationally, to prevent a recurrence.

Today, all securities regulators need to be very cognizant of our global, as well as domestic, responsibilities, whether we are implementing standards for the global over-the-counter derivatives markets; detecting and protecting against new systemic risks in our financial systems; helping each other enforce our respective laws by gathering evidence

from across the globe; examining our registrants, wherever they may be located, to ensure that they are abiding by the rules; or raising the bar on world-wide enforcement efforts to combat corrupt corporate payments, through our Foreign Corrupt Practices Act (FCPA) or similar regimes in other jurisdictions.

All securities regulators, around the world, share the overarching obligation to protect investors—the end-users of the products and services that we regulate. Fulfilling this all-important function is not possible if we stop our work at country borders or fail in our efforts to achieve robust international cooperation. Neither the SEC, nor other regulators, can go it alone, and we have many avenues to facilitate working together.

The SEC communicates frequently with market regulators, central banks, finance ministries and law enforcement authorities in other jurisdictions, directly and through our participation in international organizations—most notably, the International Organization of Securities Commissions (IOSCO) and the Financial Stability Board (FSB). The SEC also works bilaterally and multi-laterally with foreign authorities, both on policy issues with a cross-border dimension and on supervisory and enforcement issues. Indeed, the SEC has over seventy-five formal cooperative arrangements with foreign regulators and law enforcement agencies[5] and is a signatory to the IOSCO Multilateral Memorandum of Understanding (MMOU) on enforcement cooperation, to which there are now over 100 signatories.[6] All of these arrangements facilitate sharing critical enforcement and supervisory information.[7] And the SEC and other countries make extensive use of them.[8]

While international cooperation and coordination have increased significantly in recent years, we still face significant challenges from laws and practices that can impede strong regulation, supervision, and enforcement. And it is incumbent upon the SEC and our international counterparts to work through these issues in a way that provides maximum cooperation and coordination and avoids regulatory arbitrage. We must do this while recognizing that we do not operate in a one-size-fits-all world and that there are, for good reason, significant differences in our domestic markets, as well as our regulatory regimes. I will not attempt grand solutions today. But, I will focus you on a few priority areas that illustrate the dimensions of the SEC's international role and some of the challenges we face in maximizing the effectiveness of national regulatory regimes in a global market.

There is no shortage of issues to choose from. I have settled on three topics for today—one regulatory, one supervisory, and one from the enforcement space. The first topic is the SEC's current work to modernize our regulation of the asset management industry, which has been one of the SEC's core responsibilities since the 1940s under the Investment Company Act and the Investment Advisers Act, and which is of particular interest to other

domestic and international authorities assessing potential systemic risks to financial stability. Next, I will raise an area of significant supervisory challenge for us in 2016—the ability to examine our non-U.S. based registrants for compliance with SEC laws and regulations. Finally, because of its importance and its interest to this audience, I will briefly report on the SEC's FCPA enforcement program, which is so dependent on international cooperation for its success.

Regulating the Asset Management Industry

During my tenure as Chair, the SEC, as the primary regulator of the vast majority of the asset management industry, has undertaken an ambitious agenda to modernize and enhance our regulatory regime. On the international front, the FSB and IOSCO have also been focusing on this critical sector of the global markets.

The globalization of our securities markets comes during a time of exponential increase in the assets under management by SEC-registered investment advisers—from approximately $21.5 trillion in 2001 to approximately $67 trillion as of this month. And the asset management is increasingly a world-wide industry: investment advisers registered with the Commission with their principal office outside the U.S. have increased nearly 150 percent over the last 13 years. Of the more than $37 trillion in worldwide assets invested in regulated open-end funds,[9] an estimated 34 percent of those are regulated in Europe, 13 percent in Africa and the Asia Pacific, and 5 percent in the Americas outside the U.S. As the industry has grown and expanded globally, it has also become increasingly complex in the range of strategies and types of funds offered, which presents their own set of regulatory challenges.

To address the challenges and risks to investors and funds arising from this evolution, the SEC has proposed several transformative rulemakings to modernize our regulatory tools, as I publicly outlined in December 2014.[10] These proposals include: enhancing effective liquidity risk management by mutual funds and exchange traded funds (ETFs); limiting the amount of leverage that funds are permitted to obtain through the use of derivatives; modernizing funds' disclosure and reporting of information; and requiring investment adviser business continuity and transition planning. Recently, the Commission adopted the final rules to enhance the reporting and disclosure of information provided by investment advisers, including, importantly, new required reporting about separately managed accounts and their use of derivatives and borrowing. We expect the other proposed reforms to be finalized in the near-term as well.

Throughout these initiatives, the SEC staff have analyzed a range of options on how best to reduce potential risks, including those that may have systemic impact, in the asset management industry, while first and foremost protecting investors and still facilitating

capital formation. Our regulatory initiatives have reflected an activities-based approach focused particularly on registered funds' liquidity management and use of derivatives to obtain leverage.

Internationally, the FSB and IOSCO are pursuing a similar activities-based approach, as evidenced by the FSB's recent request for comment on asset management activities and potential systemic risk.[11] Likewise, IOSCO recently stated that a current priority is to address data gaps on separately managed accounts generally and in relation to those accounts' leverage and derivatives exposures.[12] In the U.S., the Financial Stability Oversight Council (FSOC) has also been engaged in a review of the potential systemic impacts of asset management products and activities.[13] We have been heavily engaged across all these efforts, contributing the SEC's extensive knowledge and the rationale of our recent reforms.

In short, regulating the asset management industry is a core pillar of the SEC's day job, and its potential impact on the global financial system also has the attention of the SEC and authorities worldwide. The SEC will continue to share its long-standing expertise with other regulators as we pursue our comprehensive approach to asset management regulation and shared objective and responsibility to the interconnected, global marketplace.

Supervising Financial Firms in a Global Marketplace:
Data Protection and the Regulators' Need for Access to Data

Another internationally important topic affecting the SEC is foreign privacy and other data protective laws that impact cross-border data transfers for supervisory purposes. A large and varied set of foreign firms have chosen to register with the SEC, including brokers, investment advisers, and other intermediaries, such as clearinghouses and platforms that facilitate trading, disseminate information to the public, and serve a variety of other critical functions in the securities markets. They also manage assets in growing amounts—advisers registered with the SEC with principal offices outside the U.S. now account for $8.7 trillion of assets under management—an amount that has quadrupled since 2003. As a result, the SEC is confronted with the challenge to supervise these registrants, wherever in the world they maintain operations, personnel, and records.

Various countries' laws, including blocking statutes, privacy, bank secrecy, and state secrecy laws, are designed to achieve important national objectives. But they also frequently create obstacles to cross-border flows of information between regulators and foreign-domiciled registrants, thus complicating, and in some instances impeding, the regulators' ability to carry out their supervisory responsibilities. Some of these laws, for example, can prohibit foreign-domiciled SEC registrants from providing the SEC with information about clients and employees, including names and account information. Other laws can

prevent foreign-domiciled registrants in certain jurisdictions from responding directly to SEC requests for information without authorization by the foreign government. Finally, certain laws can prevent the SEC from being able to conduct any type of examinations of registrants, either onsite or by correspondence.

These legal barriers obviously raise significant issues for the SEC and our international counterparts. Effective oversight of globally-active firms requires that financial regulators have a robust supervision program. I cannot emphasize strongly enough how critical the records we seek and the examinations we conduct are to the SEC's ability to assess firms' compliance with U.S. law and to protect investors and the markets. Examinations can help identify weaknesses or deficiencies in a firm's compliance program that, if addressed, can help prevent violations of law and harm to investors. Many SEC examinations, both risk-based examinations and those initiated for cause, also identify violations that already have occurred and that need to be addressed to avoid further harm.[14]

Under U.S. law, all firms registered with the SEC are required to maintain certain records relating to their operations and provide these records to the SEC staff upon request.[15] The records document how the firm and its employees conduct their business in practice and provide critical insight into the firm's risk profile, the strength of a firm's internal controls, and whether the firm is complying with applicable securities laws.[16] The SEC staff most frequently requests these basic business operations records from registrants, both domestic and foreign, in connection with a non-public supervisory examination, which typically focus on a firm's compliance with its legal obligations and its adherence to its own policies and procedures.[17]

During examinations, SEC staff may also request information on a firm's clients or its employees, when they are essential to the SEC's evaluation of a registrant's compliance program. Such information is needed to allow us to assess a registrant's compliance and to ensure that their investors are protected, but may raise privacy concerns in some jurisdictions.

In addition to having direct access to registrant books and records, a responsible regulator must also be able to interface directly with the firms it regulates. During an examination, SEC staff expects registrants to make representatives from both management and staff available to enable examiners to learn more about the registrant's operations and the records examiners have reviewed, as well as to prevent misunderstandings about the firm's business.[18] This is a core component of SEC staff's evaluation of a firm's approach to compliance and adherence to law.

Having direct relationships with the firms we oversee also helps to establish open and frank lines of communication with our regulated community. Ongoing discussions with SEC registrants also generally foster compliance within a firm and encourage a firm's support of its compliance professionals. These discussions can also facilitate self-reporting by a firm that has identified misconduct by its employees.

Let me be clear, I fully support supervisory cooperation among regulators in fulfilling our respective oversight activities of globally active firms and I am not suggesting that the SEC or any regulator should operate in isolation. Indeed, the SEC generally carries out its examinations and other ongoing monitoring of internationally regulated entities in close consultation with our foreign regulatory counterparts, who, through their own interactions with the firm, have invaluable insights about a firm's compliance culture and practices and have developed their own risk assessment of the firms we both regulate.[19]

In addition to exchanging views on a firm's risk profile and disciplinary history, the SEC and our international counterparts share previous examination results and refer supervisory issues to each other, which assists our respective staffs in directing their supervisory resources to aspects of the firms' business that present the greatest risk. Supervisory cooperation has been an excellent complement to the SEC's own oversight activities of our registered firms.[20]

More than ever before, it is critical that jurisdictions break down their information-sharing walls. Regulators must be able to directly supervise the entities registered with them to ensure compliance with the laws in their jurisdiction. One of the important lessons of the 2008 financial crisis was that regulators need a complete and accurate picture of the financial firms they regulate, regardless of where these regulated entities are located or where their regulated activities occur. As regulators, we cannot afford to have a blind or even cloudy spot.

Strong Enforcement Against Foreign Corrupt Payments

Now let me say a few words about the FCPA, both about its importance and our current enforcement program. As a securities regulator, the SEC oversees and enforces a robust disclosure regime, one of the fundamental premises of which is that public companies must accurately disclose the drivers of their business successes (and failures) and the associated risks to the company's future performance.

A company's use of illicit payments—specifically, the payment of bribes and other things of value to obtain or retain business—masks the reality that a company is not competing on its merits. Instead, the company has relied on bribes to succeed. Making illicit payments also exposes a company to potential legal liability in multiple jurisdictions, hurts

a company's reputation, and jeopardizes the company's future. Above all, corrupt payments undermine the integrity of our financial markets and have a corrosive impact on many institutions and businesses around the world. For these and other reasons, the U.S. enacted the FCPA in 1977, making it illegal, both civilly and criminally, for U.S. companies and individuals acting on their behalf to pay bribes to foreign officials.[21] Vigorous enforcement of the FCPA is a high priority for both the SEC and the Department of Justice (DOJ).

The SEC's record enforcing the FCPA is very strong and 2016 is no exception. This fiscal year, the SEC has already filed 17 actions against entities and individuals for FCPA violations, a nearly 30 percent increase from last year, and obtained more than $290 million in monetary remedies. As part of our proactive FCPA program, the SEC also makes occasional use of deferred prosecution and non-prosecution agreements in order to promote self-reporting, cooperation, and remediation.[22]

To effectively combat bribes paid by global companies that benefit from access to our capital markets by listing their stock on U.S. exchanges, the SEC is often dependent on our international counterparts to provide vital cooperation and assistance. And I am very pleased that the SEC has received assistance from an expanding list of countries in FCPA cases filed this fiscal year.[23] Let me illustrate with just one impressive example.

Earlier this year, the SEC, DOJ, and Dutch regulators entered into a global settlement with a telecommunications provider based in the Netherlands, where the company agreed to pay $795 million to resolve its violations of the FCPA in Uzbekistan.[24] The SEC charged that the Dutch company offered and paid bribes to an Uzbek government official, who was related to the President of Uzbekistan, as the company sought licenses, frequencies, channels, and number blocks in the country's regulated industry. We received significant cooperation from numerous countries during this complex investigation, including the civil and criminal authorities from Bermuda, the British Virgin Islands, the Cayman Islands, Estonia, Gibraltar, Ireland, Latvia, the Marshall Islands, Netherlands, Norway, Spain, Sweden, Switzerland, and the United Arab Emirates—truly, an exceptional global effort in a very important case.[25]

In addition to actions against companies, we prioritize charging individuals involved in bribery schemes where we have the necessary evidence and jurisdiction over the offender. Holding individuals accountable for their misconduct remains one of the most powerful deterrents in any enforcement area.

Not surprisingly, FCPA cases involving individuals requires significant and multi-faceted cooperation from our international partners. And we are getting it. This year alone, our FCPA cases against individuals included a CFO who helped falsify the company's books

and records, an engineer who bribed foreign officials and enriched himself, and a CEO who used sham consulting agreements to authorize improper payments to officials to settle a labor dispute.[26] In these cases, the SEC received meaningful and substantial assistance from our international counterparts, including civil and criminal authorities from Austria, the British Virgin Islands, Canada, the Cayman Islands, Cyprus, Denmark, Estonia, Finland, Latvia, and Liechtenstein.[27]

The fight against bribery and corruption is obviously a global effort and not limited to offending U.S. companies or their employees operating abroad. We all recognize its importance, as evidenced by the renewed commitment and focus on what more the entire international regulatory community can do to be more effective and better coordinated in dealing with corruption issues worldwide. As a first step, this requires countries to pass strong comprehensive laws targeting bribery and many jurisdictions have taken this crucial step. For example, according to a 2015 report by the Organisation for Economic Co-operation and Development (OECD), bribery is now a crime in all 41 countries that are parties to the OECD Convention.[28] This is very significant because these countries—combined—cover 64 percent of global outbound foreign direct investments and more than 50 percent of the world's exports.[29] These countries are also home to 95 of the largest 100 non-financial—and all of the top 50 financial—multinational enterprises in the world.[30]

A quick look at the most recent statistics compiled by the Working Group on Bribery of the OECD are also encouraging.[31] For example:

- Between 1999 and 2014, parties to the OECD Convention brought criminal prosecutions against 361 individuals and 126 entities for foreign bribery;[32]
- At least 95 of the individuals were sent to prison for foreign bribery;[33] and
- In addition, at least 110 individuals and 200 entities were sanctioned in civil, administrative, and criminal actions relating to foreign bribery, including accounting-related violations.[34]

The same OECD report also indicates that Germany, Hungary, South Korea, and the United Kingdom, in particular, have had impressive results in holding both individuals and entities accountable in criminal foreign bribery cases.[35]

These regulatory actions are important achievements, as foreign bribery must be a global regulatory priority. Cost alone mandates that. Another OECD report shows that the cost of corruption equals more than 5 percent of global gross domestic product, or $2.6 trillion, with over $1 trillion of bribes paid each year.[36]

The SEC will continue to do its part with our own vigorous FCPA program and by assisting international efforts of countries committed to doing their part to combat this

particular corrosive conduct that undermines the integrity of our markets. And we will continue to strongly support the important efforts of the OECD's Working Group on Bribery to expand and strengthen anti-bribery laws and enforcement throughout the world.

Conclusion

Let me stop there. While the SEC's engagement internationally includes many other areas, including the ongoing work to enhance the resiliency of central counterparties, over-the-counter derivatives regulation, and emerging areas such as fintech, I hope I have provided at least a flavor of our very robust and wide-ranging work as a regulator in and of today's global markets. Thank you.

Notes

[1] *See* Mary Jo White, Chair, *Regulation in a Global Financial System*, Investment Company Institute General Membership Meeting (May 3, 2013), *available at* https://www.sec.gov/news/speech/2013-spch050313mjw.html.

[2] *See Securities (c): Annual Cross-U.S. Border Portfolio Holdings*, Report of the Department of the Treasury, *available at* https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/fpis.aspx#usclaims.

[3] *See Semiannual OTC derivatives statistics* (Sep. 2016), Table D5.2, *available at* http://www.bis.org/statistics/derstats.htm.

[4] *See* SEC adopting rule release, *Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information* (Jul. 14, 2016), *available at* https://www.sec.gov/rules/final/2016/34-78321.pdf.

[5] The SEC has MOUs for enforcement cooperation with regulators from Argentina, Australia, Brazil, Canada, Chile, France, Germany, Hong Kong, Israel, Italy, Japan, Jersey, Mexico, the Netherlands, Norway, Portugal, Singapore, Spain, Switzerland and the United Kingdom. The SEC also has MOUs related to different aspects of supervisory oversight. For market participants and markets, the SEC has MOUs with regulators from: Mexico, Brazil, EU (ESMA), the Cayman Islands, Canada, Germany, Switzerland, Belgium, the UK (FCA and BOE) and Hong Kong. For oversight of certain entities in the asset management industry, the SEC has MOUs with EU and European Economic Area (EEA) member state regulators from the following jurisdictions: Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Latvia, Lichtenstein, Lithuania, Luxembourg, Malta, the Netherlands, Norway, Poland, Portugal, Romania, the Slovak Republic, Spain, Sweden and the United

Kingdom. With respect to exchanging information regarding issuers, the SEC has MOUs with regulators from: the United Kingdom, Belgium, Bulgaria, Portugal, Norway, Germany and Spain. Finally, the SEC has MOUs for technical assistance matters with regulators from Argentina, Chile, China, Egypt, Hungary, India, Indonesia and Russia, as well as an MOU with the Inter-American Development Bank and the United Nations Economic Commission for Latin America and the Caribbean. *See* SEC Cooperative Arrangements with Foreign Regulators, *available at* https://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml.

[6] *See* IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMoU), *available at* https://www.iosco.org/about/?subsection=mmou. As of August 2016, there were 109 full signatories to the IOSCO's MMOU, which enables securities regulators around the world to help each other conduct enforcement investigations, and 17 additional regulators are seeking legal authority in their home countries to enable them to become full signatories to the MMOU. See OICU-IOSCO, Signatories to Appendix A and Appendix B List, *available at* http://www.iosco.org/about/?subSection=mmou&subSection1=signatories; see also, SEC Website, Cooperative Arrangements with Foreign Regulators, *available at* https://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml (for a list that includes enforcement cooperation, supervisory cooperation, and technical assistance agreements).

[7] *Id*.

[8] In 2015, the SEC made 165 requests for enforcement cooperation and received 243 requests for enforcement cooperation under the IOSCO MMOU.

[9] Investment Company Institute 2016 Fact Book, *available at* http://www.icifactbook.org/.

[10] *See* Mary Jo White, Chair, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, The New York Times DealBook Opportunities for Tomorrow Conference (Dec. 11, 2014), *available at* https://www.sec.gov/News/Speech/Detail/Speech/1370543677722.

[11] *See* Financial Stability Board, *Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (Jun. 22, 2016), *available at* http://www.fsb.org/wp-content/uploads/FSB-Asset-Management-Consultative-Document.pdf.

[12] *See* The Board of the International Organization of Securities Commissions, "Statement on IOSCO's Priorities Regarding Data Gaps in the Asset Management Industry" (Jun. 2016).

[13] *See* Financial Stability Oversight Council, *Update on Review of Asset Management Products and Activities* (Apr. 18, 2016), *available at* https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf ; *see also* Mary Jo White, *Statement on Financial Stability Oversight Council's Review of Asset Management Products and Activities* (Apr. 18, 2016), *available at* https://www.sec.gov/news/statement/white-statement-041816.html.

[14] *See e.g.,* SEC Press Release, *SEC Charges Scotland-Based Firm for Improperly Boosting Hedge Fund Client at Expense of U.S. Fund Investors*, (May 10, 2012), *available at* https://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171489060; SEC Press Release, *Apollo Charged with Disclosure and Supervisory Failures*, (Aug. 23, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-165.html; SEC Press Release, *SEC Charges Investment Adviser With Failing to Clearly Disclose Additional Costs to Investors,* (Jul. 14, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-143.html; SEC Press Release, *SEC: Financial Adviser Defrauded Pro Athletes and Lied to SEC Examiners*, (May 6, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-83.html; SEC Press Release, *Guggenheim Partners Investment Management LLC Settles Charges it Failed to Disclose Conflict to Clients*, (Aug.10, 2015), *available at* https://www.sec.gov/news/pressrelease/2015-162.html; SEC Press Release, *Edward Jones to Pay $20 Million for Overcharging Retail Customers in Municipal Bond Underwritings*, (Aug. 13, 2015), *available at* https://www.sec.gov/news/pressrelease/2015-166.html; SEC Press Release, *SEC Charges KKR With Misallocating Broken Deal Expenses*, (Jun. 29, 2015), *available at* https://www.sec.gov/news/pressrelease/2015-131.html; SEC Press Release, *Blackstone Charged With Disclosure Failures*, (Oct. 7, 2015), *available at* https://www.sec.gov/news/pressrelease/2015-235.html; and SEC Press Release, SEC Press Release, *SEC Charges Investment Adviser With Fraud*, (Sep. 29, 2015), *available at* https://www.sec.gov/news/pressrelease/2015-218.html.

[15] *See, e.g.,* Securities Exchange Act of 1934 §17(a) and (b) (15 U.S.C. § 78q) and Rules 17a-3 *et seq*. thereunder (17 C.F.R. § 240.17a-3 *et seq*.); Investment Advisers Act of 1940 § 204 (15 U.S.C. § 80b-4) and Rule 204-2 thereunder (17 C.F.R. § 275.204-2).

[16] The records requested can include information about business lines, trading activities, financials, and a firm's compliance program, as well as information about the firm's owners, clients, and employees.

[17] As the Commission has stated in rulemakings, "[t]he requirements [of the books and records rules] are an integral part of the investor protection function of the Commission,

and other securities regulators, in that the preserved records are the primary means of monitoring compliance with applicable securities laws, including antifraud provisions and financial responsibility standards." Commission Guidance to Broker-Dealers on the Use of Electronic Storage Media under the Electronic Signatures in Global and National Commerce Act of 2000 with Respect to Rule 17a-4(f), 66 FR at 22917.

[18] *See* Examination Information for Entities Subject to Examination or Inspection by the Commission, *available at* https://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf; *see also* Office of Compliance Inspections and Examinations Investment Adviser Examinations: Core Initial Request for Information (Nov. 2008), *available at* https://www.sec.gov/info/cco/requestlistcore1108.htm.

[19] To carry out these cross-border examinations and information exchange with foreign counterparts, the SEC staff often uses the MOUs related to supervisory cooperation, *supra* note 4.

[20] Supervisory cooperation "is not a mechanism for altering regulatory obligations or limiting regulatory responsibility with respect to regulators that have regulated entities in common." IOSCO Final Report on Principles Regarding Cross-Border Supervisory Cooperation at (May 2010), at 15 *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD322.pdf.

[21] *See* Criminal Division of the U.S. Department of Justice and the Enforcement Division of the U.S. Securities and Exchange Commission, *FCPA: A Resource Guide to the U.S. Foreign Corrupt Practices Act*, at 2-4 and nn.1-2, (Nov. 2012), *available at* https://www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf (citing S. Rep. No. 95-114, at 4 (1977), *available at* http://www.justice.gov/criminal/fraud/fcpa/history/1977/senaterpt-95-114.pdf; H.R. Rep. No. 95-640, at 4-5 (1977), *available at* http://www.justice.gov/criminal/fraud/fcpa/history/1977/houseprt-95-640.pdf).

[22] *See* SEC Press Release, *SEC: Tech Company Bribed Chinese Officials*, (Feb. 16, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-29.html; SEC Press Release, *SEC Announces Two Non-Prosecution Agreements in FCPA Cases*, (Jun. 7, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-109.html.

[23] *See e.g.*, SEC Press Release, *VimpelCom to Pay $795 Million in Global Settlement for FCPA Violations*, (Feb. 18, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-34.html; SEC Press Release, *SEC Charges Medical Device Manufacturer With FCPA Violations*, (Jun. 21, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-126.html; SEC Administrative Release, *SEC Charges Engineer and Former Employer with Bribe Scheme in Russia*, (Mar. 3, 2016), *available at* https://www.sec.gov/

litigation/admin/2016/34-77288-s.pdf; SEC Administrative Release, *Airline Executive Settles FCPA Charges*, (Feb. 4, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-77057-s.pdf.

[24] SEC Press Release, *VimpelCom to Pay $795 Million in Global Settlement for FCPA Violations*, (Feb. 18, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-34.html.

[25] *Id*.

[26] Historically, more than 20 percent of our FCPA cases have involved actions against individuals and that percentage has grown in recent years. *See* Andrew Ceresney, Director of the Division of Enforcement, *ACI's 32nd FCPA Conference Keynote Address*, (Nov. 17, 2015), *available at* https://www.sec.gov/news/speech/ceresney-fcpa-keynote-11-17-15.html.

[27] *See* SEC Press Release, *SEC Charges Medical Device Manufacturer With FCPA Violations*, (Jun. 21, 2016), *available at* https://www.sec.gov/news/pressrelease/2016-126.html; SEC Administrative Release, *SEC Charges Engineer and Former Employer with Bribe Scheme in Russia*, (Mar. 3, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-77288-s.pdf; SEC Administrative Release, *Airline Executive Settles FCPA Charges*, (Feb. 4, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-77057-s.pdf.

[28] *See* Organisation For Economic Co-operation and Development (OECD), *Fighting the Crime of Foreign Bribery: The Anti-Bribery Convention and the OECD Working Group on Bribery*, p. 4, *available at* http://www.oecd.org/daf/anti-bribery/Fighting-the-crime-of-foreign-bribery.pdf.

[29] *Id*.

[30] *Id*.

[31] *See* Organisation For Economic Co-operation and Development, *Working Group on Bribery: 2014 Data on Enforcement of the Anti-Bribery Convention*, (Nov. 2015), *available at* http://www.oecd.org/daf/anti-bribery/Working-Group-on-Bribery-Enforcement-Data-2014.pdf.

[32] *Id*.

[33] *Id*.

[34] *Id*.

[35] For instance, a U.K. Court sentenced the former Chief Executive Officer of an oil and gas exploration company to prison for paying $200,000 in bribes to a director at the European Bank for Reconstruction and Development. That same year, Switzerland sanctioned a German company by requiring it to pay over $10 million for bribes paid to officials of a Russian gas company. *See id*.

[36] *See* Organisation For Economic Co-operation and Development, *CleanGovBiz: Integrity in Practice*, p. 2, (2014), *available at* https://www.oecd.org/cleangovbiz/49693613.pdf.

Recent Decisions Index

U.S. Circuit Courts of Appeals

PSLRA; SCIENTER

Local No. 8 IBEW Ret. Plan & Trust v. Vertex Pharmaceuticals, No. 15-2250 (1st Cir. Oct. 3, 2016)

First Circuit: Affirms Dismissal of Securities Fraud Action Against Vertex Pharmaceuticals, Finding No Basis to Infer the Company Knowingly or Recklessly Published Erroneous Interim Clinical Study Results 142

PRESUMPTION OF RELIANCE; VALUE INVESTING; LIQUIDITY RISK

Gamco Investors v. Vivendi, Nos. 13-194, 13-1377 (2nd Cir. Sep. 27, 2016)

Second Circuit Affirms That Presumption of Reliance Was Rebutted Because Value Investor Would Have Invested in Vivendi Regardless of Liquidity Risk 51

RICO; CLASS CERTIFICATION; PREDOMINANCE; PROXIMATE CAUSE

Torres v. S.G.E. Management, LLC, No. 14-20128 (5th Cir. Sep. 30, 2016) (en banc)

En Banc Fifth Circuit Holds Victims of Pyramid Scheme Were Entitled To Class Certification Under Causation Theories Based Both on Foreseeability and Inference of Reliance; Despite Dissenting Opinions, Individual Causation and Reliance Issues Did Not Predominate 53

ERISA; DISCLOSURE DUTIES; FIDUCIARY OBLIGATIONS

Lee v. Verizon Communications, Inc., No. 14-10553 (5th Cir. Aug. 17, 2015) (unpub.)

Fifth Circuit Upholds Dismissal of Current Retirees' ERISA Claim Challenging Annuity Purchase; Holds Current Plan Participants Lacked Article III Standing To Bring ERISA Claim 61

ERISA; DUTY OF PRUDENCE

Whitley v. BP, No. 15-20282 (5th Cir. Sep. 26, 2016)

Fifth Circuit: Supreme Court's Fifth Third Decision Mandates a "More Harm Than Good" Standard for ERISA Breach of Duty of Prudence Claims Based on Inside Information, Not a "More Good Than Harm" Standard........................144

U.S. District Courts

MOTION TO REMAND; MOTION TO TRANSFER; "RELATED TO" JURISDICTION; BANKRUPTCY PROCEEDINGS; INDEMNIFICATION RIGHTS OF INDIVIDUALS AND UNDERWRITERS; SECTION 22(a) REMOVAL BAR; SECTION 1452(a) JURISDICTION

Cobalt Partners, LP v. SunEdison, Inc., No. 16-cv-02263-WHA; No. 16-cv-02264-WHA; No. 16-cv-02265-WHA; No. 16-cv-02268-WHA (N.D. Cal. Aug. 26, 2016)

District Court Denies Plaintiffs' Motion To Remand and Grants
Defendants' Motions To Transfer, Holding Section 22(a)
of SLUSA Does Not Bar Transfer Under Section 1452(a) 70

MOTION TO DISMISS; SCIENTER

Feola v. Cameron, No. 15-cv-01654-JAK (C.D. Cal. Aug. 25, 2016)

District Court Dismisses, for Lack of Scienter,
Case Alleging Failure To Pay and Account for Taxes..73

SECURITIES FRAUD; SECTION 10(B); RULE 10B-5; LOSS CAUSATION; SCIENTER

Pirnik v. Fiat Chrysler Automobiles, N.V., No. 15-CV-7199 (JMF) (S.D. N.Y. Oct. 5, 2016)

Court Lets Stand Securities Fraud Claims Based on Allegation That Chrysler
Materially Misrepresented Its Compliance With Regulatory Requirements for
Safety Recalls; Dismisses for Lack of Scienter Claims Based on
Representations of Its Reserves for Recall Repairs 76

SECTION 10(B) SECURITIES FRAUD; MATERIAL MISREPRESENTATION OR OMISSION; SCIENTER; MOTION TO DISMISS

City of Pontiac General Employees' Retirement System v. Dell Inc., No. A-15-CV-374-LY (W.D. Tex. Sep 16, 2016)

Western District of Texas Declines To Dismiss Securities-Fraud Action,
Finding That Plaintiffs Sufficiently Alleged That Defendants Failed To Reveal
Known, Material Adverse Facts Regarding Future Market and Sales
Prospects, and That the Omissions in Defendants' Statements Gave
Rise to a Strong Inference of ***Scienter*** 81

SECURITIES FRAUD; MATERIAL MISREPRESENTATIONS; FORWARD-LOOKING; PUFFERY; SCIENTER; LOSS CAUSATION; SECTION 20(A)

Rihn v. Acadia Pharmaceuticals Inc., No. 15cv00575 BTM(DHB) (S.D.Cal. Sept. 19, 2016)

Securities Fraud Claims Alleging Defendants Were "on Track" To Seek
FDA Approval for Important New Drug Survive Motion To Dismiss 83

SECURITIES FRAUD; SECTION 10(B); RULE 10B-5; FALSE AND MISLEADING STATEMENTS; SCIENTER; SECTION 20(A)

Washtenaw County Employees' Retirement System v. Walgreen Co., No. 15-cv-3187 (N.D. Ill. Sep. 30, 2016)

Investors Bringing Securities Fraud Claims Were Able To Adequately Allege
That Three Statements By Defendants Were False and Misleading 87

CLASS ACTION; CLASS CERTIFICATION; SECURITIES FRAUD; FIFO; LIFO; CLASS-WIDE DAMAGES; BUILD-UP METHOD; STOCK-PRICE METHOD

City of Pontiac Gen. Employees' Ret. Sys. v. Wal-Mart Stores, Inc., No. 5:12-cv-5162 (W.D. Ark. Sept. 20, 2016)

Class Certification Granted for Wal-Mart Shareholders; Defendants'
Objections to LIFO and "Build-Up" Methods of Computing Damages Rejected 94

SECURITIES FRAUD; INTERNET BANKING; MOTION TO DISMISS

In re BofI Holding, Inc. Securities Litigation, Case No. 3:15-CV-02324-GPC-KSC (S.D. Cal. Sept. 27, 2016)

Federal District Court Allows Securities Fraud Suit To Proceed Against Internet Bank and
Its CEO for Knowingly Misrepresenting Lax Underwriting and Auditing Practices 98

SECURITIES FRAUD; SLUSA; MOTION TO DISMISS; SCIENTER; CONTROL PERSON LIABILITY; STATUTORY SELLER

Vanguard Specialized Funds v. VEREIT Inc., No. CV-15-02157 (D. Ariz. Oct. 3, 2016)

In Aftermath of AFFO Misreporting, District of Arizona Allows Bulk of
Allegations To Proceed in Securities Fraud Case Against One of
World's Largest REITs 101

SLUSA PRECLUSION; CLASS ACTION; SECURITIES FRAUD; DISMISSAL

Luis v. RBC Capital Markets, LLC, No. 16-cv-00175 (D. Minn. Oct. 13, 2016)

Plaintiffs' Putative Class Action Precluded By SLUSA Where Sale of a High Risk Investment Product Was a "Covered Security" and Allegations Focused on Fraud 107

SECURITIES FRAUD; MOTION TO STRIKE; PLEADING STANDARDS; MATERIALITY; SCIENTER; LOSS CAUSATION

In re CommVault Systems, Inc. Sec. Litig., No. 14-cv-5628 (D. N.J. Sep. 30, 2016)

Securities Fraud Claims That Defendants Misrepresented Consequences of Loss of Business Partner and Engaged in Improper Cookie Jar Accounting Adequately Alleged 110

SECURITIES FRAUD; SECURITIES EXCHANGE ACT; JUDICIAL NOTICE; INCORPORATION BY REFERENCE; FALSITY; SCIENTER

Hsu v. Puma Biotechnology, Inc., No. SACV 15-0865 (JCGx) (C.D. Cal. Sep. 30, 2016)

Investors Adequately Pled Securities Fraud Claims That Drug Maker and Its Executives Misrepresented Results of Drug Trials 114

SECURITIES FRAUD; SECTION 10(B); RULE 10B-5; SECTION 17; MISREPRESENTATIONS; PUFFERY; OMISSIONS

SEC v. Mapp, No. 4:16-CV-246 (E.D. Tex. Oct. 7, 2016)

SEC's Allegations of Securities Violations Under Section 17 of Securities Act and Sections 10(b) and 15(a) of Exchange Act Against Paid Stock Promoter Found Insufficient; SEC Allowed To Plead Additional Facts 118

PSLRA; MATERIAL MISTATEMENTS; SCIENTER

North Collier Fire Control and Rescue Dist. Firefighter Pension Plan v. MDC Partners, No. 15 Civ. 6034 (RJS) (S.D. N.Y. Sep. 30, 2016)

Southern District of New York: Dismisses Securities Fraud Action Against MDC Partners, Holding Plaintiffs' Disagreements with Defendants' Accounting Judgments and EBITDA Formulas Could Not Support a Claim 146

Delaware Chancery Court

ATTORNEYS' FEES; APPRAISAL LAWSUIT; EQUITABLE FUND DOCTRINE; SUGARLAND

In re Appraisal of Dell Inc., Consol. C.A. No. 9322-VCL (Del. Ch. Oct. 17, 2016)

Chancery Court Awards Lead Counsel in Dell Appraisal Suit Over Eight Million in Fees and Costs To Be Allocated ***Pro Rata*** Among Appraisal Class 125

MERGER; BREACH OF FIDUCIARY DUTY

In re OM Group, Inc. Stockholders Litig., No. 11216-VCS (Del. Ch. Oct. 12, 2016)

Shareholders Attacking Board Over Merger Failed To Show That Shareholders' Overwhelming Approval of Merger Was Due to Inadequate Disclosure 129

DERIVATIVE SUIT; SHARE DILUTION; MOTION TO DISMISS; DEMAND FUTILITY; CONFLICT OF INTEREST

Chester County Employees' Retirement Fund v. New Residential Investment Corp., C.A. No. 11058-VCMR (Del. Ch. Oct. 7, 2016)

Plaintiff's Improperly Pled Derivative Claims Dismissed for Failure To Demonstrate Demand Futility Where Allegations of a Defendant's Self-Dealing Fell Short of Material Interest 135

TRULIA **ATTORNEYS' FEES; DISCLOSURE-ONLY SETTLEMENTS; MATERIALITY OF SUPPLEMENTAL DISCLOSURES**

In re Receptos, Inc. Stockholder Litigation, Civil Action No. 11316-CB (Del. Ch. July 21, 2016)

Delaware Chancery Court Continues To Rein in Attorneys' Fees Under ***Trulia,*** Allowing Only $100,000 in Fees Because Supplemental Disclosures Are Not Material..139

CONTRACTS; LACHES

inTEAM Associates, LLC v. Heartland Payment Systems, Inc., C.A. No. 11523-VCMR (Del. Ch. Sep. 30, 2016)

Chancery Rules Upon Breach of Non-Competition and Non-Solicitation Claims – Laches Defense Denied...149

MERGERS; DISCLOSURES; FIDUCIARY DUTIES

Nguyen v. Barrett, C.A. No. 11511-VCG (Del. Ch. Sep. 28, 2016)

Delaware Court of Chancery Dismisses Post-Closing Disclosure Claims for Failure to Show Disloyalty or Bad Faith 151

FEE AWARDS

Judy v. Preferred Communication Systems, Inc., C.A. No. 4662-VCL (Del. Ch. Sept. 19, 2016)

Fee Award Denied to Litigation Funding Firm 153

SPOLIATION; INTERLOCUTORY APPEALS

Chrome Systems, Inc. v. Autodata Solutions, Inc., et al., C.A. No. 11808-VCG (Del. Ch. Sept. 21, 2016)

Chancery Denies Interlocutory Appeal of Spoliation Issues 154

RELEASES; SETTLEMENT AGREEMENTS

Geier v. Mozido, LLC, C.A. No. 10931-VCS (Del. Ch., Sept. 29, 2016)

Court Grants Motion to Dismiss Previously Released Claims 155

ATTORNEYS' FEES

Jay Frechter v. Cryo-Cell International, Inc., Civil Action No. 11915-VCG (Del. Ch. Oct. 7, 2016)

Mootness Fees Granted to Stockholder Challenging Bylaw Provision 156

MERGERS; CONTTROLLING STHAREHOLDERS; GOING PRIVATE; SHAREHOLDER VOTE

In re Books-A-Million, Inc. Stockholders Litigation, C.A. No. 11343-VCL (Del. Ch. Oct. 10, 2016)

Delaware Chancery Applies MFW to Dismiss Challenge to Going Private Transaction and Clarifies Obligations of Controlling Stockholders 157

DIRECTORS' DUTIES; BAD FAITH

Reiter v. Fairbank, C.A. No. 11693-CB (Del. Ch. Oct. 18, 2016)

Court Describes Board Duty of Oversight...160

DISSOLUTION

The Huff Energy Fund, L.P. v. Gershen, C.A. No. 11116-VCS (Del. Ch. Sept. 29, 2016)

Chancery Dismisses Challenge to Board's Dissolution Plan 162

Recent Decisions

PRESUMPTION OF RELIANCE; VALUE INVESTING; LIQUIDITY RISK

Gamco Investors v. Vivendi, Nos. 13-194, 13-1377 (2nd Cir. Sep. 27, 2016)

Second Circuit Affirms That Presumption of Reliance Was Rebutted Because Value Investor Would Have Invested in Vivendi Regardless of Liquidity Risk

Neil Cohen

In a case brought by a value investor Gamco against Vivendi for damages suffered because of failure to disclose liquidity risk, the Second Circuit affirmed a District Court bench trial summary judgment ruling that Gamco could not assert the rebuttable presumption of reliance and would have invested in Vivendi despite the liquidity risk.

Background

In the District Court, defendant introduced testimony that the investor was aware of or indifferent to the risks that the class plaintiffs alleged were concealed and that the investor possessed a unique depth of understanding about the company's assets and liabilities. As U.S. District Judge Shira Scheindlin noted in granting summary judgment, the claimant relied on

> his own careful assessment of Vivendi's assets and liquidity position, drawing largely from his familiarity with the company's assets and tapping into resources unavailable to the average investor. Even had Thompson known about the fraud, it would not have mattered to him: he said that he was "right the whole time" about his calculations and assessment and "was not misled" about Vivendi's debt. He thought Vivendi's supposed liquidity crisis—the very subject of the fraud— was "overblown." He did not view any of the nine corrective disclosures as "correcting" any misunderstanding he had about Vivendi's liquidity.

The District Court concluded that plaintiff Gamco did not rely on the market price as an "accurate measure of the stock's intrinsic value" in making their purchases of Vivendi stock and that it would have made those purchases even if it had known of the existence of a liquidity risk. Thus, the presumption of reliance was successfully rebutted.

The District Court recognized that attempts to rebut the presumption are "exceedingly rare" and that it is "only the unusual case in which compatible findings of materiality and non-reliance can be made." The Court concluded that, based on the findings of fact, this was "just such an extraordinary case." The Second Circuit also emphasized that its ruling was confined to the facts of this case.

In affirming the Second Circuit said

> GAMCO believes the central issue is whether GAMCO would have purchased shares "*at the same price*[]" had it been aware that many of Vivendi's statements were fraudulent. *Id*. at 103); *see also Halliburton*, 134 S. Ct. at 2408 (noting that a defendant may rebut the presumption by showing "that a plaintiff would have bought or sold the stock even had he been aware that the stock's price was tainted by fraud").
>
> Though we observe that GAMCO's framing of the appropriate inquiry has much to recommend it, we need not conclusively endorse it here. Even adopting, *arguendo*, GAMCO's preferred framing, *see* GAMCO Br. at 27 n.11 (acknowledging that the presumption may be rebutted by showing that a "plaintiff would have purchased the stock at the same price even if she had known of the fraud"), the district court did not clearly err in concluding, as detailed herein, that revelation of Vivendi's liquidity problems would not have changed GAMCO's purchasing decisions....
>
> GAMCO argues, even if it indeed still thought Vivendi securities were materially undervalued notwithstanding the crisis, it would have waited until the liquidity crisis came to light and *then* bought the stock. Such a delayed purchase not only would have mitigated the *risk* associated with the undisclosed liquidity problems (as fraud always creates some risk that the underlying calculations are erroneous), but also would have potentially netted GAMCO a more profitable investment. It was not clearly erroneous, however, for the district court to find that GAMCO would indeed have purchased Vivendi's securities at the price quoted, rather than simply await the potential of a public liquidity crisis ....
>
> It may seem unlikely, in the abstract, that an investor, aware of fraud, would opt to purchase a given security. Nevertheless, after a trial, we do not review a district court's factual findings for whether they seem, in the abstract, correct—we review the *record* for sufficient evidence in support of those judgments. And here, the record at the trial simply does not establish that it was clearly erroneous for the district court to find that GAMCO, had it known of the liquidity problems at Vivendi, would have made the choice to buy the same securities it purchased.

Editor's Note: In a separate opinion the Second Circuit also affirmed a jury verdict that Vivendi was guilty of securities fraud by making half-truths that hid liquidity risk and maintained stock price inflation. *In re Vivendi*, Nos. 15-180-cv(L) and 15-208-cv(XAP), 9/27/16.

* * *

RICO; CLASS CERTIFICATION; PREDOMINANCE; PROXIMATE CAUSE

Torres v. S.G.E. Management, LLC, No. 14-20128 (5th Cir. Sep. 30, 2016) (en banc)

En Banc Fifth Circuit Holds Victims of Pyramid Scheme Were Entitled To Class Certification Under Causation Theories Based Both on Foreseeability and Inference of Reliance; Despite Dissenting Opinions, Individual Causation and Reliance Issues Did Not Predominate

Greg Lee

Plaintiffs allegedly defrauded into joining a sales system that in reality was a pyramid scheme were entitled to class certification for their RICO claims, even though some members of the class who knew it was a pyramid scheme voluntarily participated to try to win. In reaching the opposite conclusion of a prior panel decision, an *en banc* Fifth Circuit held that the predominance requirement of Rule 23(b)(3) was satisfied because the proximate cause element of the RICO claims could be established through common proof such that individualized issues would not predominate at trial. The court determined that common questions concerning causation would predominate, regardless of whether the plaintiffs relied on a theory of foreseeability or an inference of reliance in establishing causation.

The court emphasized at the outset that, as the defendants had conceded, whether the defendants' multi-level marketing system was a fraudulent pyramid scheme was a merits issue subject to common proof. While the defendants might well have proved that it was a legitimate program, that question was to be resolved in the first instance in the district court.

Initially, the court noted that the defendants' challenge to predominance rested on their belief that causation would require individualized proof, but that premise was at odds with recent decisions of the Supreme Court—in particular, *Bridge v. Phoenix Bond & Indem. Co.*—and with decisions of the Fifth Circuit. These decisions established that fraud-based RICO claims did not require proof of first-party reliance, and this understanding of causation "largely dooms the defendants' attempt to identify individual issues of causation sufficient to preclude a finding of predominance."

Under *Bridge,* the most straightforward way of demonstrating reliance in a class wide manner was the plaintiffs' foreseeability argument, which simply required showing that the plaintiffs' losses were caused "by reason of" the defendants' operation of a fraudulent scheme. That showing could flow directly from a jury's finding that the defendants were operating a pyramid scheme, which was inherently fraudulent and per se mail fraud. "Participants are then harmed by the fraud involved in pyramid schemes not because of

any misrepresentations, but because the ultimate collapse of the scheme, and thus harm to participants, is a direct and foreseeable consequence of such structure."

An inference-based theory of causation, which was the focus of the panel opinions, was a separate basis on which to affirm certification, the court ruled. If the plaintiffs could prove that the defendants operated a fraudulent pyramid scheme, a jury reasonably could infer from the plaintiffs' payments to join the sales program that they relied on the defendants' implicit representation that the program was legitimate. While the defendants speculated some class members may have joined the fraudulent scheme knowingly, they offered no proof of this, and economic speculation alone as to what could have motivated an individual class member was not enough to defeat class certification.

The Dissents

There were three dissenting opinions. One asserted that the majority allowed the plaintiffs to satisfy predominance with respect to causation, even though all of the plaintiffs were provided information to understand the risk that the defendants' marketing program was an illegally structured enterprise. According to this dissent, the majority "dilutes both RICO's causation requirement and Rule 23's predominance requirement to the point that they have little relevance in cases based on allegations of a pyramid scheme."

A second dissent asserted that the defendants' business was the "fourth largest retail gas and electrical energy provider" in Texas. This dissent also pointed out that the majority never defined an "illegal pyramid scheme."

> I do not ever recall sending a case to a jury with so little definition of the elements of the offense, much less, for class action purposes, assuming guilt from the enterprise's mere structure, allowing an inference of class-wide reliance and requiring no proof of individual causation.

According to the third dissent, the majority

> allows any group of plaintiffs who have lost money in a multi-level marketing program to automatically obtain class certification by making the simple allegation that the program was in actuality an illegal pyramid scheme. In so doing, it minimizes the fact that many plaintiffs would be unable to show that defendants caused their injuries, and it allows the plaintiffs to skirt their burden of establishing "that the questions of law or fact common to class members predominate over any questions affecting only individual members"

under Rule 23(b)(3).

Background

Stream Energy sells gas and electricity in several states. It is not a utility, but acts as a middleman, reselling energy in deregulated markets that it buys from utilities. Its marketing arm is Ignite.

Stream allegedly has realized only small profits on its energy sales, despite large revenues, because it sells the energy just above, or sometimes even at, its costs. Rather than making meaningful profits through sales, Stream allegedly was set up like a classic pyramid scheme to make nearly all of its money through the recruitment of sales people.

Ignite allegedly operates a multi-level marketing program in which Independent Associates (IAs) sell energy to customers and recruit other individuals to join as IAs. Ignite charges individuals for the right to sell Stream's services and recruit IAs. The IAs pay Ignite $329 up front for the right to sell and recruit, and also pay an optional recurring fee for a "Homesite" website to promote their Stream business.

The putative class members were those who paid to become IAs and lost money. Allegedly 86% of individuals who signed up as IAs lost money in fees, collectively losing over $87 million, A miniscule number of individuals made significant amounts of money.

The plaintiffs sought class certification under different theories. The first was that the defendants' common marketing materials were replete with fraudulent misstatements about the amount of money an IA could make. This theory did not require the plaintiffs to prove that Ignite was a pyramid scheme; it required only proof of misrepresentations.

Other theories required proof that Ignite was a pyramid scheme. If they could establish such illegal conduct, then, they contended, they did not need to identify specific misrepresentations on which particular class members relied. Instead, they contended, all that was necessary to satisfy causation was classwide proof that their joining Ignite was a direct and foreseeable result of the defendants' pyramid scheme. They also contended proximate causation could be shown through a commonsense inference that they were duped into joining the pyramid scheme based on the representation that Ignite was a legitimate enterprise.

The district court rejected class certification on the theory that depended on specific misrepresentations because reliance would require individualized inquiry. But the court found that certification was appropriate for the other theories that depended on common proof of a pyramid scheme. It held that first-party reliance was not an element of a RICO claim predicated on mail or wire fraud, and common proof could establish proximate cause. The court noted, under the discussion of RICO causation in *Bridge v. Phoenix Bond & Indem. Co.,* 553 U.S. 639 (2008), it was enough to show that a "foreseeable and natural consequence" of the allegedly unlawful pyramid scheme was that the vast majority of IAs would lose money.

A panel of the Fifth Circuit vacated the order of certification, holding that under Rule 23(b)(3), common questions of law and fact would not predominate over individualized inquiries into causation, and the plaintiffs' knowledge. The court ruled that the district court

erred in concluding that the plaintiffs were entitled to an inference of reliance, which a jury could draw from the fraudulent and illegal nature of a pyramid scheme.

Proximate Cause

The defendants challenged the predominance element under Rule 23(b)(3). They contended that proximate cause would require individualized proof, but this premise was at odds with decisions of the Supreme Court and the Fifth Circuit. Those decisions have emphasized that RICO claims predicated on mail and wire fraud did not require first-party reliance to establish that the injuries were proximately caused by the fraud.

In *Bridge,* the Supreme Court determined that a person could be injured "by reason of" a pattern of mail fraud, even if the person had not relied on any misrepresentations. It acknowledged that "the absence of first-party reliance may in some cases tend to show that an injury was not sufficiently direct to satisfy Section 1964(c)'s proximate-cause requirement, but it is not in and of itself dispositive." At bottom, "the fact that proof of reliance is often used to prove an element of the plaintiff's cause of action, such as the element of causation, does not transform reliance into an element of the cause of action."

The Fifth Circuit applied *Bridge* in *St. Germain v. Howard,* 556 F.3d 261 (5th Cir. 2009), explaining that "no reliance requirement exists for civil causes of action under RICO for victims of mail fraud." The court relied in the same principle in *Allstate Ins. Co. v. Plambeck,* 802 F.3d 665 (5th Cir. 2015), noting that "[i]n cases predicated on mail or wire fraud, reliance is not necessary."

In *Allstate,* a group of telemarketing companies, chiropractic clinics, and law offices had convinced victims of no-fault car accidents to obtain chiropractic services in order to receive settlement payments from insurers. The district court had instructed the jury that "proximate cause was present if 'the injury or damage was either a direct result or a reasonably probable consequence of the act.'" The Fifth Circuit affirmed the verdict in the insurer's favor, holding that Allstate proved proximate cause because it was a foreseeable victim, and not one injured by chance.

Other circuits have adopted similar definitions of proximate cause under RICO. This understanding of proximate cause for fraud-based RICO claims largely doomed the defendants' attempt to identify individual issues of causation sufficient to preclude a finding of predominance.

Pyramid Scheme As Per Se Mail Fraud

Under *Bridge,* the most straightforward way of showing reliance in a classwide manner was the plaintiffs' foreseeability argument. All that was required was a showing that

the plaintiffs' losses were caused "by reason of" the defendants' operation of a fraudulent scheme.

Such a showing could flow directly from a jury's finding that the defendants were operating an unlawful pyramid scheme. Such a scheme was inherently fraudulent and was per se mail fraud. By design, a pyramid scheme's fraud inhered in its concealment of its deceptive nature. The Federal Trade Commission has recognized that a pyramid scheme harmed its participants "by virtue of the very nature of the plan as opposed to any dishonest machinations of its perpetrators."

According to the FTC, a pyramid scheme was characterized by payments by participants in exchange for the right to sell a product and the right to receive rewards for recruiting other participants. The fraud lay in the concealment of the inevitable collapse that resulted from the scheme's structure because the promise of rewards for recruiting others tended to induce participants to focus on recruitment rather than sales. The scheme collapsed when there were no more individuals to recruit who would pay those higher up the pyramid.

There was no clear line separating illegal pyramid schemes from legitimate multi-level marketing programs. The very reason pyramid schemes were illegal per se was their inherent deceptiveness and the fact that the futility of the scheme was not apparent to the participants.

Because pyramid schemes were per se mail fraud, participants could be harmed "by reason of" the fraud regardless of whether they relied on a misrepresentation about the scheme. The harm to participants—the eventual collapse of the scheme—was a direct and foreseeable consequence of the structure of the scheme.

The plaintiffs alleged that they sustained financial losses caused by the defendants' operation of a pyramid scheme. There could be no question that the plaintiffs were both the direct and foreseeable victims of the alleged fraud. By definition, a pyramid scheme operated by taking money from downstream recruits, such as the plaintiffs, who will never recoup their payments into the scheme, and funneling the money upstream to those at the top of the pyramid. Those who lost money in the scheme necessarily did so "by reason of" the fraud because the fraud was necessary to temporarily sustain the scheme, and ultimately caused its collapse. Those who profited did so only by virtue of the downstream participants.

The plaintiffs were necessary to the scheme and were its direct victims. Whether they relied on a misrepresentation about the scheme was not determinative of whether the plaintiffs could prove proximate cause under *Bridge*. As was true in that case, the class members here could prove injury "'by reason of' a pattern of mail fraud even if [they have] not relied

on any misrepresentations." The participants' injuries arose from the scheme's payment structure, and the inherent concealment of the inevitableness of those injuries.

Although a class member's knowledge that Ignite was an illegal pyramid scheme could serve as an intervening cause that would break the chain of causation, the defendants have offered no evidence that any putative class member had such knowledge before becoming an IA. The district court expressly found that the record contained no such evidence, and there was no error in that finding.

Moreover, the directness of the alleged injuries obviated any concerns found in cases with attenuated injuries. As in *Bridge,* "there are no independent factors that account for [the plaintiffs'] injury, there is no risk of duplicative recoveries by plaintiffs removed at different levels of injury from the violation, and no more immediate victim is better situated to sue."

Under this foreseeability theory of proving causation, the plaintiffs' claims with depend on common evidence. The facts necessary to prove that the defendants operated a fraudulent pyramid scheme also will suffice to show under *Bridge* that the fraud caused the alleged injuries.

Inference-Based Theory pf Causation

The panel opinions had focused on whether the plaintiffs were entitled to an inference of reliance, which could be drawn from the fraudulent and illegal nature of a pyramid scheme. This was a separate basis on which to affirm the certification ruling.

Under this theory, the fact that Ignite held itself out as a legitimate multi-level marketing program, when it really was a fraudulent pyramid scheme, gave rise to a reasonable inference that the misrepresentation induced the plaintiffs to become IAs and caused their losses. According to the plaintiffs, it could be rationally assumed that a precondition for joining Ignite was that it was a legal business opportunity, and the defendants offered no evidence that any class member knew Ignite was a pyramid scheme in which the majority of participants were bound to lose money.

It was noteworthy that the defendants did not challenge whether Ignite represented itself as a legal multi-level marketing program or whether the question was common to the class. There was a good reason they did not: by operating its program, it continued to hold itself out as legitimate. Pyramid schemes were inherently deceptive, and the misrepresentation here—that Ignite was legitimate—was subject to common proof and was not even disputed.

The question was whether the plaintiffs could employ a common inference of reliance on that misrepresentation. The defendants conceded such an inference was appropriate in some cases. They argued, however, that to invoke the inference, the plaintiffs had to establish that no rational actor would have participated had they known of the misrepresentation.

But other circuits have not applied such a narrow rule. They have permitted inferences of reliance when it followed logically from the nature of the scheme and there was common circumstantial evidence that class members relied on the fraud.

In *Klay v. Humana, Inc.,* 382 F.3d 1241 (11th Cir. 2004), the Eleventh Circuit upheld certification of a class of physicians claiming health maintenance organizations (HMOs) misrepresented they would be paid properly for medically necessary services, when in fact the doctors were underpaid. The court affirmed based on a common inference of reliance, explaining that a jury "could quite reasonably infer that guarantees concerning physician pay—the very consideration upon which those agreements are based—go to the heart of these agreements, and that doctors based their assent upon them."

Similarly, the Second Circuit in *In re U.S. Foodservice Inc. Pricing Litig.,* 729 F.3d 108 (2d Cir. 2013) held that customers allegedly overbilled in an inflated invoices scheme could be certified as a class. It reasoned that "customers who pay the amount specified in an inflated invoice would not have done so absent reliance upon the invoice's implicit representation that the invoiced amount was honestly owed."

The defendants relied on *CGC Holding Co. v. Broad & Cassel,* 773 F.3d 1076 (10th Cir. 2014), in which the court approved a common inference of reliance to certify a class of borrowers allegedly defrauded by lenders who extracted nonrefundable loan commitment fees for loans the lenders never intended to provide. Although the Tenth Circuit approved the theory of inferred reliance after concluding that no rational actor would join the scheme with knowledge of the fraud, the opinion did not appear to limit the inference to that situation. The opinion stated only that the absence of another rational explanation for the plaintiffs' behavior was sufficient to infer reliance—it did not say it was a necessary condition.

Here, if the plaintiffs prove that Ignite was a fraudulent pyramid scheme, they could use a common inference of reliance to prove proximate cause. A jury reasonably could infer that, in deciding to pay to become IAs, the plaintiffs relied on the implicit representation that Ignite was legitimate, when in fact it was a fraudulent pyramid scheme.

First, it was reasonable to infer that individuals did not knowingly join pyramid schemes because such schemes were inherently deceptive and operated only by concealing their fraudulent nature. To knowingly join the scheme required the individual to choose to become either a victim or a fraudster.

Whether a multi-level marketing program was fraudulent or legitimate depended on its internal structure. And such information was not readily apparent or interpreted.

Second, the record was devoid of evidence that a single putative class member joined as an IA despite having knowledge of the fraud. Even after the commencement of summary judgment, the defendants produced no evidence that a single class member even knew of the fraud or would have paid to become an IA knowing of the fraud. Thus, the district court correctly concluded that individual issues of reliance would not predominate at trial.

Contrary to the defendants' assertion, this focus on the absence of evidence supporting their defense did not improperly shift the burden of proof to them. The defendants, while advocating a narrower rule, have now conceded that the absence of contrary evidence would support class certification based on an inference of reliance. And, in the absence of any evidence showing that individuals joined the pyramid scheme knowingly, the district court correctly ruled that individual issues of reliance would not predominate.

Neither now nor before the district court have the defendants even attempted to bear the burden of rebutting the plaintiffs' evidence of reliance. They did not even contest the district court's factual finding.

Rather than pointing to evidence, the defendants relied on speculation alone that a hypothetical class member could have joined knowing of the fraud. But such speculation as to the improbable motivations of an undefined, but likely minute number of class members did not cause individual issues of reliance to predominate. Moreover, mere conjecture seemed particularly inappropriate here as anyone who joined a pyramid scheme hoping to become one of the few winners would become liable as a knowing participant.

For these reasons, the result here was not inconsistent with *Sandwich Chef of Texas, Inc. v. Reliance National Indemnity Insurance,* 319 F.3d 205 (5th Cir. 2003), in which insurers allegedly charged premiums in excess of approved rates, then misrepresented the correctness of those premiums. The court rejected certification because the insureds could not prove proximate cause through common proof. Unlike the defendants here, the insurers not only contended the insureds were aware they were being charged more than the filed rates, they introduced evidence that the class members individually negotiated regarding workers' compensation and insurance premiums. Here the defendants put forth no such evidence.

This did not mean that if the plaintiffs proved that Ignite was a fraudulent pyramid scheme, they necessarily prevailed under the inference theory. The inference simply was a common mechanism by which they could attempt to prove their affirmative case. The trier of fact was not required to accept the inference, and the district court may revisit its

decision and choose to decertify the class should the defendants produce individualized rebuttal evidence, causing their individualized defense to predominate.

The focus had to remain on the predominance inquiry. Thus, even if conjecture alone was sufficient to establish that a few class members might have knowingly joined the scheme, it would not necessarily cause individualized issues of reliance to predominate. Evidence indicating that a few class members decided to take the risk of being a winner in an illegal pyramid scheme did not automatically rebut the inference of reliance for the overwhelming remainder of class members or mean that individual issues concerning the atypical knowing fraudsters will predominate at trial. This was underscored by the fact that the class comprised only those who lost money participating in Ignite's program.

* * *

ERISA; DISCLOSURE DUTIES; FIDUCIARY OBLIGATIONS

Lee v. Verizon Communications, Inc., No. 14-10553 (5th Cir. Aug. 17, 2015) (unpub.)

Fifth Circuit Upholds Dismissal of Current Retirees' ERISA Claim Challenging Annuity Purchase; Holds Current Plan Participants Lacked Article III Standing To Bring ERISA Claim

Greg Lee

Current retirees failed to establish that their former employer had violated the Employee Retirement Income Security Act of 1974 (ERISA) when it amended its pension plan and transferred obligations from the ongoing plan by purchasing an annuity. Upholding dismissal of ERISA claims, the Fifth Circuit held that the former employer's decision to partially transfer pension obligations from an ongoing plan was not a breach of fiduciary duty under ERISA Section 404 because the decision by a plan sponsor to amend a plan was not a fiduciary act.

The court also rejected claims that the plan fiduciaries had committed breaches of fiduciary duty in carrying out the plan amendment. The retirees contended that the fiduciaries should have held the annuity as a plan asset, but the plan amendment did not allow for the plan to remain obligated for the benefit of the retirees. They also contended the fiduciaries should have obtained their consent, but the decision to transfer plan assets to an annuity was made by the employer as plan settlor and fell outside the scope of fiduciary duties. Moreover, ERISA does not require consent. They asserted the fiduciaries should have communicated with the beneficiaries, but they received the required notice. And, the retirees failed to sufficiently allege why the expenses of the annuity transaction were improper.

As an initial matter, the court ruled there was no violation of ERISA Section 102(b). Although the retirees contended that the Summary Plan Descriptions failed to disclose the possibility that benefit obligations would be transferred to an annuity, ERISA did not require SPDs to disclose the possibility of future annuitization.

Finally, the court ruled that the current plan participants lacked Article III standing to assert an ERISA claim because they failed to show an injury-in-fact. Rejecting the argument that fiduciary misconduct to a defined benefit plan constituted individually cognizable harm, the court pointed out that other circuits have held that constitutional standing for defined benefit plan participants required imminent risk of default by the plan, and without allegations of impact to individual benefits, the misconduct was too far removed to establish injury. The court also rejected the argument that the alleged fiduciary breach from the mismanagement of plan assets constituted an invasion of the current participants' statutory rights to proper plan management.

Background

Former participants and beneficiaries of Verizon's pension plan asserted Verizon had violated ERISA in connection with a plan amendment and annuity purchase in December 2012. The amendment applied to plan participants who already were receiving benefit payments as of January 1, 2010.

The class action involved two classes: the transferee class, comprising plan participants whose retirement benefit obligations were transferred to the annuity; and the non-transferee class, comprising plan participants whose retirement benefit obligations remained with the plan.

The district court dismissed the claims of the transferee class for failure to state a claim. The plaintiffs appealed.

Duty To Disclose

The appellants argued that the Verizon Employee Benefits Committee (VEBC), a Verizon plan fiduciary, failed to provide Summary Plan Descriptions (SPD) compliant with ERISA Section 102(b) and the pertinent Department of Labor (DOL) regulation. The provided SPDs allegedly failed to disclose the possibility that benefit obligations would be transferred to an annuity in the absence of a plan termination or spinoff/merger. This argument lacked merit in light of Fifth Circuit precedent, which holds that ERISA did not require SPDs to describe future terms, and the statutory language, which required only retrospective notice of plan amendments.

The Fifth Circuit has interpreted ERISA disclosure requirements as only extending to current aspects of the plan, and to the exclusion of potential changes which were contingent

on a plan amendment. Here, prior to the October 2012 amendment directing the annuity purchase, the plan allowed only for the transfer of benefit obligations through the plan's termination or merger into another pension plan. SPDs issued prior to the amendment were required only to address those circumstances.

It was undisputed that the plan fiduciaries provided notice shortly after the amendment's adoption, well within the time limits for notice of a plan amendment. ERISA only required that administrators provide a summary description of any material modification or change "not later than 210 days after the end of the plan year in which the change is adopted," according to 29 U.S.C. § 1024(b)(1)(B).

Consistent with this language, the Fifth Circuit has held that, within the context of ERISA disclosure requirements, there was no employer duty "to affirmatively disclose whether it is considering amending its benefit plan." Here, the pre-amendment SPDs advised participants of Verizon's reservation of the right to amend the plan, and the possibility that an amendment might affect their rights.

The transferee class also alleged that the pre-amendment SPDs failed to advise of the possible "loss of benefits" under Section 102(b). The district court rejected this claim because there was no allegation of a change in the amount of benefits that would be received. The transferee class now acknowledged that the amount of benefits remained unchanged, but asserted that the phrase "loss of benefits" also encompassed protections under ERISA and the Pension Benefit Guaranty Corporation (PBGC). They offered no authority, however, supporting the inclusion of such protections as "benefits" under Section 102.

This interpretation of "benefits" was more expansive than the ERISA regulation governing the purchase of annuities by plan fiduciaries (Annuitization Regulation), which required that such transactions guarantee a participant's "entire benefit rights." While the annuity agreement did not guarantee ERISA and PBGC protections, there was no dispute that the transaction complied with the Annuitization Regulation's guarantee requirement.

Fiduciary Duties Under Section 404(a)(1)

The transferee class asserted several breaches of fiduciary duties under ERISA Section 404(a)(1)(A), which required that plan fiduciaries use plan assets "for the exclusive purpose of … providing benefits" and "defraying reasonable expenses of administering the plan." To address such allegations, it was necessary to distinguish between fiduciary and non-fiduciary functions. A person was a fiduciary only to the extent the person had or exercised specified authority, discretion, or control over a plan or its assets. The Fifth Circuit has held that actions by a plan sponsor to modify, amend, or terminate the plan were outside the scope of fiduciary duties. Such decisions were those of a trust settlor, not a fiduciary.

Courts have drawn a distinction between decisions to alter a plan, and the implementation of those decisions. In *Beck v. PACE Intern. Union,* 551 U.S. 96 (2007), for example, the Supreme Court noted the distinction between whether to terminate a plan through an annuity purchase, and the fiduciary obligation to select an annuity provider.

The appellees cited *Beck* in support of the proposition that the decision to enter into an annuity was a sponsor decision immune from ERISA's fiduciary obligations. The appellants argued the case was inapposite as it analyzed a plan termination rather than an ongoing plan. But the distinction did not vitiate application of *Beck* here.

Beck broadly described decisions regarding the form and structure of a plan as those of a plan sponsor, and its primary focus on one type of sponsor decision did not undercut the application to other sponsor decisions regarding a plan's form and structure. Accordingly, the annuity amendment was a sponsor function of plan design, authorized under ERISA through the Annuitization Regulation.

The appellees also cited *Beck* for the principle that an employer's decision to maintain or remove pension liabilities was a design decision and settlor function. The *Beck* Court, in deciding that merger into another pension plan was not a permissible form of termination, compared the effect of annuity purchases and merger, emphasizing that the latter "represents a continuation rather than a cessation of the ERISA regime." Despite discussing the annuity purchase's effect of "formally sever[ing] the applicability of ERISA to plan assets and employer obligations," the Court did not impute fiduciary aspects to the sponsor's decision to sever ERISA applicability. Therefore, the decision to transfer pension assets outside ERISA coverage was a sponsor decision immune from fiduciary obligations.

Breach of Fiduciary Duty By Plan Sponsor

The appellants contended that Verizon breached its fiduciary duty by entering into the annuity transaction, which resulted in the partial transfer of pension obligation from an ongoing plan. They argued that, because such a transfer during an ongoing plan was not expressly authorized by ERISA, Verizon's decision was subject to ERISA's fiduciary duty provisions.

First, the decision to amend a plan concerning the composition or design of the plan was a settlor function, immune from fiduciary obligations. Accordingly, the decision to amend the plan and transfer assets into an annuity was made solely by Verizon in its settlor capacity. The appellants' position that any action that disposed of plan assets created fiduciary obligations was not supported by any authority. *Beck* tangentially addressed this, noting that the "purchase of an annuity is akin to a transfer of assets and liability (to an

insurance company)" yet maintaining its position that a decision to enter into an annuity, albeit in the context of plan termination, was a settlor function.

Second, the appellants did not offer any authority that would prohibit the transfer from an ongoing plan via an annuity transaction. Indeed, the appellees pointed to ERISA provisions and regulations that suggested such transactions were authorized, or at least not foreclosed.

ERISA, as well as DOL regulations, set forth several mechanisms by which an employer could remove liabilities from a plan. One of these was through transfer to an insurance company by an annuity purchase.

As for the ability of a plan sponsor to perform an annuity transfer during an ongoing plan, neither ERISA nor the regulations directly addressed the issue. But a DOL interpretive bulletin described circumstances in which a pension plan might purchase annuity contracts, and noted that "in the case of an ongoing plan, annuities might be purchased for participants who are retiring or separating from service with accrued vested benefits." Although the bulletin did not specifically describe this circumstance, the bulletin described potential circumstances non-exclusively, suggesting that such transfers were permitted, especially when considered in conjunction with the annuity transfer regulation.

Even assuming that ERISA prohibited annuity purchases during ongoing plans, the appellants cited no authority that would make the amendment a fiduciary function due to violation of that prohibition. Thus, the transfer of pension liabilities from an ongoing plan through an annuity transaction amendment was a settlor function, permitted under ERISA, or alternatively, that such transactions were not subject to fiduciary duty requirements.

Breaches of Fiduciary Duty By Plan Fiduciaries

The transferee class alleged breach of fiduciary duty in the implementation of the amendment. First, the alleged plan fiduciaries failed to hold the annuity contract within the plan as a plan asset, thereby maintaining ERISA and PBGC protections for the benefit of class members.

But, as the district court reasoned, the plan amendment did not allow for the plan to remain obligated for the benefit of the transferee class. Plan fiduciaries were responsible only for decisions over which they had discretion. The terms of the amendment clearly provided that the plan would have no obligation to make any payment for the pension benefits of the transferee class after the annuity transaction. Accordingly, the plan fiduciaries were without discretion to maintain pension obligations of the transferee class within the plan.

The transferee class asserted that the plan fiduciaries should have obtained the consent of the transferee class members before transferring the pension obligations to the annuity. But the determination to transfer assets to an annuity was a decision by Verizon as settlor, and did not fall within the scope of its fiduciary duties. In *Hughes Aircraft Co. v. Jacobson,* 525 U.S. 432 (1999), the Court held that three fiduciary claims were foreclosed because "without exception, plan sponsors who alter the terms of a plan do not fall into the category of fiduciaries." Moreover, the appellants' position was not supported by the terms of ERISA, which contained no consent requirement, either in the provisions detailing fiduciary duties or in the provisions governing compliant annuity purchases.

The transferee class contended that plan fiduciaries breached their duty by not communicating with beneficiaries. But they cited no ERISA provisions for this proposition, relying only on an inapposite Ninth Circuit opinion that discussed ERISA-required documentation following the denial of benefits. Although the Annuity Regulation did require that participants receive notice of the terms of the benefits to which they were entitled as part of an annuity transaction, it was undisputed that the transferee class received this notice. Following the annuity transaction, benefits no longer were governed by ERISA, and any nondisclosure did not give rise to a cognizable action.

The transferee class alleged that Verizon violated the plan provision requiring that plan assets be used for the exclusive benefit of plan beneficiaries and participants, as well as for reasonable expenses. It was undisputed that Verizon paid Prudential $1 billion more than the $7.4 billion in transferred liabilities.

The district court ruled that these allegations failed to state a claim by not specifying which aspects of the extra $1 billion were unreasonable, or how they were unreasonable. The transferee class argued that the proper inquiry was whether the $1 billion in administrative costs was a settlor cost that was wrongfully paid from plan assets, and cited a DOL advisory opinion discussing plan-related expenses for which the settlor was responsible.

But the effect of the advisory opinion was two-fold. First, the opinion, by contemplating that expenses implementing a settlor decision, such as an amendment and restructuring of the plan, were payable by the plan, refuted the appellants' argument that expenditures not associated with plan administration were unreasonable. Second, since implementation expenses by the plan were permitted to the degree they were reasonable, the advisory opinion focused the critical inquiry on the reasonableness of the expenses.

Accordingly, the reasonableness of the expenses had to be addressed by the appellants' allegations. Although the allegations enumerated various expenses associated with the implementation of Verizon's decision as settlor, they failed to address how those expenses

were not reasonable ones payable by the plan. Granted, $1 billion was a large sum, but in light of the $7.4 billion in obligations, it could not be concluded that this allegation alone was sufficient to support unreasonableness.

The transferee class alleged breach of a fiduciary duty in the selection of Prudential as the sole annuity provider. The relevant inquiry regarding selection of a provider was whether the fiduciary carefully consider DOL factors and any other factors relevant under the circumstances. If so, a fiduciary satisfied ERISA if, based on what it learned in its investigation, it selected a provider it reasonably found best to promote the interests of participants and beneficiaries.

The test of fiduciary produce was one of conduct, not results. But even when a fiduciary's conduct did not meet the standard, ERISA was satisfied if the selected provider would have been chosen had the fiduciary conducted a proper investigation.

The transferee class simply alleged that a more prudent choice would have been to contract with more than one insurer to avoid placing everyone in jeopardy of losing benefits based on the fortunes of one insurer. The district court ruled the allegations were insufficient because they were conclusory. While that was a basis for dismissal on this ground, the allegations only implicated the results of the process, not the conduct of the independent fiduciary.

There also were allegations implicating the conduct of the fiduciaries, asserting that the Prudential selection occurred on the same day as the amendment's adoption, and the fiduciaries should have taken more time. The district court acknowledged these allegations might plausibly assert that the plan fiduciaries did not consider any other provider, but ruled that such an interpretation was rendered implausible by other allegations that the independent fiduciary had been retained almost two months prior to the alleged date of decision, and that it had submitted a written determination of the transaction's ERISA compliance over a month prior to the date of the amendment.

Thus, there was no error in the district court's dismissal of the breach of fiduciary duty claim.

Interfering With Participants' Rights

The transferee class alleged that the plan amendment's transfer of benefit obligations for only certain plan participants represented intentional interference with the rights of the transferred participants in violation of ERISA Section 510. While acknowledging that Section 510 required discrimination "for the purpose of interfering with" a right, the appellants argued that Section 510 prohibited expulsion without any intent-to-interfere

requirement. The appellees took the position that the prohibition on expulsion, like that on discrimination, had to be made with the intent to interfere with a right under the plan. Neither side provided authority for their positions.

The appellees' argument that there had to be an intent to interfere was supported by a practical consideration. The appellants' reading would divorce the intent-to-interfere requirement from any prohibition other than discrimination, which would also divorce those prohibitions from the object of the interference. Such a reading, which separated ERISA prohibitions from any rights in the ERISA-governed plan, was overly broad.

The transferee class did not identify a viable right with which Verizon interfered. The transferee class asserted their right to continued participation arose from the SPD, which stated that a person was a plan participant as long as the person had a vested benefit in the plan that has not been paid in full. The district court rejected this argument, noting that the Annuitization Regulation provided that an individual ceased to be a participant when benefit rights were guaranteed by an insurer.

The appellants' argument that, when there was a conflict between the SPD and a regulation, the SPD should control, was unavailing. Even assuming the SPD controlled, the SPD advised participants of potential amendments that could affect their rights.

The transferee class's assertion of rights in ERISA and PBGC protections was unsupported. As previously discussed, there was little support in ERISA or the regulations, or case law, for including such protections as rights to which a plan participant was entitled. Moreover, the right to any such protections was dependent on the right to continued participation.

By failing to allege a viable right with which the amendment interfered, the transferee class failed to state a claim.

Constitutional Standing

The non-transferee class asserted a claim for violation of fiduciary obligations by the plan fiduciaries under ERISA Section 409(a). They alleged that the plan fiduciaries breached fiduciary duties by paying an excessive and unreasonable expense.

Section 409(a) created a right to relief against fiduciaries for the restoration of any loss to a plan resulting from the breach of fiduciary obligations. Section 502(a)(2) allowed a civil action for appropriate relief under Section 409.

The district court ruled that the plaintiff lacked constitutional standing. It determined that the plaintiff had failed to allege a sufficient injury in fact. While the plaintiff asserted injury through losses to the plan assets, the appellees agued that constitutional standing

required allegations of an injury to the individual's benefit payments, rather than injury to the plan as a whole.

For defined contribution plans, fiduciary misconduct need not threaten the solvency of the entire plan to reduce benefits below the amount that participants otherwise would receive. As a result, circuit courts have held that participants in defined contribution plans had redressable Article III standing because alleged fiduciary breaches had a direct effect on the amount of benefits.

In contrast, fiduciary misconduct in a defined benefit plan would not affect an individual's entitlement to a defined benefit unless it created or enhanced the risk of default by the entire plan. With a defined benefit plan, the plan consisted of a general pool of assets rather than individual dedicated accounts. Hence, injury to a participant was attenuated because, prior to default under the plan, the employer typically bore the entire investment risks and had to cover any underfunding as a result of a shortfall that may occur from the plan's investments. Even when an employer was unable to cover underfunding, the impact on participants was not certain because the PBGC provided protection of participants' benefits.

In circumstances similar to the present case, other circuits have concluded that constitutional standing for defined benefit plan participants required imminent risk of default by the plan, such that the participant's benefits were adversely affected. Those circuits have held that fiduciary misconduct, standing alone without allegations of impact on individual benefits, was too removed to establish the requisite injury.

It was true that those courts considered plans that remained overfunded after the alleged misconduct, while here the plan was left in a far less stable financial condition, and underfunded by almost $2 billion (or only about 66% actuarially funded) after the annuity transaction. But regardless of whether the plan was under- or over-funded, the direct injury to a participant's benefits was dependent on the realization of several additional risks which collectively rendered the injury too speculative to support standing.

Absent plan termination, the employer had to cover any shortfall resulting from plan instability. The plaintiff's allegation that the plan was underfunded merely increased the relative likelihood that Verizon would have to cover the shortfall. But there were no allegations of the realization of risks that would create the likelihood of direct injury to the participant's benefits. There was no allegation of plan termination, an inability of Verizon to address a shortfall in the event of termination, or a direct effect thereof on participants' benefits. To the contrary, the appellants conceded on appeal that actuarial underfunding resulted in no direct injury to the plaintiff.

The plaintiff also asserted he suffered an injury in the form of an invasion of his statutory rights to proper plan management, and invoked principles of disgorgement. The Fourth Circuit rejected a similar argument as conflating the concepts of statutory and constitutional standing. Its reasoning was persuasive, and these allegations, at least with regard to a direct injury to the plaintiff as a class representative, were insufficient to support standing to assert this claim.

The appellants alternatively asserted that the injury to the plan was sufficient because the plaintiff was statutorily authorized to assert the claim on behalf of the plan. Citing Supreme Court precedent that plaintiffs had standing based on the history and precedent permitting assignees to maintain suit, the appellants contended that plan participants could bring suit in a quasi-representative capacity by satisfying Article III's injury-in-fact requirement via injury to the plan.

This position could not be adopted. Both of the Supreme Court cases cited were distinguishable. First, those cases involved assignment between the parties, while here the plan and the plan participants had no such relationship, and the appellants did not argue that ERISA effected such an assignment. Since the Supreme Court's reasoning was firmly grounded on the history and tradition of assignment relationships, applying that reasoning to a circumstance in which no such relationship existed was speculative.

Even more significant, the two Supreme Court cases involved the assignor as the injured party. In contrast, the plaintiffs sought standing based on statutory authorization by an uninjured government, to seek redress by one private party of the injury to another private party.

* * *

MOTION TO REMAND; MOTION TO TRANSFER; "RELATED TO" JURISDICTION; BANKRUPTCY PROCEEDINGS; INDEMNIFICATION RIGHTS OF INDIVIDUALS AND UNDERWRITERS; SECTION 22(a) REMOVAL BAR; SECTION 1452(a) JURISDICTION

Cobalt Partners, LP v. SunEdison, Inc., No. 16-cv-02263-WHA; No. 16-cv-02264-WHA; No. 16-cv-02265-WHA; No. 16-cv-02268-WHA (N.D. Cal. Aug. 26, 2016)

District Court Denies Plaintiffs' Motion To Remand and Grants Defendants' Motions To Transfer, Holding Section 22(a) of SLUSA Does Not Bar Transfer Under Section 1452(a)

On August 26, 2016, Judge William Alsup, United States District Judge for the Northern District of California, denied Plaintiffs' motion to remand four related matters

while granting Defendants' motion to transfer the matters to the Southern District of New York. He concurrently certified the issue for interlocutory review and stayed the actions while Plaintiffs decide whether or not to seek appellate review.

This opinion is notable for being one of the first to decide on the question of whether Section 22(a) of SLUSA bars removal of actions that are "related to" bankruptcy actions pursuant to 28 U.S.C. 1452(a).

Background

Plaintiff investors in four different lawsuits all alleged Defendant SunEdison, Inc. ("SunEdison") and its officers/directors and underwriters violated various securities laws by failing to disclose information relating to SunEdison's debts and weakened liquidity. While all four actions asserted claims under Sections 11, 12 and 15 of the Securities Act of 1933, two of the lawsuits also brought claims for violations of both Maryland Securities Act and common law as well.

The actions were originally filed in San Mateo Superior Court around the end of March and beginning of April of 2016, and on April 26, 2016, SunEdison filed for Chapter 11 bankruptcy in the United States Bankruptcy Court for the Southern District of New York. As a result, proceedings against SunEdison are stayed pursuant to 11 U.S.C. 362(a), but Defendants took the opportunity to remove all of the actions to the Northern District of California pursuant to 28 U.S.C. 1452(a) as proceedings "related to" SunEdison's bankruptcy case.

Plaintiffs moved to remand and Defendants moved to transfer the action to the District Court for the Southern District of New York for referral to the bankruptcy court in that district, or at the very least, for more convenient coordination amongst the matters.

Defendants' Removal Was Proper Pursuant to 28 U.S.C. 1452(a)

The Court recognized that removal statues are generally construed against removal, but noted that plaintiffs seeking remand have the burden to prove an express exception to removal exists. The Court found that Plaintiffs failed to do so in this case. Instead, it held that Defendants were correct in arguing that their removal was consistent with 28 U.S.C. 1452(a) as it was "related to" a bankruptcy court action.

In so deciding, the Court reasoned that the Ninth Circuit had essentially adopted the Third Circuit's broad approach for determining whether an action was "related to" a bankruptcy proceeding—if "the outcome of the proceeding could conceivably have any effect on the state being administered in the bankruptcy." In other words, "if the outcome could alter the debtor's rights, liabilities, options, or freedom from action (either positively

or negatively) and which in any way impacts upon the handling and administration of the bankrupt estate." The Court found that because SunEdison's Amended and Restated Certificate of Incorporation provided indemnification of Individual Defendants and because their underwriting agreements provided indemnification for Underwriter Defendants, the indemnification rights gave rise to "related to" jurisdiction. The indemnification rights at issue here included the advancement of attorney's fees and costs, pursuant to Delaware law, which govern SunEdison's Articles of Incorporation; thus, the Court held, they were already affecting the administration of the bankruptcy estate. Thus, removal was proper.

The Section 22(a) Removal Bar Does Not Override Section 1452(a) Removal

Section 22(a) provides for concurrent jurisdiction in state and federal courts over alleged violations of the Securities Act of 1933; however, it also forbids removal of actions brought in state court that assert claims under the Act, with few exceptions (for example, certain defined class actions).

Noting the courts are divided over whether the removal bar of Section 22(a) trumps bankruptcy removal under Section 1452(a), and that the Ninth Circuit has not yet decided the issue, Judge Alsup relied on the Second Circuit, the only appellate court to have addressed the issue, in making its decision. Here the Court concluded that the Second Circuit was persuasive and correct when it decided that the bankruptcy removal provision in Section 1452(a) actually trumps the Section 22(a) bar and adopted that rule to this case.

The Court explicitly rejected Plaintiffs' arguments that the Second Circuit's reasoning as articulated in *California Public Employees' Retirement Systems v. WorldCom, Inc.*, 368 F.3d 86 (2nd Cir. 2004) was in direct conflict with the Ninth Circuit's decision in *Luther v. Countrywide Home Loans Servicing LP*, 533 F.3d 1031 (9th Cir. 2008), which held that the removal bar of Section 22(a) prevailed over the removal provision of the Class Action Fairness Act. The Court quickly disposed of this argument, finding that the cases were not actually in conflict since two different statutory frameworks were at issue, and noting that at least one other district court in the circuit (Judge Conti of the Northern District of California) had held the same—that is, that Section 22(a) does not bar removal of "related to" bankruptcy actions.

Remand Denied and Transfer Granted

Finding equitable factors did not weigh in Plaintiffs favor, especially given the facts that the ease of coordination between actions would be greater in the Southern District of New York and that no claims under California law were made, making the Southern District an equally capable forum of deciding Plaintiffs' claims, the Court held that remand

was inappropriate, and that the interest of justice and the convenience of the parties warranted transfer.

Noting the fairly new issue before the Court, it certified for interlocutory appeal under Section 1292(b) the issue of whether Section 22(a) of the 1933 Securities Act bars removal of actions "related to" a bankruptcy action pursuant to Section 1452(a).

* * *

MOTION TO DISMISS; SCIENTER

Feola v. Cameron, No. 15-cv-01654-JAK (C.D. Cal. Aug. 25, 2016)

District Court Dismisses, for Lack of Scienter, Case Alleging Failure To Pay and Account for Taxes

Michael Tu

Orrick, Herrington & Sutcliffe

On August 25, 2016, Judge John A. Kronstadt of the United States District Court for the Central District of California granted defendants' motion to dismiss plaintiffs' putative class action in connection with statements made in the Company's financial reports regarding unpaid taxes. Despite the plaintiff's confidential witness testimony, director resignations, GAP violations and alleged competitive advantages the court did not find a strong inference of scienter as to any defendants. The court allowed plaintiffs an opportunity to amend.

Background

ARCA sells new household appliances through retail stores and provides appliance recycling and replacement services for electric utility companies and under energy efficiency programs throughout North America. Utility companies often enter contracts with appliance replacement providers, such as ARCA, to implement programs that provide incentives for consumers to discontinue use of or to replace inefficient appliances.

In California, ARCA participates in recycling and replacement service programs for low income persons in Los Angeles, primarily through contracts with the Southern California Public Power Authority (SCPPA) and its participating members.

On August 6, 2014, ARCA announced that the Board of Equalization (BOE) had begun a sales and use tax examination covering the Company's California operations for 2011, 2012, and 2013. A portion of ARCA's California operations in those years consisted of

appliance replacement sales under programs conducted by utility companies, for which the company historically did not assess, collect or remit state sales tax. ARCA claimed that, for a number of reasons, including the fact that these appliance replacement programs benefited low-income customers and were paid for by public utility ratepayer funds, it believed that its appliance replacement sales through these programs could be exempt from California's sales and use tax. ARCA acknowledged, in announcing the BOE's examination, that it was possible that the BOE would disagree with the Company's position and assess taxes for the transactions in question. After the press release was issued, the price per share of ARCA stock dropped $1.11.

On February 11, 2015, ARCA issued a second press release stating that the Company anticipated a $4 million assessment by the BOE for failure to collect and remit sales taxes on appliance replacement sales. The press release also announced that certain earlier financial statements would be restated.

In an SEC filing dated February 12, 2015, ARCA stated that certain earlier financial reports and management's report on internal controls over financial reporting for the year ended December 28, 2013 should no longer be relied upon. After the SEC filing, the price per share of ARCA stock fell by $0.43.

On August 13, 2014, approximately a week after ARCA disclosed the BOE audit, Cameron retired as President and CEO. On November 3, 2014, approximately three months after the disclosure, ARCA announced Cammerrer's resignation as CFO effective November 21, 2014.

On May 18, 2015, ARCA filed an amended Form 10-K with the SEC restating the Company's financial statements for the periods from 2013 through the third quarter of 2014 (the "Restatement").

Plaintiffs alleged that the Restatement disclosed material overstatements in previously issued financial reports that did not account for sales taxes. Plaintiffs also alleged that the Company's prior representations regarding financial reporting controls were also misleading because they did not conform to GAAP.

The Complaint Failed To Allege Scienter

The court considered various categories of allegations in plaintiffs' complaint, ultimately concluding that none of them were sufficient to create the required strong inference that defendants acted with scienter.

Confidential Witnesses Statements: The court found that the statements of plaintiffs' two confidential witnesses were insufficient to establish scienter because plaintiffs did not

allege that either confidential witness communicated directly with Cameron or Cammerrer, or that either confidential witness was involved with or had first-hand knowledge regarding ARCA's decision not to charge sales tax on its California appliance sales. The allegation that ARCA collected sales tax on appliance replacement sales in one state outside California—involving a different program, different customers, and different tax laws—did not mean its failure to collect sales taxes in California was deliberate.

Resignations: The court found that plaintiffs' allegations regarding Cameron's and Cammerrer's resignations were similarly insufficient to establish scienter. The circumstances of Cameron's retirement at the age of seventy-four, after serving ARCA for thirty years, did not support an inference of suspicious circumstances associated with his resignation. Nor were the circumstances of Cammerrer's resignation suspicious, given that he was asked to remain as an advisor to assist with an orderly transition. With respect to departures by members of the board of directors, the court did not find an inference of scienter where one member resigned for personal reasons and the other three chose not to stand for reelection at the conclusion of their terms. The plaintiffs alleged no nexus between the decisions of these board members and the alleged conduct of Cameron or Cammerrer.

Competitive Advantage: The court also found that scienter could not be inferred from plaintiffs' allegation that ARCA was able to win competitive bids in California by not collecting sales tax. Plaintiffs did not identify any competitive bids ARCA won or include any allegations regarding the scope of profits ARCA earned, or anticipated earning, from California contracts under this theory. The court cited the well-established rule that the mere possibility of a motive to commit fraud cannot give rise to a strong inference of scienter.

The Restatement: The admission by ARCA in the Restatement that prior financial statements did not comply with GAAP did not give rise to a strong inference of scienter.

SCPPA Director and ARCA Competitor, City Appliance & Sales: Statements attributed in the complaint to a director of SCPPA and an ARCA competitor were also found to be inadequate. The SCPPA director was not alleged to have shared his views that ARCA's reason for nonpayment of sales tax was unusual with anyone at ARCA during the relevant time period. The statements of ARCA's competitor also were unpersuasive because what a competitor in the industry knew and did was of limited force with respect to what defendants knew and believed.

BOE FAQ Website: The FAQ section of the BOE website, which stated that sellers should obtain exemption certificates, was not sufficient to establish scienter because

the language was permissive only and there were no allegations regarding Cammerrer's knowledge of the FAQ portion of the BOE website.

The court concluded that even when viewed holistically, plaintiffs' allegations did not give rise to a strong inference of scienter at least as compelling as an inference of innocent conduct.

* * *

SECURITIES FRAUD; SECTION 10(B); RULE 10B-5; LOSS CAUSATION; SCIENTER

Pirnik v. Fiat Chrysler Automobiles, N.V., No. 15-CV-7199 (JMF) (S.D. N.Y. Oct. 5, 2016)

Court Lets Stand Securities Fraud Claims Based on Allegation That Chrysler Materially Misrepresented Its Compliance With Regulatory Requirements for Safety Recalls; Dismisses for Lack of Scienter Claims Based on Representations of Its Reserves for Recall Repairs

Amy Thayer

The Court denied a motion to dismiss claims that Fiat Chrysler Automobile (Chrysler) misrepresented its degree of compliance with regulatory requirements in the months before it entered into a consent decree admitting to violations of the National Traffic and Motor Vehicle Safety Act of 1996 (the "Safety Act"), including delayed notification to vehicle owners of 23 recalls, and agreeing to pay a record $105 million fine. In the months leading up to the consent decree, Chrysler executives received letters from the U.S. regulator criticizing its slow progress on notifying customers and replacing parts in connection with the Takata airbag recall and the recall of Jeeps with fuel tanks that could catch fire in low-impact collisions. Chrysler acknowledged in a reply letter to the regulator that its response to the recalls had not been satisfactory yet, around the same time, told the Senate that the regulator viewed its "customer-notification protocols as 'industry-best.'"

The Court, however, dismissed claims relating to statements about the sufficiency of the company's reserves to cover expenses related to recall and warranty repairs due to a lack of allegations that the defendants did not subjectively believe those estimates were correct. The allegations against defendant Richard Palmer were also dismissed because they only pertained to the reserve estimates.

The Court found that loss causation was adequately pled where the plaintiffs identified the following corrective disclosures: (1) the disclosure that Chrysler violated the Safety Act and would pay a fine for its legal violations, which was accompanied by a fall in its share price of almost 5%; and (2) FCA's subsequent admission of other Safety Act violations accompanied by payment of another fine and a stock drop of .07%.

Background

Chrysler was the holding company created following the merger of Fiat Group Automobiles and Chrysler Group LLC in October 2014. FCA U.S., a subsidiary of FCA, "is effectively a continuation of Chrysler." Defendant Richard Palmer was the Chief Financial Officer of FCA U.S. and defendant Sergio Marchionne was FCA U.S.'s Chief Executive Officer. Defendant Scott Kunselman led FCA U.S.'s Vehicle Safety and Regulatory Compliance office, which was established in August 2014 while Chrysler was handling recalls of exploding Takata airbags and Jeep fuel tanks that could catch fire in low-impact collisions. Kunselman reported directly to Marchionne.

The plaintiffs filed suit in 2015 alleging that the defendants violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder by making two types of misrepresentations: (1) those concerning FCA's regulatory compliance, and (2) those concerning the reserves the company was setting aside for vehicle recalls and warranty repairs. Marchionne, Kunselman, and Palmer allegedly were responsible for these violations as "control persons" under Section 20(a) of the Securities Exchange Act of 1934.

FCA's Regulatory Compliance

In November 2014, the Administrator of the National Highway Traffic Safety Administration (NHTSA) sent Marchionne letters saying in essence that Chrysler's efforts regarding the airbag and fuel tank recalls were deficient. In the letter concerning the airbag recall, the Administrator noted the carmaker "has consistently maintained its position at the rear of the pack." In the letter concerning the fuel tank recall, the Administrator lamented the "woeful three percent repair rate." A reply letter from Kunselman admitted Chrysler's effort was "not satisfactory."

However, in a late 2014 Senate hearing, Kunselman spoke of FCA's "high[] recall completion rate" and "rapid response" to vehicle-safety concerns. Kunselman also underscored that "NHTSA regards [Chrysler's] customer-notification protocols as 'industry-best.'"

In May 2015, the NHTSA announced it would hold a hearing on Chrysler's efforts with respect to numerous recalls. Chrysler publicly acknowledged the NHTSA hearing had

been set and expressed its willingness to cooperate. At the July hearing, NHTSA found there were "frequent[] delay[s] responding to safety problems . . . . [and] questioned why repair rates often were so low and slow."

Shortly after the hearing, FCA entered into a consent order with the NHTSA (the "First Consent Order") in which FCA admitted to violations of the Safety Act including delayed notification to vehicle owners of 23 recalls and failure "to adequately remedy defects in connection with three [recalls]." FCA also agreed to pay a $105 million fine. Thereafter, FCA's stock price dropped by about 5%.

CEO Marchionne in a July 2015 earnings call essentially admitted to lapses "in complying with [recall] requirements."

In a December 2015 amendment to the First Consent Order, FCA admitted to failing to "submit[] certain early warning information to NHTSA 'due to coding problems in its [early warning] system [and failure to] update its system to reflect new FCA brands." FCA also agreed to pay an additional $70 million fine.

Representations About Reserves for Warranty and Recall Costs

In an earnings call in January 2015, defendants Palmer and Marchionne said they expected the cost of the recalls to decrease going forward. However, in October 2015, FCA revealed that it was increasing its reserves by €761 million due to the estimated future costs of complying with the recalls. Thereafter, FCA's stock price dropped by slightly less than 5%.

Analysis

To state a claim under Section 10(b) and Rule 10b-5, plaintiffs are required to plead the following:

> (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.

The first, second, and last elements were at issue in the defendants' motion to dismiss. To establish control person liability under Section 20(a) of the Securities Exchange Act of 1934, a primary securities law violation must be established.

Plaintiffs Sufficiently Allege That FCA Materially Misrepresented Its Compliance With Applicable Regulatory Requirements

The Court found the complaint adequately alleged that FCA's representation that it was "substantially in compliance" with applicable regulations was misleading in light of FCA's

own admissions of non-compliance with the Safety Act in its First Consent Order. The defendants argued that this claim was truthful because FCA was "in substantial compliance with the myriad global regulations to which it was subject." The Court rejected this assertion because reasonable investors would think that FCA was saying it was in substantial compliance with the Safety Act and other U.S. vehicle-safety standards, as well as other applicable regulations worldwide.

The Court also rejected the defendants' argument that "its misrepresentations were merely inactionable puffery" because a trier of fact plausibly could find that Marchionne and Kunselman's oral reassurances of FCA's regulatory compliance, as well as FCA's claim of substantial regulatory compliance in its SEC disclosures, were misleading in light of FCA's admitted failure to comply with the Safety Act. Even a statement of belief that one has met regulatory standards may be actionable under *In re BioScrip, Inc. Sec. Litig.*, 95 F. Supp. 3d 711, 721–22 (S.D.N.Y. 2015).

The Court noted that Marchionne and Kunselman did not argue under *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135, 142 (2011) that they were not the "makers" of FCA's statement about its regulatory compliance in its SEC filings.

Plaintiffs Plausibly Allege That FCA's Misrepresentations About Its Regulatory Compliance Were Made With Scienter

The Court found that the defendants did not "really dispute" that Marchionne and Kunselman allegedly knew about FCA's "noncompliance with respect to at least some recalls." Rather than argue a lack of scienter, the defendants focused on how "substantial" FCA's noncompliance was—which the Court interpreted as either a disguised rehash of the defendants' failed falsity argument or a materiality argument. The Court noted that "materiality 'is generally not an appropriate basis on which to dismiss a complaint.'"

The Court found that the plaintiffs' allegations that NHTSA informed Marchionne and Kunselman of FCA's lapses in performing recall repairs and that Kunselman's office reported directly to Marchionne raised an inference of scienter.

Plaintiffs Fail Adequately To Plead the Falsity of FCA's Statements About the Sufficiency of Its Reserve Funds for Handling Repairs Due to Recalls and Warranty Provisions

The Court found that the plaintiffs failed to plead facts sufficient to show that the defendants did not actually believe their statements about the sufficiency of FCA's reserves for recalls and warranty provisions. The Court dismissed the plaintiffs' assertion that the International Financial Reporting Standards set an objective standard for reserves to cover expenses related to recall and warranty provisions because "those standards required only

that FCA's reserve provision be assessed quarterly and adjusted 'to reflect the current best estimate.'"

Analogizing from a Second Circuit case dealing with loan loss reserves, *Fait v. Regions Fin. Corp.*, 655 F.3d 105 (2d Cir. 2011), the Court found that there was no objective standard for determining whether FCA's reserves were sufficient. So, the Court applied the standard for showing scienter with respect to opinions under which the plaintiffs would have had to plead facts showing that FCA did not actually believe its statements were true when made. The Court suggested that the plaintiffs would have needed to plead facts derived from sources such as "internal analyses [and] confidential witnesses" to survive the motion to dismiss.

The Court concluded that the fact that the number of vehicle recalls increased from 2010 to 2015 and that FCA's reserves increased during this time did not show that the defendants had misled investors with respect to the adequacy of its reserves. Merely alleging facts that in retrospect suggest FCA's reserves were insufficient to cover possible losses from recalls and warranty provisions is insufficient to state a claim for securities fraud, as the Second Circuit noted in *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1129 (2d Cir. 1994). The Court determined that it was predictable that FCA's reserves would fall short if there were a spike in the number of recalls because FCA used "long-term historical averages" to estimate its recall costs. The Court also dismissed the argument that FCA's reports filed with NHTSA showed scienter because those reports did not "directly 'contradict' FCA's estimates," "demonstrat[e] the inaccuracy of [FCA's] public statements[,]" or show that FCA did not believe in the accuracy of its estimates at the time they were made.

Loss Causation Allegations Are Adequate

The Court found that loss causation was adequately pled where the plaintiff identified the following corrective disclosures: (1) FCA's disclosure that it violated the Safety Act and would pay a fine for its legal violations, which was accompanied by a fall in the price of FCA's shares by almost 5%; and (2) FCA's subsequent admission of other Safety Act violations accompanied by payment of another fine and a stock drop of .07%. The Court rejected the defendants' argument that a brief, "boilerplate" press release disclosed FCA's actions with respect to the recalls because that press release did not reveal that FCA "had violated the Safety Act in twenty-three recall campaigns" or that Chrysler had paid sizeable fines and agreed to independent monitoring to settle with NHTSA.

The Court thus dismissed the claims relating to FCA's representations about its reserve estimates but allowed the claims relating to FCA's representations about its regulatory

compliance to stand. The claims against Palmer were dismissed because they only related to the former.

Dismissal of Claims Relating to Stocks Listed on Foreign Exchanges

The Court dismissed holders of stocks listed on foreign exchanges from the class because "[t]he Second Circuit has squarely held that the U.S. securities laws do not apply to claims brought by purchasers of dual-listed stock on non-U.S. exchanges."

Denial of Leave To Amend

The Court denied the plaintiffs leave to amend their claims in "what would amount to their *fourth* complaint" because the Court previously warned the plaintiffs that they would not be given further opportunities to amend their complaint and the plaintiffs did not suggest they had additional evidence that would allow them to cure the deficiencies that the Court identified.

* * *

SECTION 10(B) SECURITIES FRAUD; MATERIAL MISREPRESENTATION OR OMISSION; SCIENTER; MOTION TO DISMISS

City of Pontiac General Employees' Retirement System v. Dell Inc., No. A-15-CV-374-LY (W.D. Tex. Sep 16, 2016)

Western District of Texas Declines To Dismiss Securities-Fraud Action, Finding That Plaintiffs Sufficiently Alleged That Defendants Failed To Reveal Known, Material Adverse Facts Regarding Future Market and Sales Prospects, and That the Omissions in Defendants' Statements Gave Rise to a Strong Inference of *Scienter*

This is a securities-fraud action brought on behalf of purchasers of Dell Inc. securities against Defendants Dell Inc. and certain of its past and present officers for violating Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Securities and Exchange Commission Rule 10b-5. Plaintiffs alleged that Defendants misleadingly informed investors to expect results "in-line" with prior quarters while in possession of contrary information. Defendants argued that Plaintiffs failed to adequately plead two essential elements of a Section 10(b) securities-fraud claim: (1) material misrepresentation or omission, and (2) *scienter*.

Defendants asserted that none of the statements were actionable because Defendants were simply disclosing accurate historical data, which does not become misleading even

if less favorable results might be predictable by the company in the future. Moreover, Defendants argued that Plaintiffs did not plead any facts to suggest that any forward-looking statement was false when made. Plaintiffs, however, argued that by misleadingly informing investors to expect results in-line with prior quarters "affirmatively create[d] an impression of a state of affairs that differs in a material way from the one that actually exists." In addition, Plaintiffs argued that because they sufficiently alleged that Defendants were aware of undisclosed facts that would undermine the accuracy of their forward-looking statements, the PSLRA's safe-harbor provision did not apply. The court concluded that, in light of Dell's specific problems, Defendants' statements and omissions regarding these problems could not be disregarded, as Plaintiffs alleged in sufficient detail Defendants' failure to reveal known, material adverse facts regarding Dell's PC market and PC-sales prospects in the future.

Defendants argued that Plaintiffs' *scienter* allegations were based on Defendants' "beliefs" instead of personal knowledge, and that none of Plaintiffs' allegations against Gladden, Felice, and Michael Dell were sufficient to be imputed to Dell Inc. The Court, however, found that the amended complaint revealed specific allegations as to the individual defendants regarding what they knew or recklessly disregarded, including the company's ballooning inventories and operations deficiencies within its sales divisions due in part to a significant decline in PC sales growth caused by a shift in demand away from higher-margin premium PCs, resulting in stagnant growth, stalling shipments, and stockpiling inventories, all of which were contradictory to statements regarding Dell's projected revenue. The Court concluded that the omissions gave rise to a strong inference of *scienter*. Therefore, the Court denied Defendants' motion to dismiss Plaintiffs' Section 10(b) claim.

Because Plaintiffs sufficiently alleged a Section 10(b) claim, their Section 20(a) claim control-person liability claim likewise survived Defendants' motion to dismiss.

* * *

SECURITIES FRAUD; MATERIAL MISREPRESENTATIONS; FORWARD-LOOKING; PUFFERY; SCIENTER; LOSS CAUSATION; SECTION 20(A)

Rihn v. Acadia Pharmaceuticals Inc., No. 15cv00575 BTM(DHB) (S.D.Cal. Sept. 19, 2016)

Securities Fraud Claims Alleging Defendants Were "on Track" To Seek FDA Approval for Important New Drug Survive Motion To Dismiss

Greg Lee

A putative class action asserting that the defendants had made material misrepresentations concerning a drug maker's preparedness to submit an application for a new drug crucial to the company adequately alleged claims of securities fraud. Chief District Judge Moskowitz held that the plaintiff had adequately alleged that the defendants' public assurances that the application remained "on track" for submission by a deadline—when in fact the company had not assessed its manufacturing and quality assurance systems, a critical step in the FDA process, resulting in a five-month delay—were materially misleading.

The court rejected the assertion that the statements were forward-looking and therefore inactionable. The "on track" assurances were representations about the current state of affairs with respect to the drug approval process. For the same reason, the court ruled the statements were not mere expressions of corporate optimism or puffery.

Ruling that the plaintiff had adequately alleged scienter, the court determined that the allegations regarding management's role in the company helped satisfy the scienter requirement. It would be incredible to conclude that the CEO, CFO, and Chief Medical Officer of the company were unaware of information that made their "on track" representations misleading. Other allegations in the complaint supported this conclusion, as did the closeness in time of the February 26 representations and the March 11 disclosure of problems.

Finally, the court was unpersuaded by the argument that loss causation was not pleaded adequately because the stock price decline was caused by the company dispelling speculation it was about to be acquired. The court pointed out that the merger speculation resulted in a price increase of $6.95, while the announcement of the drug approval delay caused a $9.94 drop.

Background

Claims under Section 10(b) and Rule 10b-5 were premised on allegations that the defendants knowingly and recklessly made materially false and misleading statements regarding the timing and status of the defendant Acadia's New Drug Application (NDA) for its lead product candidate, Nuplazid. These false and misleading statements allegedly

artificially inflated prices of Acadia stock between November 10, 2014 and March 11, 2015, the Class Period.

The defendants moved to dismiss.

Materially False and Misleading Misrepresentations or Omissions

The defendants were alleged to have repeatedly stated during the Class Period that they were "on track" to submit the NDA by the March 31, 2015 deadline and were "comfortable" with the announced timeline. In fact, Acadia allegedly had not performed a mock inspection of its manufacturing and quality assurance systems and lacked critical information regarding these important systems.

The complaint sufficiently alleged that the defendants made materially misleading misrepresentations. Acadia needed to be prepared for a pre-approval FDA inspection of its plant. It needed to be ready to show that its manufacturing and quality assurance systems and those of its third-party contract manufacturers and suppliers complied with Current Good Manufacturing Practices (CGMPs) under 21 C.F.R. §§ 210, 211. But Acadia did not complete an assessment of its systems until February or March 2015, and then learned its systems required further implementation and testing to support commercial manufacturing and supply. Acadia did not start the process early enough to transition to a commercial-grade quality assurance system by March 31, 2015.

According to the allegations, the implementation of adequate systems was a significant undertaking and a critical component of the NDA approval process. When the defendants represented that the NDA was "on track" to be submitted by March 31, 2015, without mentioning that no meaningful assessment of the systems had been conducted, they created an impression of a state of affairs that differed in a material way from the one that existed. They led the public to believe that all appropriate steps had been taken to ensure the NDA was ready for review by the deadline, and that barring unforeseen circumstances, the NDA would be submitted by that date.

Statements Were Not Forward-Looking

Although statements that Acadia "planned" on submitting the NDA by March 31, 2015, viewed in isolation, could qualify as forward-looking, statements that Acadia remained "on track" to submit the NDA by the deadline did not. In the context of this case, the "on track" assurances were representations about the current state of affairs with respect to the NDA process, which was within the defendants' knowledge and control.

In *Mulligan v. Impax Lab., Inc.,* 36 F.Supp. 3d 942 (N.D.Cal. 2014), the court rejected the argument that a similar statement by the CFO regarding the company's response to an

FDA Warning Letter was forward-looing: "Where we are now is on track, and therefore, I think investors can be comfortable that we're where we need to be." According to the court, the state "is fundamentally a representation of present fact regarding the status of Impax's response to the FDA Warning Letter."

In some instances, a statement regarding a company being "on track" might be forward-looking. Here, however, under the facts, the statements were a representation of present conditions of the NDA process, and therefore the PSLRA safe harbor did not apply.

Statements Were Not Puffery/Corporate Optimism

For similar reasons, the challenged statements were not non-actionable statements of corporate optimism. In determining whether statements were mere puffery, context had to be analyzed.

Statements regarding Acadia remaining "on track" to submit the NDA by the deadline were representations about current conditions regarding the NDA process. They were not vague statements of optimism but rather statements premised on facts. In *Mulligan,* the court rejected the assertion that the statements were mere puffery because they "contain factual representations at their core."

Scienter

The defendants argued that the complaint failed to plead scienter with the particularity required by the PSLRA, and impermissibly relied on speculation and conjecture. Their argument was not persuasive.

In *Reese v. Malone,* 747 F.3d 557 (9th Cir. 2014), the court explained that allegations regarding management's role in the company may help satisfy the PSLRA scienter requirement in three circumstances. First, the allegations may be viewed holistically, to raise a strong inference of scienter under the *Tellabs* standard. Second, allegations may independently satisfy the PSLRA when they are particular and suggested that the defendants had actual access to the disputed information. Third, in rare circumstances, such allegations may be sufficient, without accompanying particularized allegations, where the nature of the relevant fact is of such prominence that it would be absurd to suggest that management was without knowledge.

All three circumstances existed here. First, given the facts, it would be incredible to conclude that the CEO, CFO, and Chief Medical Officer were not aware of the information that made their "on track" representations misleading. The *Mulligan* court made a similar finding: "[G]iven the importance of manufacturing and quality control to the success of Impax and the fact that both areas of operation had been flagged by the FDA, it is a logical,

and strong, inference that the defendants were aware of the alleged severe and pervasive problems in Impax's Hayward facility."

Nuplazid, Acadia's most advanced product candidate, was critical to the success of the company, and the implementation of manufacturing and quality assurance systems was an important component of the NDA process. In addition, Acadia was a relatively small company—97 employees as of December 31, 2014. It would be absurd to suggest that the CEO, CFO, and Chief Medical Officer did not know that there had been no mock inspection of its manufacturing facilities and that there had been no reliable assessment of the company's manufacturing and quality assurance systems at the time they made their statements. Other allegations in the complaint supported this conclusion.

The closeness in time of the February 26, 2015 representations and the March 11, 2015 disclosure supported an inference that the CEO and the Chief Medical Officer were deliberately reckless in claiming that the NDA remained "on track" for submission by the end of the next month. "Temporal proximity of an allegedly fraudulent statement or omission and a later disclosure can be circumstantial evidence of scienter," according to *Reese*.

The scope and significance of the events underlying a disclosure also could support an inference of scienter. In light of the importance of the implementation of the manufacturing and quality control systems to the NDA process, the significant amount of work that actually remained to be done on those fronts, and the fact that no mock inspection occurred until February or March of 2015, it was highly likely that defendants were aware that their "on track" assurances lacked a factual basis.

Loss Causation

The defendants contended that the plaintiff failed to plead loss causation because, according to the allegations, the decline in the stock price upon announcement of the second delay was caused by the company dispelling speculation that it was in the process of being acquired.

But as pointed out by the plaintiff, the merger speculation resulted in a $6.95 per share increase on March 10, 2015, while the announcement of the second delay resulted in a $9.94 decline. These facts arguably established that the price of the stock was artificially inflated in part for the reasons separate from the merger rumors, namely, the defendants' statements regarding the NDA being on track for submission by March 31, 2015.

* * *

SECURITIES FRAUD; SECTION 10(B); RULE 10B-5; FALSE AND MISLEADING STATEMENTS; SCIENTER; SECTION 20(A)

Washtenaw County Employees' Retirement System v. Walgreen Co., No. 15-cv-3187 (N.D. Ill. Sep. 30, 2016)

Investors Bringing Securities Fraud Claims Were Able To Adequately Allege That Three Statements By Defendants Were False and Misleading

Greg Lee

Investors claiming that a pharmacy chain and its CEO and CFO falsely misrepresented the reasons why protected 2016 earnings goals, set as part of an earlier merger with another pharmacy chain, might not be met, were able to adequately allege that only three statements were false and misleading. Denying in part the defendants' motions to dismiss, District Judge Coleman held that the plaintiff had adequately alleged the falsity of statements concerning the existence and nature of generic drug price inflation and reimbursement pressures.

The court also ruled that the plaintiff had adequately alleged scienter on the part of the individual defendants. Given the allegations establishing that the defendants' knowledge that generic drug price inflation was a systematic trend and that the defendant pharmacy's contracts contained reimbursement caps that would cut into profits if prices increased, the inference of scienter was at least as strong as any reasonable opposing inference.

Background

Prescription drugs for Walgreen, a retail drugstore chain, represent its largest class of products and were the lead driver of its revenue and profit. The vast majority of such sales were third party sales in which the customer paid a copay and a pharmacy benefit manager (PBM), insurer, or government entity reimbursed Walgreen for the remainder of the drug's cost.

PBMs constituted the vast majority of these sales. Walgreen's contracts with several major PBMs provided fixed maximum rates of reimbursement for each drug and contained no mechanism by which those rates could be altered in response to price variations. If generic drug prices increased, Walgreen would be forced to absorb the additional cost.

In June 2012, Walgreen announced it would acquire Alliance Boots GmbH to create the world's largest pharmacy company. In the first step of the deal, it would acquire a 45% equity ownership in Alliance, while Alliance's CEO, Stefano Pessina, would acquire control of 8% of Walgreen common stock. In the second step, which required shareholder

approval, Walgreen would acquire the remaining Alliance stock in exchange for cash and Walgreen stock.

As part of the process, Walgreen announced a set of goals for FY 2016 reflecting the expected benefits of the new partnership. This included $1 billion in combined synergies, and $9-9.5 billion in adjusted earnings before interest and taxes (EBIT). From September 2012 through June 2013, the defendants continued to express optimism regarding the EBIT goal and to dismiss analysts' concerns.

In late 2013, internal long-range planning revealed that the EBIT goal was tracking under $8.5 billion. Walgreen CFO, the defendant Wade Miquelon, admitted that by the end of 2013 the company had identified the sources of the deficit as the unprecedented level of generic drug price inflation in the industry and reimbursement contracts that failed to provide meaningful inflationary relief.

Nonetheless, Walgreen restated the EBIT goal when it reported first quarter results for 2014. By March 2014, the EBIT goal was tracking around $7.5 billion.

The class period, from March to June 2014, encompassed the announcement of second and third quarter results and public statements made in the interim in which the defendants continued allegedly to downplay the risk of the EBIT goal. By June 2014 Miquelon, have determined that the EBIT goal was tracking at $7.2 to 7.5 billion, recommended to the CEO, the defendant Gregory D. Wasson, to publicly withdraw the goal. Wasson argued the scheduled earnings call should be delayed so the withdrawal of the goal could be bundled with good news.

On June 24, 2014, Walgreen issued the third quarter report and withdrew the FY 2016 earnings targets, attributing the decision to "Step 2 considerations" and "current business performance." Walgreen did not disclose the extent of the EBIT shortfall until August 6, 2014 when it confirmed that the expected 2016 EBIT was projected to be about $7.2 billion. The disclosure caused the stock price to plummet 14% in a single day.

Wasson and Pessina attributed the "unexpected" shortfall to bad forecasting, lax controls in the financial department, and poor communication between departments. Miquelon, pressured to leave, sued Walgreen for breach of contract, defamation, and tortious inference with economic advantage.

On August 6, Walgreen announced it was exercising its option to purchase the remaining 55 percent of Alliance, completing Step 2. Its September 2014 announcement of fourth quarter results explicitly acknowledged for the first time the detrimental impact that

reimbursement pressures and generic drug price inflation were having on profit margins. Several months later, Wasson resigned and Pessina replaced him as CEO.

March 2014 Statements

Walgreen issued its second quarter report on March 25, 2014, and the Wasson and Miquelon held a conference call with investors. The presentation listed the five previously announced FY 2016 goals, including the EBIT goal of $9-9.5 billion. These statements allegedly were false and misleading because they reaffirmed the EBIT goal when the defendants knew that goal was tracking at least $1.5 billion below target.

First, the characterization of the statements as a reaffirmation of the goal was incorrect. Although the defendants stated what the EBIT goal was and renewed their commitment to attempt to attain it, they also expressly acknowledged they were not currently on track to attain it. Thus, their statements were not misleading about the current status of the goal.

Moreover, the statements were not actionable based on the theory that the EBIT goal might be unobtainable because the plaintiff has not plausibly alleged that the goal was not obtainable. And the plaintiff has not alleged facts establishing that the defendant's future-looking statement that the "remained committed" to achieving the goal was false or misleading. The defendants also were not obligated to provide additional information or internal forecasts about the extent of the shortfall once it was disclosed.

The statement allegedly was misleading because it acknowledged efforts to mitigate the risk to the EBIT goal but failed to recognize that those efforts would be insufficient to counteract the severe scope of the EBIT shortfall. But the statement was that there were measures to "mitigate" the risk, not to eliminate it. Thus, for the statement to be false or misleading, the plaintiff had to allege facts showing that the defendants' measures were unable to in any way reduce the shortfall. No facts were alleged suggesting this to be the case.

Moreover, because this was a forward-looking statement, the plaintiff had to allege facts creating a strong inference that the defendants had actual knowledge of the falsity of their statements. But there was no such allegation.

Miquelon, in addressing softening profit margins, stated that "the most significant factor" affecting margins was "dramatically slower rate of new generic introductions year over year." The second-quarter form 10-Q stated margins "were negatively impacted by a significant reduction in the number of brand to generic drug conversions and lower market drive reimbursements." These statements allegedly were misleading because they misattributed the EBIT shortfall to the lack of new generic drug conversions instead of generic drug price inflation and unfavorable contract terms.

These statements were adequately alleged to be false or misleading. Miquelon stated, "we always experience some level of reimbursement pressure," indicating the pressures were routine. But it was plausibly alleged that those pressures, caused by unprecedented systematic price inflation and poor contract terms, were anything but routine and already were recognized as the primary cause behind the shortfall.

The defendants were unpersuasive in asserting that generic drug price inflation was well known and a universally recognized market trend, and therefore they had no obligation to disclose. Ordinarily, it would not be necessary to alert investors to the existence of price inflation. But the defendants were not alleged to have failed to disclose relevant market information. Rather, they were alleged to have misrepresented they were only experiencing routine reimbursement pressures and that the primary factor impacting margins was the reduction in generic conversions. These misrepresentations created a duty to disclose the inflation where none otherwise would have existed.

Moreover, the defendants' argument completely ignored the allegation that the impact of the inflation was uniquely magnified as a result of the contract terms. Hence the detrimental impact was specific to Walgreen.

Three additional statements allegedly were false and misleading because they failed to disclose that the price inflation already was unprecedented and systematic. In a March 25, 2014 press release Wasson emphasized Walgreen's "solid top-line growth" in the quarter "driven by record quarterly sales and record second-quarter prescriptions filled." But this past-looking statement was unrelated to price inflation and therefore created no obligation to disclose the existence of that trend.

Wasson also represented that Walgreen expected that "the generic drug headwind that affected the first half will ease and turn around by the end of the year." This and other accompanying forward-looking statements required allegations of facts creating a strong inference of actual knowledge of the falsity of the statements. The allegations indeed showed that by the end of 2013 the inflation was a recognized trend market-wide and that Miquelon had come to realize that it might be systematic. Other allegations showed that the unfavorable contracts offered no meaningful relief from the increasing generic drug prices.

The defendants contended, however, that the statement was accompanied by meaningful cautionary statements under the second prong of the PSLRA safe harbor provision. And in fact, the defendants adequately disclosed the risk that the inflation would undermine their predictions that the generic drug headwind would turn around.

Wasson also allegedly made a misleading statement in the press release by claiming the synergy with Alliance "is expected to exceed its second-year estimate." This representation

allegedly concealed the fact that the synergies were dwarfed by the EBIT shortfall. But the "massive" shortfall did not render the statement untrue, and no reasonable investor would misinterpret the unrelated statements as denying or minimizing the existence of the shortfall in light of the defendants' acknowledgment of that shortfall.

Nor were statements about "strong growth" in Medicare Part D prescriptions filled misleading. No reasonable investor would be misled because the statements did not address the issue of compensation or provide any reason to believe that Walgreen had not made price concessions to obtain the increased market share.

April and May 2014

The plaintiff alleged that the defendants, between issuing the March and June quarterly reports, made multiple false and misleading statements to analysts that were subsequently reported to investors. But a statement had to be attributable to a defendant, and therefore statements in analysts' reports were actionable only when they were attributed to a particular speaker.

A JP Morgan report contained statements that, while not explicitly identifying Wasson, clearly were attributable to him. But, as previously determined, a statement expressing confidence regarding the synergy target without disclosing the EBIT shortfall was not actionable because such optimism would not lead a reasonable investor to conclude that the EBIT goal was on track, especially in light of the defendants' prior contrary statements.

The statements were misleading, however, insofar as they represented there was "nothing unusual at this point" with regard to reimbursement pressures. Wasson allegedly was aware of the systematic generic drug price inflation at the time.

Statements the Head of Investor Relations, Rick Hans, allegedly attributing declining gross margins to the introduction of new generics and not to inflation, and promoting improved synergies while intentionally failing to disclose the EBIT shortfall, were not actionable. The plaintiff made no allegations concerning Hans' state of mind at the time.

June 2014

With the release of the third quarter report in June, Wasson and Miquelon held a conference call with investors. Along with a press release, statements were made that, as a result of the many Step 2 considerations in current business performance, the company was withdrawing the FY 2016 goals announced in 2012. The plaintiff contended the statements were false and misleading because the EBIT target was withdrawn, not because of the "many Step 2 considerations," but rather as a result of the shortfall, and the defendants

had waited to withdraw the EBIT goal until the announcement could be coupled with good news.

It was undisputed that the EBIT goal withdrawal resulted, at least in part, from the "current business performance," a factor the defendants disclosed. Although the decision to attribute the withdrawal to Step 2 considerations and business performance might have obscured the reasons for the withdrawal to some extent, it could not have obscured the fact that the EBIT goal was being abandoned. Thus, the statements regarding the reasons for withdrawing the goal have not been plausibly alleged to be false or misleading with respect to the EBIT goal.

The plaintiff also contended that false and misleading statements were made that, although disclosing the existence of the EBIT shortfall, failed to address its extent and misleadingly downplayed the extent by implying there was meaningful potential to make up, mitigate, or offset the shortfall.

The tone of these statements was resoundingly optimistic, which was perhaps in seeming conflict with the substantial shortfall alleged. The majority of the optimistic statements, however, concerned profit margins, synergies, or other metrics, not the EBIT goal. The statements have not been plausibly alleged to be false or misleading because they would not influence a reasonable investor's assumptions regarding the scope of the EBIT shortfall.

This was especially so because Wasson expressly state that Walgreen no longer expected to meet the EBIT goal, thus signaling that even the anticipated positive outcomes were unlikely to eliminate the shortfall. Similarly, the defendants' statements concerning their ability to "grow" EBIT were not actionable because the plaintiff has not alleged facts establishing that the defendants had actual knowledge they would be unable to increase their EBIT. Nor has the plaintiff alleged facts to establish that the representation that "there is potential, obviously," for below-the-line considerations to offset the shortfall was false and misleading standing alone.

The plaintiff contended that representations that the generic drug price inflation was "unanticipated" were false because the defendants knew of unprecedented inflation in 2013. But the statements did not identify when the defendants were surprised. The plaintiff appeared to assume, without basis in the statements, that they described events of the last quarter. But the defendants plausibly could have been stating that generic drug price inflation was unexpected a year ago, or even more likely, that it was unexpected when the EBIT goal was set in 2012. Moreover, the plaintiff has not plausibly alleged how the misrepresentations of the defendants' past knowledge were connected with the purchase or sale of a security or that they induced reliance by investors.

The plaintiff also alleged that statements that the defendants' procurement synergies would offset the impact of the price inflation and that "we are positioned better than anyone to be able to get at cost" were false. But these statements were not actionable because they did not state when a certain distribution would benefit Walgreen or that it would allow Walgreen to increase its profit margins.

Finally the plaintiff alleged that the defendants' positive remarks about growing the Medicare Part D business were materially misleading because Walgreen had to make price concessions to increase market share. But as previously discussed, it was not false and misleading to note that market share increased without disclosing that the increase was obtained through price concessions.

Regulation S-K Item 303(a) Violations

The plaintiff contended the defendants failed to comply with Item 303 by failing to disclose material known trends in their second quarter 2014 form 10-Q. But in the Northern District of Illinois it has been recognized that S-K 303(a) did not give rise to a private right of action under Rule 10b-5.

Scienter

The defendants argued the plaintiff failed to adequately allege scienter with respect to Wasson and Miquelon. The alleged false or misleading statements found to be adequately pled concerned the existence and nature of generic drug price inflation and reimbursement pressures. Wasson and Miquelon were regularly informed of inflation and pricing trends in the market and third-party reimbursement trends.

Although there were lengthy allegations as to motive, none of these applied to, or even appeared to address the limited issues remaining. It would be counterintuitive for the defendants to seek to hide the impact of the inflation when both parties appeared to agree that such inflation was a recognized market trend. Nor did the myriad allegations of self-interest and corporate intrigue seem applicable when, as here, the defendants openly disclosed far more damaging information, such the likelihood to miss the EBIT goal.

But absence of motive was not fatal to allegations of scienter. The relevant question was only whether, when the allegations were taken collectively, would a reasonable person deem the inference of scienter to be at least as strong as any opposing inference? Given the allegations establishing the defendants' knowledge that the inflation was a systematic trend and that Walgreen's contracts contained reimbursement caps that would cut into profits if prices increased, the inference of scienter was at least as strong as any reasonable opposing inference.

Section 20(a)

Miquelon contended that he could not be held liable under Section 20(a) because as CFO he reported to Wasson and therefore did not control any of his alleged misstatements. While it was true that Miquelon could not be held liable under Section 20(a) for statements that Wasson made directly, he may be held liable for statements issued by Walgreen or employees that Miquelon supervised.

* * *

CLASS ACTION; CLASS CERTIFICATION; SECURITIES FRAUD; FIFO; LIFO; CLASS-WIDE DAMAGES; BUILD-UP METHOD; STOCK-PRICE METHOD

City of Pontiac Gen. Employees' Ret. Sys. v. Wal-Mart Stores, Inc., No. 5:12-cv-5162 (W.D. Ark. Sept. 20, 2016)

Class Certification Granted for Wal-Mart Shareholders; Defendants' Objections to LIFO and "Build-Up" Methods of Computing Damages Rejected

Sana Hamelin

The Western District Court of Arkansas certified a class of Wal-Mart shareholders who alleged losses after the *New York Times* reported on a bribery scheme involving Wal-Mart's Mexican subsidiary, causing the stock price to fall nearly 10% over three days. The court ruled that the Last in First Out Method (LIFO) of computing damages was preferable to the First in First Out (FIFO) method and that defendant's objection to the "build-up" method of computing damages was premature. (See Editor's Note below for a description of the build-up method.)

The only disputed Rule 23(a) factor was typicality, with defendants contending that the named plaintiff lacked standing because, under FIFO, it suffered no losses on its trades in Wal-Mart stock, but whether the plaintiff suffered losses depended on which loss measurement methodology was employed; the LIFO method used by most courts favored the plaintiffs and was applied here. The defendants' other objection—that plaintiffs did not meet Rule 23(b)(3)'s predominance requirement—was similarly rejected since class certification did not depend on whether the build-up methodology was allowable, and plaintiffs had also proposed the widely-used stock-price methodology.

Background

On April 21, 2012, the *New York Times* published an article describing how Wal-Mart de Mexico, Wal-Mart's largest subsidiary, orchestrated a bribery scheme to obtain building

permits throughout Mexico. According to the article, Wal-Mart investigators discovered evidence of widespread bribery in 2005, but covered it up and rejected an outside firm's proposal of an independent investigation, assigning it instead to the office implicated in the bribery scheme. After the article was published, Wal-Mart stock fell nearly 10% over three days.

The plaintiffs alleged that defendants got wind of the *New York Times*' investigation and reacted by filing a Form 10-Q on December 8, 2011 (before the article's publication) that addressed potential noncompliance with the U.S. Foreign Corrupt Practices Act and announced an internal investigation and review of policies. According to plaintiffs, the 10-Q was designed to deceive investors about the timing of Wal-Mart's awareness of the suspected bribery scheme and Wal-Mart's response to it, and to forestall the blowback from the publication of the *New York Times* article. Plaintiffs alleged that Wal-Mart knew about the bribery scheme and covered it up, and its 10-Q contained statements that gave investors false assurances. This led to inflation in the stock price throughout the class period, which was defined as December 8, 2011 (the date Wal-Mart filed its Form 10-Q) to April 20, 2012 (the day before the *New York Times* article was published). After the *New York Times* article was published, the stock fell, but rebounded a few weeks later, when Wal-Mart reported a "quarterly performance surprise."

Plaintiffs brought a 10b-5 securities fraud class action on behalf of themselves and others who had purchased Wal-Mart stock during the class period, alleging that they had purchased Wal-Mart stock at artificially inflated prices and had been damaged by the omissions and/or misleading information in Wal-Mart's December 8, 2011 10-Q. Defendants' objections to the certification of the class focused on the Rule 23(a) factor of typicality and the Rule 23(b)(3) requirement of predominance.

Defendants' Typicality Objection

Defendants contended that the named plaintiff, Pontiac General Employees' Retirement System ("PGERS") did not sustain any losses and thus (1) lacked standing (which requires an injury-in-fact) to pursue its claims, individually or on behalf of the putative class; and (2) was subject to unique defenses not affecting absent class members. PGERS, claimed defendants, could not satisfy Rule 23(a)'s typicality requirement for a class representative.

However, whether PGERS suffered losses depended on the methodology employed to measure them: the LIFO or FIFO method. These methods are used in securities class actions to match purchases and sales of stock during the class period in order to measure a class member's damages. Under FIFO, stocks acquired first are assumed to have been sold first in the calculation of losses, whereas under LIFO, stocks acquired most recently

are assumed to have been the first sold. It was undisputed that using a LIFO calculation, PGERS could show that it suffered damages (although such damages would be "nominal" according to the defendants). Conversely, using the FIFO calculation showed no damages. The Court noted that the majority of courts used LIFO, which favored the plaintiff, and the defendants had failed to show that the FIFO method would be preferable in this case. The defendants' objection to typicality was rejected.

Defendants' Predominance Objection

Rule 23(b)(3)'s predominance inquiry applies to questions of damages, which must be capable of measurement on a class-wide basis, and a plaintiff must show a linkage between its theory of liability and theory of damages. The defendants claimed that predominance was not met because one of plaintiffs' two proposed damages methodologies, the "build-up methodology," failed to measure damages on a class-wide basis, had never been used in a securities class action, and was at odds with the plaintiffs' theory of liability.

The Court noted that the plaintiffs had proposed two methods of calculating damages—a stock-price method and the build-up method—and the stock-price methodology, which measures damages through an event study, was the most common approach of calculating damages in class actions. The defendants admitted it was capable of calculating class-wide damages consistent with the plaintiffs' theory of liability in this case. The Court concluded that it was "not necessary or appropriate for [it] to consider at this time whether to preclude the build-up methodology" as it would be premature. Class certification was not dependent on the resolution of whether the build-up methodology appropriately measured damages on a class-wide basis.

Class certification was granted.

Editor's Note on the Build-Up Methodology

The Court dealt summarily with the defendants' detailed arguments against the build-up methodology. The methodology and defendants' criticisms of it are summarized below.

Professor Jonathan M. Karpoff described the build-up methodology as "a reliable method of establishing damages without reference to Wal-Mart's market price." This method involved measurement of loss to a company as a result of its misconduct in the way of direct costs, restatement loss, and reputation loss. Direct costs would include outlays to investigate, defend, or remediate any consequences of the misconduct, including legal fees, penalties, and settlement payouts. Restatement loss would be the correction of any artificial inflation in the share price if the company's financial statements were in error. And

reputation loss is calculated as a residual after direct costs and restatement loss have been subtracted from the share value loss.

According to Professor Karpoff's report (which was simply a description of the build-up methodology), the share value method and build-up method "yield identical measures of the total loss to firm value," except in cases of bribery where investors may "adjust downward their valuation of the firm's shares by an amount that is slightly greater than the sum of the three cost components" because there is an additional cost attached directly to the bribe itself. Professor Karpoff's report then gave a brief overview of his working paper on foreign bribery that estimates average loss values for a sample of 143 firms that were charged with foreign bribery by U.S. regulators from 1978 through May 2013.

The defendants argued that PGERS had alleged fraud on the market, thus invoking the presumption of reliance. To take advantage of this presumption, a plaintiff must show that the misrepresentation was publicly known and the stock traded in an efficient market. Thus, the plaintiffs' theory of liability relied on the integrity of the company's stock price, and in such cases, damages are typically measured by reference to the market price. Using a method that side-stepped the market price as the measure of damages resulted in an impermissible disconnect between the damages methodology and the theory of liability, which must be "tethered." Also problematic was the fact that the build-up method seems to rely on each individual investor's assessment of the company's future costs. This type of individualized damages determination could not be made on a class-wide basis.

The defendants surmised that plaintiffs had advanced this alternative methodology so as to avoid the PSLRA's "bounce-back" provision, which limits damages if the stock price bounces back during the 90-day period following a corrective disclosure, as it did here, but also noted that the cap applies regardless of the methodology used.

Editor's Note: If accepted by the courts, the build-up calculation of damages could serve plaintiffs in cases where proximate causation of damages cannot be shown because the connection between the fraud and damages is murky. For example, in the *Vivendi* case it was unclear when "inflation maintenance" began and how it affected stockholders over time. Similarly, multiple causes of a stock decline are difficult or impossible to disaggregate. In such cases the choice is between allowing an imprecise remedy for securities fraud or allowing the defendant to escape with impunity.

The defendant objected strenuously to the build-up method because plaintiff's expert, Karpoff, did describe how it could be used to calculate damages in this case and because it could not pass "rigorous scrutiny" under *Comcast*.

* * *

SECURITIES FRAUD; INTERNET BANKING; MOTION TO DISMISS

In re BofI Holding, Inc. Securities Litigation, Case No. 3:15-CV-02324-GPC-KSC (S.D. Cal. Sept. 27, 2016)

Federal District Court Allows Securities Fraud Suit To Proceed Against Internet Bank and Its CEO for Knowingly Misrepresenting Lax Underwriting and Auditing Practices

Sharon Siegel

In a securities fraud case where investors sued a federally-chartered "Internet bank" (which provides consumer and commercial services wholly on-line) and several senior executives, a federal district court granted in part and denied in part a motion to dismiss, holding that Section 10(b) claims will proceed against the bank and its CEO because only they have the requisite scienter for material misrepresentations about the bank's sketchy lending practices, insufficient internal controls, and overall financial health. While the CEO was complicit in the scheme, the complaint failed to identify specific misrepresentations or omissions by the other individual defendants. The court declined to infer scienter for these defendants based on their alleged motive to defraud, their positions on the audit committee, or their failure to recognize the bank's accounting missteps.

Background

BofI is a consumer and commercial bank that has no brick-and-mortar branches. Instead, it offers checking and savings accounts, personal and business lending, and other banking services on-line. In recent years, BofI has grown substantially. During the class period from September 4, 2013 to February 3, 2016, BofI stock reached a high of $142.54 per share, as compared with its $11.50 per share price at its initial public offering in 2005. When the *New York Times* reported on October 13, 2015 that a BofI internal auditor filed a whistle-blower suit alleging "widespread misconduct," BofI's stock price declined by 30.2%, closing at $24.78 per share the following day. The price continued to decline until the end of the class period.

Plaintiffs' class actions were consolidated on February 1, 2016. "The gravamen of the allegations concerns Defendants' deviations from BofI's loan underwriting standards, inadequate internal control and audit measures, undisclosed related-party transactions, and other violations of the federal securities laws." Plaintiffs alleged that defendants "materially misrepresented the risk of investing in BofI by engaging in knowing and reckless conduct" such that investing in the bank was more risky than plaintiffs were led to believe.

Section 10(b)—Material Misrepresentations

The court held that plaintiffs pled, with sufficient particularity, several material misrepresentations "about its financial results, lending practices, off-balance sheet activities, and internal controls." Defendants made these statements in earnings calls, SEC filings, and conference calls and press releases about these filings. For example, BofI stated: "We continue to maintain our conservative underwriting criteria and have not loosened credit quality to enhance yields or increase loan volumes." Other representations include: "We continue to originate only full documentation, high credit quality, low loan-to-value, jumbo single-family mortgages and have not reduced our loan rates for these products"; and "we will appropriately manage our risk, and remain on sound regulatory footing as we enjoy the continued success of what we believe is the right business banking model for the future."

The court held that plaintiffs explained "with tremendous care" the reasons that these public representations were false and misleading. These explanations boil down to the allegation that, when the statements were made, "Defendants were engaged in a course of conduct that deviated from its loan underwriting standards, relied upon inadequate internal and audit controls, and failed to disclose related-party loans, among other misconduct." For example, senior underwriters described how they were pressured by senior managers to underwrite risky loans that the underwriters would have otherwise disapproved. Furthermore, plaintiffs specifically alleged that the bank's procedures failed to meet specific auditing requirements, the CEO "cleaned up" certain loan documents given to OCC examiners, and the Third Party Risk Department was sorely understaffed.

The court rejected the argument that allegations about credit quality are mere puffery, since this mischaracterization does not change the fact that BofI's actual banking practices did not meet the standards the bank espoused. Plaintiffs' allegations are not generalized or aspirational. Instead, they identify repeated and clear statements that BofI "continued to adhere to conservative loan underwriting practices and that it had not loosened credit guidelines in order to increase loan volume, when the defendants had, in fact, resorted to lax lending practices."

The court also rejected the argument that plaintiffs' confidential witnesses are unreliable. To the contrary, they were identified by title and job description, and sometimes also by supervisor.

Section 10(b)—Scienter

Applying a holistic standard, the court held that CEO Gregory Garrabrants had the requisite scienter, but that the other senior executive defendants did not. The court held that it could infer that Garrabrants "knew that BofI was deviating from its stated lending practices

and failing to maintain adequate internal and audit controls." In fact, Garrabrants "was actually complicit in misconduct," allegedly disregarding pertinent information, "cleaning up" audit reports, and not conducting background checks on certain foreign nationals. Scienter is also inferred based on the facts that Garrabrants was CEO during the entire class period, signed the Sarbanes-Oxley certifications, and repeatedly stated that the bank had appropriate underwriting and audit processes. The inference of scienter is stronger than the alternative assumption that the confidential witnesses are disgruntled workers.

However, the court declined to infer scienter for the other defendants because neither the complaint nor plaintiffs' response brief allege specific statements or omissions by these defendants. Plaintiffs also failed to provide a theory of scienter. In particular, the court declined to find scienter based on these defendants' positions or possible motives, or on all alleged facts taken together. The court would not infer scienter based on defendants' failure to recognize accounting mistakes, nor would it assume that defendants had a motive to commit fraud because they benefitted from one related-party loan. Thus, even using a holistic standard, the court did not find sufficient facts or other bases to find scienter for the other individual defendants.

Section 20(a)

The court held that plaintiffs adequately pled that Garrabrants is a "controlling person" under Section 20(a) because he could control and influence BofI. He was CEO of the company, was involved with statements central to this litigation, and also oversaw day-to-day corporate operations.

Defendants' Request for Judicial Notice

The court granted defendants' request to take judicial notice of BofI's SEC filings because this request is not subject to reasonable dispute. However, as plaintiffs requested, the court did not consider these filings for "the truth of the matters asserted therein." The court denied defendants' request to take judicial notice of other documents because the court did not rely on them in reaching its holdings on the motion to dismiss.

Motions To Seal

The court granted the parties' motions to seal to protect the identity of two confidential witnesses. The court held that a "fear-based culture" at BofI, including a fear of retaliation for dissent, is a compelling reason to seal and outweighs the public policy of disclosure.

* * *

SECURITIES FRAUD; SLUSA; MOTION TO DISMISS; SCIENTER; CONTROL PERSON LIABILITY; STATUTORY SELLER

Vanguard Specialized Funds v. VEREIT Inc., No. CV-15-02157 (D. Ariz. Oct. 3, 2016)

In Aftermath of AFFO Misreporting, District of Arizona Allows Bulk of Allegations To Proceed in Securities Fraud Case Against One of World's Largest REITs

Sana Hamelin

The District Court of Arizona declined to dismiss the bulk of plaintiffs' claims against one of the world's largest real-estate investment trusts, American Realty Capital Properties, Inc. (ARCP), and some of its former executives, holding that plaintiffs had adequately pled securities fraud claims under state and federal statutes for the defendants' overstatements of an evaluation metric provided to investors that artificially inflated its stock price. The court also denied a motion to transfer the case to the Southern District of New York because the plaintiffs could not have brought their case there without sacrificing their state law claims to a Securities Litigation Uniform Standards Act challenge.

Background

The Parties

Plaintiffs are a collection of trusts and investment companies that acquired common stock of ARCP and stock of Scottsdale-based Cole Real Estate Investments, Inc. that was later converted into ARCP stock as a result of a merger.

The Defendants: ARCP, now named VEREIT, Inc., is one of the world's largest real-estate investment trusts (REITs). ARCP conducted substantially all its business through its operating partnership, Defendant ARC Properties Operating Partnership L.P. ("the OP"). ARCP owned nearly all equity interests in the OP and was its sole general partner. Both OP and ARCP are now headquartered in Phoenix. Plaintiffs also sued ARC Properties Advisors LLC, which was ARCP's "external manager" and provided ARC with its management team, and was owned and controlled by Defendant AR Capital LLC and Defendant RCAP Holdings LLC (the "ARC Defendants").

The Executive Defendants: Also named as defendants were various former ARCP executives—Nicholas S. Schorsch, the founder, CEO and Chairman of ARCP, Brian S. Block (CFO), Lisa Pavelka McAlister (senior vice president and Chief Accounting Officer), Lisa Beeson (Chief Operating Officer), and David S. Kay (President). The executives held these positions until October 1, 2014, at which point Schorsch resigned as CEO (but stayed on as Chairman), Kay stepped down as President and replaced Schorsch as CEO and took a position on the Board. Beeson replaced Kay as President but maintained her position

as COO. In an October 29, 2014 press release, ARCP announced the departure of Block and McAlister. On December 15, 2014, ARCP announced the complete resignations of Schorsch, Kay, and Beeson.

Significant Events

The core of plaintiffs' claims concerned a metric called "adjusted funds from operations" or "AFFO." ARCP promoted AFFO as a useful metric for investors, pointing to its increasing AFFO as a reason to invest in the company. ARCP claimed its AFFO was important to evaluate the sustainability of its performance as compared with that of other similar companies, because AFFO adjusted for the company's high level of merger and acquisition activity. AFFO is also a useful metric for real estate businesses because GAAP calculations assume assets will depreciate over time but that assumption is not necessarily true for real estate. Plaintiffs alleged that ARCP inflated its reported AFFO in various ways; e.g., in calculating AFFO for properties that ARCP did not entirely own, it did not make an adjustment for its proportional ownership interest, resulting in AFFO figures that were "rosier than they should have been."

Under Schorsch's leadership, ARCP went on an acquisition binge, growing to over $20.5 billion in assets by 2013, three years after Schorsch founded the company. Included in these mergers was one with Arizona-based rival Cole Real Estate Investments for $11.2 billion that ARCP's SEC filings claimed would result in "AFFO growth."

On October 29, 2014, ARCP issued a press release announcing the conclusion of the company's Audit Committee that its financial statements for the year 2013 and the first two quarters of 2014 "should no longer be relied upon" by investors because of errors in the AFFO calculations. The Audit Committee found ARCP had incorrectly included certain amounts in its calculations, and that "this error was identified but intentionally not corrected, and other AFFO and financial statement errors were intentionally made, resulting in an overstatement of AFFO and an understatement of the company's net loss for the three and six months end[ing] June 30, 2014." The Committee also announced Defendants Block and McAlister would be leaving ARCP, and that it would investigate previously issued audited consolidated financial statements for 2013 because Block and McAlister had a role in preparing them. Analysts and credit-rating agencies reacted negatively to the news. The FBI and U.S. Attorney's Office for the Southern District of New York opened a criminal investigation into the matter. ARCP's stock price fell from $12.38 on October 28, 2014 to $10 on October 29, 2014.

On December 15, 2014, ARCP announced the resignations of Schorsch, Kay, and Beeson. On December 18, 2014, McAlister filed a defamation lawsuit based on the October

29, 2014 press release, claiming that she had repeatedly informed Schorsch, Kay and other managers about the incorrect method used in calculating AFFO. She alleged that this methodology was ordered by Schorsch and Kay and was in place until July 28, 2014.

On March 2, 2015, ARCP issued a press release and held an investor conference announcing the results of the Audit Committee's expanded investigation. ARCP admitted its internal controls for financial reporting and disclosures were deficient and it had overstated AFFO for 2011 by 7.8%, for 2012 by 2.3%, for 2013 by 22.8%, and for the first two quarters of 2014 by 35% and 10.4% respectively. It amended its 2013 annual report and the first and second quarterly reports for 2014. The Audit Committee also identified payments made to the ARC Defendants that were not properly documented, and equity awards to some executives that were not consistent with the terms authorized by the Compensation Committee. Finally, ARCP acknowledged ongoing investigations by the SEC, the U.S. Attorney's Office for S.D.N.Y., and the Secretary of the Commonwealth of Massachusetts.

Claims, Motion To Transfer and Motions To Dismiss

Plaintiffs brought claims under the Arizona Consumer Fraud Act (ACFA), Section 10(b) of the Securities Exchange Act of 1934, Section 14(a) of the Exchange Act, Sections 11 and 12(a)(2) of the Securities Act of 1933, and alleged control person liability under Section 20(a) of the Exchange Act and Section 15 of the Securities Act.

Defendants moved to transfer venue to S.D.N.Y., citing nineteen actions pending there regarding the alleged misstatements revealed in the October 29, 2014 press release.

Defendants ARCP and OP moved to dismiss the ACFA claims because choice of law rules dictated applying non-Arizona law, which does not provide a remedy, that plaintiffs had not pled a sufficient connection to Arizona, and that ACFA does not provide for aiding and abetting liability. They also moved to dismiss securities law claims (aside from control person liability) to the extent they were based on any alleged misstatements revealed for the first time in the March 2015 disclosures because plaintiffs had not alleged loss causation resulting from the disclosures. The executive defendants also filed motions to dismiss the claims against them: Beeson denied scienter had been adequately pleaded for her, Kay requested that certain allegations be stricken, which would result in insufficient allegations to support the controlling person claims, and Schorsch denied he was a statutory seller.

Court's Rulings and Key Points

Transfer: Transfer to S.D.N.Y. was denied on the basis that transfer is inappropriate where even a "real issue" exists as to whether the plaintiff could have brought the case in the transferee forum. Plaintiffs claimed, and the court agreed, that plaintiffs could not have

brought this case in S.D.N.Y. because the Securities Litigation Uniform Standards Act (SLUSA) would deprive S.D.N.Y. of jurisdiction over plaintiffs' state law claims. SLUSA applies to a "covered class action" which is defined to include "any group of lawsuits filed in or pending in the same court and involving common questions of law or fact." Thus, under SLUSA, where several lawsuits are joined, consolidated or otherwise proceed as a single action (as they might be here), none of those suits can include a state law claim in connection with the fraudulent purchase or sale of a covered security. Because SLUSA would likely prohibit plaintiffs from pursuing state law claims in S.D.N.Y., this case could not have been brought there, and transfer was therefore denied.

ACFA Claims: Defendants sought dismissal of plaintiffs' state ACFA claims on the basis that (1) Arizona law did not apply, and (2) plaintiffs' allegations lacked a meaningful nexus to Arizona. Arizona applies the Restatement (Second) of Conflict of Laws to determine controlling law for multistate torts. The court found that the factual record was too thin to allow for a meaningful conflict of laws analysis, so the defendants' motion to dismiss the ACFA claims on this basis was denied. The court also held plaintiffs had alleged acts that had a substantial connection to Arizona, such as the Cole Merger, and ARCP's subsequent operation out of Cole's former offices in Phoenix, the plaintiffs' office in Arizona that employed over 2,000 people, and some investors who were Arizona residents and suffered damages from the alleged fraud. These allegations fit with the purpose of the Consumer Fraud Act, which is to protect the public from deceptive acts. The motion to dismiss the AFCA claim was denied, but aiding and abetting under the AFCA was unlikely to be accepted by state courts and the aiding and abetting claim was dismissed.

Loss Causation: Defendants argued that plaintiffs did not adequately plead loss causation for their Section 10(b) and 14(a) claims because while plaintiffs allege the stock price fell following the October 2014 press release, the price rose slightly in the days following the March 2015 disclosures. However, this may have been because ARCP had warned investors not to rely on past financial reports and announced that the Audit Committee's investigation could prompt "further required adjustments." The Ninth Circuit has found loss causation adequately pled on such a theory in *Lloyd v. CVB Fin. Corp.*, where announcement of an investigation and subsequent stock price drop was followed by a disclosure related to that investigation which triggered only a "minimal effect" on the stock price. This was sufficient to allege loss causation because the earlier drop plausibly "reflected, at least in part, the market's concerns" about the subject of the investigation. Plaintiffs here had adequately pleaded loss causation as to the earlier financial reports, and the October 2014 press release had stated the investigation would look into internal controls; thus, the *Lloyd* analysis applied. Further, "the market could reasonably have inferred that a company that

had filed admittedly questionable financial reports since its founding might not have sound internal controls." Motion to dismiss denied.

Motion to Strike Allegations Drawn From McAlister's Complaint: Kay moved to strike a number of allegations drawn from McAlister's defamation lawsuit, but the court demurred. Kay argued that McAlister's complaint was unreliable because it was filed soon after her firing from ARCP following her identification by ARCP and Kay as at least partially responsible for the AFFO misreporting, her financial motive for filing the complaint, and her voluntary dismissal of the complaint. McAlister's complaint was verified and based on personal knowledge. None of the facts cited by Kay made McAlister's complaint inherently reliable in the court's view. Motion to strike denied.

Scienter: Kay and Beeson requested dismissal based on an inadequate pleading of scienter. In support, Kay insisted he had no prior connection to ARCP, Schorsch, or the ARC Defendants before joining ARCP as President in December 2013, that he made large purchases of ARCP stock during his employment and was compensated largely with stock, and ARCP itself never identified Kay as involved in the alleged misrepresentation. However, the court noted that it did "not expect every fraud is committed by old friends." The stock purchases were not pled in the complaint and were not properly before the court, but even if they were, they were consistent with scienter if Kay and Beeson believed they could have continued to hide the fraud. And it meant little that ARCP did not point to Kay or Beeson as participants in the alleged fraud, because it also had not pointed to Schorsch, the alleged mastermind of the entire scheme. Plaintiffs' allegations against Kay were specific enough to sustain an inference of scienter.

Plaintiffs' allegations against Beeson were less robust and focused on the timing of her departure, which could carry the less sinister inference of performance deficiencies rather than fraud. The 10(b) claim against Beeson was dismissed.

ARCP/OP's motions to dismiss for inadequate allegations with respect to scienter were also denied. ARCP did not challenge the sufficiency of plaintiffs' pleadings with respect to the matters disclosed on October 29, 2014, but argued that scienter was not supported for the misrepresentations preceding the first quarter 2014 filing. The court asked whether it was at least as strong as any opposing inference that a company that intentionally made misstatements as to the first and second quarters of 2014 also intentionally made misstatements before 2014. It answered in the affirmative. Key allegations were: (1) the misreporting of AFFO was present in each reporting period starting with ARCP's founding, and (2) certain executives allegedly took steps to cover up the errors once McAlister discovered

them. Scienter could be inferred from the alleged cover up, as it pointed to actual knowledge of relevant facts.

Statutory Seller: Schorsch denied statutory seller liability and the court agreed. He argued that Rule 9(b)'s pleading requirements applied to plaintiffs' statutory seller allegations, while plaintiffs insisted Rule 9(b) only applied to misrepresentations, and Schorsch's solicitation was subject to ordinary Rule 8(a) rules. Noting that no circuit court had addressed this question directly, the court concluded Rule 9(b) did not apply because acts creating statutory seller liability can be committed negligently.

Plaintiffs alleged that Schorsch participated in the preparation and dissemination of the Registration Statement and Prospectus. The Ninth Circuit has not addressed whether this type of allegation, without more, is sufficient to create statutory seller liability, but other circuit courts hold it is not. District courts within the Ninth Circuit are divided on the issue. Schorsch also had other involvement, such as his promotion of the Cole Merger to investors via press release and conference call in which he called it an "epic transaction." Plaintiffs also cited other statements by Schorsch that could be understood as marketing, and even if not actionable as misstatements because they constituted "puffery," were exactly the type of statements that encourage consumption. However, lacking any more "direct and active participation in the solicitation of [an] immediate sale," plaintiffs' allegations were insufficient to plead Schorsch as a statutory seller, particularly because plaintiffs had made no effort to distinguish the cases holding that participation in a "road show" is insufficient (likening calls with investors to road shows). Allegations of statutory seller liability against Beeson and Block were similar and were also dismissed.

Controlling Person Liability: Controlling person liability is properly alleged where there is both a primary violation of the underlying securities laws and allegations that defendants exercised actual power over the primary violator. Required are indicia of control over the management and policies or day-to-day affairs of the allegedly controlled entity. ARC Advisors provided ARCP with its management team and ARCP's CEO, President and CIO were all employed by ARC Advisors. Plaintiffs had sufficiently pled control person liability as to ARC Advisors. Although a much closer question for AR Capital and RCS Capital (parent companies of ARC Advisors), ARCP's alleged admission that ARC Advisors and its parent companies directed ARCP's activities, combined with the intensely factual nature of the inquiry, were sufficient to permit plaintiffs discovery on the issue. Kay was sufficiently alleged as a control person because he instructed McAlister not to correct the AFFO miscalculations, reviewed and signed ARCP's SEC filings, and participated in conference calls discussing reports with analysts. Control person liability claims against

the OP were dismissed, however, because ARCP merely operated through the OP, and was not controlled by it.

* * *

SLUSA PRECLUSION; CLASS ACTION; SECURITIES FRAUD; DISMISSAL

Luis v. RBC Capital Markets, LLC, No. 16-cv-00175 (D. Minn. Oct. 13, 2016)

Plaintiffs' Putative Class Action Precluded By SLUSA Where Sale of a High Risk Investment Product Was a "Covered Security" and Allegations Focused on Fraud

Sana Hamelin

The District Court of Minnesota agreed with defendants and dismissed the plaintiffs' putative class action, holding their fraud claims were barred by the Securities Litigation Uniform Standard Act (SLUSA). The plaintiffs' complaint alleged misrepresentations and omissions of material fact by the defendant in connection with the sale of reverse convertible notes (RCNs), a high-risk investment product. The plaintiffs claimed RCNs were not a "covered security" under SLUSA but the court disagreed despite a paucity of precedent on the issue. The court dismissed the case without prejudice, leaving plaintiffs with the opportunity to restate their claims under state law.

Background

The plaintiffs were seven retired and semi-retired individuals who invested in proprietary RCNs sold by the defendant, RBC Capital Markets, L.L.C. (RBC), a registered broker-dealer, and suffered significant losses when the notes declined precipitously in value. Plaintiffs claimed that the putative class could consist of several thousand individuals.

According to the plaintiffs, they did not understand the nature of the investments made on their behalf by RBC and had previously indicated to RBC that they had a low tolerance for investment risk. RCNs are a form of bond consisting of a high-yield, short-term note of the issuer that is linked to the performance of an unrelated reference stock. The complex nature of RCNs can make them difficult to evaluate as an investment and FINRA considers them unsuitable for unsophisticated investors. The complaint alleged that RBC promoted RCNs to the plaintiffs and other investors, and concealed from them the true risk of the products. Specifically, plaintiffs alleged that RBC (1) "intentionally failed" to screen customers to make sure RCNs complied with their stated investment goals; (2) knowingly mislabeled RCNs as "fixed-income investments" on account documents provided to investors; (3) omitted important information regarding the volatility of the stocks underlying

the RCNs; (4) failed to follow internal guidelines for marketing RCNs; and (5) had been the subject of legal and regulatory action relating to the allegedly improper marketing of RCNs, notice of which it failed to provide to investors.

Plaintiffs brought seven claims against RBC, all of which were founded in state law. Four alleged fraud in some form and violation of the Minnesota Securities Act which is analogous to SEC Rule 10b-5. The three remaining claims were for common law negligence, breach of fiduciary duty, and breach of contract. All of the plaintiffs' claims relied on the same set of allegations—that RBC failed to follow customers' instructions regarding investment risk, misrepresented the nature and safety of RCNs as investments, and omitted material information regarding legal and regulatory actions relating to RCNs—which is significant because these allegations subjected all of plaintiffs' claims, including state law claims, to SLUSA.

SLUSA

SLUSA precludes maintenance, in either federal or state court, of any "covered class action" based on state law and alleging either (a) a "misrepresentation or omission of a material fact" in connection with the purchase or sale of a covered security, or (b) the use or employment of any "manipulative or deceptive device or contrivance" in connection with the purchase or sale of a covered security.

Congress enacted the Private Securities Litigation Reform Act (PSLRA) to battle perceived abuses of the class-action vehicle in litigation involving nationally traded securities. PSLRA was meant to reduce nuisance cases by introducing heightened pleading requirements for class actions alleging fraud in the sale of national securities. However, the plaintiffs' bar attempted to avoid the new pleading requirements by filing class actions in state court based on state law. Congress reacted by passing SLUSA to prevent the frustration of the objectives of the PSLRA. Courts have interpreted SLUSA expansively and the Eighth Circuit has noted that "SLUSA should be read with the presumption that Congress envisioned a broad construction."

The Eighth Circuit's four-factor test for determining when a claim is precluded by SLUSA requires a party invoking SLUSA to show that:

(1) the action is a "covered class action";

(2) the action purports to be based on state law;

(3) the action alleges that the defendant misrepresented or omitted a material fact (or used or employed a manipulative or deceptive device or contrivance); and

(4) the action alleges that the defendant's misrepresentations or omissions of material fact were made "in connection with the purchase or sale of a covered security."

There was no dispute that this was a covered class action (defined as any lawsuit in which damages are sought on behalf of more than 50 people), nor that the plaintiffs' claims were brought pursuant to Minnesota state law. However, the parties disagreed on the remaining two factors—whether the "gravamen" of plaintiffs' claims involved misrepresentations and omissions by the defendant, and whether the fraud was in connection with the sale of a "covered security."

1. Allegations of Misrepresentations

SLUSA preemption is based on the "conduct alleged, not the words used to describe the conduct." Courts bar claims that are "facially unrelated to misrepresentations—such as those for breach of contract, breach of fiduciary duty, and negligence—when, at bottom, the essence of the complaint was an allegation of fraud." Such was the case here, as the plaintiffs had repeatedly alleged that RBC intentionally misrepresented the safety and appropriateness of RCNs as investment options, and had embarked on its course of conduct with the intent to defraud. The majority of the plaintiffs' claims sounded in fraud, thus requiring allegations of material misrepresentations and omissions as essential elements of the causes of action. SLUSA's third factor was met.

2. Covered Security

The fourth factor of the SLUSA test requires that the complaint allege that the defendant's misrepresentations or omissions of material fact were made "in connection with the purchase or sale of a covered security."

> SLUSA defines a "covered security" as a security that meets one of three requirements:
>
> (A) it may be one that is "listed, or authorized for listing" on certain national stock exchanges (e.g. the New York Stock Exchange or NASDAQ);
>
> (B) it may be listed on a national securities exchange that has listing standards that are "substantially similar" to the listing standards of one of the stock exchanges enumerated in subparagraph (A); or
>
> (C) it may be "a security of the same issuer that is equal in seniority or that is a senior security to a security described in subparagraph (A) or (B)."

The plaintiffs argued that there was no covered security here because although the performance of an RCN is tied to the performance of an underlying "reference stock" that would qualify as a covered security, the stock itself is not part of the initial investment, and the investor never takes possession of the reference stock. RCNs indisputably are not traded on a national exchange of any kind.

Noting that there is no precedent interpreting the scope of subparagraph (C), the court nevertheless agreed with the defendant's counterargument that RCNs are covered under subparagraph (C): "a security of the same issuer that is equal in seniority or that is a senior security to a security described in subparagraph (A) or (B)." RCNs are debt securities "issued" by Royal Bank of Canada (RBC's parent entity) and Royal Bank of Canada stock is traded on a national stock exchange. Because RCNs are securities issued by the same issuer—the Royal Bank of Canada—that issues securities described in subparagraph (A) of the statute, and RCNs are of at least equal seniority to Royal Bank of Canada's common stock, they are "covered securities" for purposes of SLUSA.

The court dismissed the plaintiff's complaint without prejudice so that they might restate their claims in a new lawsuit sounding only in state law.

* * *

SECURITIES FRAUD; MOTION TO STRIKE; PLEADING STANDARDS; MATERIALITY; SCIENTER; LOSS CAUSATION

In re CommVault Systems, Inc. Sec. Litig., No. 14-cv-5628 (D. N.J. Sep. 30, 2016)

Securities Fraud Claims That Defendants Misrepresented Consequences of Loss of Business Partner and Engaged in Improper Cookie Jar Accounting Adequately Alleged

Greg Lee

An investment fund acting as lead plaintiff adequately alleged claims under Section 10(b) and Rule 10b-5 that the defendants had materially misrepresented the consequences of the loss of a business partner and the use of cookie jar accounting to mask decelerating growth. Denying the defendants' motion to dismiss, District Judge Sheridan held, first, that the plaintiff had met the heightened pleading standards of Rule 9(b) and the PSLRA in alleging false or misleading statements.

The plaintiff also had adequately pleaded materiality. The plaintiff had alleged that the defendants misrepresented that the company had shifted most of its business to other partners, and when it was disclosed that, in fact, it had been unable to replace the lost business and had failed to meet annual growth targets, the stock price had plunged by over 30 percent.

Finally, the court ruled that the plaintiff had adequately pleaded scienter. The plaintiff alleged sufficient facts giving rise to a strong inference that, throughout the class period, the defendants knew or recklessly disregarded that, contrary to their repeated public

statements, the company was experiencing decelerating growth in its core software business due to the loss of the partner, and that the company had improperly deferred revenue by means of improper cookie jar accounting, to hide the truth of decelerating growth.

Background

CommVault, a provider of data and information management software, derives about half its annual revenue from licensing its software. Beginning in 2003, CommVault entered into a partnership with Dell Inc. Dell served as both a reseller and original equipment manufacturing partner to CommVault, selling CommVault's software as a stand-alone product or as integrated into Dell hardware

Beginning in fiscal 2007 through the beginning of the class period, CommVault relied on Dell for 20 percent of its total revenue. From 2006 through 2012, CommVault's revenue quadrupled.

Before the class period, CommVault told investors annual revenue would increase from $500 million in 2013 to $1 billion over the next few years. Analysts estimated that, to meet that goal, CommVault would have to grow at least 20% each year.

In the latter half of 2012, Dell acquired some CommVault competitors, including Quest Software, which ultimately ended the partnership. The defendants allegedly knew or recklessly disregarded that CommVault would not be able to reach 20% annual growth without Dell. Nonetheless, the defendants falsely reassured investors Dell had been replaced with other business partners, and the loss of revenue from Dell would not prevent reaching the target revenue.

The defendants also allegedly fraudulently concealed the decline in CommVault's business and manipulated financial results with "cookie jar" accounting. In the fourth quarter of fiscal 2013, CommVault achieved historic software revenue growth, but instead of recognizing revenue on particular licensing transactions in that quarter, the defendants improperly created a "cookie jar" of deferred revenue which had grown to $9.2 million by the end of fiscal year 2013.

The practice of deferring the recognition of revenues to a later period to manipulate earnings was a violation of Generally Accepted Accounting Principles (GAAP). The defendants allegedly used the cookie jar approach to create the illusion that CommVault was meeting its 20% annual growth targets. The manipulations allegedly concealed from investors the revenue deficiency caused by the loss of the partnership with Dell and the resulting sales force attrition.

The defendants allegedly made false and misleading statements in SEC filings, conference calls, and industry conferences with securities analysts regarding CommVault's ability to replace its Dell business and the impact of deferred revenue as an indicator of growth.

Before the opening of the market on April 25, 2014, investors learned the truth about decelerating software revenue and how the loss of Dell was a direct cause. CommVault announced that its fiscal fourth quarter profit had declined 7.8% and its software revenue had decelerated to 10 percent annually. With the disclosure, the stock price fell over 30 percent from $68.58 to $47.56, wiping out nearly $1 billion of market value.

Motion To Strike

The defendants contended it was improper at the pleading stage for the plaintiffs to include declarations of experts to fill factual voids in the complaint. The lead plaintiff countered that the declarations were in response to the court's ruling that technical support was needed to adequately allege that the cookie-jar accounting was improper. It also assorted that striking a pleading was a harsh, unwarranted remedy.

The declarations of Harvey L. Pitt, a former SEC chairman, and Harris Devor, a CPA, were proper at the pleading stage, especially when the court specifically indicated that technical support was required to support the GAAP violation. Moreover, the declarations were adequately incorporated into the complaint, and as such, only served to supplement the factual basis alleged.

Rule 9(b) and the PSLRA

The complaint met the PSLRA's particularity standards for allegations made on "information and belief." As the court previously ruled, the plaintiffs "have sufficiently alleged the confidential witnesses, their dates of employment, their job description and their relevant responsibility [and] to whom they reported." Moreover, the court discounted the defendants' argument that the CW's, as low level employees, would not have first-hand knowledge of the information and were relying on gossip. Specifically, the court previously found that "employees in the marketing departments, especially at the level of the confidential witnesses, most likely had the firsthand knowledge as to the impact occurring on the ground, and whether CommVault could meet its growth targets." Moreover, "the sales force would know the pulse of the company, and would often communicate among the different sales territories in order to facilitate leads and to learn about problems the company was experiencing … [T]hey were most likely relying upon sales activity."

As to the GAAP violations and cookie jar accounting, the second amended complaint adequately addressed the shortfalls in the first amended complaint, and sufficiently alleged

this theory. Not only did the plaintiff supplement the factual allegations with the expert declarations, but the complaint also adequately explained the GAAP requirements and why such accounting was improper. Moreover, the plaintiff identified CommVault's internal accounting methods.

The defendants argued that the CWs lacked first-hand accounting knowledge and that the complaint failed to link the allegations of deferring commissions with the alleged GAAP violation. But, considering the complaint as a whole, the plaintiff set fort a plausible claim. The defendants, by deferring recognition of software revenue, were able to create the illusion that CommVault was still a high-growth company, notwithstanding the loss of Dell. These allegations, coupled with the CWs and cookie jar allegations, were sufficient at the pleading stage.

In sum, the allegations regarding the loss of Dell, juxtaposed with the defendants' representations that they had replaced the Dell business, were sufficient to make out a claim that the defendants had made false or materially misleading statements.

Materiality

The defendants contended the plaintiff did not show they made materially misleading statements regarding deferred revenue or the relationship with Dell. But the plaintiff alleged that the defendants had made numerous statements during the class period related to the Dell partnership and CommVault's ability to meet growth targets. The defendants touted the strength of the Dell relationship in May 2012 and as late as May 2013. The stock price then plunged over 30% after CommVault disclosed that it was unable to replace the Dell business and meet its annual 20% growth targets. This satisfied the pleading standard for materiality.

Scienter

The plaintiff alleged sufficient facts giving rise to the strong inference that, throughout the class period, the defendants knew or recklessly disregarded that, contrary to their repeated public statements, CommVault was experiencing decelerating software growth due to the loss of Dell, and that the company improperly deferred software revenue to hide the truth about decelerating growth. When the complaint was examined holistically, it raised a strong inference of scienter.

The fact that the fraud allegations pertained to CommVault's core business—software licensing—may impute knowledge to the defendants. Moreover, the plaintiffs have alleged significant circumstantial evidence giving rise to a strong inference of scienter.

Finally, the sale of stock by the CEO showed he had an opportunity to commit fraud He allegedly sold 268,500 shares during the class period for more than $18.6 million. To the extent the defendants contended this merely was an exercise of options set to expire, that was a factual question outside the complaint. Moreover, the plaintiff went further and alleged the temporal proximity between the sales and the CEO's representations.

Loss Causation

The parties did not dispute loss causation. Moreover, the plaintiff alleged that the stock price plunged after the company disclosed it was unable to replace the Dell business and meet its growth targets. Therefore, the plaintiff sufficiently pled loss causation.

* * *

SECURITIES FRAUD; SECURITIES EXCHANGE ACT; JUDICIAL NOTICE; INCORPORATION BY REFERENCE; FALSITY; SCIENTER

Hsu v. Puma Biotechnology, Inc., No. SACV 15-0865 (JCGx) (C.D. Cal. Sep. 30, 2016)

Investors Adequately Pled Securities Fraud Claims That Drug Maker and Its Executives Misrepresented Results of Drug Trials

Greg Lee

In connection with a public offering, investors were able to adequately allege securities fraud claims against a drug maker and two of its top executives. Denying the defendants' motion to dismiss, District Judge Guilford held that the plaintiffs had pled both falsity and scienter well enough to allow the case to proceed. Finding that the allegations were sufficient to "allow this case to get out of the starting gate," the court observed that "[m]any of [the defendants'] arguments to the contrary are really a better measure of whether [the plaintiffs'] case will be victorious past the eighth pole and down to the finish line."

With regard to falsity, the defendants argued that when the data was evaluated by a different means, the challenged representations were true. But the court said the plaintiffs had provided enough "to force [the defendants] to pony up and present that theory another day." The court also found that the defendants' innocuous explanation for other statements "might be right, but they're not right for right now." It may be true that the plaintiffs were taking the statements out of context, but "a motion to dismiss isn't typically where that context is fully fleshed out."

Like their arguments about falsity, the court found the defendants' arguments about scienter unpersuasive at the present time. There were enough allegations to adequately plead the required state of mind.

The court acknowledged it was a "close call" whether there was enough to support a strong inference as to motive to commit fraud. But taken together and examined with the other allegations, the allegations about the timing of the alleged misrepresentations and the public offering, as well as the allegations about the individual defendants' performance-based compensation, were enough, "even if barely so."

As an initial matter, the court, expressing its frustrations generally with attorneys' confusion over the doctrines of judicial notice and incorporation by reference, made determinations at to what exhibits it would consider. The court observed, however, that its ultimate ruling would not have been any different, given the imperative to take the well-pled factual allegations as true, had it made different conclusions about the various exhibits.

Background

The defendant, Puma Biotechnology, Inc., is a drug maker. It focused its efforts almost entirely on the drug PB272, called neratinib, a therapy given after initial cancer treatment (such as surgery) to help suppress further formation of cancerous tumors.

The drug was intended for the treatment of a form of breast cancer in which cells make too many copies of a cell surface receptor called human epidermal growth factor receptor 2, or HER2. Neratinib was supposed to irreversibly bind to the HER2 and eventually slow down or stop uncontrolled cell growth.

There was a clinical trial of neratinib called ExteNET. The plaintiffs accused Puma and its executives of making false or misleading statements about the trial results.

The alleged misstatements basically were about two things. First, the trial was measured primarily by the percentage of disease free survival (DFS) among patients taking the drug versus those taking a placebo. Puma allegedly lied or misled investors about the absolute DFS rates and the improvement of DFS between the drug group and the placebo group.

Second there were the Kaplan-Meier curves used to identify trends in DFS rates over time. A widening difference between the drug group and the placebo group could suggest that the drug was effective. Puma allegedly claimed the gap was widening when in fact the gap was narrowing.

If neratinib made it to market, its expected cost would be $6,500 a month. During a public offering, Puma sold $218.5 million in stock. The defendants Alan H. Auerbach and

Charles R. Eyler, who were Puma executives, earned more than $23 million in performance-based compensation.

Lead plaintiff Norfolk County Council, which administered the Norfolk Pension Fund, and others, filed a complaint under the Securities Exchange Act. The defendants Puma, Auerbach, and Eyler (collectively, "Puma") moved to dismiss.

Judicial Notice and Incorporation By Reference

Puma asked the court to consider 28 exhibits consisting of SEC filings, transcripts of conference calls, a press release, and a set of slides from a presentation. There were fourteen or fifteen disputed exhibits. Norfolk disputed exhibits 14 and 16 through 28, and also objected to the incompleteness of exhibit 15.

Exhibit 14 was a set of slides. Norfolk argued that Puma included the wrong set, and attached a different set. The court would consider Norfolk's version without deciding whether it fell within the doctrine of incorporation by reference or judicial notice.

Exhibits 16, 17 and 19 through 26 were market analyst reports. Puma argued the court should take judicial notice of these as showing information publicly available. Norfolk argued that Puma failed to show the reports were publicly available, and that the reports reflected an inherent bias favoring Puma.

Puma did not adequately show that these exhibits should be judicially noticed. While Puma argued that the complaint referred to the reports, it did not show that the complaint referred to the same reports Puma wanted the court to consider. Puma cited several cases for the proposition that market analyst reports frequently were subject to judicial notice, but some of the cases did not clarify the types of documents they addressed. Some of the cases discussed different sorts of documents, and some discussed reports to which objections cited different grounds. All of the cases were meaningfully distinguishable.

Exhibit 18 was a transcript of a conference call that Puma wanted judicially noticed. Puma offered it to show the information publicly available and knew to the market. Norfolk argued the transcript wasn't referenced in the complaint, and argued it lacked authentication.

The more properly authenticated version of Exhibit 19 would be considered only because the parties appeared to agree that the court should consider this version of the transcript.

Exhibit 27 was a printout from the website of Herceptin, another drug used to treat HER2-positive cancer in the first year after initial treatment. Norfolk correctly argued that Puma did not adequately show the exhibit should be judicially noticed. First, Puma

appeared to improperly push the burden on a judicial notice request onto the party opposing the request, claiming the plaintiff cited no authority for its argument that the accuracy of the website was questionable just because it was used to sell Herceptin.

Puma also argued that the website linked to FDA archives and that those archives have been up since at least 2010 and could not be reasonably questioned. And, Puma's request to take judicial notice of the FDA archives, presented for the first time in its reply brief, was inappropriate, and therefore the merits of the issue would not be addressed.

Nor would judicial notice be taken of Exhibit 28, a "Policies and Exceptions" page from a website maintained by ASCO. Puma conflated judicial notice with the doctrine of incorporation by reference. Puma claimed Norfolk relied on materials submitted to ASCO, but omitted the policies governing the submission of such documents. Norfolk properly argued that Puma failed to make its case. Norfolk pointed out that the web pages provided by Puma were captured in November 2015, while the relevant period for the claims here was from July 2014 through May 2015.

The dispute over 14 or 15 exhibits may have been unnecessary. The court's ultimate ruling on the motion to dismiss would not change if the rulings on these requests had been different, given that the court generally had to accept the well-pled factual allegations as true.

Falsity, Scienter, and the Adequacy of the Allegations

Norfolk has pled both falsity and scienter well enough to allow the case to proceed. Many of Puma's arguments really were a better measure of whether Norfolk's case would be successful in the succeeding stages of the case.

Puma contended that the alleged DFS misrepresentations were not adequate because Norfolk was confusing the absolute difference between two DFS rates with another way DFS rates could be evaluated—the hazard ratio. Using the latter, the disputed representations were true, according to Puma.

But Norfolk provided enough to force Puma to present that theory at a later time. Norfolk adequately and specifically alleged why statements in a press release and a conference call with analysts in July 2014, and well as several others, could be false or at least misleading. Puma's hazard ratio explanation did not so obviously control as to stop the complaint.

This was true as well for Puma's arguments about the Kaplan-Meier curves. Puma's innocuous explanation for the statements about the curves in the same conference call might be right but they were not right for now. Perhaps it was true, as Puma argued, that Norfolk

was taking the statements out of context, but a motion to dismiss was not typically where that context was fully fleshed out.

Like Puma's arguments about falsity, its arguments about scienter were not persuasive at this stage. Norfolk pointed to another part of the conference call to show that Auerbach knew about the allegedly real trial results when he made the alleged misrepresentations. That and the other allegations were enough to adequately plead the required state of mind. The most direct way to show both that a statement was false when made and that the speaker knew it was false was via contemporaneous reports or data, available to the speaker, that contradicted the statement.

It a close call deciding whether there was enough in the complaint to support a strong inference as to motive to commit the fraud, particularly under the heightened pleading standard. But taken together and examined alongside the other allegations, the allegations about the timing of the alleged misrepresentations and the public offering, as well as the allegations about the performance-based compensation of Auerbach and Eyler were enough, even if barely so. A reasonable person would deem the inference of scienter cogent and at least as compelling as Puma's arguments to the contrary.

* * *

SECURITIES FRAUD; SECTION 10(B); RULE 10B-5; SECTION 17; MISREPRESENTATIONS; PUFFERY; OMISSIONS;

SEC v. Mapp, No. 4:16-CV-246 (E.D. Tex. Oct. 7, 2016)

SEC's Allegations of Securities Violations Under Section 17 of Securities Act and Sections 10(b) and 15(a) of Exchange Act Against Paid Stock Promoter Found Insufficient; SEC Allowed To Plead Additional Facts

Greg Lee

A state politician offered compensation to promote a company's stock came close to obtaining dismissal of securities law claims against him. Conditionally granting the defendant's motion to dismiss, District Judge Mazzant ruled that the SEC had not alleged facts sufficient to support plausible claims under Sections 17(a) and (b) of the Securities Act or Sections 10(b) and 15(a) of the Exchange Act. While the SEC's request to amend its complaint did not satisfy Rule 15, the court said it was inclined to allow the SEC to plead additional facts before dismissing the claims against the moving defendant.

In addressing fraud claims under Rule 10b-5 and Section 17(a), the court agreed with the defendant that this was purely an omissions case involving the defendant's alleged failure to disclose that he was being compensated. Nevertheless, the court found that the alleged misrepresentation that the issuer was a "great company" was mere puffery. And,

the defendant's statement that he had met with management was not accompanied by allegations to show that this truthful statement was misleading. Similarly, a statement that the offering price would double before a prospect returned from vacation was not accompanied by allegations showing the statement was false or misleading.

Turning to the omission to disclose to prospects the defendant was being compensated, the court ruled that the defendant had not duty to disclose to his investment club because he did not form a fiduciary relationship with the group. Even if a fiduciary relationship had been plausibly pleaded, the complaint failed to plead with particularity the nature of the fiduciary-like duty. The court also rejected the SEC's argument that the defendant had a general duty to disclose compensation, since the SEC was unable to offer a single case standing for the proposition that a non-broker had a duty to reveal his compensation. Recognizing that an omission could lead to liability when a defendant chose to disclose some facts, but failed to speak the whole truth, the court nevertheless concluded that the SEC had failed to identify a statement by the defendant regarding his compensation that was materially misleading.

As for the fraud claim under Section 17(b), the court held that an allegation that the defendant forwarded a promotional email from the company's CEO to a potential investor was deficient. The prospect-recipient never invested and the complaint did not allege that the defendant was paid, or would be paid for the unsuccessful recruiting effort. The allegation of a single phone call by the defendant to a single prospect was deficient because the call was not a recorded communication. Rejecting the SEC's broad interpretation of the statutory term "communication" as encompassing any oral communications, the court said the term had to be interpreted in context with the other listed communications, all of which were tangible, recorded media. The court also found it significant that all of the cases from other circuits had held defendants liable under Section 17(b) in situations involving broadly disseminated and recurring publications; not a single communication to one individual.

Finally, with respect to the Section 15(a) claim, the court found the SEC had failed to sufficiently allege that the defendant was required to register as a broker. The defendant was merely facilitating securities transactions rather than performing the functions of a broker. His conduct did not amount to effecting transactions for the account of others. The SEC presented no evidence of the defendant's possessing authority over the accounts of others.

Background

Servergy, Inc., is a computer hardware company that developed cloud-based data storage servers. From November 2009 to September 2013, it raised $26 million in private securities offerings to develop what it claimed was a revolutionary new server. The

defendant William E. Mapp, III, Servergy's co-founder and then CEO, was responsible for the fundraising.

The defendant Warren K. Paxton, Jr., a Texas legislator and now Attorney General, became involved in the fundraising campaign in the summer of 2011 when he was in the Texas House of Representatives. Paxton was a registered investment advisor from July 2003 to December 2004 and from December 2013 to November 2014.

Mapp offered to pay Paxton a 10% commission for any investors he recruited. Although Paxton told prospects he had met with management and determined Servergy was a great company, he did not conduct any due diligence or reveal to prospects he was being compensated to promote the stock.

By July 28, 2011, 5 of 12 prospects Paxton recruited had invested a total of $840,000. Servergy later issued Paxton 100,000 shares as payment for "services." Paxton was issued a Form 1099 for $100,000 for 2011.

On April 11, 2016, the Securities and Exchange Commission filed a complaint against Mapp, Paxton, Servergy, and another promoter, the defendant Caleb J. White for securities law violations. Paxton moved to dismiss.

Alleged Misrepresentations

The SEC alleged that Paxton engaged in fraud because he did not disclose to potential investors he was being paid to promote Servergy stock. Although the SEC alleged that Paxton made misrepresentations, Paxton correctly argued this was purely an omissions case. Nevertheless, the SEC's position would be addressed.

The first alleged misrepresentation was Paxton's assertion that Servergy was a "great company" that offered an interesting investment opportunity. The SEC relied on *Brody v. Transitional Hospitals Corp.,* 280 F.3d 997 (9th Cir. 2002) to show that the statements "affirmatively create[d] an impression of a state of affairs that differ[ed] in a material way from the one that actually exist[ed]."

But calling something a "great investment" was mere puffery. The SEC failed to allege that any statement by Paxton extended beyond mere corporate optimism. The puffing statements were immaterial as a matter of law and could not support a securities fraud action under Rule 10b-5 and Section 17(a) of the Securities Act.

The SEC also alleged Paxton told potential investors he had met with management, but did not allege facts to show that this truthful statement was misleading. It also claimed Paxton told an investor the offering price would double before the investor returned from vacation, but did not allege that the statement was false or misleading.

Fiduciary Duty To Disclose Compensation

The SEC alleged generally that Paxton had a duty to inform prospects he was being paid to promote Servergy stock. While the SEC spent most of its argument on the materiality of the omission, the issue was whether a duty to disclose existed. The Supreme Court has explained that whether a defendant owed such a duty turned on whether the omission rendered his statement false or misleading, not whether the omitted information was material. While Paxton's compensation may be material, Section 10(b) and Rule 10b-5(b) did not create an affirmative duty to disclose any and all material information.

The SEC alleged that Paxton had a duty to reveal his compensation to his investment club because he was in a relationship of trust. There was a circuit split as to whether a fiduciary-like relationship could trigger a duty to speak. The Fifth Circuit has not addressed the issue, but the position of other courts in the circuit that a fiduciary relationship triggered a duty to speak was persuasive.

Based on the facts alleged, Paxton did not form a fiduciary relationship with his investment group. Even if the SEC had pleaded sufficient facts to allege a plausible fiduciary relationship, the complaint was insufficient because it did not plead with particularity the nature of the fiduciary-like duty as required by the Fifth Circuit.

The complaint alleged prior dealings regarding monitoring various investments but failed to explain what they prior dealings were or whether there were any fiduciary-like duties regarding investment recommendations. The SEC made only conclusory allegations regarding Paxton's duty to tell his club members that he was being paid when he recommended the Servergy stock. Because the complaint offered neither facts sufficient to support a fiduciary relationship nor a specific duty under the alleged relationship, a securities fraud claim based on a fiduciary duty theory was not plausible.

General Duty To Disclose Compensation

The SEC argued more generally that Paxton had a duty to disclose his compensation because not doing so would be misleading. When asked to identify a case that stood for the proposition that a non-broker had a duty to reveal compensation, the SEC was unable to do so, but offered *U.S. v. Nouri,* 711 F.3d 129 (2d Cir. 2013). In that case, the court held that a registered broker had a duty to disclose he was bribed by the issuer to get his customers to buy the security. The court said not doing so would be misleading. But *Nouri* was distinguishable because the underlying omitted information—the existence of a bribe—was in itself illegal. Here, the receipt of a sales commission was not illegal.

The SEC also cited *SEC v. Torr,* 22 F.Supp. 602 (S.D.N.Y. 1938), which held that when "free-lance brokers" take initiative in recommending a stock they become "volunteer fiduciaries." But the case was contrary to Second Circuit precedent and insufficient to base a Section 17(a) claim on. Moreover, no court since *Torr* has held a stock promoter liable as a volunteer fiduciary.

Liability Based Upon Half-Truth

Absent an independent duty to disclose, omissions were actionable when the defendant elected to disclose some material facts but failed to speak the whole truth. According to the SEC, every statement Paxton made encouraging others to invest was a materially misleading half-truth. But the rule of disclosure was not as absolute as one might gather from *First Virginia Bankshares v. Benson,* 559 F.2d 1307 (5th Cir. 1977). The Fifth Circuit most likely would agree that a more precise statement of the rule was that a duty to speak the full truth on a particular subject arose when a defendant undertook to say anything on that particular subject.

Thus, the SEC would have to identify a statement by Paxton regarding his compensation that was materially misleading. The SEC relied on *SEC v. Huttoe,* 1998 WL 34078092 (D.D.C. Sept. 14, 1998), which held that a statement in a stock newsletter that the defendant publisher "may own shares" and "may act as" a paid consultant was a misleading half-truth because the defendant was being paid directly with stock for his promotional efforts.

The SEC failed to allege that Paxton made a representation regarding his compensation, and thus the half-truth assertion could not serve as the basis for liability under Rule 10b-5 and Section 17(a).

Promotional Email

The SEC alleged that Paxton defrauded investors under Section 17(b) by circulating communications describing securities without disclosing his compensation. Paxton argued that the claim failed because he did not receive consideration for publishing, publicizing, or circulating any communications describing securities.

The SEC alleged that Paxton forwarded one of Mapp's promotional emails to a prospect, but Paxton argued that the claim failed because the prospect did not invest, and therefore no sales commission was earned for the communication.

Section 17(b) required disclosure of compensation only if the compensation was received as a quid pro quo for the communication. While the SEC argued the quid pro quo was the 100,000 shares Paxton received, the complaint alleged only that Paxton was paid

for his successful recruiting efforts. There was no quid pro quo for the forwarded email because the recipient never invested.

The SEC argued that it was only necessary for Paxton to have an agreement to receive compensation. It cited *SEC v. Gagnon,* 2012 WL 994892 (E.D.Mich. Mar. 22, 2012), but the court there found the defendant liable for not fully disclosing the nature of his agreement after electing to disclose on his website that he would "earn commissions on the money that I bring in, but I will hardly get rich." In fact, he received over $3 million. Here, the SEC did not allege that Paxton elected to publicly disclose his compensation agreement, so *Gagnon* was inapplicable.

The SEC alleged that Paxton failed to conduct due diligence before forwarding the email, but did not allege that Paxton had a duty to do so. Even if a duty had been alleged, courts have held that failure to conduct due diligence on a promoted stock did not give rise to liability.

The SEC has not sufficiently pleaded facts to support a duty to conduct due diligence with respect to the veracity of the email. More importantly, the email could not serve as a plausible basis for Section 17(b) liability because the complaint did not allege facts indicating Paxton was paid or would be paid for his unsuccessful attempt to solicit the recipient.

Phone Call

The SEC alleged that Section 17(b) applied to Paxton's phone call to an investor. But Paxton argued there was no broad dissemination of the communication and the communication was not recorded one, as were the other communications listed in the statute. Paxton relied on the *noscitur a sociis* canon of statutory construction—a word was known by the company it keeps.

The SEC argued "communication" should be interpreted broadly to include any oral communications. But words in statutes should not be interpreted in isolation, ignoring important contextual information.

The SEC pointed to *United States v. Wenger,* 427 F.3d 840 (10th Cir. 2005), in which the court found liable a defendant who touted stocks in his newsletter and radio program. But because the court did not indicate whether the radio program alone was sufficient for liability, the SEC could not rely on the case to show that an unrecorded single phone call was sufficient under Section 17(b).

Paxton's interpretation was persuasive but an additional, more specific contextual canon was appropriate. Under the principle of *ejusdem generis,* when a general term followed a specific one, the general term should be understood as a reference to subjects akin to the specific one. Here, "communication" followed a list of tangible media, including circulars,

ads, newspapers, articles, and letters. Thus, the term should not be interpreted so broadly as to include all unrecorded forms of communication. Had the legislature intended the statute to cover all unrecorded communications, it could have drafted the statute more broadly.

Broad Dissemination

The parties made considerable efforts arguing whether a communication had to be broadly disseminated to serve as a basis for Section 17(b) liability. It was clear that the phone call to a single investor was not broadly disseminated. The Fifth Circuit has not expressly ruled on the issue.

The ordinary meanings of the statutory words "publish," "give publicity to," and "circulate" did not connote a private, singular communication with one intended recipient. "Publish" was defined as distributing copies to the public, and "publicity" was defined as public attention or notoriety. Thus, the plain statutory language did not lend itself to application to a single phone call because the publicity element was absent. Nor would the common meaning of "circulate"—to pass from person to person—encompass such a call.

Importantly, all of the cases in other circuits holding a defendant liable under Section 17(b) have involved broadly disseminated and recurring publications. While it was not necessary to decide how broadly a communication had to be disseminated to trigger liability, it was too far a stretch to apply Section 17(b) to a single phone call to one investor. The same reasoning could be applied to the single-recipient promotional email.

Failure To Register

The SEC alleged that Paxton was required to register as a broker but failed to do so and therefore violated Section 15(a) of the Exchange Act. Paxton claimed he was not acting as a broker as defined under the Act and therefore did not have to register. Paxton argued he did not actually handle securities, enter trades, or otherwise exert any control over anyone's account.

The Act did not define what was required to "engage in the business of effecting transactions" in securities "for the account of others." The Fifth Circuit has not interpreted this language, but the statute indicated that more activity was required than simply recommending a stock or introducing a potential investor to the company's fundraiser.

Here, Paxton was merely facilitating securities transactions rather than performing the functions of a broker. Paxton's conduct did not amount to effecting transactions for the account of others. The SEC presented no evidence of Paxton's possessing authority over the accounts of others.

Paxton was neither involved in negotiating the price or terms of a transaction, nor was he performing any of the other functions of the broker-dealer. Although he had prior

involvement in the sale of securities during his tenure as a registered broker, that factor alone was not enough to classify him as a broker-dealer rather than a finder.

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ATTORNEYS' FEES; APPRAISAL LAWSUIT; EQUITABLE FUND DOCTRINE; SUGARLAND

In re Appraisal of Dell Inc., Consol. C.A. No. 9322-VCL (Del. Ch. Oct. 17, 2016)

Chancery Court Awards Lead Counsel in Dell Appraisal Suit Over Eight Million in Fees and Costs To Be Allocated *Pro Rata* Among Appraisal Class

Sana Hamelin

Vice Chancellor Laster granted in full the fee application of lead counsel for the appraisal class following a Dell merger, rejecting the objections raised by two groups of appraisal claimants who had hired separate counsel to represent their interests. Lead counsel Grant & Eisenhofer P.A. (G&E) benefitted the appraisal class to the tune of $25,225,145.08 after their efforts through trial resulted in a determination that the fair value of Dell at the effective time was $17.62 per share, or $3.87 per share more than the merger consideration. The court deducted the requested expenses—$4,007,462.08—from the aggregate benefit achieved for the class, and then invoked *Sugarland* for an estimate of a reasonable award of attorneys fees based upon a percentage of the benefit, which here, could have been as high as $7 million (or 33% of the benefit) since G&E had litigated the case through trial. The lodestar calculation based on hours worked also amounted to over $7 million in fees. G&E, however, requested a lower amount, based on its contingency agreement with its own appraisal clients. The requested fees of $4,043,705.42, representing 19.06% of the net benefit, were "reasonable" in light of the benefit achieved and the complexity of the case, and were to be allocated *pro rata* among the appraisal class.

Two of the big shareholder groups in the appraisal action, Magnetar Capital Master Fund and Global Continuum Fund, objected to G&E's fee application, arguing that it did not account for the separate fee of over $4 million G&E had received from T. Rowe Price after it was dismissed from the appraisal class and secured a separate settlement. Magnetar and Global also objected that T. Rowe was not obliged to share in the *pro rata* allocation of the fees among the appraisal class even though it benefitted from G&E's work for the class. Magnetar and Global demanded a dollar-for-dollar reduction in their obligation for G&E's fees for fees they had paid to their separate counsel. Finally, Magnetar and Global felt that G&E's expenses were simply too high, with almost three-and-a-half million dollars in expert fees.

Vice Chancellor Laster rejected all objections, pointing out that the benefit achieved for the class was significant, and under *Sugarland*, entitled G&E to an award almost double what was requested. The complexity of the case, the fact that it was litigated through trial, the necessity of expert witnesses against a sophisticated defendant, the high contingency risk, and the benefit achieved for the class, justified the requested fees and expenses.

Background

On February 5, 2013, Dell announced that it had entered into a merger agreement with entities affiliated with its founder, Michael Dell, and Silver Lake, a private equity firm. Each publicly traded share of Dell common stock was converted into the right to receive $13.75-per-share in cash, subject to the right to seek appraisal. The merger closed on October 29, 2013.

After the merger closed, former holders of 36,704,337 shares filed a total of 13 different appraisal petitions. G&E represented 10 of the petitioners who collectively held 32,012,405 shares, representing 83% of the shares for which appraisal was sought. G&E's clients included T. Rowe, which alone sought appraisal for 26,732,930 shares. Three of the petitioners retained separate counsel, of which Magnetar and Global were two, seeking appraisal for 3,865,820 and 826,012 shares respectively.

The court consolidated the appraisal petitions in April 2014 and appointed G&E as lead counsel to represent the class on issues that were common to the entire class. Magnetar and Global did not object to G&E's appointment but objected to the proposed terms, particularly to counsel fees being allocated to the class rather than to individual clients ("double-billing"). The court invoked common fund principles and stuck with the straightforward application of Section 262(j) to allocate costs and expenses *pro rata* across the entire appraisal class.

As the case progressed, five of G&E's large appraisal claimants re-titled their shares after demanding appraisal and lost their appraisal rights, eliminating 1,675,666 shares from the appraisal class. In a post-trial ruling, the court held that T. Rowe, G&E's largest client, was not entitled to an appraisal because of its Yes vote on the merger, which eliminated 30,730,930 shares from the appraisal class. Some other claimants had various issues with their appraisal demand, eliminating another 828,652 shares from the appraisal class. In the end, the class was reduced from 38,765,130 shares to 5,505,730 shares, and Magnetar became the largest appraisal claimant with just over 70% of the remaining shares. Morgan Stanley was the only remaining G&E client, with 357,500 shares.

On May 31, 2016, the court held that the fair value of Dell at the effective time was $17.62-per-share, or $3.87-per-share more than the merger consideration. The court

awarded interest on the award at the default rate provided by the appraisal statute. On June 2, 2016, G&E sought an award of $3,964,125,60 in attorneys' fees (based on its contingency fee agreement with T. Rowe and other appraisal clients) and reimbursement of expenses in the amount of $4,035,787.18.

Magnetar and Global's Objections and Court's Holdings

Magnetar and Global opposed G&E's fee application, primarily because of T. Rowe's late departure from the case and subsequent settlement with Dell.

First, Magnetar and Global objected to paying any of G&E's fees and expenses that were incurred litigating its clients' specific entitlement issues. G&E conceded this point by deducting from its application any expenses reasonably related to G&E's litigation of its clients' entitlement issues.

Second, Magnetar and Global argued that T. Rowe should bear some of the fees and expenses that G&E incurred litigating the valuation issues, since T. Rowe leveraged the Fair Value Opinion when negotiating its settlement. The court disagreed because the appraisal statute does not permit a court to allocate expenses to former stockholders that were not entitled to seek appraisal and were not part of the appraisal class. T. Rowe's shares fell outside the scope of Section 262(j).

Third, Magnetar and Global contended that their own share of the fees and expenses allocated to the appraisal class should be reduced by the attorneys' fees and expenses that they spent for lawyers to represent their own interests. This ran counter to the consolidation order which did not permit counsel to recover from the appraisal class for issues specific to their own clients. The court pointed out that they had retained their own counsel "to protect their interests," and not to benefit the class, so they could not be entitled to recover their fees and expenses, whether from the appraisal class or as an offset, and indeed, allowing them a recovery would disproportionately burden the rest of the appraisal class who would have to pick up G&E's bill to the extent Magnetar and Global avoided paying their *pro rata* share. Magnetar and Global also claimed to contribute to the success of the litigation by consulting on tax issues and tax expert matters, but they should have applied for reimbursement for such contributions from the appraisal class, but did not do so within the time allotted for such a request.

Finally, Magnetar and Global demanded that any fee award to G&E should be reduced because G&E already received $4.2 million in fees from T. Rowe for its separate settlement with Dell. According to the court, once T. Rowe's shares were no longer part of the appraisal class, "any compensation that T. Rowe paid to G&E became a private matter." G&E generated a monetary benefit for the appraisal class and its fee award is based on that

benefit, and not on any separate benefit it obtained for T. Rowe. If Magnetar and Global did not bear their full *pro rata* share of the benefit reaped for the appraisal class, they would be unjustly enriched.

To the extent Magnetar and Global objected to the method G&E relied upon to calculate its fees—its contingency agreements with its appraisal clients—the court merely pointed out that both the lodestar calculation and the *Sugarland* factors favored a fee of over $7 million, whereas G&E had requested only about $4 million.

Court's Disquisition on Expenses and Interest

Expenses: Magnetar and Global objected to the expenses submitted by G&E based on the size of the bill, arguing that the reduction of approximately 86% in the appraisal shares held by G&E's clients "warranted a lesser investment in expenses." But Vice Chancellor Laster responded that "the expenses of appraisal litigation do not scale proportionately with the size of the appraisal class." G&E still needed experts on valuation, tax and sale-process issues, still needed to conduct discovery, file documents, and try the case. In Laster's view, "this was a case that required the highest level of investment. Facing skilled defense counsel who retained eminent experts of their own, G&E had to hire similarly high caliber experts and expend the resources necessary to achieve a successful outcome." Chancery Court judges in the five appraisal cases immediately preceding the Dell opinion all concluded that the deal price is the most reliable indicator of a company's fair value. To prove otherwise in the Dell case, Vice-Chancellor Laster wrote, G&E "had to conduct discovery into the sale process and develop well-supported arguments as to why the process fell short for purposes of price discovery." Expenses totaling $4,007,462.08 represented 15.89% of the aggregate benefit of $25,225,145.08, which was a "reasonable level of investment in reimbursable expenses."

Vice Chancellor Laster also made a point to deduct expenses from the total benefit to the class first, before determining the amount of a reasonable attorneys' fee, rather than taking the "all-in" approach which may award attorneys a combined 30% in fees and costs as measured against the benefit conferred. The all-in award shortchanges attorneys if expenses are considerable, as they would be in a case that goes all the way through trial.

Interest: The court stated that the interest that accrues on the original merger consideration should not be treated as part of the benefit conferred, because that amount of interest is necessary to keep the petitioners in the same position as if they had received fair value on the date of the merger. Conversely, the interest that accrues on the incremental amount awarded over the merger consideration should be treated as part of the benefit conferred, because that amount is necessary to bring the value of the incremental benefit forward to

the present date. This was a departure from the treatment of interest in *In re Appraisal of Shell Oil Co*., 1992 WL 321250 (Del. Ch. Oct. 30, 1992), which had incorporated into its benefit calculation the interest awarded on the base amount of the merger consideration as well as the interest awarded on the fair value award in excess of the merger consideration.

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MERGER; BREACH OF FIDUCIARY DUTY

In re OM Group, Inc. Stockholders Litig., No. 11216-VCS (Del. Ch. Oct. 12, 2016)

Shareholders Attacking Board Over Merger Failed To Show That Shareholders' Overwhelming Approval of Merger Was Due to Inadequate Disclosure

Greg Lee

In a challenge to a merger, disgruntled shareholders claiming that board members had breached their fiduciary duties in a merger transaction failed to show that the overwhelming shareholder vote approving the merger was due to inadequate disclosure. Granting the defendants' motion to dismiss, Vice Chancellor Slights held that the shareholders' fully informed, disinterested and uncoerced approval of the merger agreement cleansed any failure of the board to act reasonably to seek the transaction offering the best value reasonably available. Because of the approval of the transaction by a majority of shareholders, the standard of review of the transaction shifted from enhanced scrutiny to the business judgment rule. Since the plaintiffs did not allege that the merger amounted to waste, they could not overcome the presumption of the business judgment rule.

In seeking to overcome the shareholder approval, the plaintiffs raised three alleged disclosure failures of the proxy. First, they contended that the proxy omitted information regarding a competing bid, but the court concluded that there was no material omission and no materially misleading partial disclosure. The court explained that the partial disclosure rule was implicated only when the omission of a related fact rendered the partially disclosed information materially misleading. The information available to shareholders allowed them to conclude that the board in good faith had determined that the competing offer would not be more favorable to shareholders than the merger proposal or that the offer was not reasonably capable of being completed on a timely basis.

Second, the plaintiffs alleged that the proxy omitting information about the conflicts of interest of the company's CEO. But the court found that the plaintiffs alleged no facts from which it reasonably could infer that the omitted facts relating to the CEO's connection with the company's suitor reflected an actual conflict or were otherwise material.

Finally, the court found that the proxy had adequately disclosed the company's engagement of an investment bank and its compensation. With the disclosures, the shareholders knew precisely the amount of the bank's compensation and the circumstances under which it would be paid; and they were aware that the board new that the bank had received significant fees from the company's suitor in recent years.

Background

Former shareholders of OM Group, Inc., filed a class action against former members of the OM board of directors seeking declarations that they breached their fiduciary duties and an award of post-closing "recissionary damages." The claims arose from a merger transaction between OM and Apollo Global Management, LLC. Claims of aiding and abetting a breach of fiduciary duty against Apollo were voluntarily dismissed.

Faced with a threat of shareholder activism, the board of OM Group allegedly rushed to sell the company cheaply to avoid the aggravation of a prolonged proxy fight. OM's financial advisors allegedly had advised that separate sales of OM's various businesses would yield maximum value for shareholdings. The board, allegedly ignoring this advice, decided to sell a single package and hurried the pre-signing sale process and post-signing market check in a way that ensured strategic buyers would have no time or desire to pursue piecemeal transactions. The board's rush allegedly was unreasonable and in violation of fiduciary duties.

The Apollo transaction allegedly fell beneath reasonableness in three respects. First, the OM Board deliberately shut out strategic acquirers from the process in favor of a quick deal with a financial sponsor because it knew that strategic acquirors would be more interested in acquiring individual OM business units rather than the entire company.

Second, the board failed to manage conflicts among its contingently compensated investment bankers, especially with respect to Deutsche Bank which had received significant fees from Apollo over the three years leading up to the merger. Finally, the board relied upon, and allowed the bankers to rely upon, projections manipulated to understate OM's prospects in order to lead the bankers to conclude that a less than reasonable merger price was fair.

Shareholders voted overwhelmingly to approve the merger. But the plaintiffs alleged that the vote should be disregarded because it was the product of incomplete and misleading public disclosures.

The defendants moved to dismiss.

Standard of Review

Delaware had three tiers of review for evaluating director decisions: the business judgment rule, enhanced scrutiny, and entire fairness. The entire fairness standard generally applied when the board labored under actual conflicts of interest. Although the directors allegedly acted out of self-interest, the plaintiffs did not advocate an entire fairness standard. This likely was because the complaint alleged no facts from which it could be inferred that a majority of the board was interested in the merger or that the board labored under the influence of a controller.

Hence, the question was whether the proper standard was the business judgment rule or enhanced scrutiny under *Revlon*. Because the OM shareholders were cashed out, it would appear that *Revlon* governed and the sales process should be reviewed to determine whether the directors acted reasonably pursued the transaction that offered the best value reasonably available.

But before undertaking a *Revlon* analysis, it was necessary to account for the fact that the shareholders overwhelmingly approved the merger. If that approval involved a fully informed, uncoerced vote, then the business judgment rule would apply and the board's approval of the merger would be insulated from all attacks other than waste.

Shareholders' Vote

Plaintiffs seeking to hold directors liable for approving a merger approved by shareholder had to show either than the transaction amounted to corporate waste or that the shareholder vote was uninformed or coerced. The plaintiffs chose the latter, arguing that the OM board either failed to disclose material information or made materially misleading partial disclosures regarding the merger.

According to the plaintiffs, the shareholder vote should be ignored because the proxy was misleading in three material respects: (1) it omitted information regarding the competing bid of Advanced Technology & Materials Co., Ltd., through misleading partial disclosures, (2) it omitted information about the alleged conflicts of interest of the defendant Steven J. Demetriou, OM's CEO and chairman of the board, and (3) it omitted information about the evolution of Deutsche Bank's engagement and the timing of the OM board's discovery of the extent of Deutsche Bank's conflicts.

Advanced's Competing Bid

The plaintiffs relied on *Arnold v. Society for Sav. Bancorp, Inc.,* 650 A.2d 1270 (Del. 1994), which recognized that a partial and incomplete disclosure of arguably immaterial information regarding the history of negotiations leading to a merger might result in a materially misleading disclosure if not supplemented with information that would allow

shareholders to draw a complete picture. The plaintiffs conceded that the negotiations with Advanced were so tentative and the likelihood of a deal with Advanced was so speculative that facts concerning its proposal would be deemed immaterial. Nevertheless, they argued that once the proxy mentioned discussions with Advanced, the board was obligated to provide accurate, full and fair characterization of those events.

The plaintiffs' statement of Delaware law regarding disclosures was correct as a general matter, but not complete. The partial disclosure rule was implicated only when the omission of a related fact rendered the partially disclosed information materially misleading. Given the proxy's discussions of the Advanced overture, with references to defined terms within the merger agreement that placed the potential proposal in context, it could not be reasonably inferred that the absence of the information the plaintiffs identified rendered the proxy materially misleading.

The proxy, which provided a discussion of "Subsequent Events" following a history of the merger negotiations, disclosed that prior to the expiration of the Go-Shop Period, the board received a written takeover proposal. Thus, shareholders were aware of a proposal that potentially competed with the Apollo offer. The proxy stated, that the board, after consulting with its financial advisors and legal counsel, determined that this proposal was one that under the merger agreement could lead to a "superior" offer.

Based on this information, the shareholders knew that, under the merger agreement, this submitted proposal either was or could lead to a bona fide offer for at least 50% of the stock or 90% of the assets, and that the board, in good faith, thought the proposal could be more favorable to shareholders than the Apollo offer. The proxy made clear, however, there could be no assurance that this proposal or any other alternative proposal from the same party could result in a superior proposal.

The company later announced that this anonymous bidder (Advanced) would not be making a superior proposal. This allowed the shareholders to conclude that for financial, legal, or regulatory reasons, the board, in good faith, had determined that the offer would not be more favorable to shareholders or that it was not reasonably capable of being completed on a timely basis.

Indeed, given that Advanced, a Chinese company, faced unresolved and potentially unresolvable regulatory obstacles to an acquisition of certain OM assets that were connected to the U.S. military, the disclosure that Advanced could not make a superior proposal reflected accurately the board's assessment that Advanced was not able to make a proposal on a timely basis that was reasonably capable of being completed from a regulatory

perspective. Accordingly, there was no material omission and no materially misleading partial disclosure.

CEO's Conflicts of Interest

The plaintiffs contended that the failure to inform shareholders that Demetriou was chairman and CEO of a company partially owned by Apollo, and that he met with Apollo during the sales process, were material omissions. Of course, shareholders were entitled to know when a fiduciary had a self-interest that arguably was in conflict with their own.

Materiality was the touchstone of the board's duty to disclose. Not every fact tending remotely to suggest that a board member's interest might differ in some respect from that of the shareholders amounted to a material omission. Facts had to be alleged from which it could be reasonably inferred that there was a substantial likelihood that a reasonable shareholder would consider the omission important in deciding how to vote.

No such facts were alleged. The complaint alleged that Demetriou was the CEO of Aleris, 18.99% of which was owned by Apollo through affiliates as part of an investment group, and Demetriou had lunch with a key employee in Apollo's metals group. No facts were alleged that would allow a reasonable inference that a single lunch meeting would somehow compromise Demetriou's independence or otherwise be material to a reasonable investor.

Notably, there was no allegation that Apollo controlled or even influenced Demetriou or that he controlled or had undue influence over any other board member. The conclusory allegation that he was influenced to support the transaction due to his relationship with Apollo did not make it reasonably conceivable that this information should have been included in the proxy, or if included, would have changed the total mix of information or would be important to a reasonable investor in deciding how to vote.

Deutsche Bank Conflicts

The plaintiffs claimed the proxy failed to disclose that the board did not discover the precise fees paid by Apollo to Deutsche Bank until it approved the merger, and failed to disclose that the board initially contemplated hiring the bank on a flat-fee basis but then inexplicably settled on a contingency fee.

Because of the central role played by investment banks in strategic alternatives, full disclosure has been required of bank compensation and potential conflicts. It was important that shareholders understand what factors might influence a financial advisor's analysis. Here, the proxy thoroughly and accurately disclosed the terms under which the bank was engaged and the extent to which the bank previously had provided services to Apollo, and

to Platform Specialty Products Corporation, which had expressed an interest in purchasing an OM business.

The proxy disclosed that Deutsche Bank would be paid $1.5 million upon delivery of a fairness opinion and that payment of the balance of the fee was contingent upon consummation of the merger. The proxy also disclosed that Apollo had paid more than €140 million in fees to the bank since January 1, 2013. Shareholders were advised that the board knew upon the bank's engagement that it had an ongoing relationship with Apollo and its affiliated funds and had received significant fees from Apollo and its affiliates over the prior three years.

With these disclosures, shareholders knew precisely the amount and circumstances under which Deutsche Bank would be paid. And they knew that the board was aware the bank had received significant fees from Apollo. It was not reasonably conceivable that shareholders would have found the timing of the board's discovery that "significant fees" meant €140 million to be important in deciding whether to vote for the merger.

The plaintiffs' argument that the proxy omitted that the board altered the compensation arrangement fared no better. While the plaintiffs were correct that Delaware required full disclosure of investment bank compensation and potential conflicts, they failed to state in what manner the proxy materially missed the mark. The shareholders were fully apprised of the bank's past work with Apollo and of the contingent nature of its engagement. They were not misled as to the bank's incentives.

Facts have not been alleged to allow the conclusion that it was reasonably conceivable that any of the omissions regarding Deutsche Bank would have significantly altered the total mix of information available to shareholders or that a reasonable investor would have considered this information important in deciding how to vote on the merger. Hence, the allegations regarding Deutsche Bank failed to state a disclosure claim and failed to undermine the cleansing effect of shareholder approval.

* * *

DERIVATIVE SUIT; SHARE DILUTION; MOTION TO DISMISS; DEMAND FUTILITY; CONFLICT OF INTEREST

Chester County Employees' Retirement Fund v. New Residential Investment Corp., C.A. No. 11058-VCMR (Del. Ch. Oct. 7, 2016)

Plaintiff's Improperly Pled Derivative Claims Dismissed for Failure To Demonstrate Demand Futility Where Allegations of a Defendant's Self-Dealing Fell Short of Material Interest

Sana Hamelin

In a case where a stockholder brought direct claims against New Residential Investment Corp., a Real Estate Investment Trust (REIT), and affiliated entities based on allegations that it overpaid for a third party's assets with stock in a self-interested transaction, the Court of Chancery held that demand was not excused as all of plaintiff's claims were derivative rather than direct, even if the stock issuance had caused a dilution in plaintiff's shares. It further held that plaintiff had not pled particularized facts sufficient to infer a defendant's material interest in the challenged transactions, so demand was not excused under Rule 23.1. Since the plaintiff pled potentially viable claims, however, dismissal was with leave to replead.

Background

Plaintiff Chester County Employees' Retirement Fund is a stockholder of New Residential, a publicly traded REIT. Defendant FIG managed New Residential at the time of the challenged transactions, and employed all of New Residential's officers and employees. Defendant Fortress owns 100% of the stock of FIG Corp.

On February 22, 2015, New Residential acquired all 71 million outstanding shares of Home Loan Servicing Solutions, Ltd. (HLSS) for $18.25 per share in cash, for a total of $1.3 billion. In April 2015, New Residential purchased HLSS's assets and assumed its liabilities (except for a term loan and approximately $50 million in post-closing liabilities) for another $1.4 billion. In order to help fund the HLSS acquisition, New Residential conducted two public offerings in April and June of 2015. HLSS sold the 28,286,980 New Residential shares it had received as consideration in New Residential's April offering. New Residential sold an additional 29213,020 shares to the public for $15.25 per share, and in June, sold $444 million worth of shares at $15.88 per share. The stock issued to fund the HLSS acquisition increased the New Residential paid-in equity capital account which, under the Stock Options Plan, authorized New Residential to issue options awards to FIG's

sole managing member, and FIG became entitled to a greater management fee equal to 1.5% of any new equity raised.

The complaint alleged that FIG's annual management fee increased from $19.7 million to $26.1 million, a $6.5 million increase, as a direct result of the stock issued to HLSS in the asset purchase. On April 8, 2015, New Residential recharacterized certain income from HLSS servicer advances from an increase in fair market value to interest income, which increased New Residential's pro forma interest income from $524.2 million to $695.1 million. As a result, FIG's incentive compensation increased from $34.5 million to $78.3 million. Further, after the HLSS acquisition, on May 7, 2015, New Residential and FIG re-negotiated the management agreement and retroactively changed the amortization of non-routine expenses in calculating FIG's incentive compensation, which led to a $3.3 million increase in FIG's 2015 incentive compensation. Three director defendants had dual roles at New Residential and Fortress, calling into question their disinterestedness.

The plaintiff alleged that New Residential overpaid for HLSS given the risky state of the HLSS business and some of its liabilities that New Residential assumed. Several months before the HLSS acquisition on September 15, 2014, the SEC initiated an investigation into HLSS's restatement of its financial statements. HLSS agreed to a cease and desist order and a $1.5 million settlement payment, which New Residential agreed to pay in the acquisition. On September 29, 2015, Standard & Poor, downgraded the rating of HLSS's debt servicer to below average, triggering a default on $2.525 billion of notes that New Residential had to pay.

The plaintiff brought claims for breach of fiduciary duties for overpayment for the HLSS assets with stock and issuing options for New Residential shares to FIG's sole managing member. The plaintiff argued that this stated a direct claim because the equity value and voting power of plaintiff's shares were reduced through the transactions. Defendants responded that any dilution plaintiff suffered was the unavoidable accounting result of a transaction with a third party that allegedly injured New Residential, and thus the claim must be derivative.

The Law on Direct and Derivative Suits

Stockholders of Delaware corporations can sue directly for injuries they have incurred in their individual capacities as stockholders, and derivatively on behalf of a corporation in which they own shares if Rule 23.1 requirements have been satisfied. Whether a claim is direct or derivative depends on (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually).

In *Gentile v. Rosette*, the Supreme Court held that in a "typical corporate overpayment case, a claim against the corporation's fiduciaries for redress is regarded as exclusively derivative, irrespective of whether the currency or form of overpayment is cash or the corporation's stock." However, a corporate overpayment case may result in both a direct and derivative claim where a controlling stockholder causes the corporation to issue excessive shares of its stock in exchange for lower-value assets, and the exchange causes an increase in the controlling stockholder's share percentage and a corresponding decrease in the share percentage owned by the public (minority) shareholders.

In *Feldman v. Cutaia*, the Court of Chancery emphasized the limited reach of *Gentile*, stating that for a transaction between a corporation and a third party to give rise to a direct claim, the corporation must have a controlling stockholder that used its controlling position to orchestrate the transaction. The court believed that limiting *Gentile* was necessary to avoid "swallow[ing] the general rule that equity dilution claims are solely derivative." The Supreme Court affirmed and stated that "[i]n the absence of a controlling stockholder, 'such equal "injury" to the [company's] shares resulting from a corporate overpayment is not viewed as, or equated with, harm to specific shareholders individually."

Conversely, in *Carsanaro v. Bloodhound Technologies, Inc.*, the Court of Chancery held that dilution of economic value through new stock issuances to venture capitalists gave rise to a direct claim, even without a controlling stockholder, because the board was not independent from the venture capitalists. Standing to pursue individual challenges to self-interested stock issuances, said the court, will exist if a controlling stockholder stood on both sides of the transaction or if the board that effectuated the transaction lacked a disinterested and independent majority. The *Carsanaro* court recognized that prohibiting direct stockholder claims would be inequitable when strong derivative claims would be extinguished by a merger.

Finally, the Court of Chancery in *In re El Paso Pipeline Partners, L.P. Derivative Litigation* reiterated the broader view that a dual natured claim should be treated as derivative for purposes of Rule 23.1 and the doctrine of demand, but as direct for purposes of determining whether sell-side investors can continue to pursue the claim after a merger.

Demand Futility

The court held that even if it was assumed the claims here were dual-natured, a Rule 23.1 demand analysis was called for to best "harmonize[] the case law." Since the plaintiff failed to demand that the board of New Residential bring a derivative suit, plaintiff must plead particularized facts showing that demand was excused as futile to avoid dismissal under Rule 23.1. A stockholder plaintiff may satisfy the demand requirement by either

making demand on the board to undertake corrective action or demonstrating that any such demand isfutile and, therefore, that demand is excused. Where a plaintiff fails to comply with the demand requirement and fails to plead with particularity why a demand would be futile, the complaint will be dismissed.

In *Aronson v. Lewis*, the Supreme Court articulated a two-part test to show demand futility: whether a reasonable doubt is created that (1) the directors are disinterested and independent, and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.

Plaintiff adequately pled that to the extent Fortress was materially interested in the side benefits it received from the HLSS transactions, three of New Residential's directors who owed fiduciary obligations to both New Residential and Fortress were not disinterested. Because all of the director defendants' alleged conflicts were based on their relationships with Fortress, plaintiff had to show that Fortress was *materially* interested in the challenged transactions. Although the plaintiff pled facts alleging that Fortress received $6.5 million in increased management fees, $43.8 million in increased incentive fees, 8,543,538 stock options, $57 million in stock sale proceeds and $3.3 million in increased compensation, the court did not believe the plaintiff adequately demonstrated that Fortress's interest was material. Allegations that some of the effects of the challenged transaction "benefitted Fortress alone are not enough," stated the court. Without allegations of the materiality of the fees and options, the plaintiff had not cast a reasonable doubt on the independence of the directors, nor had the plaintiff alleged that board approval did not meet the business judgment test.

Demand was not excused and claims were dismissed, but because plaintiff pled "potentially viable claims," the court gave plaintiff leave to replead.

* * *

***TRULIA* ATTORNEYS' FEES; DISCLOSURE-ONLY SETTLEMENTS; MATERIALITY OF SUPPLEMENTAL DISCLOSURES**

In re Receptos, Inc. Stockholder Litigation, Civil Action No. 11316-CB (Del. Ch. July 21, 2016)

Delaware Chancery Court Continues To Rein in Attorneys' Fees Under *Trulia,* Allowing Only $100,000 in Fees Because Supplemental Disclosures Are Not Material

Sharon Siegel

In a consolidated stockholder class action suit challenging the high-profile acquisition of one biopharmaceutical company by another, where the case settled quickly leaving only the question of attorneys' fees for plaintiffs' counsel, the Delaware Chancery Court awarded the modest sum of $100,000 under the *Trulia* standard (as compared with the $350,000 sought). This bench ruling signals the continuing demise of disclosure-only settlements in the absence of material supplemental disclosures. The only benefit to the class was Receptos' management's estimate of likelihood for securing regulatory approval of a drug because this information enabled stockholders to gain some understanding about the confidence of management in getting regulatory approval.

The court held that the primary issue in determining attorneys' fees here was the "benefit conferred," and that the supplemental disclosures here were not material (although some of them were "of some value"). The court emphasized:

> There is no right to cover one's supposed time and expenses just because you sue on a deal, and plaintiffs should not expect to receive a fee in the neighborhood of $300,000 for supplemental disclosures in a post-*Trulia* world unless some of the supplemental information is material under the standards of Delaware law.

The court added the lesson that contingency cases are "meant to be risky." The court also noted that the issues addressed in this acquisition were fairly straightforward, the case "settled very early, and the amount of heavy lifting in the case was actually very modest" (although plaintiffs' counsel did spend "time and effort" on the case).

By way of background, plaintiffs' counsel sought $350,000 in attorneys' fees and expenses in conjunction with stockholder class actions that challenged Celgene Corporation's proposed acquisition of Receptos, Inc., for $232 per share. These cases were filed in July 2015 and consolidated on August 4, 2015. The parties self-expedited with stipulations on August 13, 2015 and settled the case the next day solely for supplemental disclosures. The transaction closed by the end of the month. After *Trulia* was decided, the parties in March 2016 stipulated to the case's dismissal with prejudice to the named plaintiffs, and without

prejudice to any other putative class members. The only pending issue was plaintiffs' attorneys' petition for $350,000 in attorneys' fees. Defendants argued for a maximum of $75,000 since all supplemental disclosures were non-material.

The court sided with Defendants after a detailed assessment of the materiality of a litany of supplemental disclosures based on the touchstone of benefit to the corporation and its stockholders. The court divided these disclosures into three categories: the company's financial projections, financial analyses by Receptos' financial advisor, and the transaction's background.

At the outset, the court stressed that "the recommendation statement already contained the complete set of the company's risk-adjusted projections for the period from 2015 to 2032, including the unlevered free cash flows." In addition, Receptos' financial advisor relied on these projections in conducting its analyses.

The supplemental disclosures added three sets of data points with respect to financial projections, none of which were material. The court held that two of these sets—"a line for revenue in each year of the model assuming no risk adjustments" and "a line to the risk-adjusted projections translating the projected net income for each year of the model into an earnings-per-share figure"—provided no additional "meaningful value." The court characterized the first category as "pie-in-the-sky" since it assumed that Receptos' drug at issue would be easily approved, while the second category was relevant only to a meaningless analysis by the company's financial advisor. The third set of data points—Receptos' management's estimate of likelihood for securing regulatory approval of a drug—was somewhat useful, but not material, because it was already baked into the projections. Nonetheless, this information enabled stockholders to gain some understanding about the confidence of management in getting regulatory approval.

Turning to the financial analyses, the court characterized two supplemental disclosures as "tell-me-more" and held that they are not material. "An illustrative discounted future share price analysis" was not material because it was given to the board only for informational purposes and confirmed that the transaction price was fair. Second, "some sensitivities associated with changing certain assumptions in the sum-of-the-parts DCF analysis" relayed the obvious conclusion that the results of a DCF analysis will change if the underlying assumptions are adjusted.

Finally, the court held that two supplemental disclosures regarding the transaction's background were not material. The first pertained to "the disclosure of certain payments that were part of collaboration proposals" between parties. Since the recommendation statement mentioned these proposals and "disclosed that they yielded a lower value than

the Celgene proposal," the supplemental disclosure merely confirmed that the Celgene proposal was fair. The second supplemental disclosure was that Celgene, "in its preliminary indication of interest," mentioned the need to welcome Receptos employees to Celgene in the event of a merger. The court held that this statement was not a disclosure of Receptos' expectation that its management would receive well-paid positions post-merger, but rather "a vague statement that was, at most, an expression of good will." The court observed that the statement was not explicit about any negotiations for compensation packages or any actual conflicts of interest.

* * *

Best of the Blogs

PSLRA; SCIENTER

Local No. 8 IBEW Ret. Plan & Trust v. Vertex Pharmaceuticals, No. 15-2250 (1st Cir. Oct. 3, 2016)

First Circuit: Affirms Dismissal of Securities Fraud Action Against Vertex Pharmaceuticals, Finding No Basis to Infer the Company Knowingly or Recklessly Published Erroneous Interim Clinical Study Results

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Reprinted from Securities Law Alert

On October 3, 2016, the First Circuit affirmed dismissal of a securities fraud action alleging that Vertex Pharmaceuticals and several of its executives "turned a blind eye" to "study results that seemed too good to be true" in order to reap "a windfall on the sale of their stock." The First Circuit found no allegations to support plaintiffs' contention that defendants knowingly or recklessly "announced interim results that overstated the improvement in lung function" of patients taking an experimental drug combination for the treatment of cystic fibrosis.

Plaintiffs' Allegations Failed to Raise a Strong Inference of Scienter

The First Circuit noted that "Vertex's public description" of its interim clinical study results allegedly "contained an error that made unexpectedly good results look even better than they were." However, the court found the inference that Vertex knowingly or recklessly published the inaccurate study results was not "strong enough to equal the alternative inference that Vertex was negligent in viewing very good results as being even better than they in fact were."

Interim Study Results Were Neither Implausible Nor Obviously Wrong

With respect to plaintiffs' contention that Vertex itself described the study results as "unexpected," the First Circuit explained that "many studies of new pharmaceutical products result in surprises, both good and bad." The court reasoned that "Vertex made the investment necessary to design and perform a study testing" the experimental drug

combination because the company "must have thought that positive results were possible, even if not probable."

As to plaintiffs' claim that "it was obvious that there was something wrong with the [interim] results," the First Circuit found no allegations "that scientists in general, much less those at Vertex, regarded the interim results as implausible." The court also noted that plaintiffs did "not allege that anybody at Vertex responsible for receiving, reviewing, and reporting the results had actually spotted the error in the interpretation of the results before the discovery that led to" Vertex's announcement of corrected study results.

The First Circuit rejected plaintiffs' argument that it would be "'absurd' to suggest that [d]efendants were not aware of the suspect nature of the results" given the importance of the study to the company. The court stated that "the importance of a particular item can support an inference that the defendant is paying close attention to that item." However, the court explained that "[s]uch an inference . . . is only helpful in establishing scienter if that close attention would have revealed an incongruity so glaring as to make the need for further inquiry obvious." Here, the court found no allegation of "such an obvious incongruity" between the expected interim results and the reported interim results.

The First Circuit found similarly meritless plaintiffs' contention that defendants should have cross-checked the interim results against the raw data, which allegedly would have uncovered the error in question. The court found the complaint's allegations "insufficient to establish that the erroneously interpreted end results . . . were themselves so obviously suspect that [the court could] draw a strong inference that the defendants were reckless in failing to consult the raw data themselves for verification." The court further noted that plaintiffs pointed to no "legal requirement, or any undertaking by Vertex, that obligated the company to double-check the interim results before announcing them."

Defendants Had No Financial Motive to Report Overstated Interim Results

The First Circuit also "considered" and rejected plaintiffs' theory that "defendants had a financial motive to 'turn[] a blind eye' to the erroneous interpretation of the interim results because of the stock price spike precipitated by the error." First, the court observed that Vertex's CEO did not sell any stock during the class period, and found the CEO had "no motive to ignore an error that was obvious and that would therefore soon become known." The court explained that "[a]nnouncing good results on such a study would have been clearly better for Vertex than announcing great results only to reduce them to good by shortly thereafter confessing error, thereby harming the company's credibility and its reputation for competence."

As to the allegation that five Vertex employees "sold almost $32 million worth of stock following release of the overstated interim results," the First Circuit stated that "insider trading in suspicious amounts or at suspicious times may be probative of scienter." In this case, however, the court observed that neither the current CEO nor the company's former CEO who now serves on the board of directors allegedly "engage[d] in any inconsistent trading behavior during the class period." The court found that in order "to regard the stock sales as either motive for the fraud or evidence of the defendants' knowledge that the interim study results had been misinterpreted," it would have to "hypothesize either that the error was obvious only to those defendants who made unprecedented sales, or that it was obvious to all, yet the company's current and former CEOs nevertheless went along with announcing obviously flawed results." The court explained that the complaint "offers no fact suggesting that the sellers knew more than the nonsellers."

The First Circuit found that there was "a simple alternative explanation" for the insiders' stock sales. Following announcement of the interim results, Vertex's stock price "suddenly jumped a large amount" following "a long period of steady or dropping stock prices." The court reasoned that "[s]uch an increase—no matter what its cause—creates a substantial incentive for holders to sell unless they believe the price will continue to rise and are willing to wait."

The court concluded that plaintiffs' allegations did "not paint the required strong inference of scienter," and affirmed dismissal of plaintiffs' complaint.

* * *

ERISA; DUTY OF PRUDENCE

Whitley v. BP, No. 15-20282 (5th Cir. Sep. 26, 2016)

Fifth Circuit: Supreme Court's *Fifth Third* Decision Mandates a "More Harm Than Good" Standard for ERISA Breach of Duty of Prudence Claims Based on Inside Information, Not a "More Good Than Harm" Standard

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Reprinted from Securities Law Alert

On September 26, 2016, the Fifth Circuit held the Southern District of Texas applied the wrong pleading standard in determining whether an amended ERISA complaint

brought by the beneficiaries of BP's employee stock ownership plan passed muster under the Supreme Court's decision in *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014).[1] In *Whitley*, the Fifth Circuit stated that "[u]nder the Supreme Court's formulation," a plaintiff asserting an ERISA breach of the duty of prudence claim based on inside information "bears the significant burden of proposing an alternative course of action so clearly beneficial that a prudent fiduciary *could not conclude* that it would be more likely to harm the fund than to help it." The Fifth Circuit determined the district court had instead erroneously considered whether "no prudent fiduciary would have concluded that" the alternative actions "would do more good than harm."

The District Court Erred in Considering Whether No Prudent Fiduciary Would Have Concluded the Alternative Actions Would Have Done "More Good Than Harm"

The Fifth Circuit explained that in *Fifth Third*, the Supreme Court held that in order "[t]o state a claim for breach of the duty of prudence on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it." *Id*. (quoting *Fifth Third*, 134 S. Ct. 2459).

The Fifth Circuit also noted that in *Amgen v. Harris*, 136 S. Ct. 758 (2016),[2] the Supreme Court "confirmed" that plaintiffs asserting an ERISA breach of the duty of prudence claim based on inside information must "plausibly allege that *no* prudent fiduciary could have concluded that the proposed alternative action would do more harm than good."

In the case on appeal before the Fifth Circuit, however, the Southern District of Texas had evaluated plaintiffs' proposed amended complaint by considering whether "on the basis of the pleadings alone, . . . *no* prudent fiduciary would have concluded that [the alternatives] would do *more good than arm*." The Fifth Circuit determined that this formulation was "not equivalent" to the *Fifth Third* standard, and found the district court had "erred" by "alter[ing] the language of *Fifth Third* to reach its holding."

Plaintiffs' Amended Allegations Did Not Meet the *Fifth Third* Standard

Turning to the allegations of plaintiffs' amended complaint, the Fifth Circuit explained that plaintiffs "theorize[d] that BP stock was overpriced because BP had a greater risk exposure to potential accidents than was known to the market." The Fifth Circuit found that it did "not seem reasonable to say that a prudent fiduciary at that time could not have concluded that (1) disclosure of such information to the public or (2) freezing trades of

[1] Please click here to read our prior discussion of the *Fifth Third* decision.

[2] Please click here to read our prior discussion of the *Amgen* decision.

BP stock—both of which would likely lower the stock price—would do more harm than good." To the contrary, the Fifth Circuit determined that "a prudent fiduciary could very easily conclude that such actions *would* do more harm than good."

The Fifth Circuit deemed plaintiffs' amended complaint insufficient to meet the *Fifth Third* standard, and held "the district court [had] erred in granting [plaintiffs'] motion to amend."

* * *

PSLRA; MATERIAL MISTATEMENTS; SCIENTER

North Collier Fire Control and Rescue Dist. Firefighter Pension Plan v. MDC Partners, No. 15 Civ. 6034 (RJS) (S.D. N.Y. Sep. 30, 2016)

Southern District of New York: Dismisses Securities Fraud Action Against MDC Partners, Holding Plaintiffs' Disagreements with Defendants' Accounting Judgments and EBITDA Formulas Could Not Support a Claim

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Reprinted from Securities Law Alert

On September 30, 2016, the Southern District of New York dismissed with prejudice a securities fraud action against MDC Partners and certain of its officers and directors for failure to allege either material misstatements or scienter.[3] The court held plaintiffs' goodwill-related allegations were insufficient to meet the standard for pleading a securities fraud claim based on a misstatement of opinion. As to plaintiffs' claim that defendants used a "misleading version of EBITDA," the court found that companies are free to calculate EBITDA as they deem appropriate, provided they disclose their methodology. With respect to plaintiffs' contention that the company failed to disclose the full amount of compensation paid to its CEO, the court found the allegedly underreported amount was neither quantitatively nor qualitatively material. Finally, the court held plaintiffs' allegations of insider stock sales did not support an inference of scienter "because the vast majority [of those] trades occurred a year or more before the alleged revelation of the fraud."

Plaintiffs Failed to State a Securities Fraud Claim as to Alleged Goodwill- Related Misstatements

[3] Simpson Thacher represents MDC Partners and two of the individual defendants in this action.

Plaintiffs contended that MDC Partners had "overstated its goodwill balance" in violation of Generally Accepted Accounting Principles ("GAAP") by failing to record a goodwill impairment for a poorly performing subsidiary that was ultimately merged into another one of the company's subsidiaries. The court held plaintiffs "failed to plead that [d]efendants made any false or misleading statements in connection with MDC's goodwill reporting" for several reasons. First, the court noted that "the law in the Second Circuit is clear that allegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim." The court explained that "GAAP provisions are subject to interpretation and tolerate a range of reasonable treatments, leaving the choice among alternatives to management."

Second, the court observed that under "well-settled" Second Circuit law, "goodwill estimates are opinion statements because they depend on management's determination of the 'fair value' of the assets acquired and liabilities assumed, which are not matters of objective fact and will vary depending on the particular methodology and assumptions used." To plead a securities fraud claim based on an alleged misstatement of opinion, such as an estimate of goodwill, plaintiffs must allege that (1) "the speaker did not hold the belief she professed," (2) "the supporting fact[s] she supplied were untrue," or (3) "the stated opinion, although sincerely held and otherwise true as a matter of fact, omitted information whose omission made the stated opinion misleading to a reasonable investor."

Here, the court held the complaint did "not satisfy these pleading requirements." The court found plaintiffs "allege[d] nothing more than disagreement with MDC's accounting judgments, which cannot support a fraud claim."

Plaintiffs Failed to State a Securities Fraud Claim Based on Allegedly "Nonstandard" Formulas for Calculating EBITDA

Plaintiffs further claimed defendants "misleadingly" used "the common term EBITDA" in MDC's public filings when in fact defendants calculated EBITDA based on formulas that allegedly did not comport with "the industry standard definition." The court held plaintiffs "failed to plead that [d]efendants made any false or misleading statements in connection with MDC's disclosures relating to EBITDA."

The court explained that MDC's Form 10-Qs did not "tout" or even use the phrase "industry standard" in describing the company's use of EBITDA as one factor in measuring its performance. Moreover, the court found that MDC's class period earnings releases "specifically explained how MDC had calculated the 'EBITDA' amounts reported in those releases." The court held that "[n]o reasonable investor would ignore these definitions,

much less assume that the reported EBITDA [was] governed by" a generic industry standard definition.

The court also rejected plaintiffs' contention that "MDC misled investors by changing its 'nonstandard' calculation of EBITDA from quarter to quarter." The court held "this argument misses the mark" because "EBITDA is a non-GAAP metric for which there is no right formula." The court found "[t]he fact that a plaintiff may take issue with the way a company chooses to calculate these metrics is of no moment because it is not fraudulent for a reporting entity to calculate metrics that, like EBITDA, are not defined under GAAP." The court explained that "[u]nless [p]laintiffs can show that MDC somehow misled investors about how it actually calculated EBITDA, which they have not, there can be no claim for fraud."

Allegedly Underreported CEO Income Was Neither Qualitatively Nor Quantitatively Material

Plaintiffs claimed that "MDC failed to disclose the true amount of compensation paid" to its CEO, both by "underreporting [his] perquisites," such as the CEO's use of a corporate apartment, and by allegedly "improperly reimbursing" certain of his expenses. The court found the allegedly underreported income was neither quantitatively nor qualitatively material under the factors set forth in *Litwin v. Blackstone Group*, 634 F. 3d 706 (2d Cir. 2011).

The court explained that in *Litwin*, the Second Circuit "made clear that courts may evaluate materiality at the pleading stage," and courts that do so must consider both quantitative and qualitative factors. The court observed that the Second Circuit has held that "a five percent numerical threshold—i.e., at least a five percent difference between an inaccurate versus accurate financial disclosure—is a good starting place for assessing the materiality of the alleged misstatement." The court further stated that "useful 'qualitative factors' include (1) concealment of an unlawful transaction, (2) significance of the misstatement in relation to the company's operations, and (3) management's expectation that the misstatement will result in a significant market reaction."

Applying this standard to plaintiffs' allegations concerning the CEO's perquisites, the court found the amount at issue was "well below the Second Circuit's 5% threshold." The court held this category of compensation "was not materially misstated" given "its minuscule impact on [the CEO's] overall compensation" and plaintiffs' "failure to identify any qualitative factors that would otherwise support materiality."

With respect to plaintiffs' allegations concerning expense reimbursements, the court found that if compared against the company's total expenses for the year, the allegedly underreported reimbursements "would amount to a paltry 0.18%—well below the Second Circuit's 5% threshold and clearly immaterial." The court observed that if the underreported

income was measured against the CEO's compensation for the year, however, "the percentage lands above the threshold at 10.2%."

The court determined that even if the appropriate benchmark was the CEO's compensation for the year (rather than the company's total expenses), the court could not end its analysis without "also consider[ing] qualitative factors of materiality." The court found the amount of the allegedly underreported reimbursements would "hardly register[ ]" to a reasonable investor. The court deemed it "not substantially likely that a reasonable shareholder" would have considered this additional compensation "important" "in deciding whether to purchase MDC securities." The court concluded that the allegedly underreported reimbursements did not amount to a material misstatement.

Allegations of Insider Stock Sales Failed to Raise a Strong Inference of Scienter

Finally, the court rejected plaintiffs' effort to plead scienter based on insider stock sales because most of the "trades occurred nearly a year or more before the end of the [c]lass [p]eriod." The court explained that it has "consistently held that stock sales occurring even a few months before the alleged revelation of the fraud do not raise a strong inference of scienter." In this case, "[b]ecause the vast majority of the [i]ndividual [d]efendants' trades occurred a year or more before the alleged revelation of the fraud," the court held the insider stock sales did "not support an inference of fraudulent motive."

* * *

CONTRACTS; LACHES

inTEAM Associates, LLC v. Heartland Payment Systems, Inc., C.A. No. 11523-VCMR (Del. Ch. Sep. 30, 2016)

Chancery Rules Upon Breach of Non-Competition and Non-Solicitation Claims – Laches Defense Denied

Carl Neff

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Delaware Chancery Law Blog

The Court of Chancery has recently issued a string of decisions, including *Kraft v. WisdomTree Investments, Inc.* in which it has tightened the application of the equitable defense of laches to make it more likely that a claim brought after the actual or presumptive statute of limitations has expired will be dismissed.

However, in the recent Chancery decision of *inTEAM Associates, LLC v. Heartland Payment Systems, Inc.,* C.A. No. 11523-VCMR (Del. Ch. Sept. 30, 2016), the Court declined to bar claims under the doctrine of laches. There, Vice Chancellor Montgomery-Reeves adjudicated various breaches of contract, non-competition and non-solicitation claims brought by two Delaware entities, inTEAM Associates, LLC ("inTEAM") and Heartland Payment Systems, Inc. ("Heartland").

The entities each own K-12 school meal management software. inTEAM's predecessor, School Link Technologies, Inc. ("SL-Tech"), and Heartland entered into a transaction in which Heartland bought substantially all of SL-Tech's assets. The transaction was detailed in three agreements that were executed together and work in tandem. These agreements contain various non-competition, non-solicitation, exclusivity, and cross-marketing and support obligations.

As an affirmative defense, Heartland among other things asserted that laches barred recovery by inTEAM. Heartland asserted that inTEAM unnecessarily delayed in bringing the suit by waiting 9 months after the alleged misconduct to file its action. However, the Court noted that inTEAM submitted a letter to Heartland two months prior to commencing suit, notifying Heartland of its breach. The Court did not find that the 7-month delay was prejudicial to Heartland.

The Court also noted that if the alleged injury is Heartland's investment in a particular relationship to compete with inTEAM, Heartland engaged in that behavior before inTEAM knew about the breach. To the extent that Heartland has incurred some cost by investing further in a competitive relationship after finding out about inTEAM's objections, it did so at its own risk, as it was on notice of its possible violation.

In sum, the Court held that inTEAM did not breach any of its contractual obligations, but that Heartland breached its noncompetition and exclusivity obligations, and inTEAM's chief executive officer breached certain of his non-solicitation provisions. The Court further found that no affirmative defense excused any of the breaches.

This decision demonstrates the limitation of the application of laches. To defeat a claim based upon this affirmative defense, when it is brought within the applicable statute of limitations, a legitimate showing of prejudice will be required.

* * *

MERGERS; DISCLOSURES; FIDUCIARY DUTIES

Nguyen v. Barrett, C.A. No. 11511-VCG (Del. Ch. Sep. 28, 2016)

Delaware Court of Chancery Dismisses Post-Closing Disclosure Claims for Failure to Show Disloyalty or Bad Faith

Paul Weiss

In *Nguyen* v. *Barrett*, the Delaware Court of Chancery dismissed post-closing claims that the board acted disloyally or in bad faith by failing to make the challenged disclosures. The Court also reiterated Delaware's strong preference that plaintiffs assert and pursue disclosure claims pre-closing so there is an opportunity to remedy these concerns prior to the stockholder vote.

The plaintiff challenged disclosures made in connection with the acquisition of Millennial by AOL, Inc. Prior to closing, the plaintiff sought a preliminary injunction of the merger based on Millennial's failure to disclose its financial advisor's unlevered, after-tax free cash flow ("UFCF") projections. Even though banker-prepared projections typically need not be disclosed under Delaware law, the plaintiff argued that Millennial should disclose the UFCF projections because they were based on components provided by Millennial management. After review of the proxy and precedent, however, the Court of Chancery concluded that management did not prepare the UFCF projections and denied plaintiff's request for a preliminary injunction. The Delaware Supreme Court denied plaintiff's request for an interlocutory appeal of such holding.

After the merger closed, the plaintiff elected to continue pursuing just two disclosure claims: one challenging the failure to disclose the UFCF projections and another challenging Millennial's proxy disclosures relating to its financial advisor's contingent fee arrangement.

In granting the defendants' motion to dismiss, the Court made several holdings that serve as helpful reminders when litigating disclosure claims.

Where a board is exculpated for duty of care claims pursuant to 8 Del. C. § 102(b)(7), a plaintiff pleading post-closing disclosure claims must allege facts making it reasonably conceivable that there has been a non-exculpated breach of fiduciary duty by the board.

- The Millennial board was exculpated for duty of care claims under 8 *Del. C.* § 102(b)(7). Therefore, to sustain a breach of fiduciary duty claim against the Millennial board, the plaintiff had to demonstrate a breach of the board's duty of loyalty. This required a showing that

a majority of the board was not disinterested or independent, or was otherwise disloyal or acted in bad faith in failing to make the alleged material disclosures.

- The only conflict or bad faith action that the plaintiff alleged with regard to a majority of the directors, however, was that they were motivated to enter into the transaction with AOL to accelerate the vesting of their options to avoid unspecified "risk." The Court found that this allegation did not demonstrate board disloyalty with regard to either disclosure claim, and that it is "well-settled that where the interests of the directors and stockholders are aligned, as here, the accelerated vesting of shares in a merger does not create a conflict of interest."

The Court reiterated that the preferred method for pursuing disclosure claims is pre-closing while there is still an opportunity to remedy such concerns prior to a stockholder vote.

- The Court noted that, because of the judicial interest in ensuring that stockholder votes are fully informed, it was more likely to find that plaintiffs had waived the right to pursue any disclosure claim post-closing that had been pled but that plaintiffs had failed to pursue pre-closing.
- Here, the plaintiff had pled the claim relating to disclosure of the financial advisor's contingent fee arrangement prior to closing, but then failed to pursue the claim. The Court ultimately did not reach a conclusion as to whether the plaintiff had waived the claim, as it determined that the claim failed on its merits.

Disclosure that a "substantial portion" of a financial advisor's fee was contingent on completion of a merger is generally sufficient, absent some indication that the fee is exorbitant, unusual or otherwise improper.

- The Court distinguished *In re Atheros Communications, Inc.*, where the company's disclosure that its advisor's fee was "substantially contingent" on the deal's closing was found to be insufficient. In *Atheros*, nearly all (98%) of the advisor's fee was contingent, which the *Atheros* court found to "exceed[] both common practice and common understanding of what constitutes 'substantial,'" and "may fairly raise questions about the financial advisor's objectivity and self-interest." Thus, the Court in *Nguyen* noted that *Atheros* does not undermine the body of case law holding that disclosure that a "substantial portion" of a fee is contingent is sufficient under a more standard set of facts.

- Here, the plaintiff did not allege any facts indicating that the fee at issue fell outside the general rule, and therefore, the Court found the disclosure that a "substantial portion" of the advisor's fee was contingent to be sufficient.

* * *

FEE AWARDS

Judy v. Preferred Communication Systems, Inc., C.A. No. 4662-VCL (Del. Ch. Sept. 19, 2016)

Fee Award Denied to Litigation Funding Firm

Carl Neff

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Delaware Chancery Law Blog

The Court of Chancery recently denied a fee award to a litigation funding firm in the decision of *Judy v. Preferred Communication Systems, Inc*., C.A. No. 4662-VCL (Del. Ch. Sept. 19, 2016). There, Vice Chancellor Laster denied an equitable fee award on multiple grounds:

1. Movant gratuitously financed the litigation brought by plaintiff, and as a voluntary financier, movant cannot seek an equitable fee award;
2. Movant financed plaintiff's attempt to take over the company, and case law has held that a movant cannot obtain an equitable fee award under such circumstances;
3. Movant cannot establish the necessary causal connection between its litigation financing and the value of the licenses; and
4. Movant cannot recover a quantum meruit award, and in any event cannot recover all of the expenses it has claimed. Movant cannot recover the amounts it spent to hire lawyers for individuals to pursue personal claims against the company or for lawyers to appear before the FCC and take positions adverse to the Company. Nor can PSI recover the myriad of ordinary business expenses that it has included in its petition.

Accordingly, the Court denied movant's fee application.

* * *

SPOLIATION; INTERLOCUTORY APPEALS

Chrome Systems, Inc. v. Autodata Solutions, Inc., et al., C.A. No. 11808-VCG (Del. Ch. Sept. 21, 2016)

Chancery Denies Interlocutory Appeal of Spoilation Issues

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Delaware Chancery Law Blog

The Court of Chancery recently ruled on a request for interlocutory appeal as it related to the Court's rulings on spoliation issues. In the decision of *Chrome Systems, Inc. v. Autodata Solutions, Inc., et al.*, C.A. No. 11808-VCG (Del. Ch. Sept. 21, 2016), Vice Chancellor Glasscock declined to certify the interlocutory appeal.

Plaintiff brought the case alleging that defendants improperly dissolved a joint venture of the parties. By previous bench ruling, the Court found that the parties contractually agreed to arbitrate the dispute, excluding injunctive relief. The Court retained jurisdiction in the event the arbitrator found that certain issues were non-arbitrable. Otherwise the arbitration moved forward on an expedited path.

The Plaintiff asked this Court to hold a hearing on, and use the contempt power to redress, the Defendants' alleged spoliation (over which the Court reserved jurisdiction as well). By bench ruling on March 10, 2016, the Court exercised its discretion to hear only that evidence of spoliation or litigation misconduct occurring after the litigation was filed, which has the potential to have worked a fraud on the Court. The Court found that other evidence of misconduct should be presented to the arbitrator, who will be able to avoid prejudice to the Plaintiff resulting from any spoliation by the Defendants.

Plaintiff proceeded to pursue an interlocutory appeal and request to certify that appeal, in that it wanted to present all pre- and post-litigation evidence of spoliation. The Court found that certification is inappropriate. In doing so, the Court provided (while citing Supreme Court Rule 42(b)(ii)):

> As Supreme Court Rule 42 makes clear, interlocutory appeal is an extraordinary remedy, which "should be exceptional, not routine, because [such appeals] disrupt the normal procession of litigation, cause delay, and can threaten to exhaust scarce party and judicial resources." Before certifying an appeal, I must determine that an interlocutory appeal would bring "substantial benefits that will outweigh the certain costs that accompany" such an appeal.

* * *

RELEASES; SETTLEMENT AGREEMENTS

Geier v. Mozido, LLC, C.A. No. 10931-VCS (Del. Ch., Sept. 29, 2016)

Court Grants Motion to Dismiss Previously Released Claims

Francis Pileggi

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Delaware Corporate and Commercial Litigation Blog
(http://www.delawarelitigation.com)

Justin M. Forcier, an associate in the Delaware office of Eckert Seamans, prepared this post.

In *Geier v. Mozido, LLC*, C.A. No. 10931-VCS (Del. Ch., Sept. 29, 2016), the Court of Chancery granted Mozido, LLC ("LLC") and Mozido, Inc.'s ("Inc.") motion to dismiss claims by plaintiff Philip Geier ("Geier") because Geier released his claims against the entities in a previous settlement agreement.

Background: In March 2012, after several courting attempts, Geier agreed to join the LLC board of directors. As an incentive, Geier acquired 1% of the outstanding membership units (the "Options"). After resigning from the board a year later, Geier loaned LLC $3 million through the Philip H. Geier Irrevocable Trust (the "Geier Trust") and The Geier Group, LLC (the "Geier Group"). LLC defaulted on that loan and the Geier Trust and Geier Group filed a suit to recover. An LLC board member repaid the loan and filed an action in Florida against a member of the LLC ("Liberty") for reimbursement. In the settlement agreement for that action, Liberty and LLC sought the release of any claims Geier, the Geier Trust, and the Geier Group could assert. In that agreement (the "General Release"), the Geier Group and the Geier Trust were named as releasers, but Geier was not.

In 2013, LLC assigned all of its rights and interests to Inc. However, Inc. did not assume LLC's liability for the Options. Geier made a formal demand in 2014 to exercise his rights to the Options, but both LLC and Inc. have refused.

Analysis: The court reviewed this motion under the well-known Rule 12(b)(6) standard; however, the court noted that the release was governed under New York law. Geier made two separate arguments for why the release did not bind him: First, he argued that reading all of the documents surrounding the release together, the release was only meant to bind the Geier Trust and the Geier Group; and second, the terms of the release show that he was not a releaser.

The court rejected both of these theories. First, the court observed that the release was captioned "General Release" and did not contain any carve outs or limitations on who was bound by its terms. Furthermore, no parol evidence could have been considered since there was no ambiguity. Citing New York law, the court declined to consider the other documents because the General Release was executed separately from the other releases in the settlement documents. The court stated that the different agreements contained separate assents and there was no indication that the General Release was not meant to stand on its own.

Therefore, it had to be interpreted within its own four corners and no extrinsic documents could be considered. Second, the court observed that the General Release expressly named the Geier Trust and the Geier Group as releasers, but it also stated that it applied to any claims the releasors' "affiliates, subsidiaries, and parents . . . ever had, now have or hereafter can have" against the releasees. The court found that Gieir is an affiliate of the Geier Group and the Geier Trust because the complaint shows that he is in control of both entities—Geier is a co-trustee of the Geier Trust and Chairman of the Geier Group.

Finally, the court found that Geier also released his claims against Inc., even though it was not explicitly named in the General Release. Simply stated, the General Release contained broad language defining a "releasee" to mean those entities that were named as well as any subsidiaries of the LLC. Since Inc. is a subsidiary of LLC, Geier had no recourse against either entity.

* * *

ATTORNEYS' FEES

Jay Frechter v. Cryo-Cell International, Inc., Civil Action No. 11915-VCG (Del. Ch. Oct. 7, 2016)

Mootness Fees Granted to Stockholder Challenging Bylaw Provision

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Delaware Chancery Law Blog

In the recent decision of *Jay Frechter v. Cryo-Cell International, Inc.,* Civil Action No. 11915-VCG (Del. Ch. Oct. 7, 2016), the Court of Chancery granted a mootness fee in connection with a lawsuit brought by a stockholder challenging a bylaw provision. The bylaw provision at issue indicated that directors could be removed "for cause" at a "special meeting" of stockholders. The plaintiff asserted that under Section 141(k) of the Delaware

General Corporation Law, stockholders have the right to remove directors without cause, and thus the provision was unlawful.

After the Plaintiff moved for summary judgment, the Company amended its bylaw to remove the language complained of, mooting the action. The Court found that the provision at issue was "misleading to stockholders and could have a chilling effect on the exercise of their franchise under Section 141, because providing a procedure to remove directors for cause (and remaining silent as to removal without cause) could indicate to a reasonable stockholder that cause was a requisite for removal."

The Court considered the *Sugarland* factors and found that a mootness fee of $50,000 for plaintiff's counsel was warranted.

* * *

MERGERS; CONTTROLLING STHAREHOLDERS; GOING PRIVATE; SHAREHOLDER VOTE

In re Books-A-Million, Inc. Stockholders Litigation, C.A. No. 11343-VCL (Del. Ch. Oct. 10, 2016)

Delaware Chancery Applies MFW to Dismiss Challenge to Going Private Transaction and Clarifies Obligations of Controlling Stockholders

Christopher E. Austin

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In a recent decision[4], Vice Chancellor Laster of the Delaware Court of Chancery clarified certain issues related to the obligations of a controlling stockholder that often arise in connection with going private and similar transactions. The case involved a relatively conventional proposal by a controlling stockholder (the Anderson family) to acquire the remaining shares of Books-A-Million, Inc. ("BAM") from BAM's minority stockholders. The family structured the proposal with the goal of satisfying the conditions of the MFW decision so that any challenge to the transaction would benefit from the favorable "business judgment" level of judicial review.[5]

In litigation challenging the buyout, minority stockholders of BAM alleged that the defendants should not get the benefit of MFW because the members of BAM's special committee of independent directors acted in bad faith and irrationally and therefore two

[4] In re Books-A-Million, Inc. Stockholders Litigation, C.A. No. 11343-VCL (Del. Ch. Oct. 10, 2016).

[5] Kahn v. M&F Worldwide Corp. (Del. 2014).

elements of the MFW decision were not satisfied.[6] In particular, the plaintiffs alleged that the committee's decision to recommend the transaction was irrational and in bad faith because (i) a third party had indicated an interest in acquiring BAM at a price higher than that offered by the family, (ii) the committee determined that pursuing the third party offer was not feasible because the family (as is normal in these types of situations) indicated it was unwilling to sell its controlling interest in BAM and (iii) the committee nonetheless proceeded to negotiate with the family and ultimately recommend that the family's offer be accepted even though the offered price was less than that proposed by the third party.

Vice Chancellor Laster rejected the plaintiffs' theory and, after concluding that the family had complied with the other elements of MFW, reviewed the claim under the business judgment rule and granted defendants' motion to dismiss the complaint.[7] The opinion confirmed the following important principles:

A controlling stockholder has no obligation to sell its share or otherwise facilitate a third party offer. The Vice Chancellor confirmed that the "rights of [controlling stockholders] include[] the right not to have to sell their shares"[8] and that the Anderson family "did not breach its duties by refusing to sell its shares" to the third party offering a higher price.[9]

A controlling stockholder does not breach fiduciary duties simply by offering to acquire the minority's shares, even at a price lower than the price that might be available from a third party bidder. Vice Chancellor Laster confirmed that the Anderson family "did not breach any duty to the corporation or its minority, nor did it overreach or threaten exploitation, by proposing a going-private transaction at a substantial premium to the market price", even though that price was lower than the price offered by the third party.[10] In reaching this conclusion, the Vice Chancellor, relying heavily on former Chancellor Allen's opinion in Mendel[11], noted that the fact that the price offered by the controlling stockholder was lower than the price offered by a third party was not sufficient to establish unfairness or inadequacy. In particular, a simple comparison of the two prices was inappropriate since the price offered by a controlling stockholder does not (and need not) reflect a control premium (since the controlling stockholder already has control), while a third party offer necessarily includes a control premium. Instead, the Vice Chancellor noted that the inquiry should

[6] The two elements were (i) the members of the committee were "independent in fact" and (ii) the committee met its duty of care in negotiating a fair price.

[7] See our prior discussions of the application of the business judgment rule in various circumstances here, here and here.

[8] In re Books-A-Million at 30.

[9] Id. at 31.

[10] Id. at 31.

[11] Mendel v. Carroll, 651 A.3d 297 (Del. Ch. 1994).

focus on whether the "amount of the minority discount was extreme" and not "within a rational range of discounts" and no facts were validly pled to support a "reasonable inference" that the discount fell outside of such a range.[12]

The independent directors generally have no obligation to seek to dilute a control block to facilitate a third party transaction opposed by the controlling stockholder. In some cases, a board considers whether it would be appropriate to take actions to dilute a controlling stockholder's control position (e.g., by issuing new shares or options) in order to facilitate the acquisition of the company by a third party over the objection of the controlling stockholder. The BAM decision confirmed that the directors have no obligation to do so – and indeed doing so might violate the directors' duties to the controlling stockholder – unless the controlling stockholder's action "could be considered an abuse of power or exploitation of the minority".[13] And importantly, the Vice Chancellor confirmed that simply submitting a proposal to acquire the minority's shares, and concurrently indicating an unwillingness to support third party offers, would not normally constitute such abusive or exploitative conduct.[14]

Although these principles are not a surprise to experienced practitioners, Vice Chancellor Laster's opinion is an important confirmation of their continued validity and, significantly, indicates the continued viability of MFW notwithstanding the creative efforts of the plaintiffs' bar to seek to limit its benefits.[15]

Finally, one practical question raised by the BAM decision is whether it will encourage special committees to solicit third party offers even in the face of a statement by the controlling stockholder that it is not willing to sell its shares or otherwise facilitate a sale of the company to a third party. Vice Chancellor Laster noted that although doing so is not required (a "committee can satisfy its duty of care by negotiating diligently with the assistance of advisors"), (1) a "committee goes one better when it takes the additional step of gathering additional information through a market canvas" and that doing so "allowed

[12] In re Books-A-Million at 35.

[13] Id. at 28.

[14] The Vice Chancellor did note that, by following MFW, the Anderson family had an "even stronger argument" as to the lack of abusive or exploitative conduct. Even if the family did not seek to comply with all elements of MFW (e.g., by not conditioning the transaction on a majority of the minority stockholder vote), its conduct would presumably not have been found abusive or exploitative, although in such a case the transaction would of course have been reviewed under the less favorable "entire fairness" standard.

[15] Many commentators speculated that a footnote in the MFW opinion (suggesting that the original MFW complaint would have survived a motion to dismiss) might limit the benefit of the decision if trial court judges were not willing to grant motions to dismiss and continued to permit cases to proceed to discovery as to whether the MFW requirements were in fact satisfied. The Vice Chancellor's willingness to terminate the BAM case at the motion to dismiss stage is further evidence that the footnote has not had such an impact to date.

the [c]ommittee to test the [f]amily's conviction about not being a seller" and (2) the third party offer "would be a data point in any post-closing appraisal action, giving the [f]amily a reason to bump their offer."[16] It is not clear, however, that third parties will be prepared to expend the time and effort required to submit a credible offer when the likelihood that the offer will result in a transaction will normally be quite low.

* * *

DIRECTORS' DUTIES; BAD FAITH

Reiter v. Fairbank, C.A. No. 11693-CB (Del. Ch. Oct. 18, 2016)

Court Describes Board Duty of Oversight

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The Delaware Court of Chancery recently provided an exemplary explanation of Delaware law on the requirements that must be met before directors can be found liable for breaching their duty of oversight.

Key Background Facts: This case involved a claim that the board of directors of Capital One Financial Corporation breached its fiduciary duties of oversight in connection with its alleged failure to adequately monitor the bank's activities in connection with check cashing services, and in particular, allegedly failed to monitor compliance with the federal laws and regulations regarding money laundering.

Key Legal Principles Addressed: The Court of Chancery found that the standard under Delaware law for imposing oversight liability, sometimes referred to as *Caremark* liability, requires evidence of bad faith, meaning that "the directors knew that they were not discharging their fiduciary obligations."

The court reasoned that this type of claim, often described as one of the most difficult to prevail upon in corporate litigation, failed to allege facts from which it reasonably may be inferred that the defendant directors consciously allowed Capital One to violate the federal requirements so as to demonstrate that they acted in bad faith. Specifically, the plaintiff

[16] Id. at 40.

failed to plead with particularity that a majority of the directors of Capital One faced a substantial likelihood of liability.

It would take more space than typically allocated for a blog post to recite the excellent recitations of the law by the court regarding the nuances and prerequisites of both: (1) the duties of oversight of the board of directors, which is part of the duty of loyalty, a subset of which is the duty of good faith; and (2) the prerequisites for a plaintiff to successfully allege a breach of the duty of oversight such that it will survive a motion to dismiss under either Rule 23.1 or 12(b)(6).

Several gems can be found on pages 14 and 15 of the slip opinion, in which the court explains that the *Rales* test applies in this context as opposed to the *Aronson* because in connection with a *Caremark* claim, it is the lack of action by a board or an alleged violation of the board's oversight duties that must be examined as opposed to an allegedly improper decision.

In addition, the prerequisites that must be satisfied by a plaintiff alleging a *Caremark* claim are usefully enunciated in page 17 through 20 of the slip opinion.

I will provide a few selected excerpts, but those needing to know the nuances of Delaware law on this topic need to read the whole opinion.The court explained that in order to establish a breach by the directors of their fiduciary duty by failing to adequately implement controls and monitoring procedures, plaintiffs would need to show either:

> (1) That the directors knew, or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure approximately resulted in the losses complained of.

The opinion referred to the Delaware Supreme Court's reinforcement of the *Caremark* framework for director oversight liability by clarifying that: "To impose personal liability on a director for failure of oversight requires evidence that the directors 'knew that they were not discharging their fiduciary obligations.'" *See* footnote 48 and accompanying text.

* * *

DISSOLUTION

The Huff Energy Fund, L.P. v. Gershen, C.A. No. 11116-VCS (Del. Ch. Sept. 29, 2016)

Chancery Dismisses Challenge to Board's Dissolution Plan

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Alexandra D. Rogin, an Eckert Seamans' associate, prepared this overview.

A recent Chancery opinion held that stockholder approval and the business judgment rule barred fiduciary duty claims against a board that dissolved the company.

Background

The Delaware Court of Chancery recently dismissed a stockholder's breach of contract and fiduciary claims against a dissolving company. This action stems from Defendant Longview Energy Company's ("Longview") decision to dissolve Longview after the company sold a significant portion of its assets. Plaintiff, The Huff Energy Fund ("Huff"), was the largest Longview stockholder, holding approximately 40% of Longview's common stock. Huff brought suit to challenge the dissolution.

A Shareholders Agreement (the "Agreement") between Huff and Longview required a unanimous vote of the Board for any act having "a material adverse effect on the rights of [Longview's stockholders], as set forth in" the Agreement. The Agreement also provided Longview with the right of first offer if Huff were to transfer any shares, and provided that the company would continue to exist and remain in good standing under the law.

The sale and dissolution plan at issue was approved by the Longview Board and shareholders, over the abstention of one Huff board designee.

Huff's Allegations: Huff alleged that Longview breached the Agreement because the dissolution had "a material adverse effect" on its right to transfer its Longview stock to Longview. Accordingly, Huff alleged that the Board's decision was subject to the unanimity requirement. Additionally, Huff asserted that dissolution violated the obligation to "continue to exist." Finally, Huff brought a fiduciary claim against the Board for adopting the dissolution plan without exploring more favorable alternatives in violation of *Revlon*, and as an unreasonable response to a perceived threat in violation of *Unocal*.

Court's Analysis

The court first held that the individual Board defendants could not be liable for breach of contract because they signed the Agreement as company representatives, and not in their individual capacities. Additionally, Huff failed to adequately plead a tortious interference claim, as the allegations were improperly raised for the first time in briefing.

Next, the Court held that Huff failed to plead breach of contract against the Board. Huff argued that the unanimity requirement applied to any act effecting any right referenced in the contract. However, the Court found that Huff's interpretation contradicted common sense. Huff's interpretation would unreasonably subject all extra-contractual "rights" to the unanimity requirement, solely because they were referenced in relation to another right actually created by the Agreement. Therefore, because the Agreement did not create a "right of transferability" for Huff, but instead allowed Longview the right of first offer, the Court rejected Huff's argument that the dissolution vote violated the Agreement.

The Court also found that dissolution itself did not breach the Agreement's provision requiring Longview to "continue to exist and [] remain in good standing under [the law]." The provision was merely a commitment to remain in good standing as a Delaware corporation, and not a "commitment to exist 'come what may,'" as Huff asserted. Huff's interpretation was also unreasonable in light of other contract provisions referencing a potential merger or sale.

Next, the Court found that there was no fiduciary violation in approving the transaction. Huff failed to plead that the Board was not disinterested and independent. That the dissolution plan provided severance pay to certain directors, that some members had personal friendships, and that one member acted with alleged "animosity" towards Huff did not indicate that the Board was "interested" in the transaction to a degree that would rebut the business judgment rule. Regardless, despite Huff's allegations toward individual Board members, Huff failed to plead that a majority of the Board that approved the transaction were not independent. Thus, entire fairness did not apply.

The Court next turned to Huff's *Revlon* and *Unocal* arguments. *Revlon* did not apply because the applicable policy concerns were absent. Specifically, the adoption of the plan did not constitute a "final stage" transaction or effect a "change of control." Similarly, *Unocal* did not apply. The Court noted that Huff "cite[d] no cases…indicating either that (1) the adoption or filing of a certificate of dissolution or (2) the board's 'perception' that a shareholder posed a threat to any individual director's 'power' over the corporation implicates the 'omnipresent specter' lingering in those instances where *Unocal* scrutiny has been invoked."

Conclusion

Therefore, the Court held that Huff failed to plead any contractual breach or fiduciary violations. The Court also noted the significance of the shareholder vote in addition to Board approval. Even if enhanced scrutiny applied, "the Longview stockholders' [informed] approval cleansed the transaction thereby irrebuttably reinstating the business judgment rule." Accordingly, the Court invoked the business judgment rule and dismissed Huff's complaint in its entirety.

* * *

What Data Given to Experts is Discoverable

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Delaware Corporate and Commercial Litigation Blog
(http://www.delawarelitigation.com)

This post was prepared by Justin Forcier, an associate in the Delaware office of Eckert Seamans.

The focus of this blog is key Delaware corporate and commercial litigation decisions. That includes the Complex Commercial Litigation Division of the Superior Court. The rules and procedures in that court are not always the same as those in the Court of Chancery. It remains important to know the differences. For example, Court of Chancery Rule 26 and Superior Court Rule 26 are not identical, regarding what information provided to a party's expert is discoverable.

Two recent rulings address this topic: *CIM Urban Lending GP v. Cantor Commercial Real Estate Sponsor, L.P.*, C.A. No. 11060-VCS (Del. Ch. May 19, 2016) (TRANSCRIPT) and *Green v. Nemours Found.,* C.A. No. N15C-03-208 (Del. Super. Aug. 17, 2016).

Superior Court Rule 26: The Superior Court of Delaware recently took a close look at Superior Court Rule 26 and made some very important distinctions regarding what is discoverable and what is not when it comes to information given to a party's expert.

Background: In *Green*, the Superior Court considered plaintiff's counsel inadvertently including two documents titled "Work Product Memorandum" and "Deposition Preparation Exhibits" in a binder that was produced to defense counsel prior to taking the plaintiff's

expert's deposition. The plaintiff sought to recover those documents once the mistake was realized. After returning the documents, defendants' counsel filed a motion to compel their production.

Analysis: The Superior Court has adopted the federal version of Rule 26(b), which requires counsel to "identify facts or data that the party's attorney provided and that the expert considered in forming the opinions to be expressed" and "identify assumptions that the party's attorney provided and that the expert relied on in forming the opinions to be expressed."

The court left no stone unturned with its analysis of Rule 26 — often relying on the Advisory Committee's comments to the Rule when it was amended. The Superior Court held that documents are deemed "considered," and thus not privileged, "if it was seen by the expert, regardless whether he relies upon it and indeed, even if he rejects it entirely."

However, the court did not extend such a sweeping definition of the other non-disclosure exception — the requirement that assumptions provided by counsel to the expert be disclosed. The Superior Court stated: "So to the extent the attorney communicates with the expert his 'assumptions' about the case — be they hypotheticals or other possibilities — these communications are privileged from disclosure unless the expert were to aver that he 'relied' on the assumption as posited by the attorney."

Court of Chancery Rule 26: The Court of Chancery's ruling in *CIM Urban Lending GP* stems from a dispute over the language in a limited partnership agreement and cross motions to compel information provided to each parties' experts. The plaintiffs sought documents that the defenses' expert relied on in determining his report. The defendants sought documents from the plaintiffs regarding a pre-litigation investigation into whether the limited partnership agreement was breached.

Analysis: Citing Chancery Rule 26(b)(4), which requires production of facts and opinions to which the expert is expected to testify and a summary of the grounds for each opinion, the court held that the information that was actually considered and relied on in the final defendants' expert's report was not privileged because that expert report was placed at issue since the expert will be testifying at trial.

However, the court held that documents considered and relied on by a non-testifying expert to prepare a pre-litigation report were protected work product and not discoverable. This is a very important distinction made by the court.

Finally, it is important to note that, unlike the Superior Court, the Court of Chancery has not adopted the most-recent language of the federal rules. Both the Superior Court and the Court of Chancery Rules contain substantially similar language in Rules 26(b)(1)–(4).

Importantly, however, Court of Chancery Rule 26 does **not** have a counterpart to Superior Court Rule 26(b)(6), which expressly exempts: (1) the compensation that the expert is paid; (2) the facts or data provided to the expert; and (3) the assumptions provided to the experts from any claim of privilege.

However, the Guidelines on Best Practices for Litigating Cases before the Court of Chancery (the "Guidelines") expresses a preference for parties to stipulate what information is privileged. It's also important to note that according to the Guidelines, parties are encouraged to agree to stipulate that "[m]aterials or information that may have been viewed or considered*but not relied upon* by the [e]xpert" are **not** discoverable, and the court provides a sample stipulation to address these issues.

* * *

This Cold Bud Is For You: SEC Sanctions Anheuser-Busch for "Chilling" Employee from Communicating with SEC

Orrick, Herrington & Sutcliffe

On September 28, 2016, the SEC announced that Anheuser-Busch agreed to pay $6 million to settle charges of Foreign Corrupt Practices Act and Dodd-Frank whistleblower violations. The SEC's order stated that AB InBev violated the FCPA when an Indian joint venture orchestrated payments to Indian officials to obtain commercial benefits for Crown Beers, AB InBev's wholly owned Indian subsidiary.

With respect to the whistleblower violations, the SEC stated that a Crown employee had informed AB InBev of the potential FCPA violations in 2010 and 2011, and his employment was terminated in early 2012. At some point the employee began voluntarily communicating with the SEC. The employee mediated his employment law disputes with the company in late 2012 and entered into a settlement agreement, which included a $250,000 liquidated damages provision if the employee violated its confidentiality provisions. After signing the agreement, the employee stopped communicating with the SEC, claiming the agreement prevented him from doing so and he did not want to risk triggering the liquidated damages provision. Only after the Commission issued an administrative subpoena did the whistleblower resume communications with Commission staff.

The SEC held that AB Inbev's separation agreement violated Rule 21F-17(a), promulgated under Dodd-Frank, which provides that "No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement…." Specifically, the separation agreement's confidentiality language, which did not contain a carve out for SEC communications, impeded the whistleblower from communicating directly with Commission staff about possible securities law violations.

The SEC's order noted that AB Inbev had taken various remedial measures before the SEC issued its fine, including amending its separation agreements that impose confidentiality restrictions on departing employees of its US entities to state the following: "*I understand and acknowledge that notwithstanding any other provision in this Agreement, I am not prohibited or in any way restricted from reporting possible violations of law to a governmental agency or entity, and I am not required to inform the Company if I make such reports*."

The AB Inbev order is just the latest in a recent string of SEC enforcement activity under Rule 21F-17 (see here and here), and once again highlights the importance that all companies that fall within the SEC's enforcement jurisdiction (this goes beyond just public companies) make sure that their separation agreements and other employment-related agreements and policies, including confidentiality agreements, codes of conduct, employee handbooks, and equity agreements, do not contain confidentiality, non-disparagement, or other standard provisions that the SEC may interpret as "chilling" employees from communicating with the SEC.

* * *

Supreme Court Considers the Scope of Tipper/Tippee Liability Under the Securities Exchange Act of 1934

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Simpson Thacher & Bartlett LLP

Reprinted from Securities Law Alert

The Supreme Court heard oral arguments on October 5, 2016, in *Salman v. United States*, No. 15-628, a case in which the Court will consider a question at the center of many insider trading prosecutions: whether the personal benefit necessary to establish liability under *Dirks v. SEC*, 463 U.S. 646 (1983) requires proof of "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable

nature," as the Second Circuit held in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), *cert. denied*, No. 15-137 (U.S. Oct. 5, 2015),[17] or only that the insider and the tippee shared a close family relationship, as the Ninth Circuit held *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015), *cert. granted*, 84 U.S.L.W. 3401 (U.S. Jan. 19, 2016) (No. 15-628).[18]

Although no federal statute or regulation expressly prohibits insider trading, courts have construed Section 10(b)—a "catch-all clause" in the Securities Exchange Act of 1934 (the "1934 Act")—to prohibit insider trading as a type of securities fraud. Today, under *Dirks*, determining whether trades executed by someone who has received material nonpublic information (a "tippee") qualifies as a type of fraud prohibited by the 1934 Act "depends in large part on the purpose of the [insider's] disclosure." 463 U.S. at 662. *Dirks* held that liability can only attach where the insider personally benefited directly or indirectly from the disclosure. *Id*. If the insider received no personal benefit from the disclosure, then there has been no breach of duty to stockholders, and no derivative breach can be attributed to tippees who trade on the information. *Id*. Thus, showing that the disclosing insider personally benefited from the tip is critical to establishing insider trading liability in this context.

Oral Argument Highlights

The oral argument focused on each party's test for determining when a tipper received a "personal benefit" in exchange for material nonpublic information. Petitioner contended that the insider must receive a concrete benefit. In particular, the insider must receive either a pecuniary benefit, or something that may translate into a financial benefit (e.g., a reputational benefit with monetary value).

Petitioner offered two primary defenses for this formulation. First, criminal statutes are generally construed narrowly, and the elements ought to clearly demarcate what is and is not illegal. According to Petitioner, a broader formulation would be ambiguous, and thus would subject market participants to unpredictable prosecutions. Second, it is well-accepted that not all trading on material nonpublic information is unlawful. Petitioner reasoned that if the satisfaction one experiences from sharing information and helping another were sufficient, then the "personal benefit" element would always be satisfied when information is intentionally shared. All information sharing would *ipso facto* be illegal. But Petitioner cautioned that his rule would not permit all information sharing among family members. For example, because family members are often financially inter-dependent, benefiting a family member could, in some instances, financially benefit the tipping insider.

[17] Please click here to read our prior discussion of the *Newman* decision.

[18] Please click here to read our prior discussion of the *Salman* decision.

The government took a different view, arguing that the 1934 Act broadly prohibits giving information to another—whether a relative, friend, or even a casual acquaintance—"for that person to be able to profit on it." Responding to questions from the bench, the government conceded that the tipping insider must know that the tippee will trade upon the information for criminal liability to attach.

In support of its position, the government asserted that the obligation giving rise to the cause of action for insider trading tracks the common law duty of "loyalty," which is breached when one uses information for a personal reason. In addition, the government argued that a broad construction is necessary as a policy matter to prevent insiders from freely sharing information with friends and family, which could disrupt markets.

During oral argument, the Justices posed several hypotheticals to evaluate how the parties' competing frameworks would assign liability in different scenarios. For example, responding to Petitioner's contention that an insider must receive some tangible gain in order to satisfy the personal benefit requirement, Justice Kagan asked about an insider who planned to give a friend money, but decided to provide valuable nonpublic information instead. By contrast, in a hypothetical posed to the government, Chief Justice Roberts underscored that not all information sharing is done for personal gain: suppose an individual asks a friend to join him for a weekend retreat, and the friend declines, explaining that he has to work on an important transaction for Google. In Chief Justice Roberts' hypothetical, even if the tippee trades on the material nonpublic information, the insider did not offer the information as a gift or otherwise benefit from the disclosure. Throughout the oral argument, it was clear that the Justices were trying to reconcile two competing concerns.

The Justices appeared to support the notion that an insider need not receive a tangible, immediate financial benefit in exchange for disclosing material nonpublic information. But certain Justices appeared wary of a test that could expose all sharing of material nonpublic information to potential liability. If the personal benefit element is to serve as a limiting principle, it must be given a more precise and workable definition.

The Justices also appeared to grapple with a number of other issues. In *Dirks*, the Supreme Court expressly stated the "elements of fiduciary duty and exploitation of nonpublic information . . . exist when an insider makes a gift of confidential information to a trading relative or friend" because the "tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient." 463 U.S. at 664. Although this clear pronouncement would appear to foreclose Petitioner's narrow framing, it was not central to the *Dirks* holding and thus could be considered non-binding dicta. Additionally, Justice Breyer engaged in a line of questioning aimed at resolving whether information-sharing with a

relative ought to be treated differently. He posited that helping a relative may be analogous to helping one's self, thus creating a special rule inapplicable to a scenario where an insider assists a friend or casual acquaintance. Given the number of issues in play, and the varied questions from the Justices, whether a clear majority exists in support of a particular formulation remains uncertain.

* * *

United States Court of Appeals
For the First Circuit

No. 15-2250

LOCAL NO. 8 IBEW RETIREMENT PLAN & TRUST, on behalf of itself and all others similarly situated,

Plaintiff, Appellant,

v.

VERTEX PHARMACEUTICALS, INC.; JOSHUA BOGER, Ph.D.; JEFFREY LEIDEN, Ph.D.; PETER MUELLER, Ph.D.; PAUL SILVA; ELAINE ULLIAN; NANCY J. WYSENSKI,

Defendants, Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS

[Hon. F. Dennis Saylor IV, U.S. District Judge]

Before

Torruella, Kayatta, and Barron,
Circuit Judges.

Amanda F. Lawrence, with whom David R. Scott, Joseph P. Guglielmo, Beth A. Kaswan, Donald A. Broggi, and Scott + Scott, Attorneys at Law, LLP, were on brief, for appellant.

John F. Sylvia, with whom Andrew Nathanson, Matthew D. Levitt, Rebecca L. Zeidel, and Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C., were on brief, for appellees.

October 3, 2016

KAYATTA, **Circuit Judge**. During the course of clinical trials for an experimental drug combination intended to treat a fatal lung disease, Vertex Pharmaceuticals, Inc. ("Vertex") announced interim results that overstated the improvement in lung function exhibited in a group of patients receiving the combination treatment. Following this announcement, Vertex's stock price rose from $37.41 per share to close at $64.85 three weeks later. It then lost some of its gain, dropping to $57.80, after Vertex corrected the initial release's overstatement. Acting on behalf of all those who acquired Vertex stock during the period in which the overstatement stood uncorrected, Local No. 8 IBEW Retirement Plan & Trust ("Local No. 8") filed this securities fraud class action complaint against Vertex and six past and current Vertex employees. The district court dismissed the complaint, finding that it failed to create a strong inference that the defendants had acted with scienter, the requisite mental state. See Local No. 8 IBEW Ret. Plan v. Vertex Pharm., Inc., 140 F. Supp. 3d 120, 137 (D. Mass. 2015). We agree and so affirm.

I. Background[1]

As one of the world's largest biotechnology companies, Vertex researches, develops, and sells treatments for a variety of

[1] Because Local No. 8 appeals from a judgment granting the defendants' motion to dismiss, we take the facts alleged in the complaint as true and draw all reasonable inferences from those

ailments. In 1998, Vertex began working on drugs to combat cystic fibrosis, a fatal and as yet incurable lung disease. In early 2012 it gained Food and Drug Administration ("FDA") approval to market a drug, Kalydeco, to treat patients with a rare form of the disease. This approval, along with a contemporaneous drop in the value of Vertex's stock due to Vertex's diminishing returns from another product line, prompted Vertex to focus its energies on developing a more broadly marketable cystic fibrosis treatment.

In pursuit of this aim, Vertex explored a "combination therapy," in which a cystic fibrosis patient first undergoes a course of treatment with an experimental drug called VX-809 and only then begins taking Kalydeco. Hoping that this combination would be effective against the most common form of cystic fibrosis, Vertex began a three-phase clinical investigation required for FDA approval. See N.J. Carpenters Pension & Annuity Funds v. Biogen IDEC Inc., 537 F.3d 35, 39 (1st Cir. 2008) (describing the FDA approval process); 21 C.F.R. § 312.21 (describing the three phases of clinical investigation). On May 7, 2012, while the second phase of this process was ongoing, Vertex issued a press release announcing interim results drawn from roughly half of the 108 enrolled patients.[2] The press release focused in particular on

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facts in favor of Local No. 8. See In re Bos. Sci. Corp. Sec. Litig., 686 F.3d 21, 27 (1st Cir. 2012).

[2] Phase 2 trials are typically closely controlled, small-scale studies designed to evaluate an experimental treatment's

one of the principal markers used to evaluate the effectiveness of a cystic fibrosis treatment: lung function, as measured by the amount of air a patient is capable of exhaling in one second. According to the press release,

> [o]f those who received [the combination therapy], approximately 46 percent (17/37) experienced an absolute improvement from baseline to Day 56 [of the trial period] in lung function of 5 percentage points or more, and approximately 30 percent (11/37) experienced an absolute improvement from baseline to Day 56 of 10 percentage points or more. None of the patients treated with placebo (0/11) achieved a 5-percentage point or more improvement from baseline to Day 56 in lung function.

The press release described these results as "exceed[ing] [Vertex's] expectations," although it cautioned that "complete data" were not yet available and that "the final outcomes of this clinical trial or future clinical trials . . . may be less favorable than the interim analysis reported today, or may not be favorable at all."[3]

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efficacy, as well as its short-term side effects and potential risks. See 21 C.F.R. § 312.21(b).

[3] Although the text of the press release was not incorporated into Local No. 8's complaint and was instead submitted by the defendants in support of their motion to dismiss, we may--as the district court did--nevertheless consider it at this stage because it is referenced in the complaint, it is central to Local No. 8's claim, and no party disputes its authenticity. See Schaefer v. Indymac Mortg. Servs., 731 F.3d 98, 100 n.1 (1st Cir. 2013). We also consider the subsequent press releases issued by Vertex on May 29, 2012 and June 28, 2012, both of which were submitted to the court below without objection.

The same day, Vertex held a conference call for media and investors. On the call, Vertex's Executive Vice President and Chief Scientific Officer, Peter Mueller ("Mueller"), described the interim results as "really, really fantastic" and went on to say, "I have never seen anything like this." Vertex's Chief Executive Officer ("CEO"), Jeffrey Leiden ("Leiden"), also expressed confidence in the results, saying that they were "driving us to . . . plan for potential market entries sooner than we had previously planned" and that, "[p]ending final data this summer and discussions with regulators, we look forward to accelerating the development of our [cystic fibrosis] combination regimen." Nancy Wysenski ("Wysenski"), at that time Vertex's Chief Commercial Officer and Executive Vice President, further noted that the number of patients who stood to benefit from the combination treatment under review exceeded 70,000--a market that could translate into billions of dollars in potential sales.[4]

Vertex's stock price swiftly responded to the announcement of the promising interim results. On May 7, 2012, the day of the announcement, Vertex stock closed at $58.12 per share--up from the prior close of $37.41, with a trading volume

[4] Vertex's Chief Financial Officer confirmed in a call the following day that "the data [were] beyond our expectations" and that Vertex sought "to drive . . . quickly into" the next phase of the clinical investigation in order to "get to . . . patients as fast as possible with this combination therapy."

forty times higher than average. By May 25, 2012, the closing price had risen to $64.85 per share. Meanwhile, five Vertex employees named as defendants in this suit--Joshua Boger ("Boger"), then Vertex's Director; Paul Silva ("Silva"), who had formerly served as Vertex's Vice President and Corporate Controller; Elaine Ullian ("Ullian"), Vertex's co-lead independent director; Mueller; and Wysenski--sold a total of 539,313 shares of Vertex stock, collecting almost $32 million in all.

On May 29, 2012, Vertex announced in a press release that the interim results that had so energized its market prospects had overstated the improvement in lung function exhibited among the Phase 2 patients receiving the combination treatment. The error, as Vertex acknowledged that day in a conference call, stemmed from a "misinterpretation" as to whether the results Vertex had received from the third-party statistical analysis vendor reflected the absolute improvement in the patients' lung function or, rather, the improvement relative to the patients' baseline levels of lung function.[5] When evaluated properly, Vertex's press release explained, the data showed that 35 percent of the patients

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[5] According to the complaint, a relative improvement means "a percentage change from baseline," whereas an absolute improvement is "the numerical distance between the baseline measurement and the improved measurement." For our purposes, it appears that we need only understand the distinction to mean that an absolute improvement is more favorable than a relative improvement of the same percentage.

taking the combination treatment (rather than 46 percent, as had initially been reported experienced an absolute improvement of 5 percent or more, and that 19 percent (rather than 30 percent, as had initially been reported) experienced an absolute improvement of 10 percent or more. Immediately following the announcement of the corrected results, the closing price of Vertex stock experienced its greatest decline in three years, dropping to $57.80 per share, down from $64.85 per share on May 25, yet still well up from the May 4 close of $37.41.

Just short of two years later, Local No. 8 filed a class-action complaint against Vertex--as well as Boger, Leiden, Mueller, Silva, Ullian, and Wysenski--on behalf of all those who, like Local No. 8, had acquired Vertex stock between the announcement of the overstated interim results on May 7, 2012, and the announcement of the corrected results on May 29, 2012. The complaint charged all defendants with securities fraud under section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), and the Securities and Exchange Commission's Rule 10b-5, 17 C.F.R. § 240.10b-5. It also charged the six individual defendants with joint and several liability under section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a), for the alleged securities fraud, on the theory that these defendants "controlled Vertex, and/or controlled other Individual Defendants"; and charged Boger, Mueller, Silva, Ullian, and

Wysenski with insider trading under section 20A of the Exchange Act, id. § 78t-1(a). The gravamen of the alleged fraud, according to the complaint, is that, "[w]hen faced with . . . study results that seemed too good to be true, Defendants, rather than checking the results, turned a blind eye, accepting and promoting unlikely data that offered them a windfall on the sale of their stock."

The defendants moved to dismiss for failure to state a claim, see Fed. R. Civ. P. 12(b)(6), arguing that the facts alleged in the complaint fail to generate a strong inference that the defendants acted with the mental state required to render them liable under section 10(b) and Rule 10b-5. The district court agreed. It found as well that Local No. 8's section 20(a) and section 20A claims could not survive in the absence of a proper section 10(b) and Rule 10b-5 claim, and dismissed the complaint. See Local No. 8, 140 F. Supp. 3d at 137. This timely appeal ensued.

II. Analysis

We review de novo the district court's grant of the defendants' motion to dismiss for failure to state a claim. Aldridge v. A.T. Cross Corp., 284 F.3d 72, 78 (1st Cir. 2002).

A. Section 10(b) and Rule 10b-5

To successfully state a securities fraud claim under section 10(b) and Rule 10b-5, a plaintiff must adequately allege, among other things, scienter. "Scienter . . . is 'a mental state

embracing intent to deceive, manipulate, or defraud.'" Id. at 82 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976)). A plaintiff can establish scienter "by showing that defendants either 'consciously intended to defraud, or . . . acted with a high degree of recklessness.'" Miss. Pub. Emps.' Ret. Sys. v. Bos. Sci. Corp. ("Boston I"), 523 F.3d 75, 85 (1st Cir. 2008) (quoting Aldridge, 284 F.3d at 82). "Recklessness in this context is 'a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care.'" In re Smith & Wesson Holding Corp. Sec. Litig., 669 F.3d 68, 77 (1st Cir. 2012) (quoting Miss. Pub. Emps.' Ret. Sys. v. Bos. Sci. Corp. ("Boston II"), 649 F.3d 5, 20 (1st Cir. 2011)). The omission must "present[] a danger of misleading buyers or sellers that is either known to the defendant or is so obvious the actor must have been aware of it." Id. (quoting Boston II, 649 F.3d at 20). This form of recklessness is "closer to a lesser form of intent" than it is to ordinary negligence. Greebel v. FTP Software, Inc., 194 F.3d 185, 199 (1st Cir. 1999).[6]

[6] Local No. 8 attempts to dilute this stringent standard by citing to a Ninth Circuit case, In re Oracle Corp. Sec. Litig., 627 F.3d 376 (9th Cir. 2010), which stated that recklessness arises where the defendant "had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts although he could have done so without extraordinary effort," id. at 390 (quoting Howard v. Everex Sys., Inc., 228 F.3d 1057, 1064 (9th Cir. 2000)). While

To determine whether the complaint here adequately alleges that the defendants acted with this culpable mental state, we eschew the ordinary standards of Federal Rule of Civil Procedure 8(a)(2), which require only that the plaintiff "plead[] factual content that allows the court to draw the reasonable inference that the defendant[s] [are] liable for the misconduct alleged," Ashcroft v. Iqbal, 556 U.S. 662, 678 (2009). Instead, Congress has directed us to evaluate section 10(b) and Rule 10b-5 claims of this type under the heightened pleading standards of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737. See Aldridge, 284 F.3d at 78. As is relevant here, the PSLRA provides that a complaint must "state with particularity facts giving rise to a strong inference that the defendant[s] acted with [scienter]." 15 U.S.C. § 78u-4(b)(2)(A). Under this standard, "[a] complaint will survive . . . only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing

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the Ninth Circuit has indeed recently applied this formulation of recklessness in assessing the adequacy of a complaint under the PSLRA, Reese v. Malone, 747 F.3d 557, 569 (9th Cir. 2014), even more recently it has rejected this same formulation as insufficient for assessing such a complaint, applying instead the formulation used in this circuit. In re NVIDIA Corp. Sec. Litig., 768 F.3d 1046, 1053 & n.7 (9th Cir. 2014), cert. denied sub nom. Cohen v. Nvidia Corp., 135 S. Ct. 2349 (2015). In any event, however one might describe the law in the Ninth Circuit, we see no reason not to continue to apply a standard that makes clear that allegations of merely unreasonable conduct do not sufficiently plead scienter.

inference one could draw from the facts alleged." Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 324 (2007).

Local No. 8 argues on appeal that the complaint adequately alleges facts making it as likely as not that the defendants recklessly turned a blind eye to an obvious danger that the announced interpretation of the initial results was wrong.[7] To support this argument, Local No. 8 points to the cumulative probative force of seven facts alleged in the complaint. We are mindful that "[e]ach individual fact about scienter may provide only a brushstroke," but it is our obligation to consider "the resulting portrait." In re Cabletron Sys., Inc., 311 F.3d 11, 40 (1st Cir. 2002). Accordingly, we examine each alleged fact in turn, and then conclude by assessing them cumulatively.

First, Vertex itself described the results as unexpected, or as "exceed[ing] . . . expectations." The results were unexpected because, the complaint alleges, it was known "within Vertex" that VX-809 caused Kalydeco to "work less well." The fact remains, though, that Vertex made the investment necessary to design and perform a study testing the two drugs in combination. So, its puffing professions of surprise notwithstanding, Vertex

[7] Local No. 8 contends that the district court improperly conflated the recklessness standard with an actual knowledge standard. We do not find the district court to have done so, but because we review the dismissal of Local No. 8's complaint de novo under the proper standard, the outcome of this appeal in no way depends on our so finding.

must have thought that positive results were possible, even if not probable. We suspect, too, that many studies of new pharmaceutical products result in surprises, both good and bad.

This moves us to Local No. 8's second and related point, which arises from the complaint's allegations concerning the science of cystic fibrosis research. Local No. 8 alleges that cystic fibrosis research focuses on both "lung function and sweat chloride." Because cystic fibrosis progressively and eventually fatally obstructs the lungs, "pulmonary function is an important marker of cystic fibrosis lung disease severity." As a measure of pulmonary function, scientists test the patient for "Forced Expired Volume" ("FEV"). Local No. 8 alleges that scientists studying cystic fibrosis also measure "sweat chloride levels" because cystic fibrosis impairs the tissues of the sweat glands, thereby elevating the concentration of chloride in the patient's sweat.

The interim results reported to and by Vertex showed increased FEV measurements, but no material drop in sweat chloride levels. Local No. 8 argues that some people have described sweat chloride levels to be the "gold standard" in cystic fibrosis research, and that "individuals at the Company were '<u>highly</u> skeptical' of the study results because of the lack of sweat chloride improvements." Therefore, reasons Local No. 8, it was obvious that there was something wrong with the results.

Missing from the allegations is any contention that any defendant viewed the sweat chloride levels as incompatible with the FEV measurements, or that any of the unnamed individuals conveyed any such skepticism to any defendant. Greebel, 194 F.3d at 199; cf. Auto. Indus. Pension Trust Fund v. Textron Inc., 682 F.3d 34, 39 (1st Cir. 2012) (inference that defendants suspected a statement was misleading is weaker where "warnings by subordinates or expressions of concern by executives are notably absent"). The complaint does not even allege that scientists in general, much less those at Vertex, regarded the reported results as implausible. And given that the final results reflected the same phenomenon (improved FEV and steady sweat chloride levels), there is no reason given here to presume that scientists in general must view the possibility of such results as obviously wrong. Notably, too, Vertex reported the sweat chloride levels in the same press release in which it reported the positive FEV results. So it would seem most likely that Vertex itself did not view the former as belying the latter, and neither apparently did the market.[8]

[8] Contrary to Local No. 8's assertion, Boston I is not "particularly on point." In Boston I, we reversed the dismissal of a section 10(b) claim, 523 F.3d at 94, finding that the defendants' own statements in connection with a manufacturing change to a medical device could be read as an admission that the change had been made in response to a design defect that the defendants had not previously disclosed, see id. at 88. No such potentially facially incriminating statements are at issue here.

Third, Local No. 8 alleges that the study was very important to Vertex, and that it would therefore "be 'absurd' to suggest that Defendants were not aware of the suspect nature of the results." It is true that the importance of a particular item to a defendant can support an inference that the defendant is "paying close attention" to that item. Institutional Inv'rs Grp. v. Avaya, Inc., 564 F.3d 242, 271 (3d Cir. 2009). Such an inference, however, is only helpful in establishing scienter if that close attention would have revealed an incongruity so glaring as to make the need for further inquiry obvious. See id. at 270-71 (noting that a "steep decline" in operating margins creates inference that Chief Financial Officer, who "was paying close attention to these numbers," would investigate the cause). We have already discussed why the complaint fails to establish that the announced results, on their face, contained such an obvious incongruity.

Similarly, some cases have recognized that certain key facts known to lower-level company managers concerning a company's flagship product, such as whether a $100 million contract has been signed to sell the product, or that sales are falling fast rather than rising, are very likely known to senior management who made repeated public announcements concerning sales of the product. See, e.g., Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 706-10 (7th Cir. 2008). But the complaint here does not

allege that anybody at Vertex responsible for receiving, reviewing, and reporting the results had actually spotted the error in the interpretation of the results before the discovery that led to the second announcement.

Fourth, Local No. 8 points to its allegation that the specific error in the publicly reported results--namely, the substitution of relative improvement for absolute improvement in lung function--was so "fundamental" that it should have been apparent to the Vertex pulmonologist responsible for receiving the raw data from the third-party vendor "regardless of how [the data] w[ere] presented by the vendor." The pulmonologist is not a defendant, however, and there is no allegation that any party responsible for the decision to announce the interim results received the raw data. The fact that a Vertex pulmonologist was the one who received the raw data actually cuts sharply against Local No. 8 because there is no allegation that even this pulmonologist noticed or suspected that Vertex's reported interpretation of the results was incorrect, or told anyone of any skepticism. The complaint does assert in conclusory fashion that the pulmonologist "should have known" of the error. Yet, the complaint tells us nothing about the precise form of the information conveyed by the vendor, or the vendor's reliability. Negligence by the pulmonologist, too, hardly gets Local No. 8 anywhere. Rather, it adds a concrete reason why the erroneous

interpretation of the study results would not have been obvious to the executives to whom the pulmonologist reported the results.

Even making the reasonable inference, as Local No. 8 urges, that the defendants had access to the raw data--review of which would allegedly have rendered the error obvious through "simple math"--we have already determined that the complaint's allegations are insufficient to establish that the erroneously interpreted end results (which are all the individual defendants are alleged to have received) were themselves so obviously suspect that we can draw a strong inference that the defendants were reckless in failing to consult the raw data themselves for verification.[9]

Fifth, in its appellate brief, Local No. 8 also observes that it is "rare[]" to publish interim results and implies that Vertex's decision to do so here is probative of scienter. However, the complaint nowhere alleges that the publication of interim results was anomalous, and so we do not consider this argument in assessing whether the complaint has stated a claim. Nor does Local No. 8 point to any legal requirement, or any undertaking by Vertex,

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[9] At oral argument, counsel for Local No. 8 noted that, prior to discovery, few plaintiffs will be in a position to make specific allegations about the form of internal documents. "But while a trawl through archives may sometimes catch a few fish, Congress," for reasons of its own, "deliberately raised the entry bar to discovery . . . through the PSLRA's heightened pleading standards." Textron, 682 F.3d at 40.

that obligated the company to double-check the interim results before announcing them.

Sixth, we have considered Local No. 8's allegations that the defendants had a financial motive to "turn[] a blind eye" to the erroneous interpretation of the interim results because of the stock price spike precipitated by the error. Cf. Aldridge, 284 F.3d at 83 ("When financial incentives to exaggerate [material information] go far beyond the usual . . . , they may be considered among other facts to show scienter." (emphasis supplied)). Here, several facts strongly suggest that at least Vertex's CEO, Leiden, had no motive to ignore an error that was obvious and that would therefore soon become known. Leiden, who touted the erroneous interim results as driving Vertex "to accelerat[e] the development of [its] [cystic fibrosis] combination regimen," is not alleged to have sold any stock during the class period. Local No. 8 contends that this was "a major study that . . . was central to [Vertex's] prospects." Announcing good results on such a study would have been clearly better for Vertex than announcing great results only to reduce them to good results by shortly thereafter confessing error, thereby harming the company's credibility and its reputation for competence. Combined with the foregoing points, this fact makes it quite unlikely (and certainly less than 50-50) that any error was so obvious that Leiden must have known that the

results were mistaken (and would therefore soon have to be withdrawn or corrected).

Local No. 8 therefore places its focus on the fact that the other five defendants sold almost $32 million worth of stock following release of the overstated interim results. According to the complaint, these sales were "unusual when compared to [the individual defendants'] trading history before and after" the three-week class period. Local No. 8 argues that this unusual activity, together with the inferences that can be drawn from the defendants' failure to double-check the interim results, makes "the inference that Defendants turned a blind eye to the suspect test results to line their own pockets . . . at least as strong" as an inference of negligence.

It is well settled that "[i]nsider trading in suspicious amounts or at suspicious times may be probative of scienter." Boston I, 523 F.3d at 92 (citing Greebel, 194 F.3d at 197; Greenstone v. Cambex Corp., 975 F.2d 22, 26 (1st Cir. 1992)). At the outset, however, it bears noting that, in addition to Leiden, defendant Boger did not engage in any inconsistent trading behavior during the class period. Boger, who was Vertex's Director at the time, sold consistently small amounts of stock on a more or less weekly basis before, during, and after the class period.

So, to regard the stock sales as either motive for the fraud or evidence of the defendants' knowledge that the interim

study results had been misinterpreted, we must hypothesize either that the error was obvious only to those defendants who made unprecedented sales, or that it was obvious to all, yet the Director and CEO nevertheless went along with announcing obviously flawed results. The complaint, though, offers no fact suggesting that the sellers knew more than the nonsellers. To the contrary, the largest seller, Wysenski, was not a scientist. And our discussion of Leiden's salient interests and motive renders a stretch any inference that he would have gone along with announcing obviously erroneous results.

The complaint's chronology also offers a simple alternative explanation of the stock sales. After a long period of steady or dropping stock prices, the stock price suddenly jumped a large amount. Such an increase--no matter what its cause--creates a substantial incentive for holders to sell unless they believe the price will continue to rise and are willing to wait. Sales in the historical context described in the complaint carry little force in implying knowledge that the stock will drop.[10] All in all, the presence of this perfectly understandable, innocent

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[10] By contrast, consider a case of more or less steady stock price, followed by a nonpublic adverse event, inside sales, and then public disclosure of the adverse event. See, e.g., SEC v. Rocklage, 470 F.3d 1, 3-4 (1st Cir. 2006).

reason to sell, combined with the poor fit between the facts and Local No. 8's theory, leaves us short of the scienter mark.[11]

Seventh, there is, finally, the fact that Vertex announced the retirement of Wysenski, aged fifty-four at the time, "suddenly and without any forewarning" on June 8, 2012--just one day after Iowa Senator Charles Grassley had sent a letter to Securities and Exchange Commission Chairwoman Mary Shapiro asking her to probe whether "Vertex . . . executives . . . took advantage of the spike in the stock knowing the news of the clinical data being overstated would be made public eventually, which in turn would negatively affect the stock value." From these circumstances, Local No. 8 asks us to infer (1) that the defendants were aware of Senator Grassley's letter, and (2) that the letter prompted Wysenski's retirement (3) because it correctly exposed that Wysenski, at a minimum, had deliberately turned a blind eye to the risk that the announced interim results were erroneous.

[11] Local No. 8 cites a Ninth Circuit case, No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., 320 F.3d 920 (9th Cir. 2003), which it describes as "analogous." However, a major factor in the America West court's determination that the stock sales at issue were "unusual and suspicious," id. at 940, was the fact that "[m]ost of the [alleged insiders] sold 100% of their shares, with the lowest percentage being 88%," id. at 939. Here, by contrast, the two most senior defendants made no sales out of the ordinary course, and the complaint contains no allegation as to what proportion of his or her total stock any other defendant sold during the class period.

These allegations both point a finger at Wysenski and tend to exculpate the others who did not retire or leave the company. The question is whether they add enough to permit a claim against Wysenski; i.e., whether they make "the inference of scienter . . . at least as compelling as any opposing inference one could draw from the facts alleged." Tellabs, 551 U.S. at 324. It is reasonable to infer that Vertex knew of Senator Grassley's letter,[12] and that Wysenski's departure had something to do with her stock sales. But Local No. 8 must take us a step further. For Local No. 8 to prevail, we would need to infer that Wysenski left or was pushed out for a particular reason; i.e., because she had unlawfully misled the market. If that were the reason, though, it would have applied to all defendants because the complaint makes no suggestion that Wysenski (a nonscientist handling marketing) knew anything more about the test results than did the others (who neither left nor were forced out in this timeframe).

[12] When asked about this point at oral argument, counsel for Local No. 8 stated, wrongly, that the complaint alleged that Senator Grassley's letter was publicly available, rather than asking us to take judicial notice of contemporaneous news reports establishing that the letter was indeed public. See, e.g., Beth Healy, US Senator Charles Grassley Raises Vertex Stock Profits Issue with SEC Chief, Boston Globe, June 7, 2012, available at https://www.bostonglobe.com/business/2012/06/07/senator-charles-grassley-raises-vertex-stock-profits-issue-with-sec-chief/cogtZEGDw2GhiDGt5DNbIK/story.html. Because we do not find this point to be dispositive, we do not decide whether we would otherwise elect to take such notice sua sponte.

Alternative explanations abound. Wysenski's very large sales and the spotlight focused on those sales could have given rise to her retirement without any hint of fraud. Large insider sales by a senior manager, regardless of the reason for such sales, can present a major embarrassment for a company. Perhaps negligence by Wysenski in preparing the erroneous press release prompted a forced retirement. Picking among these explanations, without the benefit of factual allegations suggesting Wysenski knew something the other defendants did not know, depends on a degree of guesswork inconsistent with the PSLRA pleading standard.

Cumulatively, the brushstrokes here do not paint the required strong inference of scienter. Vertex's public description of a scientific study contained an error that made unexpectedly good results look even better than they were; there is no claim that the pulmonologist who received and reviewed the raw data behind the results noticed or reported the error to company executives; the company's CEO, a scientist, had no plausible reason to announce results infected with an error that would most likely soon mar otherwise good news and harm Vertex by leading to an embarrassing correction; and there is no claim that the other defendants possessed any additional information. Given the foregoing, the stock sales by some of the individual defendants and the timing of Wysenski's retirement (which might otherwise look very different) cover too little canvas to evoke inferences

of scienter strong enough to equal the alternative inference that Vertex was negligent in viewing very good results as being even better than they in fact were.

Accordingly, the allegations underlying Local No. 8's claim that the defendants acted with scienter fall short of what Congress demands in the securities fraud context. We therefore affirm dismissal of the section 10(b) and Rule 10b-5 claim.

B. Section 20(a) and 20A

Local No. 8 concedes that its remaining claims are derivative of its section 10(b) and Rule 10b-5 claim. Because we conclude that the district court properly dismissed the latter, it follows that the district court properly dismissed the former. We therefore affirm the dismissal of Local No. 8's remaining claims.

III. Conclusion

Under the PSLRA, this action can only move forward if we find that the allegations make it at least as likely as not either that the defendants knew the results as reported were wrong, or that it was obvious to the defendants that they would discover the error if they looked. Because we, like the district court, cannot so find, we affirm the dismissal of the complaint.

13-1194(L)
GAMCO v. Vivendi

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

August Term 2015

(Argued: March 3, 2016 Decided: September 27, 2016)

No. 13-1194(L), 13-1377(XAP)

GAMCO INVESTORS, INC., GAMCO GLOBAL SERIES FUNDS, INC., GABELLI CAPITAL ASSET FUND, THE GABELLI VALUE FUND, INC., THE GABELLI ASSET FUND, THE GABELLI GLOBAL MULTIMEDIA TRUST INC., THE GABELLI EQUITY TRUST, INC.,

Plaintiffs-Appellants-Cross-Appellees,

THE GAMCO MATHERS FUND, THE GABELLI CONVERTIBLE AND INCOME SECURITIES FUND, INC., GAMCO INTERNATIONAL GROWTH FUND, INC.

Plaintiffs,

-v.-

VIVENDI UNIVERSAL, S.A., VIVENDI S.A.,

Defendants-Appellees-Cross-Appellants.

Before: CABRANES, LIVINGSTON, and LYNCH, *Circuit Judges*.

Plaintiffs-Appellants-Cross-Appellees, so-called "value investors," appeal from the judgment of the United States District Court for the Southern District of New York (Scheindlin, *J.*), granting judgment to the Defendants because they had rebutted the fraud-on-the-market presumption of reliance invoked by the Plaintiffs as part of their claim under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b). For the reasons stated below, we **AFFIRM** the judgment of the district court.

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PER CURIAM:

This appeal stems from the same set of underlying facts as those in *In re Vivendi S.A. Securities Litigation*, Nos. 15-180-cv(L), 15-208-cv(XAP), in which we have today issued a separate opinion. Plaintiffs-Appellants-Cross-Appellees (collectively, "GAMCO") are so-called "value investors" who make their own estimation of the value of a publicly-traded company's securities and attempt to

buy such securities when the market price is lower than its own valuation, betting that the market price will rise over time. Between 2000 and 2002, GAMCO invested in the securities of Defendants-Appellees-Cross-Appellants Vivendi Universal, S.A. and Vivendi S.A. (collectively, "Vivendi"). Thereafter, when the nature of Vivendi's liquidity situation came to light, the price of those securities dropped dramatically.

GAMCO subsequently brought a securities fraud action against Vivendi under § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), as well as the Securities Exchange Commission's ("SEC") Rule 10b–5 ("Rule 10b–5") promulgated thereunder, 17 C.F.R. § 240.10b–5. After a bench trial solely on the question whether Vivendi successfully rebutted the fraud-on-the-market presumption of reliance invoked by GAMCO to satisfy the reliance element of its § 10(b) claim, *see Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988), the District Court for the Southern District of New York (Scheindlin, *J.*) entered judgment for Vivendi. *See GAMCO Investors, Inc. v. Vivendi, S.A.*, 927 F. Supp. 2d 88, 91 (S.D.N.Y. 2013) ("*GAMCO*"). GAMCO now appeals.[1]

[1] Vivendi also cross-appeals from the district court's determination that Vivendi was barred by collateral estoppel from contesting the other elements of GAMCO's § 10(b) claim. Because we affirm the district court's decision in favor of Vivendi, we need not reach this claim.

DISCUSSION

"On appeal from a bench trial, the district court's findings of fact are reviewed for clear error and its conclusions of law are reviewed *de novo*." *Beck Chevrolet Co., Inc. v. Gen. Motors LLC*, 787 F.3d 663, 672 (2d Cir. 2015) (quoting *Mobil Shipping & Transp. Co. v. Wonsild Liquid Carriers Ltd.*, 190 F.3d 64, 67 (2d Cir. 1999)).

To succeed on a § 10(b) and Rule 10b–5 claim, a plaintiff must prove "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2407 (2014) (quoting *Amgen Inc. v. Conn. Retirement Plans and Tr. Funds*, 133 S. Ct. 1184, 1192 (2013)). The traditional way a plaintiff demonstrates reliance is directly, *i.e.* "by showing that he was aware of a company's statement and engaged in a relevant transaction . . . based on that specific misrepresentation." *Id.* (quoting *Amgen*, 133 S. Ct. at 1192)). However, a plaintiff may, in some circumstances, invoke a "rebuttable presumption of reliance." *Id.* at 2408. This presumption rests on the "'fraud-on-the-market' theory" which states "that 'the

market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.'" *Id.* (quoting *Basic*, 485 U.S. at 246). Because "the typical 'investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price'—the belief that it reflects all public, material information— . . . his 'reliance on any public material misrepresentations . . . may be presumed for purposes of a Rule 10b–5 action.'" *Id.* (quoting *Basic*, 485 U.S. at 247). But the presumption, as its name suggests, is rebuttable.[2] "Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption . . . ." *Id.* (quoting *Basic*, 485 U.S. at 248) (alteration omitted).

As an initial matter, GAMCO argues that the District Court "erred in concluding that . . . because Vivendi demonstrated that Plaintiffs are value investors[,] Vivendi . . . proved [GAMCO] did not rely on the integrity of the

[2] To demonstrate successfully that the presumption should apply in a given case, "a plaintiff must [show] . . . (1) that the alleged misrepresentations were publicly known, (2) that they were material, (3) that the stock traded in an efficient market, and (4) that the plaintiff traded the stock between the time the misrepresentations were made and when the truth was revealed." *Id*. It was not contested at the trial that the presumption itself applied, only whether it had been rebutted.

market in purchasing Vivendi [securities]." GAMCO Br. at 41. According to GAMCO, though it, like most value investors, does not believe that the market price necessarily equals, at any given time, the efficient value of a security (and thus makes its money by identifying under- or over-valued securities), *Halliburton* forecloses the conclusion that this fact alone suffices to rebut the presumption.[3] Vivendi, for its part, suggests that such a showing indeed suffices to rebut the presumption. *See* Vivendi Br. at 33; *cf. Teamsters Loc. 445 Freight Div. Pension Fund v. Bombardier Inc.*, 546 F.3d 196, 199 n.4 (2d Cir. 2008) ("The . . . fraud-on-the-market theory involves [the] rebuttable presumption[] . . . 'that . . . investors rely on the market price of securities as an accurate measure of their intrinsic value.'" (quoting *Hevesi v. Citigroup Inc.*, 366 F.3d 70, 77 (2d Cir. 2004)).

It is true that the district court reasonably found facts that demonstrate that GAMCO's purchasing decisions relied in large part on an independent valuation

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[3] *See Halliburton*, 134 S. Ct. at 2410 ("Debates about the precise *degree* to which stock prices accurately reflect public information are . . . largely beside the point."); *id.* at 2411 (noting that "there is no reason to suppose that . . . the value investor[] is as indifferent to the integrity of market prices as Halliburton suggests"); *but see id.* (noting that "*Basic* never denied the existence of [value] investors," as "*Basic* concluded only that 'it is reasonable to presume that *most* investors . . . will rely on the security's market price as an unbiased assessment of the security's value in light of all public information.'" (quoting *Amgen*, 133 S. Ct. at 1192)).

of the worth of Vivendi's securities that was separate and distinct from the market price. The district court found that GAMCO would begin by calculating a "Private Market Value[]" ("PMV") for a given security — a value that approximated "the price that an informed industrialist would be willing to pay for [the company], if each of its segments were valued independently in a private market sale." *GAMCO*, 927 F. Supp. 2d at 94–95. GAMCO would then compare this PMV to the public market price. If there was a sufficiently large "spread between [the] PMV and the market price," and if there was evidence of the existence of a "catalyst," *id.* at 94–96, or "some dynamic that [GAMCO thought was] going to help surface value over time," J.A. 359, then GAMCO would generally elect to purchase the security in question. Employees at GAMCO often referred to its PMV as the "intrinsic value" of the stock, *see, e.g.*, J.A. 338, 508, and frequently referred to the market price, in contrast, as reflecting the whims of the sometimes "irrational . . . Mr. Market," J.A. 358.

Though the district court indeed found that GAMCO does not necessarily consider the market price to be an efficient reflection of the objective value of a security at any given time, however, it explicitly disclaimed any reading of its opinion as suggesting that this fact was sufficient, on its own, to rebut the

presumption. *See GAMCO*, 927 F. Supp. 2d at 102 ("[O]ne can imagine a case where an investor . . . used the market price of a security merely as a comparator with a private method of valuation, but in which the fraud on the market presumption could not fairly be rebutted, because, but for the material misstatements, that investor would not have transacted in the securities at issue."). We thus decline to explicate the contours of *Halliburton* here, further theorize on the presumption, or otherwise address the relevance of the typical value investing model to a rebuttal showing. The district court's holding was, instead, based on a much narrower theory: that, given the facts in the record, Vivendi proved that GAMCO would have purchased Vivendi securities even had it known of Vivendi's alleged fraud. *See Halliburton*, 134 S. Ct. at 2408 (observing that a defendant may rebut the presumption by demonstrating, *inter alia*, "that a plaintiff would have bought or sold the stock even had he been aware that the stock's price was tainted by fraud"); *Kline v. Wolf*, 702 F.2d 400, 403 (2d Cir. 1983) (noting that the presumption may be rebutted through a showing "that plaintiffs did not significantly rely on the integrity of the market or that, even if they had known of the alleged misrepresentation, they would still have purchased the stock").[4] GAMCO argues that this factual conclusion was error, and asserts that

[4] The district court found facts sufficient to establish that that it was more likely

"[i]t was clearly erroneous for the District Court to find that a sophisticated financial manager would purchase securities in advance of undisclosed adverse information which would have the predic[t]able impact of causing market prices

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than not that GAMCO would have purchased the relevant securities even if it had known that Vivendi's statements were misrepresenting its liquidity. *See GAMCO*, 927 F. Supp. 2d at 97 (finding, *inter alia*, that "the liquidity crisis at Vivendi was irrelevant to Plaintiffs' investment decisions"). Nevertheless, GAMCO takes issue with the district court's approach to determining whether GAMCO would have purchased the security even if it had known there was a fraud. Specifically, GAMCO questions the district court's reliance on the argument that GAMCO would have considered Vivendi's securities a *more attractive* investment had Vivendi fully divulged its liquidity problems to the entire market prior to GAMCO's purchase. *See id.* at 102 (where the district court observes that "in this counterfactual scenario [where Vivendi did not commit any fraud] . . . the price of Vivendi ADS's would have been lower" as the market price would have fallen with revelation of the truth, and thus "Plaintiffs would have seen Vivendi as a *more* attractive investment"). GAMCO does not necessarily question the premise that, if Vivendi had fully disclosed its liquidity problems to the market, then the market would likely have internalized the value of those problems, the stock's price would have fallen, and the spread between the PMV and the market price would thus have been larger. Nor does GAMCO deny that it may have purchased the security at this lower price had there been no fraud at all. Rather, GAMCO contests the relevance of the district court's inquiry to what GAMCO believes is the central issue, namely whether GAMCO would have purchased shares "*at the same price*[]" had it been aware that many of Vivendi's statements were fraudulent. *Id.* at 103 (emphasis added) (internal quotation marks omitted); *see also Halliburton*, 134 S. Ct. at 2408 (noting that a defendant may rebut the presumption by showing "that a plaintiff would have bought or sold the stock even had he been aware that the stock's price was tainted by fraud").

Though we observe that GAMCO's framing of the appropriate inquiry has much to recommend it, we need not conclusively endorse it here. Even adopting, *arguendo*, GAMCO's preferred framing, *see* GAMCO Br. at 27 n.11 (acknowledging that the presumption may be rebutted by showing that a "plaintiff would have purchased the stock at the same price even if she had known of the fraud"), the district court did not clearly err in concluding, as detailed herein, that revelation of Vivendi's liquidity problems would not have changed GAMCO's purchasing decisions.

to decline." GAMCO Reply Br. at 8. Our review of the record demonstrates that it was not "clearly erroneous" for the district court to so conclude as to GAMCO itself. Under that deferential standard of review, we must accept the district court's findings of fact "unless we have a definite and firm conviction that a mistake has been committed." *Souratgar v. Lee*, 720 F.3d 96, 103 (2d Cir. 2013) (internal quotation marks omitted). We therefore need not, and do not, decide whether we would have reached the same factual conclusions as the district court.

First, though GAMCO repeatedly asserts on appeal that it is all but unthinkable that a sophisticated investor would ever buy a security if he was aware its market price might be tainted by fraud, the idea was not so ridiculous to the Chief Investment Officer of Gabelli & Co. Asked whether he would "buy a stock in a company . . . [where he] knew . . . the price was inflated as a result of a management fraud," Mario Gabelli testified that such a purchase was "possible, but very unlikely," and clarified that he would "assign a 90-10 probability" to such a scenario. J.A. 530–31. He went on to qualify this statement, noting "[t]here would have to be a lot of other circumstances." *Id.* at 531. The district court largely dismissed Gabelli's testimony as "motivated

hairsplitting by an interested witness." *GAMCO*, 927 F. Supp. 2d at 94. It is thus highly significant that a prominent witness the district court believed was exaggerating the facts in *favor* of the plaintiffs admitted on the stand that, in the abstract, there was a *ten percent* possibility that, in a given case, he would buy stock inflated by fraud. Such testimony, at minimum, established — in contrast to GAMCO's repeated suggestions — that GAMCO had no ironclad policy against purchasing a stock it believed might be inflated by fraud, provided that other circumstances made the deal one worth pursuing.

To that end, the record in this case includes sufficient evidence supporting the district court's finding that such circumstances were present here: in other words that, even if aware of Vivendi's liquidity problems and its concealment of those problems, GAMCO would still have believed the deal it made was a good one. As already noted, the district court reasonably found that the core of GAMCO's investment decisions could be reduced to two questions: first, was there a material spread between market price and PMV, and second, was there reason to believe a catalyst would cause the market to recognize this discrepancy in the next two to five years. Evidence in the record also supported the district court's conclusion that, had GAMCO known of the liquidity problems at Vivendi,

such knowledge would not have altered the answers to either of these questions.

As to the spread, Andrew Rittenberry, the analyst primarily responsible for calculating Vivendi's PMV in the relevant period, testified that, once he learned of the liquidity crisis at Vivendi (as the fraud came to light), the knowledge of the liquidity problems had no "impact [on his] PMV calculation," as he believed those problems constituted "a short-term issue . . . . [s]omething that could be solved within a year or so." J.A. 401-03. Rittenberry also testified that PMV was generally calculated to anticipate the value of the company over the long haul. This testimony further supports the district court's factual finding that GAMCO would not have believed that a short-term problem, especially one that it did not perceive to be as significant as the market ultimately came to believe it was, would affect its calculation of the spread. *See* J.A. 368 (noting that, in calculating the PMV, Rittenberry "projected the business performance of [the] differen[t] pieces of the business over a five-year period"); J.A. 383 ("[T]he goal in buying a stock is to have it appreciate 50 percent over a two-year period"); J.A. 527 (testimony of Mario Gabelli: "So the way we think is like a McKinsey thinking out over the next five or ten years"). Thus, the record supports the district court's conclusion that, if GAMCO had known of the liquidity problems and

their concealment, GAMCO would still have believed Vivendi's PMV to be "materially higher" than the public market price. J.A. 363.

Second, it was also not clearly erroneous for the district court to conclude that knowledge of Vivendi's liquidity problems would not have changed GAMCO's belief that a catalyst was likely — *i.e.*, its belief that the market price would rise towards the PMV, if not immediately, then over the course of the next several years. Such evidence came in various forms. First, GAMCO continued to buy Vivendi securities as the full extent of Vivendi's alleged fraud came to light. GAMCO argues that this information is hardly dispositive of whether GAMCO would have purchased *prior* to the revelation of the fraud at the same price at which it purchased (given that the revelation caused the market price to fall as fraud-induced inflation dissipated). That may indeed be so, but the evidence is *specifically* relevant to the narrower question whether knowledge of the liquidity problems would have affected GAMCO's belief in the existence of a catalyst. That GAMCO continued to buy reasonably suggested to the district court that GAMCO still believed a catalyst to be on the horizon (and thus demonstrated that the liquidity problems had not altered, and would not have altered, this conclusion). Further, Gabelli testified that a "change of

management" was one of the most frequent catalysts on which GAMCO would rely in purchasing a stock. J.A. 482. This testimony further reinforced the district court's factual findings: had GAMCO known of the liquidity problems at Vivendi (notwithstanding whether they had been fraudulently concealed), the potential for a change in management would have seemed even more likely.

In short, evidence in the record supported the district court in concluding that, had GAMCO known of Vivendi's liquidity problems, GAMCO would still have believed, first, that Vivendi's securities were substantially undervalued by the market and second, that an event was likely to happen in the next few years that would awaken the market to that fact. Further, the record provided sufficient evidence to find that GAMCO would have believed that, even if the liquidity crisis in fact came to light, it would resolve within a short period of time — and thus, that even if the market price might go down in the short run, the potential for long-term profit still remained. In other words, whereas one can imagine situations in the abstract where a sophisticated investor, apprised of a fraud, would necessarily conclude that a security was no longer a logical purchase, the district court did not clearly err in concluding, on *this* record, that *in this case*, and with regard to *this particular fraud*, GAMCO would still have

viewed Vivendi's securities as a profitable investment — even if it might have been concerned about the hidden liquidity risks.

GAMCO counters this extensive evidence by citing, almost exclusively, to testimony of Andrew Rittenberry, which GAMCO employs to argue that the district court's factual findings were clearly erroneous. Asked whether, assuming the information "did not affect [his] PMV calculation, a liquidity crisis would similarly not affect [his] buy, sell, or hold recommendation," Rittenberry replied, "[n]o, not necessarily." J.A. 401. "The big driver," he continued, "[is] PMV. But the discount to the PMV between the market price and the PMV is a key factor. If there is a liquidity crisis or some type of event like that, you would expect the discount to widen. I mean you would expect the stock to go down." *Id*. When further asked whether he "would expect the public market price to go down," Rittenberry answered, "[y]es. You wouldn't want to buy it in front of that — if you thought it was going to go down, you would wait to buy it or buy more or recommend to buy more at that point." *Id.*

Pointing to Rittenberry's testimony, GAMCO argues that even if it would not have believed the liquidity problems to affect Vivendi's PMV, and even if it would still have believed it likely the investment would be profitable over the

long run, the record renders clearly erroneous the district court's finding that it would have purchased Vivendi's securities had it known of the fraud. This is because, GAMCO argues, even if it indeed still thought Vivendi securities were materially undervalued notwithstanding the crisis, it would have waited until the liquidity crisis came to light and *then* bought the stock. Such a delayed purchase not only would have mitigated the *risk* associated with the undisclosed liquidity problems (as fraud always creates some risk that the underlying calculations are erroneous), but also would have potentially netted GAMCO a more profitable investment.

It was not clearly erroneous, however, for the district court to find that GAMCO would indeed have purchased Vivendi's securities at the price quoted, rather than simply await the potential of a public liquidity crisis. First, both Rittenberry's testimony and GAMCO's argument rest on the assumption that Rittenberry (and GAMCO) would have *known* that the stock price would indeed go down upon revelation of the liquidity crisis. As already noted, however, the district court reasonably found facts demonstrating that Rittenberry, or GAMCO, apprised of the hidden liquidity risks, would not have been so certain. At the time GAMCO had to make its purchasing decision, even if it had known of the

fraud, it would not have been able to see the future. And the record evidence as to how GAMCO would have approached determining how likely it was that the hidden risks would be exposed in a way that would materially affect the market price does not support GAMCO's position.

Thus, Rittenberry testified that, when he did find out about the liquidity problems, he believed that they constituted a very short-term concern with minimal impact on Vivendi's value. It was therefore not clearly erroneous for the district court to infer that GAMCO, privy to this information prior to its relevant purchases, would have believed it possible that the crisis would pass without incident or public revelation, or at minimum be uncertain as to just how the market would value the crisis were it to come to light. Given that the record makes clear that GAMCO would, in at least some circumstances, have purchased a security even believing it was tainted by fraud, it is highly relevant that the record also provides sufficient evidence to find that GAMCO would have believed *this particular fraud* unlikely to become material.

Further, against this uncertainty of a future, hypothetical *better deal*, the record provided evidence that GAMCO had reasons to believe the deal — which, as already noted, would have appeared to be a good one — could get *worse* if

GAMCO waited. As Rittenberry testified, the premise of GAMCO's model was that it found a stock was "trad[ing] at a discount to what [GAMCO believed] it[] [was] worth *temporarily*," and that "that discount [would] . . . narrow over time." J.A. 357 (emphasis added). As a general matter, then, to wait, rather than buy the stock, always risked the possibility that the prophesied catalyst would come early, or that the market would recognize that the value of the stock was depreciated. Further, Gabelli testified that he believed the market, in the aggregate, to be "down sharply" by the beginning of 2001, J.A. 522, and in GAMCO's December 2000 Annual Report to investors, it "forecast . . . an economic (and earnings) recovery" in "the second half of 2001" which would "help[] . . . renew investor confidence and revive the market," J.A. 591. To wait for the hypothetical revelation of the liquidity problems, then, would risk not only that the market, specifically, would realize that Vivendi's stock was undervalued, but also that the market, generally, would rebound and the market price would rise accordingly, sacrificing the spread. It was not clearly erroneous for the district court to conclude that GAMCO, aware of the fraud, would not have waited to buy the securities.

In other words, the premise of Rittenberry's testimony, and GAMCO's

argument, assumes what it seeks to prove: that GAMCO would have known that the liquidity problems would manifest in the way that, in hindsight, they manifested, and would thus obviously have waited to buy if it purchased at all. But the district court's rejection of that conclusion was not clearly erroneous. Further, GAMCO exaggerates the probative value of Rittenberry's testimony in another way as well. Even on its own terms, Rittenberry's testimony does not clearly suggest that GAMCO would not have bought if it had known of the hidden liquidity risks. Asked whether knowledge of such a hidden crisis would "not affect" his buy or sell recommendation, Rittenberry, not unlike Gabelli, answered equivocally: "no, *not necessarily*." J.A. 401 (emphasis added). And, when describing what his recommendation would be, he *did not* say that he would recommend that GAMCO not buy; instead, he testified that "if [he] thought [the market price] was going to go down, [he] would wait to buy it *or buy more or recommend to buy more at that point*." *Id.* (emphasis added). In other words, the district court did not have to read this testimony as GAMCO reads it. Instead, it could reasonably have read Rittenberry's testimony as suggesting that GAMCO would buy and then wait and *buy more* if indeed the liquidity problems surfaced. Such an approach would potentially allow GAMCO to ensure it

captured a good deal when it saw one while hedging against the possibility of an uncertain future.

It may seem unlikely, in the abstract, that an investor, aware of fraud, would opt to purchase a given security. Nevertheless, after a trial, we do not review a district court's factual findings for whether they seem, in the abstract, correct — we review the *record* for sufficient evidence in support of those judgments. And here, the record at the trial simply does not establish that it was clearly erroneous for the district court to find that GAMCO, had it known of the liquidity problems at Vivendi, would have made the choice to buy the same securities it purchased.[5]

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[5] We also conclude that GAMCO's challenge to the district court's grant of summary judgment is unreviewable. GAMCO concedes that we do not have jurisdiction to hear an appeal from a denial of summary judgment after a trial, unless the "district court's error was purely one of law." *Stampf v. Long Island R.R. Co.*, 761 F.3d 192, 201 n.2 (2d Cir. 2014); *see* GAMCO Reply Br. at 31–32. GAMCO further acknowledges that one ground on which the district court denied summary judgment was its finding that "GAMCO could possibly have uncovered non-public corrective information which would rebut the presumption of reliance." GAMCO Br. at 9; *see also* J.A. 92. GAMCO concedes that, as a *legal matter*, this scenario does indeed rebut the presumption of reliance. *See* GAMCO Br. at 27 n.11 (noting that one of the "recognized ways to rebut the . . . presumption [is when] plaintiff possessed non-public information concerning the fraudulent misstatements."). GAMCO argues that evidence in the record created no material question of fact, at summary judgment, whether GAMCO had such information. This argument misses the point. To the degree that GAMCO agrees with the legal standard the district court applied (non-public corrective information can rebut the presumption of reliance) and argues only that the district court erred in finding a material question of fact *pursuant* to that

CONCLUSION

Accordingly, and finding no merit in the Plaintiffs' remaining arguments, we **AFFIRM** the judgment of the District Court.

legal standard, at least one ground for the district court's denial of summary judgment was not a pure error of law, but one of fact. Thus, the denial is not reviewable by this Court. *See Stampf*, 761 F.3d at 201 n.2.

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 14-20128

United States Court of Appeals
Fifth Circuit
FILED
September 30, 2016
Lyle W. Cayce
Clerk

JUAN RAMON TORRES; EUGENE ROBISON,

Plaintiffs - Appellees

v.

S.G.E. MANAGEMENT, L.L.C.; STREAM GAS & ELECTRIC, L.T.D.; STREAM S.P.E. G.P., L.L.C; STREAM S.P.E., L.T.D.; IGNITE HOLDINGS, L.T.D; ET AL,

Defendants - Appellants

Appeal from the United States District Court
for the Southern District of Texas

Before STEWART, Chief Judge, and JOLLY, DAVIS, JONES, SMITH, WIENER, DENNIS, CLEMENT, PRADO, OWEN, ELROD, SOUTHWICK, HAYNES, GRAVES, HIGGINSON, and COSTA, Circuit Judges.

WIENER and COSTA, Circuit Judges, joined by STEWART, Chief Judge, and DAVIS, SMITH, DENNIS, PRADO, ELROD, SOUTHWICK, GRAVES, HIGGINSON, Circuit Judges :

The Plaintiffs-Appellees brought a civil action under the Racketeer Influenced and Corrupt Organizations Act (“RICO”), 18 U.S.C. §§ 1961–68, alleging that Stream Energy, through its multi-level marketing program, Ignite, as well as a number of other defendants, (collectively the “Defendants”) operated a fraudulent pyramid scheme. The Plaintiffs allege that the fraud has

caused them financial losses. The district court certified a class of plaintiffs (the "Plaintiffs"), comprising those who lost money participating as Independent Associates ("IAs") in Ignite's program. We now review that certification en banc.

I.

Stream Energy sells gas and electricity to customers in Texas, Georgia, Pennsylvania, Maryland, New Jersey, New York, and the District of Columbia. Ignite is the marketing arm of Stream. Although Stream sells energy to customers, it is not a public utility that directly produces energy by owning the energy-producing infrastructure. Instead, it acts more as a middleman, reselling gas and electricity in deregulated energy markets that it buys from actual utilities. According to the Plaintiffs, Stream has realized only small profits on its energy sales, despite its large revenues, because Stream sells energy just above, or sometimes even at, its costs.

Rather than making meaningful profits through its sales, the Plaintiffs contend that Stream is set up like a classic pyramid scheme to make almost all of its money through the recruitment of salespeople. According to the Plaintiffs, it works like this: Stream's marketing arm, Ignite, operates a multi-level marketing program in which IAs (1) sell energy to customers, and (2) recruit other individuals to join as IAs who in turn sell energy to customers and recruit individuals to join as IAs. Under the IA program, Ignite charges individuals for the right to sell Stream services to customers and to recruit IAs. An IA pays Ignite $329 up front for the right to sell Stream energy and to recruit IAs, and also pays an optional recurring fee for a "Homesite" website that the IA can

use to promote his or her Stream business.[1] The putative class members are those individuals who paid to become IAs and lost money.

For each energy customer recruited, Ignite pays the IA a small percentage of that customer's bill as a commission, known as "Residual Income" or "Monthly Energy Income" ("MEI"). According to the Plaintiffs, however, the far more lucrative opportunities come from the recruitment of other IAs. Ignite pays IAs "Leadership Income" for recruiting other IAs. When an IA recruits another IA, he or she receives income from both (1) energy sales by that IA and his downline IAs, and (2) recruitment of other IAs by that IA and his downline IAs.

An IA's success depends primarily on recruiting a "downline" of other IAs who, in turn, recruit other IAs and customers into the Ignite program. As an IA recruits more IAs, he proceeds up a ladder of Ignite leadership positions. All IAs start out as "Directors," the lowest level of Ignite leadership. By recruiting more IAs, an IA can move up three additional leadership levels, first to "Managing Director," then to "Senior Director," and finally to "Executive Director." By building a downline, the IA also receives MEI for customers whom the downline IAs recruit to join Stream, along with bonuses for the recruitment of IAs both by the first IA and his downline IAs.

Ignite also promotes a "3&10 program." Under this program, Ignite pays an IA a $100 bonus if the IA enrolls four customers in the first 30 days. An IA can substitute purchase of the Homesite for two customers, and can be his or her own first customer, in which case that IA needs to recruit only one other customer to receive this bonus. Ignite offers an additional $100 bonus if the IA can obtain six additional customers within sixty days, and a $100 bonus for the

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[1] The purchase of the Homesite website was not a requirement to participate as an IA, but many IAs nonetheless purchased it to provide "necessary" exposure to potential customers.

first three new IAs that an IA recruits. If an IA recruits another IA who in turn enrolls four customers in his or her first thirty days, Ignite will pay the first IA a third $100 bonus. If the IA recruits two IAs and those recruits each enroll four customers in their first thirty days, Ignite will pay two more $100 bonuses. Ignite calls this the "3&10 program" because it requires an IA to recruit three new IAs and ten new customers (or seven if the IA purchased the Homesite and enrolls his or herself as a customer).

Over time, Stream's market has become saturated, and the Plaintiffs claim that they have lost money as a result of their participation in the IA program. The Plaintiffs allege that over 86% of individuals who signed up as IAs lost money in fees, collectively losing over $87 million. In contrast, a miniscule number of individuals have made significant sums of money.

This suit was brought by former IAs Juan Ramon Torres and Eugene Robison, who allege that Stream, Ignite, and various individual defendants have violated RICO. They sought to certify a class consisting of those IAs who have lost money as a result of participating in Ignite's program. The Plaintiffs sought certification under different theories.

The first was that the Defendants' common marketing materials were replete with fraudulent misstatements about how lucrative becoming an IA could be, and that—because all class members saw at least one of these statements—the Plaintiffs could show that their injuries arise from a common set of frauds. This theory did not require the Plaintiffs to prove that Ignite is a pyramid scheme; instead, it required only proof of specific misrepresentations.

But they also sought certification under theories that would require the Plaintiffs to prove that Ignite is a pyramid scheme. If they could prove that illegal conduct—and everyone acknowledges that the liability question is common to all class members—then the Plaintiffs contended that they did not need to identify specific misrepresentations on which particular class members

relied, as individual reliance is not an element of a RICO claim. Instead, the Plaintiffs contended that RICO's causation requirement could be satisfied by classwide proof that their joining Ignite was a direct and foreseeable result of the Defendants' engaging in a pyramid scheme. Proximate cause could also be shown, they argued, through a common sense inference that they were duped into joining the pyramid scheme based on the representation that Ignite is a legitimate enterprise.

In response, the Defendants asserted primarily that the predominance requirement of Federal Rule of Civil Procedure 23(b)(3) is not met because individual issues of reliance will necessarily lead to an individualized causation inquiry under RICO. They also disagreed with the Plaintiffs' arguments that reliance is not a required element under RICO.

The district court rejected class certification on the Plaintiffs' theory that depends on specific misrepresentations, concluding that whether the Plaintiffs relied on the array of alleged misrepresentations would require an individualized inquiry. But the court found that class certification was appropriate as to the Plaintiffs' other theories that depend on common proof of a pyramid scheme. It held that first-party reliance is not an element of a RICO claim predicated on mail or wire fraud, and common proof could establish the proximate cause that is required. Although it focused primarily on the argument that a jury could logically infer that class members joined Ignite based on the implicit representation that it is a legal multi-level marketing program, it also recognized a more direct theory for proving proximate causation on a classwide basis: under the discussion of RICO causation in *Bridge v. Phoenix Bond & Indem. Co.*,[2] it is enough to show that a "foreseeable

[2] 553 U.S. 639 (2008).

and natural consequence" of the allegedly unlawful pyramid scheme is "that the vast majority of the unwitting IAs would lose money."[3]

The Defendants then filed a petition for interlocutory review with this court under Federal Rule of Civil Procedure 23(f), and a motion to stay proceedings pending resolution of that petition. The district court declined to stay the proceedings, at which time the Defendants filed a motion to stay with this court. This court granted a stay and granted the petition for review in March 2014. The panel majority agreed with the Defendants that individual issues of causation will predominate at trial and reversed the district court's class certification. We then granted the Plaintiffs' petition for rehearing en banc.

II.

The narrow issue in this case is whether the Plaintiffs may prove RICO causation through common proof such that individualized issues will not predominate at trial. The import of this inquiry is whether class certification is appropriate under Federal Rule of Civil Procedure 23(b)(3). We emphasize at the outset, and the Defendants conceded at the district court,[4] that whether Ignite's multi-level marketing program is a fraudulent pyramid scheme is a merits issue subject to common proof. The Defendants might well prove that Ignite is a legal multi-level marketing program. That question, however, is left to be resolved in the first instance at the district court.

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[3] *Torres v. SGE Mgmt. LLC*, No. 4:09-CV-2056, 2014 WL 129793, at *9 n.13 (S.D. Tex. Jan. 13, 2014) (quoting *Bridge*, 553 U.S. at 657).

[4] At the class certification hearing before the district court, defense counsel categorized the issue of whether Ignite operates a pyramid scheme as "irrelevant" to the issue of class certification.

A.

We review a district court's certification of a class for abuse of discretion, but if the court's error is a matter of law, the court necessarily abuses its discretion.[5] Our review is deferential "in recognition of the essentially factual basis of the certification inquiry and of the district court's inherent power to manage and control pending litigation."[6]

To obtain class certification, the party seeking it must initially comply with Federal Rule of Civil Procedure 23. That party must first satisfy Rule 23(a)'s requirements of numerosity, commonality, typicality, and adequacy of representation.[7] If successful, that party must next satisfy the provisions of one of Rule 23(b)'s three subsections.[8] Here, the Plaintiffs rely on subsection (3), "which requires that questions of law or fact common to the class predominate over questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy."[9] "The Rule 23(b)(3) predominance inquiry tests whether proposed classes are sufficiently cohesive to warrant adjudication by representation."[10] The Plaintiffs have the burden of showing that these requirements are met.[11]

The Defendants do not dispute the district court's Rule 23(a) determination and contend only that it erred in finding Rule 23(b)(3)'s

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[5] *Sandwich Chef of Tex., Inc. v. Reliance Nat'l Indem. Ins. Co.*, 319 F.3d 205, 218 (5th Cir. 2003).

[6] *Regents of Univ. of Cal. v. Credit Suisse First Bos. (USA), Inc.*, 482 F.3d 372, 380 (5th Cir. 2007) (internal quotation mark omitted) (quoting *Allison v. Citgo Petroleum Corp.*, 151 F.3d 402, 408 (5th Cir. 1998)).

[7] FED. R. CIV. P. 23(a).

[8] FED. R. CIV. P. 23(b).

[9] *Ahmad v. Old Republic Nat'l Title Ins.*, 690 F.3d 698, 702 (5th Cir. 2012) (citing FED. R. CIV. P. 23(b)).

[10] *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 623 (1997).

[11] *Wal-Mart Stores, Inc. v. Dukes*, 564 U.S. 338, 350–51 (2011).

predominance requirement met. "Considering whether 'questions of law or fact common to class members predominate' begins, of course, with the elements of the underlying cause of action."[12]

B.

RICO makes it unlawful to conduct or participate in an enterprise's affairs "through a pattern of racketeering."[13] To bring a RICO claim, a plaintiff must prove: "(1) the identification of a person, who, (2) through a pattern of racketeering activity, (3) uses or invests income derived therefrom to acquire an interest in or to operate an enterprise engaged in interstate commerce, or acquires, maintains an interest in, or controls such an enterprise."[14] The second element, the pattern element, requires "at least two predicate acts of racketeering activity."[15] Here, the putative class members advance two patterns of racketeering activity: (1) mail fraud in violation of 18 U.S.C. § 1341 and (2) wire fraud in violation of 18 U.S.C. § 1343.

RICO affords a private right of action only to a plaintiff who can show that he or she has been injured "by reason of" a violation of RICO's criminal prohibitions.[16] The Supreme Court requires plaintiffs to establish both but-for cause and "proximate cause in order to show injury 'by reason of' a RICO violation."[17] Proximate cause "should be evaluated in light of its common-law foundations [and] . . . requires 'some direct relation between the injury asserted

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[12] *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 804, 809 (2011); *see also Castano v. Am. Tobacco Co.*, 84 F.3d 734, 744 (5th Cir. 1996) ("[A] court must understand the claims, defenses, relevant facts, and applicable substantive law in order to make a meaningful determination of the certification issues.").

[13] 18 U.S.C. § 1962(c).

[14] *Crowe v. Henry*, 115 F.3d 294, 296 (5th Cir. 1997) (citing 18 U.S.C. § 1962(a), (b)).

[15] *Id.* at 297.

[16] 18 U.S.C. § 1964(c).

[17] *Bridge v. Phoenix Bond & Indem. Co.*, 553 U.S. 639, 654 (2008) (quoting *Holmes v. Sec. Inv'r Prot. Corp.*, 503 U.S. 258, 268 (1992)).

and the injurious conduct alleged.'"[18] "When a court evaluates a RICO claim for proximate cause, the central question it must ask is whether the alleged violation led directly to the plaintiff's injuries."[19]

The Defendants' challenge to predominance rests on their belief that this causation element will require individualized proof. But that premise, and thus much of their opposition to class certification, is at odds with recent decisions from the Supreme Court and this court emphasizing that RICO claims predicated on mail and wire fraud do not require first-party reliance to establish that the injuries were proximately caused by the fraud.[20]

As the Supreme Court put it in *Bridge v. Phoenix Bond & Indemnity Co.*: "[A] person can be injured 'by reason of' a pattern of mail fraud even if he has not relied on any misrepresentations."[21] The Court explained that "[p]roof that the plaintiff relied on the defendant's misrepresentations may in some cases be sufficient to establish proximate cause, but there is no sound reason to conclude that such proof is always necessary."[22] It further recognized that "the absence of first-party reliance may in some cases tend to show that an injury was not sufficiently direct to satisfy § 1964(c)'s proximate-cause requirement, but it is not in and of itself dispositive."[23] At bottom, "the fact that proof of reliance is often used to prove an element of the plaintiff's cause of action, such as the element of causation, does not transform reliance into an element of the cause of action."[24] Indeed, "[u]sing the mail to execute or attempt to execute a

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[18] *Hemi Grp., LLC v. City of New York*, 559 U.S. 1, 9 (2010) (quoting *Holmes*, 503 U.S. at 268).

[19] *Anza v. Ideal Steel Supply Corp.*, 547 U.S. 451, 461 (2006).

[20] *Bridge*, 553 U.S. at 654; *Allstate Ins. Co. v. Plambeck*, 802 F.3d 665, 676 (5th Cir. 2015).

[21] 553 U.S. at 649.

[22] *Id.* at 659.

[23] *Id.*

[24] *Id.* (quoting *Anza*, 547 U.S. at 478 (Thomas, J., concurring in part and dissenting in part)).

scheme to defraud is indictable as mail fraud, and hence a predicate act of racketeering under RICO, even if no one relied on any misrepresentation."[25]

We applied *Bridge* in *St. Germain v. Howard*, explaining that "no reliance requirement exists for civil causes of action under RICO for victims of mail fraud."[26] We relied on the same principle in *Allstate Ins. Co. v. Plambeck*, noting again that "[i]n cases predicated on mail or wire fraud, reliance is not necessary."[27] That case involved a group of telemarketing companies, chiropractic clinics, and law offices that convinced not-at-fault car accident victims to obtain chiropractic services so as to receive settlement payments from insurance companies. Allstate alleged that this group of defendants was liable under RICO's civil fraud statute for racketeering activity involving mail and wire fraud. After a trial, the jury returned a verdict in Allstate's favor. As to RICO causation, the district court instructed the jury that "proximate cause was present if 'the injury or damage was either a direct result or a reasonably probable consequence of the act.'"[28] The defendants appealed, challenging the jury's causation determination based on the absence of evidence that Allstate relied on the misrepresentations. We affirmed the verdict, holding that Allstate proved proximate cause because it was a foreseeable victim, and not one "wronged by the caprice of chance": "The objective of the enterprise was to collect from the insurance companies; the entire structure of the system . . . shows that Allstate's paying up was not just incidental but was the object of the collaboration."[29]

Other circuits have adopted similar definitions of proximate causation under RICO. For example, the Sixth Circuit considers whether a direct

[25] *Id.* at 648.
[26] 556 F.3d 261, 263 (5th Cir. 2009).
[27] 802 F.3d 665, 676 (5th Cir. 2015).
[28] *Id.*
[29] *Id.*

relationship between the injury and alleged conduct exists, whether the plaintiff's injury is a foreseeable consequence of the alleged conduct, and whether the casual connection between the injury and alleged conduct is logical and not speculative.[30] The Seventh Circuit looks simply to the "probability of a harm attributable to the defendant's wrongful act."[31] The First Circuit, relying on the Supreme Court's discussion in *Holmes v. Securities Investor Protection Corp.*,[32] looks to the directness between the injury and alleged conduct with reference to "three functional factors": (1) concerns about proving damages from attenuated injuries, (2) preventing multiple recoveries, and (3) whether societal interest in deterring the alleged conduct is served by the case.[33] The Fourth Circuit has also held in an unpublished decision that "*Bridge*'s holding eliminates the requirement that a plaintiff prove reliance in order to prove a violation of RICO predicated on mail fraud" in all contexts, not just third-party reliance cases.[34]

As will be shown below, this understanding of the causation requirement for fraud-based RICO claims—that such claims, unlike most common law fraud claims, do not require proof of first-party reliance—largely dooms the Defendants' attempt to identify individual issues of causation sufficient to preclude a finding of predominance.

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[30] *See Wallace v. Midwest Fin. & Mortg. Servs., Inc.*, 714 F.3d 414, 419 (6th Cir. 2013); *Brown v. Cassens Transp. Co.*, 546 F.3d 347, 357 (6th Cir. 2008) (applying *Bridge* and concluding that the plaintiffs pled proximate cause because "the defendants' fraudulent acts were a 'substantial and foreseeable cause' of the injuries").

[31] *BCS Servs., Inc. v. Heartwood 88, LLC*, 637 F.3d 750, 759 (7th Cir. 2011).

[32] 503 U.S. 258 (1992).

[33] *In re Neurontin Mktg. and Sales Practices Litig.*, 712 F.3d 21, 35–36 (1st Cir. 2013).

[34] *Biggs v. Eaglewood Mort., LLC*, 353 F. App'x 864, 867 (4th Cir. 2009).

C.

Under *Bridge*, the most straightforward way of demonstrating reliance in a classwide manner is the Plaintiffs' foreseeability argument.[35] This just requires showing that the Plaintiffs' losses were caused "by reason of" the Defendants' operation of a fraudulent scheme.

That showing could flow directly from a jury's finding that the Defendants are operating a pyramid scheme as opposed to a lawful multi-level marketing program. Pyramid schemes are "inherently fraudulent" and are *per se* mail fraud, a RICO predicate act.[36] And, by design, a pyramid scheme's fraud inheres in its concealment of the deceptive nature of the "robbing Peter to pay Paul" payment structure.[37] In fact, the Defendants' CEO characterized this payment structure in an internal document as a "pyramid" in which "[t]here are Peters here to rob for the purpose of paying Paul." **SRE.26.** The Federal Trade Commission has recognized that a pyramid scheme harms its

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[35] Although the panel found that the *Bridge* theory was forfeited (Majority Opinion at 10), we reach a different conclusion. The only "concession" the Plaintiffs made in their original briefing to the panel was simply a worst-case-scenario alternative argument: "Plaintiffs maintained below that *Bridge* marked an important change by moving the lens from reliance to proximate cause. But that proposition is irrelevant because, as defendants acknowledge . . . the district court agreed with defendants and applied a reliance theory of proximate cause in this case." The alternative nature of that argument is evident from the several pages in both the Plaintiffs' panel and en banc briefing advancing this *Bridge*-based causation theory. We thus find this issue is not forfeited.

And, as noted above, in certifying the class, the district court adopted both the *Bridge* argument and the argument that a classwide inference of reliance was permissible. It seemed to combine the two. We will address each theory on its own as either one seems sufficient.

[36] *See Webster v. Omnitrition Int'l, Inc.*, 79 F.3d 776, 781 (9th Cir. 1996); *United States v. Gold Unlimited, Inc.*, 177 F.3d 472, 484 (6th Cir. 1999) ("Unquestionably, an illegal pyramid scheme constitutes a scheme to defraud.").

[37] *See In re Koscot Interplanetary, Inc.*, 86 F.T.C. 1106, 1181–82 (1975) (recognizing that "the right to sell product in an entrepreneurial chain is also likely to prove worthless for many participants, by virtue of the very nature of the plan as opposed to any particular dishonest machinations of its perpetrators"); *see also Webster*, 79 F.3d at 781 (recognizing that "the *operation* of a pyramid scheme constitutes fraud" and stating that "[m]isrepresentations . . . follow from the inherently fraudulent nature of a pyramid scheme as a matter of law" (emphasis added)).

participants "by virtue of the very nature of the plan as opposed to any dishonest machinations of its perpetrators."[38] Likewise, the Ninth Circuit recognizes that "[o]peration of a pyramid scheme constitutes fraud for purposes of . . . various RICO predicate acts."[39]

The Federal Trade Commission instructs that a pyramid scheme is characterized by payments by participants in exchange for "(1) the right to sell a product *and* (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to the sale of the product to ultimate users."[40] The fraud lies in the concealment of the inevitable collapse that results from the scheme's structure because "[t]he promise of lucrative rewards for recruiting others tends to induce participants to focus on the recruitment side of the business at the expense of their retail marketing efforts, making it unlikely that meaningful opportunities for retail sales will occur."[41] That structure, which focuses on recruitment of people, not products, inevitably causes the scheme to collapse when participants run out of individuals to recruit and there are no more new recruits to pay those higher up the pyramid. But "[n]o clear line separates illegal pyramid schemes from legitimate multilevel marketing programs."[42] Indeed, "the very reason for [their] *per se* illegality . . . is their inherent deceptiveness and the fact that the futility of the plan is not apparent to the consumer participant."[43]

Because pyramid schemes are *per se* mail fraud, which include inherent concealment about the deceptive payment scheme, one who participates in a

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[38] *In re Koscot*, 86 F.T.C. at 1182.

[39] *Webster*, 79 F.3d at 781.

[40] *In re Koscot*, 86 F.T.C. at 1180.

[41] *Webster*, 79 F.3d at 782; *see also id.* at 784 ("By the very structure of a pyramid scheme, participants' efforts are focused not on selling products but on recruiting others to join the scheme.").

[42] *Gold Unlimited*, 177 F.3d at 475.

[43] *Webster*, 79 F.3d at 788 (citation and quotation marks omitted).

pyramid scheme can be harmed "by reason of" the fraud regardless of whether he or she relied on a misrepresentation about the scheme. "An inherently fraudulent pyramid scheme . . . would fall within the[ ] broad definitions of fraud" under RICO even if no misrepresentations occur.[44] Participants are then harmed by the fraud involved in pyramid schemes not because of any misrepresentations, but because the ultimate collapse of the scheme, and thus harm to participants, is a direct and foreseeable consequence of such structure.

Here, the Plaintiffs allege that the Defendants operated a fraudulent pyramid scheme, which has caused them financial losses. There can be no question that the Plaintiffs are both the direct and foreseeable victims of the alleged fraud. By definition, a pyramid scheme operates by taking money from downline recruits, like the Plaintiffs, who will never recoup their payments, and funneling the money to those at the top of the pyramid. Such schemes depend on "there [being] Peters . . . to rob for the purpose of paying Paul." Those who lose money in a pyramid scheme necessarily do so "by reason of" the fraud because the fraud is necessary to temporarily sustain the scheme, and ultimately causes the scheme's collapse. And, those who profit from a fraudulent pyramid scheme make money *only* by virtue of the participation of downline investors, like the Plaintiffs, who lose money.

The Plaintiffs are necessary to the scheme and are the direct victims of the scheme. Equally clear is that the Plaintiffs are the foreseeable victims of the alleged fraud: "Pyramid schemes are destined to collapse, and the most recent entrants to lose their money."[45]

Whether the Plaintiffs relied on a misrepresentation about the scheme is thus not determinative of whether the Plaintiffs can prove proximate

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[44] *Id.* at 788, 789, & n.7.
[45] *Id.* at 785.

causation under *Bridge*. As was true in that case, the class members here can prove injury "'by reason of' a pattern of mail fraud even if [they have] not relied on any misrepresentations."[46] The participants' injuries arise from the scheme's payment structure, and the inherent concealment of the inevitableness of those injuries.

Further, although a class member's knowledge that Ignite is an illegal pyramid scheme could serve as an intervening cause that would break the chain of causation,[47] the Defendants, as will be discussed more below, have offered no evidence that any putative class member knew Ignite was an illegal pyramid scheme before joining as an IA. The district court expressly found that the record contained no such evidence, and we find no error in that determination.

Moreover, the directness of the Plaintiffs' alleged injuries obviates any concerns that might exist in cases with attenuated injuries. As in *Bridge*, "there are no independent factors that account for [the Plaintiffs'] injury, there is no risk of duplicative recoveries by plaintiffs removed at different levels of injury from the violation, and no more immediate victim is better situated to sue."[48]

The Plaintiffs' claims under this foreseeability theory of proving causation will rise or fall on common evidence. The facts necessary to prove that the Defendants operated a fraudulent pyramid scheme will also suffice to

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[46] *Bridge*, 553 U.S. at 649; *see also Kerrigan v. ViSalus, Inc.*, 112 F.Supp.3d 580, 607 (E.D. Mich. 2015) (noting that the plaintiff's "mail and wire fraud allegations do not rest upon misrepresentations" but only on the operation of the pyramid scheme, which "as a matter of law, constitutes a scheme to defraud in violation of the mail and wire fraud statutes").

[47] *Bridge*, 553 U.S. at 659 ("[I]f the county knew petitioners' attestations were false but nonetheless permitted them to participate in the auction, then arguably the county's actions would constitute an intervening cause breaking the chain of causation between petitioner's misrepresentations and respondents' injury.").

[48] *Id.* at 658.

show under *Bridge* that the fraud caused the Plaintiffs' injuries. Accordingly, under this theory of causation, individualized issues of causation will not predominate.

D.

We will also address the inference-based theory of causation that was the focus of the panel opinions. We find that this is a separate basis on which to affirm the certification ruling.

Under this theory, the Plaintiffs argue that Ignite's holding itself out as a legitimate multi-level marketing program, when in fact it was a fraudulent pyramid scheme, gives rise to a reasonable inference that that misrepresentation induced their paying to join as IAs and caused their losses. This, the Plaintiffs assert, is because (1) it may be rationally assumed that a precondition for joining Ignite was that it was a legal business opportunity, and (2) the Defendants have offered no evidence of any putative class member who joined or would have joined knowing Ignite was a fraudulent pyramid scheme, in which the majority of participants are bound to lose money.

We note initially that the Defendants do not challenge whether Ignite represented itself to be a legal multi-level marketing program or whether this question is common to the class. They do not do so for good reason: by operating its program, Ignite has and continues to hold itself out as a legal multi-level marketing program. The Federal Trade Commission's persuasive precedent recognizes that pyramid schemes make "the inevitably deceptive representation (*conveyed by their mere existence*) that any individual can recoup his or her investment by means of inducing others to invest."[49] Pyramid schemes are inherently deceptive because their very structure conceals the fact that those at the bottom of the pyramid will be unable to recoup their

[49] *In re Koscot Interplanetary, Inc.*, 86 F.T.C. 1106, 1181 (1975) (emphasis added).

investment. Accordingly, we conclude that the misrepresentation at issue here—that Ignite is a legal multi-level marketing program—is subject to common proof and is not even disputed.

We turn next to the question whether the Plaintiffs may employ a common inference of reliance based on that alleged misrepresentation. The Defendants concede that a common inference of reliance is appropriate in some cases. They urge us to adopt a rule requiring that, to invoke an inference of reliance in a fraud case, the Plaintiffs must establish that no rational actor would have participated had they known of the misrepresentation. Other circuits, however, have not applied such a narrow rule. Instead, they have permitted inferences of reliance when it follows logically from the nature of the scheme, and there is common, circumstantial evidence that class members relied on the fraud.

In *Klay v. Humana, Inc.*,[50] the Eleventh Circuit upheld the certification of a class of physicians claiming that health maintenance organizations (HMOs) misrepresented that they would pay them for medically necessary services, but instead underpaid them.[51] The Eleventh Circuit affirmed the class certification based on a common inference of reliance on those misrepresentations, explaining that "[a] jury could quite *reasonably infer* that guarantees concerning physician pay—the very consideration upon which those agreements are based—go to the heart of these agreements, and that doctors based their assent upon them."[52] Similarly, in *In re U.S. Foodservice Inc. Pricing Litigation*,[53] the Second Circuit held that customers who were allegedly overbilled by a food distributor's inflated invoices scheme could be

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[50] 382 F.3d 1241 (11th Cir. 2004).
[51] *Id.* at 1259–61.
[52] *Id.* (emphasis added).
[53] 729 F.3d 108 (2d Cir. 2013).

certified as a class.[54] It reasoned that "customers who pay the amount specified in an inflated invoice would not have done so absent reliance upon the invoice's implicit representation that the invoiced amount was honestly owed."[55] Conspicuously absent from both the Eleventh and Second Circuits' decisions was any requirement that the plaintiffs prove that *no* other rational explanation existed for their behavior other than reliance.[56]

Given the unfavorable holdings of the courts' decisions in *Klay* and *U.S. Foodservice*, it is unsurprising that the Defendants relegated these opinions to a footnote in their en banc briefing. Instead, they urge this court to rely on the Tenth Circuit's recent opinion in *CGC Holding Co. v. Broad & Cassel*.[57] That court approved a common inference of reliance to certify a class when a class of borrowers alleged that a group of lenders fraudulently extracted nonrefundable loan commitment fees from the borrowers for loans that the lenders never intended to provide.[58] It explained that:

> The plaintiffs' theory of the case rests on a straightforward premise—that no rational economic actor would enter into a loan commitment agreement with a party they knew could not or would not funds the loans. Accordingly, plaintiffs' payment of up-front fees allows for a reasonable inference that the class members

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[54] *Id.* at 122.

[55] *Id.* at 120 (quoting *Klay*, 382 F.3d at 1259).

[56] *See Klay*, 382 F.3d at 1259 (requiring only a "reasonabl[e] infer[ence]"); *U.S. Foodservice*, 729 F.3d at 120–22 (requiring only a common inference of reliance and rejecting mere conjecture about whether class members would have overpaid anyway even if they knew of fraud). In contrast, the narrower standard proposed by Ignite could not be applied to the facts of *Klay* or *U.S. Foodservice* given that we can easily imagine reasons why the physicians in *Klay* would have assented to the underpayments with full knowledge of the misrepresentation (for example, the need to maintain access to the HMOs' patients), or why the customers in *U.S. Foodservice* might have paid the overstated bills (for example, a desire to maintain their business relationships).

[57] 773 F.3d 1076 (10th Cir. 2014)

[58] *Id.* at 1080.

> relied on lenders' promises [to fund their loans], which later turned out to be misrepresentations . . . .[59]

Although the Tenth Circuit approved the theory of inferred reliance after concluding that no rational actor would join the scheme had he or she known of the fraud, we do not read its opinion as limiting an inference of reliance to that situation. That court's opinion says only that the absence of another rational explanation for the plaintiffs' behavior is *sufficient* to infer reliance—it does not say it is a *necessary* condition. And tellingly, the Tenth Circuit cited the district court's opinion in this case approvingly.[60]

Turning to the facts of this case, we conclude that if the Plaintiffs prove that Ignite is a fraudulent pyramid scheme, they may use a common inference of reliance to prove proximate causation under RICO. A jury may reasonably infer that, in deciding to pay to become IAs, the Plaintiffs relied on Ignite's implicit representation that it is a legal multi-level marketing program, when it is in fact a fraudulent pyramid scheme. Two points support this conclusion.

First, it is reasonable to infer that individuals do not knowingly join pyramid schemes because (1) pyramid schemes are inherently deceptive and operate only by concealing their fraudulent nature; and (2) knowingly joining a pyramid scheme requires the individual to choose to become either a victim or a fraudster. Both points support a reasonable inference that the class members would not have knowingly joined a fraudulent pyramid scheme.

Whether a multi-level marketing program is fraudulent or legitimate depends on its internal structure. And such information is not readily apparent or interpreted. "[T]he very reason for the *per se* illegality of [such] schemes is

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[59] *Id.* at 1081, 1091–92 ("More specifically the fact that a class member paid the nonrefundable up-front fee in exchange for the loan commitment constitutes circumstantial proof of reliance on the misrepresentations and omissions regarding Hutchens's past and the defendant entities' ability or intent to actually fund the promised loan.").

[60] *Id.* at 1091 n.8.

their inherent deceptiveness and the fact that the 'futility' of the plan is not 'apparent to the consumer participant.'"[61] If a scheme's illegality were apparent, the scheme would not work. After all, the whole point of a pyramid scheme is to dupe *unwitting* investors into joining. The sheer improbability that more than a handful of class members (and even a handful seems unlikely) would be able to recognize that Ignite was a fraudulent pyramid scheme before joining as IAs supports the reasonableness of the Plaintiffs' inference of reliance.[62]

Second, the record is devoid of evidence that a single putative class member joined as an IA despite having knowledge of the fraud. Even after the close of discovery and the commencement of summary judgment motions before the district court, the Defendants produced *no* evidence that a single class member even knew of the fraud or would have paid to become an IA knowing of the fraud. Faced with this vacuum of evidence, the district court correctly concluded that individual issues of reliance will not predominate at trial.

The Defendants protest, however, that our pointing to the absence of evidence supporting their defense somehow improperly shifts the burden of proof to them. Not so. The Defendants, while advocating a narrower rule, have now conceded in their en banc brief that the *absence of contrary evidence* would support class certification based on an inference of reliance: "To be sure, in cases where a plaintiff has demonstrated that nobody would want the

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[61] *Webster v. Omnitrition Int'l, Inc.*, 79 F.3d 776, 788 (9th Cir. 1996) (quoting *People v. Bestline Prods., Inc.*, 132 Cal. Rptr. 767, 788 (1976)).

[62] Notably, the representation that Ignite was a legal multi-level marketing scheme, which was a precondition to class members' participation in this financial transaction, is distinguishable from the misrepresentations involving consumer purchases in which courts have rejected an inference of reliance. *See, e.g.*, *McLaughlin v. Am. Tobacco Co.*, 522 F.3d 215, 225 & n.7 (2d Cir. 2008) (rejecting an inference of reliance in a case involving the consumer purchase of light cigarettes because individuals purchase light cigarettes for a number of reasons, but recognizing that "a financial transaction does not usually implicate the same type or degree of personal idiosyncratic choice as does a consumer purchase").

opportunity the defendant is offering, then class certification could be appropriate—absent contrary evidence.” The district court was tasked with determining how a trial would proceed. That court did not simply presume that individual issues of reliance would not predominate; rather, it specifically made this conclusion based on its determination that the Plaintiffs' case could be made with common evidence. And, in the absence of any evidence showing that individuals joined the pyramid scheme knowingly—the district court correctly ruled that individual issues of reliance will not predominate.[63]

Neither now nor before the district court have the Defendants even attempted to bear this burden of rebutting the Plaintiffs' evidence of reliance.[64] On appeal, they do not even contest the district court's factual finding, which we review only deferentially for an abuse of discretion. Had the Defendants presented evidence that could rebut the Plaintiffs' common inference of reliance on an individualized basis, we and the district court might have concluded that individual issues of reliance would predominate at trial. In the total absence of such evidence, however, we have no evidentiary basis to conclude that the district court abused its discretion in holding otherwise.

Rather than pointing to evidence, the Defendants rely on speculation alone that a hypothetical class member *could* have joined as an IA despite knowing of the fraud. But such sheer speculation as to the improbable motivations of an undefined, but likely minute number of class members does

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[63] *See Webster*, 79 F.3d at 788 (“As to justifiable reliance, the defendants have not carried their burden on summary judgment of showing a lack of evidence to prove this element. To the contrary, defendants argue strenuously that their scheme was not fraudulent, and that plaintiffs were justified in relying upon the statements made in the promotional materials.”).

[64] Notably, the Plaintiffs are not required to prove the negative fact that they did not have knowledge of the fraud: “The plaintiff doesn't have to prove a series of negatives; he doesn't have to ‘offer evidence which positively exclude[s] every other possible cause . . . .’” *BCS Servs.*, 637 F.3d at 757 (quoting *Carlson v. Chisholm-Moore Hoist Corp.*, 281 F.2d 766, 770 (2d Cir. 1960) (Friendly, J.)).

not cause individual issues of reliance to predominate. Our inquiry looks to how the trial will proceed;[65] trials are grounded in evidence, not extra-record attorney speculation. As our sister circuit recognized, "if bald speculation that some class members might have knowledge of a misrepresentation were enough to forestall certification, then no fraud allegations of this sort (no matter how uniform the misrepresentation, purposeful the concealment, or evident plaintiffs' common reliance) could proceed on a class basis."[66] And mere conjecture that some class members may have acted with knowledge of the misrepresentation seems particularly inappropriate here as anyone who joins a pyramid scheme hoping to become one of the few winners sitting at the top of the pyramid would become liable as a knowing participant.

For these reasons, our result in the instant case is not inconsistent with *Sandwich Chef of Texas, Inc. v. Reliance National Indemnity Insurance.*[67] There, insureds alleged that insurers charged premiums in excess of approved rates, then misrepresented the correctness of the premiums charged.[68] We rejected class certification because the insureds could not prove proximate causation through common proof. Unlike the Defendants in the instant case, the insurers in *Sandwich Chef* not only contended that the insureds "were aware that [the insurance] carriers were charging them more than the filed rates," but also "*introduced evidence* that . . . class members individually negotiated with insurers regarding workers' compensation and insurance

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[65] *See Sandwich Chef*, 319 F.3d at 220 ("Certification of a class under Rule 23(b)(3) requires that the district court consider how the plaintiffs' claims would be tried.").

[66] *U.S. Foodservice*, 729 F.3d at 122; *see also Pub. Emps.' Ret. Sys. of Miss. v. Merrill Lynch & Co.*, 277 F.R.D. 97, 119 (S.D.N.Y. 2011) ("Sheer conjecture that class members 'must have' discovered [the misrepresentations] is insufficient to defeat Plaintiff's showing of predominance when there is no admissible evidence to support Defendant's assertions.").

[67] 319 F.3d 205 (5th Cir. 2003). We also note that to the extent it believed RICO requires proof of individualized reliance, *Sandwich Chef* is overruled by *Bridge*.

[68] *Id.* at 224.

premiums."[69] Thus, "[k]nowledge that invoices charged unlawful rates, . . . according to a prior agreement between the insurer and the policyholder, would eliminate reliance and break the chain of causation."[70] Here, the Defendants have put forth no such evidence.[71]

None of this is to say that if the Plaintiffs prove that Ignite is a fraudulent pyramid scheme, they must necessarily prevail at trial if this inference-theory is advanced. The inference of reliance to which the Plaintiffs are contingently entitled is simply the common mechanism by which they seek to prove their affirmative case. The jury may or may not make this inference in the Plaintiffs' favor: "[T]he trier of fact is not required to accept the inference; it is merely permitted to utilize it as common evidence to establish the class's *prima facie* claims under RICO."[72] And the district court may revisit its decision and choose to decertify the class should the Defendants eventually produce individualized rebuttal evidence causing their individualized defense to predominate.

But the focus must remain on the predominance inquiry. We thus recognize that even if conjecture alone is sufficient to establish that a few class members might have knowingly joined a fraudulent pyramid scheme, this will not necessarily cause individualized issues of reliance to predominate at trial. In the context of the fraud-on-the-market theory, the Supreme Court's recent

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[69] *Id.* at 220 (emphasis added); *see id.* at 216 ("In concluding that individual issues predominate in this case, we have relied on evidence that defendants maintain shows that Wall Street and other potential class members, directly or through others, negotiated premiums that varied from filed rates, and that they were aware that carriers were charging them more than the filed rate.").

[70] *Id.* at 220.

[71] *See U.S. Foodservice*, 729 F.3d at 120 (distinguishing our precedent in *Sandwich Chef* because there, the record contained "*no such individualized proof* indicating knowledge or awareness of the fraud by any plaintiffs").

[72] *CGC Holding Co.*, 773 F.3d at 1093.

pronouncement in *Halliburton Co. v. Erica P. John Fund, Inc.* is highly instructive:

> While this [argument that an individual plaintiff aware of the fraud would have still bought the stock] has the effect of "leav[ing] individualized questions of reliance in the case," there is no reason to think that these questions will overwhelm common ones and render class certification inappropriate under Rule 23(b)(3). That the defendant might attempt to pick off the occasional class member here or there through individualized rebuttal does not cause individual questions to predominate.[73]

This reasoning applies with equal weight here.[74] Evidence indicating that a few class members decided to take the risk of being a winner in an illegal pyramid scheme does not automatically rebut the inference of reliance for the overwhelming remainder of class members or mean that individual issues concerning the atypical knowing fraudsters will predominate at trial. This is underscored by the fact that the instant class is comprised of only those who *lost money* participating in Ignite's program.

In sum, we conclude that if the Plaintiffs prove that the Defendants operated a fraudulent pyramid scheme, a jury may reasonably infer from the Plaintiffs' payments to join as IAs that they relied on Ignite's implicit representation of legitimacy, when in fact it was a fraudulent pyramid scheme. Although it is not impossible that some class members might have joined as

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[73] 134 S. Ct. 2398, 2412 (2014) (second alteration in original) (internal citation omitted).

[74] This principle that a small number of anomalous class members should not defeat predominance is not unique to securities fraud cases. The Supreme Court made a similar pronouncement last term in an opinion addressing an overtime time class action. *See Tyson Foods, Inc. v. Bouaphakeo*, 136 S. Ct. 1036, 1045 (2016) ("When 'one or more of the central issues in the action are common to the class and can be said to predominate, the action may be considered proper under Rule 23(b)(3) even though other important matters will have to be tried separately, such as damages or *some affirmative defenses peculiar to some individual class members*.'" (quoting 7AA Wright & Miller § 1778)).

IAs despite knowledge of the fraud, economic speculation alone as to what could have motivated an individual class member is not enough to defeat class certification. Based on the deception inherent in pyramid schemes and the losing proposition that they present to the vast majority of participants, it is highly unlikely that many—if any—of such class members exist. And more importantly, the district court expressly found no evidence indicating that *any* putative class member knew of the fraud. Because the Defendants failed to demonstrate that such individualized issues will affect even a single class member at trial, we find no error in the district court's conclusion that individualized issues of causation will not predominate. Accordingly, we affirm the district court's class certification.

III.

The class certification of the district court is AFFIRMED.

E. GRADY JOLLY, Circuit Judge, joined by Edith H. Jones and Edith Brown Clement, Circuit Judges, and joined, as to Parts IB and II, by Priscilla R. Owen, Circuit Judge, dissenting:

The majority concludes that the plaintiffs do not need to make any showing of reliance to establish proximate cause under RICO. Citing the Supreme Court's decision in *Bridge v. Phoenix Bond & Indemnity Co.*, 553 U.S. 639 (2008), and this circuit's recent decision in *Allstate Insurance Co. v. Plambeck*, 802 F.3d 665 (5th Cir. 2015), the majority opinion holds that the plaintiffs have satisfied Rule 23's predominance requirement for RICO proximate cause simply because the plaintiffs have made a sufficient showing that Ignite is an illegal pyramid scheme, and that they lost money by investing. The majority thus asserts that the plaintiffs do not need to show that the defendants made any false representation upon which the plaintiffs relied to make their losing investment.

I.

A.

First, the majority errs in its cavalier disregard of evidence of individualized knowledge among the class members. The majority concludes that the plaintiffs have met Rule 23's predominance inquiry with respect to causation under RICO simply because there is evidence suggesting Ignite was a pyramid scheme. In reaching this holding, the majority opinion ignores that, from the outset of their involvement with Ignite, the plaintiffs were provided all the information needed to warn investors of Ignite's likely illegality.

Again, there is no quarrel here with the majority opinion's simple assertion that reliance is not a prerequisite for proving proximate cause under

RICO.[1] The facts of this case, however, do not allow for such a glossy approach to class certification. The majority's reasoning has force only to the extent that the plaintiff-investors were actually unaware of Ignite's fraudulent structuring. *See Bridge*, 553 U.S. at 658–59 (stating that, although first-party reliance is not a formal element of a RICO claim, proximate cause fails where there is evidence that the aggrieved party or an intermediary knew of the fraud, because such knowledge acts as an "intervening cause breaking the chain of causation between petitioners' misrepresentations and respondents' injury"); *see also Sandwich Chef of Tex., Inc. v. Reliance Nat'l Indem. Ins. Co.*, 319 F.3d 205, 218–19 (5th Cir. 2003) (recognizing that knowledge, which is actually a defense to causation, is a relevant consideration when addressing class certification). Moreover, as both parties concede, for the purposes of proximate cause, it does not matter whether Ignite actually is a pyramid scheme. Instead, the relevant inquiry is whether there are class members who understood Ignite was likely to be a pyramid scheme, but invested anyway. If

[1] However, the plaintiffs' brief accompanying their motion for class certification concedes, on numerous occasions, that some degree of reliance is still necessary to sustain a RICO claim, even following *Bridge*. *See, e.g.*, Doc. 134, at 9 n.13 ("The Supreme Court cautioned [in *Bridge*] that 'someone' must have relied on the misrepresentations for the [plaintiffs] to prove the 'by reason of' RICO language. . . . Third-person reliance of any kind is sufficient to meet the *Bridge* standard."); *see also id.* at 12–13 ("Proximate cause here is very simple and requires no individualized proof: it is akin to a fraud-on-the market scheme in which common sense provides the natural and straightforward inference that the enticement to invest was acted on by the purchasers of the worthless product."); *id.* at 13 ("Here, 274,000 people acted on the representations made by the Defendants on the SGE website and in countless 'business representations' that the 'business opportunity' presented a lucrative financial opportunity. Proof of reliance is contained in the proximate cause."). These comments are telling of the inconsistent, shifting character of the plaintiffs' causation arguments. Throughout this litigation, the plaintiffs have leaned primarily, if not exclusively, on their theory of "inferred reliance." Their briefing included only passing, vague statements suggesting the opposite. Now, after downplaying the "no reliance needed" theory of proximate cause before the district court and the three-judge panel, the plaintiffs revive it as their principal argument in these en banc proceedings. In doing so, the plaintiffs move the goal posts on both the defendants and this court.

so, the line of causation becomes too tenuous to maintain through common evidence solely based on the contention of Ignite's alleged illegality.

The majority opinion takes for granted that no individualized issues of knowledge exist among the plaintiff class, asserting that "the record is devoid of evidence that a single putative class member joined [Ignite] despite having knowledge of the fraud." It adopts this position notwithstanding that the plaintiffs, by their own admission, were provided the information that Ignite was likely an illegal pyramid scheme. The record shows that the tell-tale signs of an illegal pyramid scheme were disclosed to the plaintiffs in the documents they were provided before signing up for Ignite. Ignite's business plan, published to potential investors, openly preached recruiting additional IAs over selling Ignite's purported product, residential energy.[2] Similarly, Ignite's published compensation scheme, which the plaintiffs do not dispute is accurate and was provided to all investors, also bears all the hallmarks of an illegal pyramid scheme. For example, Ignite paid only fifty cents in commission to new IAs per each energy customer they enrolled. In contrast, those IAs that were higher up in the pyramid structure received the bulk of profit resulting from the sale of residential energy. This mark, of course, is a defining trait of a pyramid scheme, but it is also a trait that the plaintiffs themselves assert was made obvious to Ignite's investors from the outset.

In their en banc briefing, the plaintiffs themselves repeatedly urge that *anyone* could see that the only realistic way to make money as an Ignite IA was to recruit new IAs to work underneath you, and to teach those new IAs to do

[2] The Ignite business plan states "[f]ortunately, [Ignite] is not about becoming an energy expert or salesperson. You need only a few customers to be successful." Similarly, an Ignite PowerPoint slide, reproduced in the instructional materials handed out to new IAs, instructs IAs to enroll only "a few customers," and to then teach downline IAs to "do the same."

the same. The plaintiffs emphasize that common sense compels the conclusion that Ignite's business model was illegal from the outset, since the unsustainability of such a scheme is apparent on its face; eventually, there are no more new IAs to recruit. According to the plaintiffs, "[a]ny 'energy company' sales program that is 'not about becoming an energy salesperson' necessarily collapses; if everyone tries to succeed by 'duplicating' a huge class is inevitably left with a loss when the recruits run out." Appellees' Supplemental En Banc Brief at 7. Taking the plaintiffs at their own emphatic word, it follows that the class members who took minimal time to read the investment materials would have developed serious concerns about Ignite's risk and illegality. Still, they invested. The plaintiffs, however, contend, in contradictory fashion, that these overt "buyer beware" warnings were insufficient to put even a single plaintiff on notice that Ignite was actually an illegally structured venture. At the very least, these warnings were sufficient to cause the prudent investor to question Ignite's business structure before blindly investing.

It is true that our caselaw, of course, does not require an investor to comb through the finest details of a defendant's business plan to preserve a later claim for fraud. But it does, however, require that a plaintiff-investor do some minimum amount of research into the nature of an investment opportunity before signing up, losing money, and crying fraud. *See Martinez Tapia v. Chase Manhattan Bank, N.A.*, 149 F.3d 404, 409 (5th Cir. 1998) ("The investor who seeks to blame his investment loss on fraud or misrepresentation must himself exercise due diligence to learn the nature of his investment and associated risks. . . . [T]he party claiming fraud and/or misrepresentation must exercise due diligence to discover the alleged fraud and cannot close his eyes and simply wait for facts supporting such a claim to come to his attention.").

In addition to the investment documents, a cursory Google search would have led the plaintiffs to a *Dallas Morning News* article, published during the time frame relevant to class certification, in which an economic expert expressly stated that Ignite was an illegal pyramid scheme, destined to result in a loss of money for most of its investors. Indeed, the plaintiffs themselves refer to this article in their complaint, but still contend that there is no sound basis to conclude that at least part of the class members were aware that Ignite was thought to be an illegal venture, but chose to "take their chances" and sign up anyway.

Standing on its own, the evidence above is enough to undermine the notion that all 200,000-plus members of the putative class were unaware that Ignite had all the indicia of an illegal pyramid scheme. But this is not the extent of the evidence suggesting knowledge of the defendants' fraud, which the plaintiffs now allege was a surprise. In fact, there is significant evidence that Ignite's own promoters, when talking to potential investors, were explicit about the company's dubious structuring. The defendants routinely held large, revival-style recruitment events, where Ignite executives and promoters explained Ignite's business model. Although each recruiter's style differed, there was a common theme in their presentations: Ignite offered potential IAs a great opportunity to make money, albeit through recruiting other IAs instead of through actual sales. Indeed, one promoter, Randy "the Cowboy" Hedge, told a crowd of potential investors that, to scare off the faint of heart, he would sometimes refer to Ignite as a "pyramid" deal. Hedge suggested that he did this because he knew that those people who remained interested in joining Ignite, even after hearing the alarm-sounding descriptive "pyramid" applied to

its business model, were chiefly concerned about making money, and not about the details of Ignite's structuring.[3]

The majority opinion dismisses this evidence of individualized knowledge by deeming it too speculative. Citing a four-decade-old order from the Federal Trade Commission, published when pyramid schemes were still a relatively new form of potential fraud, the majority urges that pyramid schemes are "inherently deceptive," to the extent that unsophisticated consumer-investors could not possibly discern whether Ignite's business model was illegal before joining up. What is implied by this statement is that a multi-level marketing scheme that, at first glance, bears the indicia of legality may, upon deeper investigation, reveal subtleties of its structuring that actually make it an illegal pyramid scheme. Such subtleties, however, are entirely absent from this case. Indeed, as discussed above, all the evidence necessary to conclude Ignite was a pyramid scheme was provided to the class members and they still chose to invest; moreover, at least a number of the plaintiffs were exposed to recruitment pitches that emphasized Ignite's pyramid character. This evidence, even if thought not to be conclusive on whether most plaintiffs knew of the likelihood that Ignite was an illegal pyramid scheme, is far more

[3] *See* Audio Recording 207.16. This "pyramid deal" reference was not as a stray remark. *See id.* (Hedge, when referring to allegations that Ignite is a pyramid scheme: "Hey look, have any of y'all heard that? Has anyone ever . . . Let's get something straight—I don't care if you call it an octagon, parallelogram, rectangle—they're sending me a check."); Audio File 207.3 ("Let's be honest, I don't know what you do, but I guarantee you there's somebody above you who does less and makes more, yes? You're in a pyramid [in tone of a doubter]. Hey, if you're married, if you're married you're in a pyramid, and she's on the top. You can call it a hexagon, octagon, rectangle, circle, oblong, I don't care! Pay me!"). Other promoters, although perhaps not as brazenly as Hedge, regularly emphasized in their speeches that the only way to make money as an Ignite IA was to minimize selling energy in favor of recruiting down-line IAs. *See* Recording of Ignite Executive Greg McCord, Audio File 627571 ("How do you make money [as an IA]? Well, if you keep concentrating on customers, you won't make money. It's the end of story.").

than "speculative." At the very least, the defendants are entitled to probe these plaintiffs' understanding of the Ignite investor documents and accompanying sales pitches, in an effort to challenge the plaintiffs' supposed naiveté of Ignite's unsustainability. Accordingly, these lingering problems of individualized knowledge among many of the class preclude a finding that, consistent with the meaning and requirements of Rule 23, common issues predominate with respect to proximate cause under RICO. *See Sandwich Chef*, 319 F.3d at 220.

B.

Next, given that the evidence discussed above raises concerns of individualized knowledge, the majority errs in placing the burden regarding the appropriateness of class certification with the defendants, instead of the plaintiffs. The majority opinion asserts that, even assuming there is record evidence showing an indeterminate number of plaintiffs knew of Ignite's illegality, the record evidence fails to show that individualized issues of knowledge will actually undermine those issues common to the class. The majority opinion points out that knowledge is an affirmative defense, which the defendants must raise and prove at trial. According to the majority, the fact that a "few" plaintiffs might be "picked off" because of issues of individualized knowledge does not defeat class certification, so long as issues common to the class continue to predominate over the "outliers."

There is no questioning that, as a general proposition, a class may be certified even when a few stray issues of individualized knowledge remain among the class's members. It is certainly correct that Rule 23 requires a predominance of common issues, not a uniformity of them. More relevant here, however, is that Rule 23 also requires that the *plaintiffs*, not the defendants, carry the burden of establishing whether class certification is appropriate

under Rule 23; the plaintiffs must do so by showing that individualized inquires will not cast a shadow over those issues common to the entire class. *See Wal-Mart Stores v. Dukes*, 131 S. Ct. 2541, 2551 (2011). This burden includes showing that a defendant's proffered affirmative defense, if based on individualized issues of knowledge, applies only to an insignificant segment of the putative class. *See Gene & Gene LLC v. BioPay LLC*, 541 F.3d 318, 329 (5th Cir. 2008). ("An affirmative defense is not per se irrelevant to the predominance inquiry, as the parties seem to believe. We have noted that the predominance of individual issues necessary to decide an affirmative defense may preclude class certification." (internal citation and quotation marks omitted)); *Sandwich Chef*, 319 F.3d at 220 (stating that Rule 23 requires that the district court's predominance inquiry account for any individual issues of knowledge that will be "components of defendants' defense against RICO fraud.").

The plaintiffs, however, disregard this burden under Rule 23. Importantly, the plaintiffs *do not even attempt* to show that the defendants' proffered defense of individualized knowledge applies only to an insignificant number of plaintiffs. Instead, they argue that a lack of knowledge may be presumed, because no "rational" individual would ever participate in an illegal pyramid scheme. Again, this theory—which, at different points in this case's history, the plaintiffs have referred to as the "fraud-on-the-market" theory, the "rational economic actor" theory, and the "inferred reliance" theory—is the only basis upon which the district court granted class certification.[4] It follows that,

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[4] *See* Dist. Ct. Doc. 169 at 15 ("To the extent the plaintiffs seek 23(b)(3) certification based on a fraud-on-the-market theory and the common sense inference that independent associates ["IAs"] were duped into joining a pyramid scheme, the Court finds that the class can be certified."); *see also id.* at 15 n.13 ("[A]ll the class members are presumed to be relying

if such a theory were accepted in error, individualized issues of knowledge overwhelm those issues common to the class, rendering this class action unfit for certification. The plaintiffs, however, did not even confront the evidence suggesting individualized knowledge; instead, as stated, they chose to seek an inference of reliance—and hence, an inference that all of the plaintiffs lacked knowledge of Ignite's illegality—based solely on an "implicit" misrepresentation, made by virtue of Ignite's mere existence.

As discussed below, the plaintiffs' theory of "inferred reliance" is both logically strained and is belied by the absence of any actual misrepresentation on behalf of the defendants. Ultimately, however, it does not matter whether reliance is required to establish RICO proximate cause; even if no showing of reliance is necessary, superseding issues of individualized knowledge cloud the waters of RICO causation. Accordingly, the plaintiffs have failed to meet their burden, under Rule 23(b)(3), of showing that common issues predominate with respect to RICO's proximate cause element.

II.

Let us now turn to the majority's alternative holding regarding the appropriateness of an inference of reliance in this case. The majority opinion asserts that, assuming reliance on a misrepresentation must be shown to establish RICO causation, the plaintiffs have done so through common evidence. The plaintiffs, however, do not point to any common, specific misrepresentation upon which they relied, much less offer evidence demonstrating reliance. Instead, they seek an "inference" of reliance on an "implicit" misrepresentation. The plaintiffs contend that, simply by seeking to

on the same misrepresentation—that the Ignite business opportunity was a legal, non-fraudulent venture.").

recruit new customers and investors, Ignite falsely held itself out as a legitimate business opportunity. They further assert that, because the legality of Ignite's business structure would have been a bedrock assumption of any reasonable investor, the court may infer that the plaintiffs relied on this implicit misrepresentation when choosing to join Ignite.[5] In arguing that an inference is appropriate here, the plaintiffs point to a handful of circuit-level cases that have allowed a class-wide inference of reliance under certain circumstances: *CGC Holding Company, LLC v. Broad & Cassel*, 773 F.3d 1076 (10th Cir. 2014), *In re U.S. Foodservice Inc. Pricing Litigation*, 729 F.3d 108 (2d Cir. 2013), and *Klay v. Humana, Inc.*, 382 F.3d 1241 (11th Cir. 2004).

These cases are distinguishable. Both *Foodservice* and *Klay* allowed a jury to "infer" reliance when the false representations at issue were straightforward misstatements of an amount owed or paid on a bill or invoice. Those courts concluded that a jury could infer reliance because an individual's payment of a bill or acceptance of a payment was, in effect, an acknowledgment of reliance on the correctness of the amount in the bill or payment. This reliance makes sense, as no rational economic actor would knowingly pay extra for nothing. *CGC Holding* also involved a scenario where the plaintiffs were purchasing a worthless product; they were applying for loans and paying a non-refundable fee to the defendants, even though the defendants had already decided that they would eventually deny the plaintiffs' loan applications. Indeed, every single case, cited by the plaintiffs or the district court, where an

[5] As I have already indicated, although cast as an inference of "reliance," the plaintiffs' theory doubles as a means of inferring that all of the class members lacked knowledge of Ignite's likely illegality, since, according to the plaintiffs, no rational economic actor would ever pursue a fraudulent business opportunity.

"inference of reliance" was used to establish RICO causation involves allegations of a palpable, specific misrepresentation.[6]

The plaintiffs here, however, seek a wholly novel application of the inferred reliance theory. They urge the court to conclude that, as a matter of law: No rational person would ever knowingly invest in a business venture that could be illegal. Such an implausible argument ignores that, even if Ignite was a pyramid scheme, it allowed IAs the *chance* to make money. By the plaintiffs' own admission, roughly 10–15% of investors made a profit over the time frame relevant to this litigation. Unlike the "something-for-nothing" transactions that served as the basis for an inference of reliance in the other circuit-level decisions, a person could rationally invest in a pyramid scheme with the hope that he or she might profit significantly, notwithstanding knowledge that a majority of participants will likely be losers. As for the majority's altruistic suggestion that an inference of reliance is appropriate because no rational individual would ever knowingly chance defrauding others in an effort to make money for herself, I respectfully suggest that our criminal docket demonstrates the error of this assumption.

There is no attempt here to defend the legality of the defendants' alleged pyramid scheme. The point is that the plaintiffs cannot maintain this class action as it has been structured and presented to the court. The plaintiffs do

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[6] *See, e.g.*, *Rikos v. Procter & Gamble Co.*, 799 F.3d 497 (6th Cir. 2015) (defendant falsely advertised its dietary supplement as promoting digestive health when it, in fact, had no such effect); *Negrete v. Allianz Life Ins. Co. of N. Am.*, 287 F.R.D. 590 (C.D. Cal. 2012) (defendant induced class members to purchase deferred annuities by means of misleading statements and omissions regarding the value of those annuities); *Minter v. Wells Fargo Bank, N.A.*, 274 F.R.D. 525 (D. Md. 2011) (defendant was a mere front organization formed to circumvent legislation designed to prevent market-distorting business practices within the real estate settlement services industry); *Chisolm v. TranSouth Fin. Corp.*, 194 F.R.D. 538 (E.D. Va. 2000) (defendants conspired with one another in a "churning" scheme to defraud consumer used-car purchasers).

not allege, much less offer any common evidence, that the defendants misrepresented any aspect of its business structure; nor do they allege that the defendants misrepresented the plaintiffs' likelihood of being able to sign up enough customers or downline recruits to make a profit. One is blind to reality to assume perfunctorily that approximately 200,000 IAs, pitching this scheme to each other and among themselves, were predominantly motivated only by an implicit, unspoken representation that Ignite was a "legal business opportunity." Given the lack of an actual misrepresentation, coupled with the fact that the plaintiffs had all the information necessary to know that Ignite was a risky pyramid scheme, the plaintiffs' theory of reliance is ill-adapted and out of place. Without this inference, the plaintiffs do not offer any common evidence with respect to proximate causation under RICO. Thus, the class should be decertified for failure to meet Rule 23's predominance requirement.

III.

To sum up: the majority opinion allows the plaintiffs to overcome Rule 23's predominance inquiry with respect to RICO causation, even though all of the plaintiffs were provided the information to understand the risk that Ignite was an illegally structured enterprise. Moreover, at least part of the class was warned of the risk of investing in Ignite by the defendants' own promotional representatives. It is impossible rationally to presume that, out of 200,000-plus investors, a significant number of the class were not aware of the precise character of their investment.

The majority opinion dilutes both RICO's causation requirement and Rule 23's predominance requirement to the point that they have little relevance in cases based on allegations of a pyramid scheme. Indeed, if the court finds class certification appropriate here—in a case with over 200,000 putative class members, all of whom learned about Ignite at different times

and through different channels of communication, and undoubtedly held different levels of knowledge about the company's business plan—it is difficult to see when individualized issues among class members would preclude certification under Rule 23.

Accordingly, I respectfully dissent.

EDITH H. JONES, Circuit Judge, joined by EDITH BROWN CLEMENT, dissenting.

I am pleased to join Judge Jolly's dissent to the class certification approval in this case. The majority's rules, as Judge Jolly's dissent shows, afford far less scrutiny to class actions in cases involving mere allegations of "illegal pyramid schemes," and are legally ill-founded. I wish to make two observations, lest the reader of the majority opinion believe that Stream Energy is already condemned for operating an illegal pyramid scheme. Courts should not be in the business of writing one-sided opinions that lay a thumb on the scale simply by ignoring proof that does not comport with their conclusions. Thus, a few facts, as opposed to suppositions and allegations, cast doubt on the ease with which the majority condemns Stream's marketing method as illegal.

First, Stream Energy has existed in Texas for more than a decade and has become the fourth largest retail gas and electrical energy provider in this state. Stream is also authorized to sell energy in a half dozen additional jurisdictions. Stream serves over a million Texas customers, in part because it offers energy at competitive prices. Stream characterizes its marketing subsidiary Ignite's business as multilevel marketing, the bare bones of which are sketched in the majority and dissenting opinions. Whatever else may be the case, however, Stream sells a lot of real product to real people at favorable prices and its marketing model has yet to collapse.

Second, the majority never defines an "illegal pyramid scheme." The majority cites two elements described by the FTC over forty years ago: it is characterized by payments by participants in exchange for "(1) the right to sell a product and (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to the sale of the product to ultimate users." *In re Koscot Interplanetary, Inc.*, 86 F.T.C. 1106 (1975). But

the FTC has refused more rigorously to define an illegal pyramid scheme, and the majority opinion admits that "[n]o clear line separates illegal pyramid schemes from legitimate multilevel marketing programs." (citation omitted). Indeed, there are dozens of legitimate, longstanding multilevel marketing companies in the United States (*e.g.*, Avon, Mary Kay Cosmetics, Amway, and Tupperware). The majority thus leaves it to the unfettered and untutored discretion of the district court and jury to decide whether Ignite is an "illegal pyramid scheme." I do not ever recall sending a case to a jury with so little definition of the elements of the offense, much less, for class action purposes, assuming guilt from the enterprise's mere structure, allowing an inference of class-wide reliance and requiring no proof of individual causation.

If this isn't stacking the deck legally, I don't know what is. But I surmise that even plaintiffs' counsel do not really believe Stream runs an "illegal pyramid marketing scheme." Had they truly believed this, they could have invoked the Department of Justice or FTC to assist in shutting Stream down. Instead, they claim to be suing to recover about $329 apiece for over 200,000 IAs who, they assert, lost money on their "investments" with Stream. This amount, nearly $60 million, would be trebled pursuant to RICO, exposing Stream to over $190 million in potential damages, plus contingent attorneys' fees. Since this is far more than Stream is worth, however, the plaintiffs' attorneys must either want to take over the business themselves or simply strong-arm a settlement, leaving the "illegal pyramid scheme" in place until it pays off.

This, I suggest, is the price of lowering the standards for liability and stripping businesses of the ability to know in advance what the law commands. Reckless allegations of undefined illegality, coupled with immense uncertainty as to outcomes, are an affront to the rule of law.

HAYNES, Circuit Judge, dissenting:

The majority opinion allows any group of plaintiffs who have lost money in a multi-level marketing program to automatically obtain class certification by making the simple allegation that the program was in actuality an illegal pyramid scheme. In so doing, it minimizes the fact that many plaintiffs would be unable to show that defendants caused their injuries, and it allows the plaintiffs to skirt their burden of establishing "that the questions of law or fact common to class members predominate over any questions affecting only individual members." FED. R. CIV. P. 23(b)(3).

The Supreme Court has emphasized that for plaintiffs to satisfy the causation requirement of a civil RICO claim, there must be "some direct relation between the injury asserted and the injurious conduct alleged." *Bridge v. Phoenix Bond & Indem. Co.*, 553 U.S. 639, 654 (2008) (citation omitted). With over 200,000 plaintiffs in this case, there are numerous and disparate motivations behind each plaintiff's decision to participate in Ignite's multi-level marketing program, many of which weaken or sever any chain of causation.

For example, some of the plaintiffs could have been fully aware of the questions surrounding Ignite's legality, but nevertheless decided to participate for the simple reason of making a profit. For these plaintiffs, there would be no "direct relation" between the funds lost and Ignite's actions; the cause of any losses incurred would be based on the plaintiffs' own informed decision to take on a calculated risk that ultimately did not pay off. In other words, these plaintiffs' own assumption of risk "would constitute an intervening cause breaking the chain of causation between" Ignite's actions and these plaintiffs' injuries. *Id* at 658. By affirming the certification of a class that includes this

subset of plaintiffs, the majority opinion provides a potential bailout for those who knowingly gambled and lost.

Other plaintiffs could have joined Ignite's program for the sole purpose of selling (or learning the business of selling) energy, which, as Judge Jones's dissenting opinion points out, is an aspect of the business that is indisputably legal. For these plaintiffs, Ignite's structure as a purported pyramid scheme could not have caused their injury, as any losses would be directly related only to an "independent[] factor[]." *Id.* at 654 (citation omitted). Specifically, their losses would have been caused by their own inability to sell the energy necessary in order to turn a profit.

Other plaintiffs may have joined Ignite solely to take advantage of Ignite's training courses or networking opportunities, while others could have participated without any intention of making a profit in order to help out a friend or family member who was already a part of the program. For these plaintiffs, it would be impossible for Ignite to have caused any alleged injury, because no injury exists: these plaintiffs obtained exactly what they were hoping to receive by participating in Ignite's program. By affirming the certification of a class that includes these plaintiffs, the majority opinion allows those who have already received the benefit of their bargain with Ignite to potentially recoup the fees paid and effectively receive Ignite's products and services for free. In so doing, the majority opinion undermines one of the purposes of RICO causation, which the Supreme Court has stated is "to obviate the risk of multiple recoveries." *Id.* (citation omitted).

Plaintiffs could have participated in the program as "a form of escape, a casual endeavor, a hobby, a risk-taking money venture, or scores of other things." *Poulos v. Caesars World, Inc.*, 379 F.3d 654, 668 (9th Cir. 2004) (concluding that class certification was inappropriate in a civil RICO case

because the various motivations for gambling precluded common issues from predominating over individual ones). Each plaintiff had subjective and individualized reasons for joining Ignite's multi-level marketing program. As the parties seeking class certification, plaintiffs had the burden to show that—despite each plaintiff's differing motivations and expectations—common questions "predominate over any questions affecting only individual members." FED. R. CIV. P. 23(b)(3); *see Wal-Mart Stores, Inc. v. Dukes*, 564 U.S. 338, 350–51 (2011). This they failed to do. I respectfully dissent.

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

United States Court of Appeals
Fifth Circuit
FILED
August 17, 2015
Lyle W. Cayce
Clerk

No. 14-10553

WILLIAM LEE, Individually, and as Representatives of plan participants and plan beneficiaries of the Verizon Management Pension Plan; JOANNE MCPARTLIN, Individually, and as Representatives of plan participants and plan beneficiaries of the Verizon Management Pension Plan; EDWARD PUNDT,

Plaintiffs - Appellants

v.

VERIZON COMMUNICATIONS, INCORPORATED; VERIZON CORPORATE SERVICES GROUP, INCORPORATED; VERIZON EMPLOYEE BENEFITS COMMITTEE; VERIZON INVESTMENT MANAGEMENT CORPORATION; VERIZON MANAGEMENT PENSION PLAN,

Defendants - Appellees

Appeal from the United States District Court
for the Northern District of Texas
USDC No. 3:12-CV-4834

Before BENAVIDES, SOUTHWICK, and COSTA, Circuit Judges.

PER CURIAM:*

Before the court is a retirement-plan dispute brought by current and former participants and beneficiaries of Verizon's pension plan ("the Plan"). Plaintiffs, representing two certified classes, allege violations under the Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1461 ("ERISA"), by the pension plan sponsors and administrators as a result of a plan amendment and subsequent annuity purchase in December of 2012. The certified classes are distinguished by the annuity transaction, which transferred benefit obligations for some Plan beneficiaries to a group insurance annuity, resulting in the following classes: the Transferee Class, represented by Plaintiffs William Lee and Joanne McPartlin (collectively, "Transferee Class representatives"), comprising Plan participants whose retirement-benefit obligations were transferred to the annuity; and the Non-Transferee Class, represented by Plaintiff Edward Pundt ("Pundt"), comprising Plan participants whose retirement-benefit obligations remained with the Plan. Plaintiffs appeal the district court's dismissal of the claims of the Transferee Class for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6), as well as the dismissal of the sole claim of the Non-Transferee Class under Rule 12(b)(1) for lack of constitutional standing.

We affirm.

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* Pursuant to 5TH CIR. R. 47.5, the court has determined that this opinion should not be published and is not precedent except under the limited circumstances set forth in 5TH CIR. R. 47.5.4.

I. BACKGROUND

A. Factual History

Unless otherwise noted, the following factual history is based on Appellants' allegations in the second amended complaint ("SAC"), the live pleading at the time of the district court's dismissal order.

In August of 2012, Verizon Investment Management Corp. ("VIMCO"), a wholly-owned subsidiary of Verizon Communications Inc. ("Verizon"), retained Fiduciary Counselors, Inc. ("FCI or Independent Fiduciary") as an independent fiduciary to "represent the participants and beneficiaries in connection with the selection of the insurance company (or insurance companies) to provide an annuity" and to negotiate "the terms of the annuity contract or contracts." On or about September 8, 2012, over a month prior to the date of the amendment, the Independent Fiduciary provided a written determination of the transaction's compliance with ERISA.

In October of 2012, Verizon's board of directors amended the Plan terms to provide for an annuity transaction, effective December 7, 2012. The amendment applied to Plan participants who were already receiving benefit payments as of January 1, 2010; this effectively divided the Plan participants into the 41,000 members of the Transferee Class, and the roughly 50,000 members of the Non-Transferee Class. Regarding payments to those retirees, the amendment directed the Plan to purchase an annuity meeting the following requirements: (1) guaranteeing payment of pension benefits for all transferred Plan participants; (2) maintaining benefit payments in the same

form that was in effect at the time of the annuity transaction; and (3) relieving the Plan of any benefit obligation for any transferred Plan participants.[1]

Also in October of 2012, Verizon entered into a definitive purchase agreement with Prudential, VIMCO, and FCI. Under the terms of the agreement, Verizon would purchase a single-premium, group annuity contract from Prudential for $8.4 billion, in settlement of $7.4 billion in Plan benefit obligations. Plan fiduciaries notified members of the Transferee Class about the annuity transaction.

Shortly after Plaintiffs' motion for preliminary injunction against the annuity transaction was denied, the annuity parties consummated the annuity transaction on December 10, 2012.

B. Procedural History

The Transferee Class representatives filed their original complaint on November 27, 2012; the complaint was immediately followed by their application for a temporary restraining order.[2] In an order dated December 7,

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[1] The relevant provisions of the Amendment are as follows:

(i) The annuity contract shall fully guarantee and pay each pension benefit earned by a "Designated Participant."

(ii) The annuity contract shall provide for the continued payment of the Designated Participant's pension benefit . . . in the same form that was in effect under the Plan immediately before the annuity purchase . . . .

. . . .

(iv) After the annuity purchase . . . , the Plan shall have no further obligation to make any payment with respect to any pension benefit of a Designated Participant . . . . ROA.119–20.

The term "Designated Participant" generally describes members of the Transferee Class, as it includes Plan participants who were receiving benefits at the time of the annuity transaction, and who had retired before January 1, 2010.

[2] At the request of the Transferee Class representatives, the application for temporary restraining order was converted into a motion for a preliminary injunction.

2012 ("*Lee I*"), the district court denied the application.[3] On January 25, 2013, the Transferee Class representatives filed their first amended complaint, to which Plaintiff Pundt joined, and the district court certified the classes on March 28, 2013.

In an order dated June 24, 2013 ("*Lee II*"), the district court granted Defendants' motion to dismiss the Transferee Class's claims for failure to state a claim under Rule 12(b)(6), and the Non-Transferee Class's claim under Rule 12(b)(1) for lack of constitutional standing.[4] The court also granted Plaintiffs leave to amend.[5]

Plaintiffs filed the SAC on July 12, 2013.[6] In an order dated April 11, 2014 ("*Lee III*"), the district court dismissed the SAC in its entirety for failing to cure the deficiencies identified in *Lee II*.[7] Specifically, the district court reasoned that, as amended, the first and third claims of the Transferee Class, as well as the claim of the Non-Transferee Class, warranted dismissal for the reasons stated in *Lee II*;[8] the district court then more fully addressed the amended allegations regarding the Transferee Class's second claim before dismissing that claim as well.[9]

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[3] *Lee v. Verizon Commc'ns Inc.*, 2012 WL 6089041, at *1 (N.D. Tex. Dec. 7, 2012) ("*Lee I*").

[4] *Lee v. Verizon Commc'ns Inc.*, 954 F.Supp.2d 486, 499 (N.D. Tex. June 24, 2013) ("*Lee II*").

[5] *Id.*

[6] ROA.1372-1422 ("SAC").

[7] *Lee v. Verizon Commc'ns Inc.*, 2014 WL 1407416, at *9 (N.D. Tex. Apr. 11, 2014) ("*Lee III*").

[8] *See id.* at *2.

[9] *See id.* at *2–9.

II. DISCUSSION

A. Standard of Review

This court reviews *de novo* a district court's dismissal for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6).[10] In doing so, the court applies the familiar *Twombly*-plausibility standard, according to which "we must accept as true all well-pleaded facts."[11] "To survive a Rule 12(b)(6) motion to dismiss, a complaint does not need detailed factual allegations, but must provide the plaintiff's grounds for entitlement to relief—including factual allegations that when assumed to be true raise a right to relief above the speculative level."[12]

The court similarly evaluates the Rule-12(b)(1) dismissal of the claim by the Non-Transferee Class for lack of standing. As with a 12(b)(6) dismissal, this court reviews *de novo* a district court's dismissal under 12(b)(1).[13] As a matter of subject matter jurisdiction,[14] standing under ERISA § 502(a) is subject to challenge through Rule 12(b)(1).[15] Where, as here, the movant mounts a "facial attack" on jurisdiction based only on the allegations in the complaint, the court simply considers "the sufficiency of the allegations in the complaint because they are presumed to be true."[16]

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[10] *See Rosenblatt v. United Way of Greater Houston*, 607 F.3d 413, 417 (5th Cir. 2010) (citing *Cuvillier v. Taylor*, 503 F.3d 397, 401 (5th Cir. 2007)).

[11] *Id.* (citing *Baker v. Putnal*, 75 F.3d 190, 196 (5th Cir. 1996)).

[12] *Id.* (internal quotation marks omitted).

[13] *See Ballew v. Continental Airlines, Inc.*, 668 F.3d 777, 781 (5th Cir. 2012) (citing *Ramming v. United States*, 281 F.3d 158, 161 (5th Cir. 2001)).

[14] *See Cobb v. Cent. States*, 461 F.3d 632, 635 (5th Cir. 2006); *see also Hermann Hosp. v. MEBA Med. & Benefits Plan*, 845 F.2d 1286, 1288–89 (5th Cir.1988) (considering ERISA standing as a question of subject matter jurisdiction).

[15] *See* Fed. R. Civ. P. 12(b)(1).

[16] *Paterson v. Weinberger*, 644 F.2d 521, 523 (5th Cir. 1981).

B. Duty to Disclose under ERISA § 102(b), 29 U.S.C. § 1022(b)

The Transferee Class first asserts that that the Plan fiduciaries breached their fiduciary duties under ERISA by failing to disclose the annuity transaction's effect on payor responsibilities and participant enrollment in the Plan. At the outset, the following is undisputed: (1) the Plan provided Summary Plan Descriptions ("SPDs"); (2) the Plan fiduciaries promptly disclosed the amendment shortly after its adoption; and (3) the annuity transaction did not change the form or amount of benefits. However, Plaintiffs argue that the pre-amendment SPDs were insufficient because they did not give notice of the annuity transaction.

ERISA § 102(b) requires an SPD to describe "circumstances which may result in disqualification, ineligibility, or denial or loss of benefits."[17] In turn, the pertinent regulation promulgated by the Department of Labor ("DOL") requires an SPD to describe "circumstances which may result in . . . loss[] . . . of any benefits that a participant or beneficiary might otherwise reasonably expect the plan to provide."[18] Appellants first argue that the Verizon Employee Benefits Committee ("VEBC"), a Verizon plan fiduciary, failed to provide compliant SPDs by not disclosing the possibility that benefit obligations could be transferred to an insurance-company annuity absent a plan termination or spin-off/merger. As explained below, this argument lacks merit in light of this court's precedent, which holds that ERISA does not require SPDs to describe future terms, and statutory language requiring only retrospective notice of plan amendments.

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[17] 29 U.S.C. § 1022(b) (2012).
[18] 29 C.F.R. § 2520.102-3(*l*) (2015).

First, as Appellees note, we have previously interpreted ERISA disclosure requirements as only extending to current aspects of the plan, and to the exclusion of potential changes which are contingent upon a plan amendment. In *Wise v. El Paso Natural Gas Co.*,[19] this court held that "Section 1022(b) relates to an individual employee's eligibility under then existing, current terms of the Plan and not to the possibility that those terms might later be changed, as ERISA undeniably permits."[20] The decisions cited by Appellants do not vitiate this principle, as both decisions addressed the disclosure of existing plan terms, not potential, amendment-contingent terms.[21] In this case, prior to the October-2012 amendment directing the annuity purchase, the Plan only allowed for the transfer of benefit obligations through the Plan's termination or merger into another pension plan; SPDs issued prior to the amendment were only required to address those circumstances.

Further, it is undisputed that the Plan fiduciaries provided notice shortly after the amendment's adoption, well within the time limits imposed for notice of plan amendment. ERISA only requires that administrators provide a summary description of any material modification or change "not later than 210 days after the end of the plan year in which the change is adopted."[22] In keeping with this language, we previously held in *Martinez v. Schlumberger, Ltd.*[23] that, within the context of ERISA disclosure

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[19] 986 F.2d 929 (5th Cir. 1993).
[20] *Id.* at 935.
[21] *See Koehler v. Aetna Health Inc.*, 683 F.3d 182, 189 (5th Cir. 2012); *Layaou v. Xerox Corp.* 238 F.3d 205, 211 (2d Cir. 2001)).
[22] 29 U.S.C. § 1024(b)(1)(B).
[23] 338 F.3d 407 (5th Cir. 2003).

requirements, there is no employer duty "to affirmatively disclose whether it is considering amending its benefit plan."[24] Appellees also correctly note that the pre-amendment SPDs advised participants of Verizon's reservation of the right to amend the Plan, and the possibility that an amendment might affect their rights under the Plan.

As a second basis for violation, the Transferee Class alleges that the pre-amendment SPDs failed to advise of the possible "loss of benefits." The district court rejected this claim because the Transferee Class failed to allege a change in the amount of benefits they would receive. On appeal, the Transferee Class acknowledges that the amount of benefits remains unchanged under the terms of the annuity contract. However, the Transferee Class also asserts that the phrase "loss of benefits" encompasses federal protections under ERISA and the Pension Benefit Guaranty Corporation ("PBGC").[25] Appellants, however, provide no authority supporting the inclusion of ERISA and PBGC protections as "benefits" within the meaning of § 102. Countenancing against Appellants' argument, this interpretation of "benefits" is more expansive than the ERISA regulation governing the purchase of annuities by plan fiduciaries ("Annuitization Regulation"), which requires that such transactions guarantee a participant's "entire benefit rights."[26] As discussed further below, the annuity agreement does not guarantee ERISA and PBGC protections, but Appellants do not dispute that the transaction complies with the Annuitization Regulation's guarantee requirement.

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[24] *Id.* at 428.
[25] *Id.*
[26] 29 C.F.R. § 2510.3-3(d)(2)(ii) (2015).

Accordingly, we find no error in the district court's dismissal of the Transferee Class's claim under ERISA § 102.

C. Fiduciary Duties under ERISA § 404(a)(1), 29 U.S.C. § 1104

The Transferee Class asserts several breaches of fiduciary duties under ERISA § 404(a)(1)(A), which requires that plan fiduciaries use plan assets "for the exclusive purpose of[] . . . providing benefits" and "defraying reasonable expenses of administering the plan."[27] In doing so, a fiduciary must act "solely in the interest of [plan] participants,"[28] and employ the "care, skill, prudence, and diligence" of a "prudent man" acting in like circumstances.[29] Section 8.5 of the Plan mirrors that of § 404, requiring that assets of the Plan be used "for the exclusive benefit of [participants and beneficiaries] and shall be used to provide benefits under the Plan and to pay the reasonable expenses of administering the Plan and the Pension Fund, except to the extent that such expenses are paid by [Verizon]."[30]

Fiduciary vs. Non-Fiduciary Functions. First, it behooves the analysis to distinguish between fiduciary and non-fiduciary roles, a function-centric consideration "that is aided by the common law of trusts which serves as ERISA's backdrop."[31] Further, though an employer may, at different times, wear "hats" as both a sponsor and administrator,[32] "fiduciary duties under ERISA are implicated only when it acts in the latter capacity."[33] Thus, where

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[27] 29 U.S.C. § 1104(a)(1)(A) (2012).
[28] *Id.* § 1104(a)(1).
[29] *Id.* § 1104(a)(1)(B).
[30] ROA.83.
[31] *Beck v. PACE Intern. Union*, 551 U.S. 96, 101 (2007).
[32] *See Pegram v. Herdrich*, 530 U.S. 211, 225–26 (2000).
[33] *Beck*, 551 U.S. at 101.

a claim alleges breach of an ERISA fiduciary duty, the threshold question is whether the "person employed to provide services under a plan . . . was acting as a fiduciary (that is, was performing a fiduciary function) when taking the action subject to complaint."[34] In making this threshold evaluation, "[a] person is a fiduciary only to the extent he has or exercises specified authority, discretion, or control over a plan or its assets."[35]

In contrast, we have previously held that actions by a plan sponsor "to modify, amend or terminate the plan" are outside the scope of fiduciary duties; "such decisions are those of a trust settlor, not a fiduciary."[36] In *Hughes Aircraft Co. v. Jacobson*, the Supreme Court noted that, "[i]n general, an employer's decision to amend a pension plan concerns the composition or design of the plan itself and does not implicate the employer's fiduciary duties which consist of such actions as the administration of the plan's assets," as well as decisions "regarding the form or structure of the Plan . . . ."[37] The *Jacobson* Court emphatically concluded that "without exception, plan sponsors who alter the terms of a plan do not fall into the category of fiduciaries."[38]

Courts have drawn a distinction between decisions to alter a plan, and the implementation of those decisions. For example, in *Beck v. PACE Intern. Union*, the Court noted the distinction between whether to terminate a plan

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[34] *Pegram*, 530 U.S. at 226.

[35] *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 251 (5th Cir. 2008) (internal quotation marks omitted); *see also* 29 U.S.C. § 1002(21)(A) (2012) (providing that "[a] person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets[] . . . or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.").

[36] *Id.* at 251.

[37] *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 444 (1999).

[38] *Id.* at 444-45.

through an annuity purchase, and the fiduciary obligation in its selection of an annuity provider.[39] Appellees rely in part upon *Beck* to support two sponsor-fiduciary distinctions, distinctions which are disputed by Appellants but which affect multiple issues.

Beck involved an employer's filling dual roles as plan sponsor and administrator, and the Court considered the question of whether a plan sponsor's choice of plan termination through the purchase an annuity, rather than merger with another pension plan, constituted a decision as a plan sponsor or fiduciary.[40] The *Beck* Court first noted the general principle that an employer's decisions regarding the form or structure of a plan are immune from ERISA's fiduciary obligations, and that these decisions include termination and (in most cases) merger.[41] Recognizing that ERISA imposed fiduciary obligations on the method of termination, *e.g.* the fiduciary obligation on selecting an annuity provider, the *Beck* Court acknowledged that the choice between possible methods of termination, *i.e.* annuitization or merger, created a plausible basis to consider merger as a fiduciary action within that context.[42] Ultimately, *Beck* did not reach ERISA's fiduciary application to merger, as the Court determined merger was not a permissible method of termination under ERISA.[43]

Appellees first cite *Beck* in support of the proposition that the decision to enter into an annuity is a sponsor decision immune from ERISA's fiduciary obligations. In turn, Appellants argue that *Beck* is inapposite as it analyzed a

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[39] 551 U.S. 96, 101–02 (2007).
[40] *See id.*
[41] *See id.*
[42] *See id.* at 102.
[43] *Id.* at 110.

plan termination, rather than an ongoing plan. This distinction does not vitiate *Beck*'s application to the instant circumstances. The *Beck* Court broadly described decisions regarding the form and structure of a plan as those of a plan sponsor, and its primary focus on one type of sponsor decision does not undercut the application to other sponsor decisions regarding a plan's form and structure. Accordingly, we hold the annuity amendment was a sponsor function of plan design, authorized under ERISA through the Annuitization Regulation.

Appellees also cite *Beck* for the principle that an employer's decision to maintain or remove pension liabilities is a design decision and settlor function. In deciding that merger was not a permissible form of termination, the *Beck* Court compared the effect of annuity purchases and merger, emphasizing that the latter "represents a *continuation* rather than a *cessation* of the ERISA regime."[44] Despite discussing the annuity purchase's effect of "formally sever[ing] the applicability of ERISA to plan assets and employer obligations" (including the employer's release from ERISA's requirement to make PBGC premium payments), the *Beck* Court did not impute fiduciary aspects to the sponsor's decision to sever ERISA's applicability.[45] Consistent with *Beck*, therefore, we consider the decision to transfer pension assets outside ERISA coverage as a sponsor decision immune from fiduciary obligations.

Also relating to the sponsor-fiduciary distinction, Appellants assert that the district court mischaracterized some of their claims as asserted against Verizon and the Plan fiduciaries, VIMCO and VEBC. In Appellants' view, the

[44] *Id.* at 106 (emphasis in original).
[45] *Id.*

claim was asserted only against the Plan fiduciaries, and the district court's considering the claim as asserted against Verizon was questionable. However, regarding some of the alleged bases for fiduciary breach, the allegations in the SAC implicate the act of amending the Plan to direct the annuity purchase, an act by Verizon as settlor, as well as the acts involved in implementing the annuity purchase, which involve functions of the Plan fiduciaries. As a result, we hold the district court properly addressed Verizon's role as sponsor, before addressing the implementation of the transaction involving VIMCO and VEBC. We separately consider these alleged breaches below.

1. Alleged Breach by Plan Sponsor

Appellants first assert that Verizon breached its fiduciary duty by entering into the annuity transaction, which resulted in the partial transfer of pension obligation from an ongoing Plan. Because such a transfer during an ongoing plan is not expressly authorized by an ERISA provision or regulation, Appellants posit that Verizon's decision was subject to ERISA's fiduciary duty provisions. This argument lacks merit for several reasons: (1) precedent suggests that the amendment was a settlor function; (2) ERISA and related regulations authorize annuity purchases, and do not prohibit such purchases during an ongoing plan; and (3) even assuming ERISA prohibits annuity purchases during an ongoing plan, Appellants cite no authority that the prohibition's violation would subject an otherwise settlor function to fiduciary requirements.

First, the precedent cited above describes the decision to amend a pension plan concerning the composition or design of the plan as a settlor function, immune from fiduciary strictures. Accordingly, the decision to amend the Plan and transfer assets into an annuity was made solely by Verizon in its

settlor capacity. Appellants' argument against this principle, broadly that any action which disposes of plan assets creates fiduciary obligations, is not supported by any authority. The *Beck* Court tangentially addressed Appellants' argument, noting that "[t]he purchase of an annuity is akin to a transfer of assets and liability (to an insurance company)" yet maintaining its position that a decision to enter into an annuity (albeit during a plan termination) was a settlor function.[46]

Secondly, Appellants do not proffer any authority that would prohibit the transfer from an ongoing plan via an annuity transaction. At the same time, Appellees respond with ERISA provisions and regulations which suggest such transactions are authorized, and at least are not foreclosed.

In the first instance, ERISA provisions, as well as regulations promulgated by the Department of Labor, set forth several mechanisms by which an employer may remove liabilities from a pension plan, one of which is through transfer to an insurance company by an annuity purchase.[47] Upon transfer via annuity purchase, an individual is no longer "a participant covered under an employee pension plan or a beneficiary receiving benefits under an employee pension plan," so long as the individual's entire benefit rights are (1) guaranteed by the insurance company; (2) enforceable against the insurance company at the sole choice of the individual; and (3) the individual is issued notice of the benefits to which he or she is entitled under the plan.[48] Appellants do not dispute that the annuity transaction complied with these requirements,

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[46] *Id*. at 102.
[47] *See* 29 C.F.R. § 2510.3-3(d)(2)(ii) (2015). *See also* 29 U.S.C. §§ 1341 (termination); 1058 (merger).
[48] 29 C.F.R. § 2510.3-3(d)(2)(ii) (2012).

transferring the entire benefit rights of the Transferee Class and satisfying the three requirements for removal from the Plan.

Regarding the ability of a plan sponsor to perform an annuity transfer *during an ongoing plan*, neither ERISA itself nor the regulations promulgated thereunder speak directly to this point. However, a Department of Labor interpretive bulletin describes circumstances in which a pension plan might purchase annuity contracts, and notes that "*in the case of an ongoing plan*, annuities might be purchased for participants who are retiring or separating from service with accrued vested benefits."[49] Although the bulletin does not specifically describe this circumstance, the bulletin describes potential circumstances non-exclusively, suggesting that such transfers are permitted, especially when considered in conjunction with the annuity-transfer regulation.

Finally, even assuming *arguendo* that ERISA prohibits annuity purchases during ongoing plans, Appellants cite no authority which would make the amendment a fiduciary function due to violation of that prohibition. In light of the above considerations, we hold that the transfer of pension liabilities from an ongoing plan through an annuity transaction amendment is a settlor function, permitted under ERISA, or, alternatively, that such transactions are not subject to fiduciary duty requirements.

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[49] *See* Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974, 60 Fed. Reg. 12328, 12328 (Mar. 6, 1995) (providing,

> [p]ension plans purchase benefit distribution annuity contracts in a variety of circumstances. Such annuities may be purchased for participants and beneficiaries in connection with the termination of a plan, or in the case of an ongoing plan, annuities might be purchased for participants who are retiring or separating from service with accrued vested benefits.).

2. Alleged Breaches by Plan Fiduciaries

The Transferee Class also alleges breach of fiduciary duty in the implementation of the amendment. In this regard, the Transferee Class asserts several grounds, alleging that Plan fiduciaries: (1) failed to hold the annuity contract as a Plan asset; (2) failed to obtain consent of the Transferee Class members; (3) failed to communicate with the Transferee Class members prior to the annuity transaction; (4) violated the terms of § 8.5 of the Plan; and (5) failed to select more than one annuity provider.[50] We consider these breaches *seriatim*.

Failure to Hold Annuity Contract within Plan as Plan Asset. The Transferee Class maintains that Plan beneficiaries should have held the annuity contract as a Plan asset ("internal annuity"), and that such an arrangement would have maintained ERISA and PBGC protections for the benefit of the class members.

However, as the district court reasoned, the plan amendment did not allow for the Plan to remain obligated for the benefit of the Transferee Class. As noted above, the Plan fiduciaries are only responsible for decisions over which they have discretion. Although disputed by Appellants, the terms of the amendment clearly provide that the Plan will have no obligation to make any payment for the pension benefits of the Transferee Class after the annuity transaction. Within the strictures of the amendment terms, Plan fiduciaries

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[50] The Transferee Class also alleged that the annuity transaction breached a fiduciary duty by underfunding the Plan in violation of several statutes. The district court dismissed this claim and, although the Transferee Class makes passing reference to underfunding in its brief, it does not substantively urge review the district court's dismissal of this ground on appeal. The issue is therefore waived. *See Cinel v. Connick*, 15 F.3d 1338, 1345 (5th Cir. 1994) (citation omitted).

were without discretion to maintain pension obligations of the Transferee Class within the Plan.[51]

Failure to Obtain Transferee Consent. The Transferee Class also asserts that the Plan fiduciaries should have obtained the consent of the Transferee Class members before transferring the pension obligations to the annuity contract. In the first instance and as the district court noted, the determination to transfer assets to an annuity was a decision made by Verizon as settlor, and does not fall within the scope of its fiduciary duties. In *Hughes Aircraft Co. v. Jacobson*, the Supreme Court held that three fiduciary claims were foreclosed because "without exception, plan sponsors who alter the terms of a plan do not fall into the category of fiduciaries."[52] The Eighth Circuit decision in *Howe v. Varity Corp.*,[53] a pre-*Jacobson* decision to which Appellants cite for the consent requirement, does not succeed in imputing fiduciary obligations to an action which the Supreme Court has deemed immune from those obligations. We further note that Appellants' position is neither supported by the terms of ERISA, which itself contains no such requirement for consent, either in the provisions detailing fiduciary duties,[54] or in the provisions governing ERISA-compliant annuity purchases.[55]

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[51] The SAC does not describe in any detail how selecting an internal annuity was an amendment-compliant option within the discretion of Plan fiduciaries. At a minimum, however, maintaining the PBGC protections sought by the Transferee Class requires the payment of premiums, *see* 29 U.S.C. § 1307, which would run afoul of the amendment's requirement that, after the annuity transaction, "the Plan shall have no further obligation to make *any payment with respect to any pension benefit* of a Designated Participant." ROA.120 (emphasis added).

[52] *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 443 (1999) (citing *Lockheed Corp. v. Spink*, 517 U.S. 882, 890-91 (1996)).

[53] 36 F.3d 746, 756 (8th Cir. 1994), *aff'd on other grounds*, 516 U.S. 489 (1996).

[54] 29 U.S.C. § 1104(a).

[55] 29 C.F.R. § 2510.3-3(d)(2)(ii).

Failure to Communicate with Transferees. The Transferee Class also asserts that Plan fiduciaries breached their duty by not communicating with beneficiaries. Although the Transferee Class asserts that "ERISA and its accompanying regulations" require such communication, the Transferee Class does not cite any actual ERISA provisions, and only cites to the Ninth Circuit decision of *Booton v. Lockheed Med. Benefit Plan*, an inapposite opinion which discussed the ERISA-required documentation following the denial of benefits.[56] Although the Annuity Regulation does require that participants receive notice of the terms of the benefits to which they are entitled as part of the annuity transaction,[57] it is undisputed that the Transferee Class received this notice. After the annuity transaction, the benefits are no longer governed by ERISA, and any nondisclosure does not give rise to a cognizable action.[58]

Expenses of Annuity Transaction. As part of the annuity transaction, it is undisputed that Verizon paid Prudential a total of $8.4 billion, $1 billion more than the amount of the transferred liabilities. The Transferee Class alleges that Verizon violated § 8.5 of the Plan, requiring that Plan assets be used for the exclusive benefit of Plan beneficiaries and participants, as well as reasonable expenses of administering the Plan and Pension Fund. In the SAC, the Transferee Class alleges as follows:

> However, almost $1 billion more than necessary to cover the transferred liabilities was paid by Prudential by the Plan for amounts other than benefits and reasonable expenses of administering the Plan. The extra $1 billion payment was applied toward expenses, not for administering the ongoing Plan, but to

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[56] 110 F.3d 1461, 1463 (9th Cir. 1997).

[57] 29 C.F.R. § 2510.3-3(d)(2)(ii).

[58] *See Beck v. PACE Intern. Union*, 551 U.S. 96, 106 (2007).

> enable avoidance of payment of such expenses by the Plan sponsor, [Verizon], thus violating Section 8.5 . . . .[59]
>
> The extra $1 billion payment was used to pay Verizon's-the settlor's obligations for third-party costs related to the annuity transaction, including fees paid to outside lawyers, accountants, actuaries, financial consultants and brokers. Those expenses and fees should have been charged to Verizon's corporate operating revenues, not charged to the Plan and Master Trust.[60]

The district court ruled that these allegations failed to state a claim by not specifying "which aspects of the extra $1 billion of expenditures were unreasonable, or how they were unreasonable."[61] The Transferee Class argues that the district court's reasonableness analysis is misplaced, and that the proper inquiry is whether the additional $1 billion in administrative costs was a settlor cost which was wrongfully paid from Plan assets, constituting a fiduciary breach. The Transferee Class supports their position by citing to a Department of Labor advisory opinion discussing plan-related expenses for which a settlor is responsible. The advisory opinion provides:

> Expenses incurred in connection with the performance of settlor functions would not be reasonable expenses of a plan as they would be incurred for the benefit of the employer and would involve services for which an employer could reasonably be expected to bear the cost in the normal course of its business operations. *However, reasonable expenses incurred in connection with the implementation of a settlor decision would generally be payable by the plan.*[62]

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[59] SAC at ¶ 114 (emphasis in original).

[60] *Id*. at ¶ 115.

[61] *Lee III*, 2014 WL 1407416, at *4 (citing *Lee II*, 954 F.Supp.2d at 494).

[62] Dept. of Labor Advisory Opinion 2001-01A (January 18, 2001) (emphasis added). Available at: http://www.dol.gov/ebsa/regs/aos/ao2001-01a.html.

Appellants quote the first portion, but omit the italicized portion of the advisory opinion from their brief.[63] The effect of the advisory opinion, upon which Appellants otherwise rely, is two-fold. First, by contemplating that expenses implementing a settlor decision, such as an amendment and restructuring of a plan, are payable by the plan, the advisory opinion refutes Appellants' argument that expenditures not associated with plan administration are unreasonable. Second, since implementation expenses by the plan are permitted to the degree they are reasonable, the advisory opinion focuses the critical inquiry on the reasonableness of the expenses.

In light of the foregoing, reasonableness of the expenses must be addressed by the Transferee Class's allegations. Here, although the allegations enumerate various expenses associated with the implementation of Verizon's decision as settlor, they wholly fail to address how those expenses are not reasonable expenses which are payable by the plan. To be sure, $1 billion in expenses is a large sum but, in light of the $7.5 billion in attendant obligations, we will not conclude that this allegation alone is sufficient to support unreasonableness under our pleading standards. In light of the threadbare allegations, along with the size and complexity of the annuity transaction, we agree with the district court's dismissal of this ground as insufficiently supported.

Failure to Select Multiple Annuity Providers. The Transferee Class further alleges a breach of fiduciary duty by selecting Prudential as the sole annuity provider. Regarding the selection of an annuity provider, this court described the relevant inquiry in *Bussian v. RJR Nabisco, Inc.*, as follows:

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[63] *See* Blue Br. 38–39.

> [W]hether the fiduciary, in structuring and conducting a thorough and impartial investigation of annuity providers, carefully considered [the factors enumerated in the Department of Labor Interpretive Bulletin 95-1] and any others relevant under the particular circumstances it faced at the time of decision. If so, a fiduciary satisfies ERISA's obligations if, based upon what it learns in its investigation, it selects an annuity provider it "reasonably concludes best to promote the interests of [the plan's] participants and beneficiaries."[64]

In a later decision, we clarified that the test of fiduciary prudence "is one of conduct, not results."[65] Even where a fiduciary's conduct does not meet that standard, "ERISA's obligations are nonetheless satisfied if the provider selected would have been chosen had the fiduciary conducted a proper investigation."[66]

In support of this showing, the Transferee Class simply alleges that a more prudent choice would have been to contract with more than one insurer, to avoid "put[ting] all of the Plan's eggs in one basket" and "placing everyone in jeopardy of losing retirement benefits based upon the fortunes of a single insurer."[67] The district court ruled that these allegations did not support a fiduciary breach because they were conclusory.[68] While that is a basis for dismissing this ground, the allegations also only implicate the results of the process, and not the conduct of FCI.

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[64] 223 F.3d 286, 300 (5th Cir. 2000) (quoting *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir. 1982)) (second alteration in original).

[65] *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 253 (5th Cir. 2008).

[66] *Bussian v. RJR Nabisco, Inc.*, 223 F.3d 286, 300 (5th Cir. 2000) (citation omitted).

[67] SAC at ¶ 109.

[68] *See Lee III* at 2014 WL 1407416, at *7.

Additionally, however, the SAC includes allegations implicating the conduct of the Plan fiduciaries, asserting that the Prudential selection occurred on the same day as the amendment's adoption and that "VIMCO and Plan fiduciaries did not prudently allow any period of time, much less a reasonable time period for consideration [of the annuity provider(s)]."[69] Acknowledging that these allegations might plausibly assert that the Plan fiduciaries did not consider any annuity provider other than Prudential, the district court ruled that such an interpretation nevertheless was rendered implausible in light of other allegations in the SAC. To wit, the SAC alleges both that VIMCO employed FCI almost two months prior to the alleged date of decision,[70] and that FCI had submitted a written determination of the transaction's compliance with ERISA over a month prior to the date of the amendment.[71]

We agree, and find no error in the district court's dismissal of the Transferee Class's claim for fiduciary breach.

D. Violation of ERISA § 510, 29 U.S.C. § 1140

The Transferee Class also alleged a violation of ERISA § 510 in the Plan amendment's transfer of benefit obligations for only certain Plan participants, asserting that such expulsion represented intentional interference with rights of the transferred participants.[72]

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[69] SAC at ¶ 110.

[70] *Id.* at ¶ 29(A).

[71] *Id.* at ¶ 29(C).

[72] As an initial point, Appellants argue that this case brings the question of whether a plan amendment can be actionable under § 510 directly before the court, and cites several previous opinions which did not address the issue. *See McGann v. H & H Music Co.*, 946 F.2d 401, 406 n.8 (5th Cir. 1991), *cert. denied sub nom*, *Greenberg v. H & H Music Co.*, 506 U.S. 981 (1992); *Hines v. Mass. Mut. Life Ins. Co.*, 43 F.3d 207, 210 n.5 (5th Cir. 1995), *overruled on other grounds*, *Arana v. Ochsner Health Plan*, 338 F.3d 433 (5th Cir. 2003). However,

Section 510 provides that it is "unlawful for any person to discharge, fine, suspend, expel, discipline, or discriminate against a participant . . . for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan."[73] The district court dismissed this claim, ruling that the Transferee Class failed to allege a viable right with which Verizon intended to interfere.[74]

Although acknowledging that § 510 requires discrimination "for the purpose of interfering with" a right, Appellants posit that § 510 prohibits expulsion without any intent-to-interfere requirement. Appellees argue that the prohibition on expulsion, like that on discrimination, must be made with the intent to interfere with a right under the plan. Neither party provides authority for their positions, and instead rely solely on their interpretation of the provision's language.

Appellees' argument that expulsion must be attended by intent to interfere in order to be actionable, however, is supported by a practical consideration. Appellants' construction would divorce the intent-to-interfere requirement from any prohibition other than discrimination, which would also divorce those prohibitions from the object of the interference, *i.e.* "any right to which such participant may become entitled under the plan." Such a reading, which separates ERISA prohibitions from any rights in the ERISA-governed plan, is overly broad.

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because we hold that Appellants failed to allege a right with which Verizon intended to interfere, the issue is not before us.

[73] 29 U.S.C. § 1140.

[74] *Lee III*, 2014 WL 1407416, at *2 (citing *Lee II*, 954 F.Supp.2d at 495).

Thus reading the expulsion prohibition to require an intent to interfere with a right under the Plan, Appellees proffer two bases for affirming the district court's dismissal of this claim. First, as the district court ruled, the Transferee Class did not identify a viable right with which Verizon interfered. In the SAC, the Transferee Class alleges interference with two rights, their continued participation in the Plan, and ERISA and PBGC protections. The Transferee Class asserts their right to continued participation arises from the language in the SPD, providing: "You are a plan participant as long as you have a vested benefit in the plan that has not been paid to you in full."[75] The district court rejected this argument, noting that the Annuitization Regulation provides that an individual ceases to be a participant when benefit rights are guaranteed by an insurance company.[76] On appeal, Appellants respond that, where the language of an SPD conflicts with that of a regulation, the SPD should control. This argument is unavailing even assuming the SPD controls because the SPD advised participants of the potential amendments which could affect their rights.[77] Although unaddressed by the district court, the Transferee Class assertion of rights in ERISA and PBGC protections is unsupported. As previously discussed regarding Appellants' similar assertion in Issue I, there is little support in ERISA provisions or regulations, or case law, for including ERISA protections and PBGC benefits as rights to which a plan participant is entitled.[78] Further, as Appellees point out, the right to any

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[75] ROA.77.
[76] *See* 29 C.F.R. § 2510.3-3(d)(2)(ii) (2015).
[77] ROA.75.
[78] *See* III.B., *supra*.

of ERISA and PBGC protections is dependent on the class members' right to continued participation.

By failing to allege a viable right with which the amendment interfered, the Transferee Class failed to state a claim and we find no error in the dismissal of this claim.

E. Constitutional Standing

On behalf of the Non-Transferee Class, Plaintiff Pundt asserts, through ERISA § 502(a)(2), 29 U.S.C. §§ 1132(a)(2) and (a)(3), a claim for relief under ERISA § 409(a), 28 U.S.C. § 1109, for violation of fiduciary obligations by the Plan fiduciaries. The district court ruled in *Lee III* that Pundt lacked constitutional standing to assert this claim, as asserted in the SAC, by reference to its prior basis for dismissal in *Lee II*.[79] Pundt challenges this ruling on appeal, and we must first address this challenge prior to any consideration of the merits since "[t]he requirement that jurisdiction be established as a threshold matter . . . is inflexible and without exception."[80]

Section 502(a)(2) of ERISA allows a civil action to be brought by "a participant, beneficiary or fiduciary for appropriate relief under [ERISA § 409]."[81] In turn, § 409(a) creates a right to relief against fiduciaries for the restoration of any loss to a plan resulting from the breach of "any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter."[82] On appeal, the Non-Transferee Class asserts that Plan

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[79] *See Lee III*, 2014 WL 1407416, at *2 (citing *Lee II*, 954 F.Supp.2d at 496).
[80] *Steel Co. v. Citizens for a Better Env't*, 523 U.S. 83, 94–95 (1998).
[81] 29 U.S.C. 1132(a)(2) (2012).
[82] 29 U.S.C. 1109 (2012).

fiduciaries breached fiduciary duties by paying an excessive and unreasonable expense, echoing the ERISA § 404 basis alleged by the Transferee Class.[83]

The dispute centers not on whether Pundt has statutory standing under § 502, but instead whether he has constitutional standing under Article III.[84] In order to establish the "irreducible, constitutional minimum" of Article-III standing,[85] "a plaintiff must show (1) an injury in fact, (2) a sufficient causal connection between the injury and the conduct complained of, and (3) a likelihood that the injury will be redressed by a favorable decision."[86] The showing involves an injury-in-fact requirement that the plaintiff has a "personal stake in the outcome of the controversy,"[87] such that the injury is "concrete and particularized," and "actual or imminent, not conjectural or hypothetical."[88] "An allegation of future injury may suffice if the threatened injury is 'certainly impending,' or there is a 'substantial risk' that the harm will occur.'"[89]

The district court ruled that Pundt had failed to allege an injury in fact sufficient to support constitutional standing. Appellants argue Pundt was injured through "losses to Plan assets held on [Pundt's] behalf as a direct result of the fiduciary mismanagement of Plan assets in violation of ERISA," and that

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[83] As with the allegations by the Transferee Class regarding breach of fiduciary duties under ERISA § 404(a), the Non-Transferee Class alleged below that the annuity transaction underfunded the Plan in violation of ERISA and the Internal Revenue Code. The Non-Transferee Class, however, does not urge review of those allegations on appeal.

[84] U.S. CONST. art. III, § 2.

[85] *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560 (1992).

[86] *Susan B. Anthony List v. Driehaus*, --- U.S. ---, 134 S.Ct. 2334, 2341 (2014) (quoting *Lujan*, 504 U.S. at 560-61) (internal quotation marks and alterations omitted).

[87] *Id.* (quoting *Warth v. Seldin*, 422 U.S. 490, 498 (1975)).

[88] *Id.* (quoting *Lujan*, 504 U.S. at 560) (internal quotation marks omitted).

[89] *Id.* (quoting *Clapper v. Amnesty Int'l USA*, 568 U.S. ---, --- n.5, 133 S.Ct. 1138, 1147, 1150 n.5) (internal quotation marks omitted).

this "invasion of his statutory right to proper management of Plan assets" is sufficiently concrete to provide standing.[90] Appellees argue instead that constitutional standing requires allegations to support injury against an individual's benefit payments, rather than injury to the plan as a whole. We agree with the district court's dismissal for lack of subject matter jurisdiction.

Direct Harm to Participants. Pundt first argues that fiduciary misconduct to his defined benefit plan presents individually cognizable harm, but this position is not supported by case law. The cases cited by Appellants discuss plans which, in contrast to the defined-benefit plan at issue here, present a more direct risk of harm from fiduciary misconduct.[91] For example, as the Supreme Court explained in *LaRue v. DeWolff, Boberg & Assocs.*, "[f]or defined contribution plans . . . fiduciary misconduct need not threaten the solvency of the entire plan to reduce benefits below the amount that participants would otherwise receive."[92] As a result, other circuit courts have held that participants in defined-contribution plans had redressable, Article III standing because alleged fiduciary breaches had a direct effect on the amount of benefits.[93]

A defined-contribution plan presents a starkly different circumstance than a defined-benefit plan, which "'as its name implies, is one where the

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[90] Blue Br. 52.

[91] *See Tolbert v. RBC Capital Markets Corp.*, 758 F.3d 619 (5th Cir. 2014) (considering ERISA's application to a wealth accumulation plan, another type of "employee pension benefit plan" whereby benefits are dependent upon individual employee contributions and investment performance); *Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984) (considering a profit-sharing trust).

[92] *LaRue v. DeWolff, Boberg & Assocs., Inc.*, 552 U.S. 248, 255–56 (2008).

[93] *See, e.g., Harris v. Amgen, Inc.*, 573 F.3d 728, 735–36 (9th Cir. 2009).

employee, upon retirement, is entitled to a fixed periodic payment.'"[94] In contrast to plans in which fiduciary misconduct might present a more direct impact on a participant's interest, fiduciary misconduct in a defined-benefit plan "will not affect an individual's entitlement to a defined benefit unless it creates or enhances the risk of default by the entire plan" since such a plan "consists of a general pool of assets rather than individual dedicated accounts."[95] As a result, the injury to participants like Pundt is attenuated as, prior to default under the plan, "the employer typically bears the entire investment risk and—short of the consequences of plan termination—must cover any underfunding as the result of a shortfall that may occur from the plan's investments."[96] Moreover, even where an employer is unable to cover underfunding, the impact on participants is not certain since the PBGC provides statutorily-defined protection of participants' benefits.[97]

The degree to which the impact of fiduciary misconduct must be realized on this causal chain in order to establish standing is a matter of first impression for this court. However, considering similar circumstances, our sister circuits have concluded that constitutional standing for defined-benefit plan participants requires imminent risk of default by the plan, such that the participant's benefits are adversely affected; in turn, those courts have held that fiduciary misconduct, standing alone without allegations of impact on

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[94] *Beck v. PACE Intern. Union*, 551 U.S. 96, 98 (2007) (quoting *Comm'r v. Keystone Consol. Indus., Inc*., 508 U.S. 152, 154 (1993)).

[95] *LaRue*, 552 U.S. at 255 (contrasting the impact of fiduciary misconduct in defined-contribution and defined-benefit plans).

[96] *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 439 (1999).

[97] *See* 29 U.S.C. § 1322.

individual benefits, is too removed to establish the requisite injury.[98] The Fourth Circuit found such "risk-based theories of standing unpersuasive, not least because they rest on a highly speculative foundation lacking any discernible limiting principle."[99] It is true that those courts considered plans which remained overfunded after the alleged fiduciary misconduct, while here the complaint alleges that, immediately after the annuity transaction, the plan was "left in a far less stable financial condition and underfunded by almost $2 billion or only about 66% actuarially funded."[100]

However, regardless of whether the plan is allegedly under- or over-funded, the direct injury to a participants' benefits is dependent on the realization of several additional risks, which collectively render the injury too speculative to support standing. In the first instance and as previously discussed, absent plan termination, the employer must cover any shortfall resulting from plan instability.[101] Pundt's allegation that the plan was underfunded, and less financially stable, merely increases the relative likelihood that Verizon will have to cover a shortfall. However, Pundt's allegations do not further allege the realization of risks which would create a likelihood of direct injury to participants' benefits. To wit, Pundt does not allege a plan termination, an inability by Verizon address a shortfall in the event of a termination, or a direct effect thereof on participants' benefits; on

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[98] *See, e.g.*, *David v. Alphin*, 704 F.3d 327, 338 (4th Cir. 2013); *Harley v. Minn. Mining & Mfg. Co.*, 284 F.3d 901, 906 (8th Cir. 2002), *Perelman v. Perelman*, 919 F.Supp.2d 512, 517–520 (E.D. Pa. Jan. 24, 2013), *aff'd*, 2015 WL 4174537 (3rd Cir. July 13, 2015).

[99] *David*, 704 F.3d at 338.

[100] ROA.1386.

[101] *See Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 439 (1999).

the contrary, Appellants concede on appeal that the actuarial underfunding resulted in no direct injury to Pundt.

Pundt also asserts that he directly suffered constitutionally cognizable injury through invasion of his statutorily created right, specifically that the alleged fiduciary breach from the mismanagement of Plan assets constitutes an invasion of his statutory rights to proper Plan management, and invokes principles of disgorgement. In *David v. Alphin*, however, the Fourth Circuit rejected a similar argument as conflating the concepts of statutory and constitutional standing.[102] We agree with the Fourth Circuit's reasoning in this regard. Article III standing is distinct from statutory standing, and we decline to undermine this distinction by recognizing the latter as conferring the former. Though the Supreme Court in *Lujan v. Defenders of Wildlife* allowed that the invasion of statutory rights might create standing, *Lujan* addressed constitutional standing arising from *de facto* injury, which is not alleged by a breach of fiduciary duty.[103] Importantly, the *Lujan* Court clarified that a legislative creation of rights does not eliminate the injury requirement for a party seeking review.[104] Accordingly, at least with regard to a direct injury to Pundt as a class representative, we conclude that the allegations are insufficient to support his standing to assert this claim.

Harm to Plan as Injury-in-Fact. While the alleged fiduciary misconduct is thus too attenuated to suffice as direct injury to Pundt, Appellants alternatively assert that the injury to the Plan itself is sufficient because Pundt is statutorily authorized to assert the claim on behalf of the Plan.

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[102] *See David*, 704 F.3d at 338.
[103] 504 U.S. 555, 577–78 (1992).
[104] *See id.* at 578.

In support of his argument that a direct-benefit plan participant may bring suit on behalf of the plan, Appellants quote (without attribution) the Supreme Court's discussion in *Sprint Communications Co., L.P. v. APCC Services, Inc.*, of the various examples where courts permit suit for the benefit of parties that are not themselves bringing suit.[105] The *Sprint* Court held that an assignee for collection has Article III standing, even where the recovered proceeds of the claim are promised to the assignor, and even though the assignee did not originally suffer any injury.[106] Supporting the proposition that "the assignee of a claim has standing to assert the injury in fact suffered by the assignor," the *Sprint* Court cited to *Vermont Agency of Natural Resources v. United States ex rel. Stevens*.[107] In *Vermont Agency*, the Court held that a relator had Article III standing to bring a *qui tam* action because, through the government's partial assignment its claim for damages, the government had conferred its injury in fact to the relator.[108] In both *Sprint* and *Vermont Agency*, the Court found that the petitioners had standing based on the history and precedent permitting assignees to maintain suit.[109]

In light of this precedent, Appellants posit that Plan participants may bring suit in a quasi-representative capacity, satisfying Article III's injury-in-fact requirement via an injury to the Plan. However, we decline to adopt this

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[105] 554 U.S. 269, 287–88 (2008) (noting that "federal courts routinely entertain suits which will result in relief for parties that are not themselves directly bringing suit. Trustees bring suits to benefit their trusts; guardians ad litem bring suits to benefit their wards; receivers bring suit to benefit their receiverships; assignees in bankruptcy bring suit to benefit bankrupt estates; executors bring suit to benefit testator estates; and so forth.").

[106] 554 U.S. at 285–87.

[107] 529 U.S. 765 (2000).

[108] *See id.* at 773.

[109] *See Sprint*, 554 U.S. at 285–86.

position because both *Sprint* and *Vermont Agency* are distinguishable in critical respects. First, those cases involved assignment between the parties, while here the Plan and Plan participants have no such relationship, and the Appellants do not argue that ERISA effects such an assignment (as did the statute in *Vermont Agency*). Since the Court's reasoning in both cases was firmly grounded on the history and tradition of assignment relationships, applying that reasoning to a circumstance in which no such relationship existed is speculative.

Second and even more significant, *Sprint* and *Vermont Agency* both involved the assignor as the injured party. Here, on the other hand, Appellants seek standing based on statutory authorization by an uninjured government, to seek redress by one private party of the injury to another private party. As the Eighth Circuit noted regarding similar circumstances, extending *Sprint* in such a way raises "serious constitutional concerns," because "[i]f Congress could assign an ERISA plan's claim to a participant who is not injured, . . . then what principled reason would preclude Congress from assigning the claim to any stranger?"[110] Collectively, the facts and reasoning of *Sprint* and *Vermont Agency* allow a practical answer to this question, permitting Congress to satisfy the injury-in-fact by statutory assignment, yet only when the government is the injured party. Bearing in mind that "[i]n no event . . . may Congress abrogate Article III minima," we decline to otherwise construe and expand the reasoning of *Sprint*.[111]

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[110] *McCullough v. AEGON USA Inc.*, 585 F.3d 1082, 1086 (8th Cir. 2009).
[111] *Gladstone Realtors v. Village of Bellwood*, 441 U.S. 91, 100 (1979).

For those reasons, we find no error the district court's dismissing the claim of the Non-Transferee Class for lack of subject matter jurisdiction.

III. CONCLUSION

For the foregoing reasons, we AFFIRM the judgment of the district court.

REVISED October 3, 2016

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

United States Court of Appeals
Fifth Circuit
FILED
September 26, 2016
Lyle W. Cayce
Clerk

No. 15-20282

RALPH WHITLEY, Individually and on behalf of others similarly situated; FRANKIE RAMIREZ; DAVID M. HUMPHRIES; CHARIS MOULE; EDWARD F. MINEMAN; SYED ARSHADULLAH; JERRY T. MCGUIRE; MAUREEN S. RIELY; THOMAS P. SOESMAN,

Plaintiffs - Appellees

v.

BP, P.L.C.; ANTHONY HAYWARD; THE SAVINGS PLAN INVESTMENT OVERSIGHT COMMITTEE; RICHARD J. DORAZIL; COREY CORRENTI; MARVIN DAMSMA; JAMES DUPREE; PATRICK GOWER; JEANNE M. JOHNS; PATRICIA H. MILLER; STEPHEN J. RINEY; BRIAN D. SMITH; LORD JOHN BROWNE; STEPHANIE C. MOORE; BP CORPORATION NORTH AMERICA, INCORPORATED; BP AMERICA, INCORPORATED; LAMAR MCKAY; GREGORY T. WILLIAMSON; NEIL SHAW; THOMAS L. TAYLOR; BP CORPORATION NORTH AMERICA, INCORPORATED'S BOARD OF DIRECTORS; ROBERT A. MALONE,

Defendants - Appellants

Appeal from the United States District Court
for the Southern District of Texas

Before WIENER, CLEMENT, and COSTA, Circuit Judges.

EDITH BROWN CLEMENT, Circuit Judge:

In this stock-drop suit, the question on appeal is whether the district court erred in holding that the plaintiff stockholders' amended complaint stated a plausible claim under the pleading standards of *Fifth Third Bancorp v. Dudenhoeffer,* 134 S. Ct. 2459 (2014). Because we conclude that it did, we reverse and remand.

I.

BP, p.l.c. ("BP") is a multinational oil and gas company headquartered in London, England. BP offered its employees a choice of investment and savings plans (the "Plans") regulated by ERISA, 29 U.S.C. §§ 1001-1461. The Plans included the BP Stock Fund—an employee stock ownership plan ("ESOP") comprised primarily of BP stock—as an investment option.

On April 20, 2010, the BP-leased *Deepwater Horizon* offshore drilling rig exploded, causing a massive oil spill in the Gulf of Mexico and a subsequent decline in BP's stock price. The BP Stock Fund lost significant value, and the affected investors filed suit on June 24, 2010, alleging that the plan fiduciaries: (1) breached their duties of prudence and loyalty by allowing the Plans to acquire and hold overvalued BP stock; (2) breached their duty to provide adequate investment information to plan participants; and (3) breached their duty to monitor those responsible for managing the BP Stock Fund.

The district court determined that the fiduciaries' investments in company stock were entitled to a "presumption of prudence" under *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 255 (5th Cir. 2008) (applying *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995), *abrogated by Fifth Third*, 134 S. Ct. 2459). The district court held that the plaintiffs (hereafter "stockholders") had failed to overcome the *Moench* presumption and dismissed their claims under Federal Rule of Civil Procedure 12(b)(6). The stockholders appealed, and while their appeal was pending in this court, the Supreme Court issued *Fifth Third*, holding that there was no such "presumption of prudence" under ERISA. 134

S. Ct. at 2467. Instead, the Court held that "[t]o state a claim for breach of the duty of prudence on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it." *Id.* at 2472. This court then vacated the district court's judgment and remanded for reconsideration in light of *Fifth Third*. *Whitley v. BP, P.L.C.*, 575 F. App'x 341, 343 (5th Cir. 2014).

On remand, the stockholders moved to file an amended complaint alleging, as per *Fifth Third*, that the defendant fiduciaries possessed unfavorable inside information about BP and that they could have taken various alternative actions that would not have done more harm than good to the BP Stock Fund. The district court held that: (1) the stockholders had plausibly alleged that the defendants had inside information; and (2) the stockholders had plausibly alleged two alternative actions that the defendants could have taken that met the *Fifth Third* standard: freezing, limiting, or restricting company stock purchases; and disclosing unfavorable information to the public. The district court granted the motion to amend with respect to pleading these alternative actions. It then certified the defendants' motion for interlocutory appeal.

II.

Under 28 U.S.C. § 1292(b), this court has "appellate jurisdiction over the order certified to the court of appeals," and "review is not limited to the controlling question of law formulated by the district court in its certification order." *Hines v. Alldredge*, 783 F.3d 197, 200 (5th Cir. 2015). This court reviews "de novo a district court's grant or denial of a Rule 12(b)(6) motion to dismiss." *Id.* at 200–01 (quoting *True v. Robles,* 571 F.3d 412, 417 (5th Cir. 2009)). Here, because the district court's grant of leave to amend was the functional

equivalent of a denial of a Rule 12(b)(6) motion to dismiss, and was based on a question of law, this court reviews the district court's order de novo.

III.

ERISA, 29 U.S.C. §§ 1001-1461, protects participants in voluntarily established, private sector retirement plans. It does this "by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans." 29 U.S.C. § 1001(b). It "provides that an employer who sponsors an employee plan may also serve as a fiduciary of that plan," and it "imposes on the employer-fiduciary and on those who manage the plan strict statutory duties, including loyalty, prudence, and diversification." *Kirschbaum*, 526 F.3d at 248.

Here, the BP Stock Fund was an ESOP. "The term 'employee stock ownership plan' means an individual account plan . . . which is designed to invest primarily in qualifying employer securities . . . ." 29 U.S.C. § 1107(d)(6)(A). When the share price of an employer's stock decreases, the value of an employee-held ESOP account decreases as well. When the share price of an employer's stock decreases significantly, the affected employees often sue to recover their losses on their investments in employer stock. Such actions are commonly known as "stock-drop" suits.

Courts have recognized a tension between a fiduciary's duty to prudently manage investments under ERISA and Congress's allowance of funds composed primarily of employer stock. In *Moench*, the Third Circuit framed the question as follows: "To what extent may fiduciaries of [ESOPs] be held liable under [ERISA] for investing solely in employer common stock, when both Congress and the terms of the ESOP provide that the primary purpose of the plan is to invest in the employer's securities[?]" 62 F.3d at 556. There, the plaintiffs sued after their employer, a bank, collapsed, wiping out their ESOP investments. After a lengthy discussion of the history and purpose of ERISA

and ESOP funds, the Third Circuit ultimately held that "an ESOP fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision." *Id.* at 571. This presumption was later adopted by several other circuits, including this one in *Kirschbaum*, 526 F.3d at 255.

The *Moench* presumption was rejected by the Supreme Court in *Fifth Third*. 134 S. Ct. 2459. There, the defendants included a large financial services firm and the plaintiffs were ESOP participants. The firm's stock price plummeted seventy-four percent during the great recession. The plaintiffs sued, alleging that "the fiduciaries knew or should have known that Fifth Third's stock was overvalued and excessively risky" based on both public information and nonpublic, i.e., inside, information. *Id.* at 2464. The district court held that the defendants were entitled to a "presumption that their decision to remain invested in Fifth Third stock was reasonable," *Dudenhoeffer v. Fifth Third Bancorp,* 757 F. Supp. 2d 753, 758 (S.D. Ohio 2010), and cited *Moench*. The district court held that the plaintiffs had failed to allege sufficient facts to overcome the presumption and dismissed the complaint under Rule 12(b)(6). The Sixth Circuit reversed. *Dudenhoefer v. Fifth Third Bancorp*, 692 F.3d 410, 424 (6th Cir. 2012). The Sixth Circuit did not reject the application of the presumption; rather, it held that the presumption concerns questions of fact that do not apply at the pleading stage. *Id.* at 418-19.

The Supreme Court noted that "[i]n applying a 'presumption of prudence' that favors ESOP fiduciaries' purchasing or holding of employer stock, the lower courts have sought to reconcile congressional directives that are in some tension with each other." 134 S. Ct. at 2465. "On the one hand, ERISA itself subjects pension plan fiduciaries to a duty of prudence," while "[o]n the other hand, Congress recognizes that ESOPs are 'designed to invest primarily in' the stock of the participants' employer, § 1107(d)(6)(A), meaning that they

are *not* prudently diversified." *Id.* After reviewing the "pertinent provisions of ERISA," the Court held that "the law does not create a special presumption favoring ESOP fiduciaries" and that "the same standard of prudence applies to all ERISA fiduciaries, including ESOP fiduciaries, except that an ESOP fiduciary is under no duty to diversify the ESOP's holdings." *Id.* at 2467.

The Court nonetheless recognized the plaintiffs' "legitimate" concern "that subjecting ESOP fiduciaries to a duty of prudence without the protection of a special presumption will lead to conflicts with the legal prohibition on insider trading" because "ESOP fiduciaries often are company insiders and because suits against insider fiduciaries frequently allege . . . that the fiduciaries were imprudent in failing to act on inside information they had about the value of the employer's stock." *Id.* at 2469. The Court disagreed that the presumption of prudence applied by the lower courts was "an appropriate way to weed out meritless lawsuits" and stated that such a task could "be better accomplished through careful, context-sensitive scrutiny of a complaint's allegations." *Id.* at 2470.

Turning to pleading standards, the Court stated that "where a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible as a general rule, at least in the absence of special circumstances." *Id.* at 2471. The Court then stated:

> To state a claim for breach of the duty of prudence on the basis of inside information, a plaintiff must plausibly allege an alternative action that the defendant could have taken that would have been consistent with the securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it.

Id. at 2472. The Court vacated and remanded, "leav[ing] it to the courts below to apply the foregoing to the complaint in this case in the first instance." *Id.* at 2473.

The Ninth Circuit soon took on the challenge of interpreting the Supreme Court's *Fifth Third* pleading standards in *Harris v. Amgen, Inc.*, 788 F.3d 916 (9th Cir. 2015). *Harris*—like this case—was an employee stock-drop action that was filed before *Fifth Third*. In *Harris*, the plaintiffs alleged that Amgen, a pharmaceutical company, concealed unfavorable information about a drug, and that when the unfavorable information came to light, Amgen's share price declined significantly. The plaintiffs claimed "that fiduciaries of Amgen's stock-ownership plans knew or should have known that the stock was overvalued based on inside information, and should have either removed the Amgen stock as an investment option or revealed to the general public" the unfavorable inside information. *Id.* at 924 (Kozinski, J., dissenting from denial of rehearing en banc). The Ninth Circuit decided that the allegations in the plaintiffs' complaint—despite being written before *Fifth Third*—were sufficient because it was "plausible" that the "defendants could remove the Fund from the list of investment options without causing undue harm to plan participants." *Id.* at 938. The court further held that the Supreme Court had "articulated certain standards for ERISA liability in *Fifth Third*" but that the Ninth Circuit had "already assumed those standards" in an earlier opinion. *Id.* at 940.

The Supreme Court reversed. *Amgen Inc. v. Harris*, 136 S. Ct. 758 (2016). The Court clarified that the *complaint itself* must plausibly allege "that a prudent fiduciary in the same position 'could not have concluded' that the alternative action 'would do more harm than good.'" *Id.* at 760 (quoting *Fifth Third*, 134 S. Ct. at 2463). The Court clarified that a court cannot simply presume that the plaintiff's proposed alternatives would satisfy the *Fifth Third* standards; rather, "the facts and allegations supporting that proposition

should appear in the stockholders' complaint." *Id.* Noting that the plaintiffs were the "masters of their complaint," the Court left it to the district court to determine whether the *Amgen* plaintiffs could amend their complaint to satisfy the standards of *Fifth Third*. *Id.*

In light of these decisions, the district court here erred when it altered the language of *Fifth Third* to reach its holding. In *Fifth Third*, the Supreme Court stated that the plaintiff's proposed alternative must be one that "a prudent fiduciary in the same circumstances would not have viewed as *more likely to harm the fund than to help it*." 134 S. Ct. at 2472 (emphasis added). But here the district court stated that it could not determine, "on the basis of the pleadings alone, that *no* prudent fiduciary would have concluded that [the alternatives] would do *more good than harm*" (second emphasis added). These statements are not equivalent. Under the Supreme Court's formulation, the plaintiff bears the significant burden of proposing an alternative course of action so clearly beneficial that a prudent fiduciary *could not conclude* that it would be more likely to harm the fund than to help it.

Here, the stockholders have failed to do so. Indeed, in certifying this case for interlocutory appeal the district court recognized that if defendants have correctly read *Dudenhoeffer* to require "plaintiffs to plausibly allege that *no* prudent fiduciary could have concluded that the proposed alternative action would do more harm than good"—and *Amgen* has since confirmed that is the standard—then the plaintiff's claim should be dismissed. In their amended complaint, the stockholders state that their proposed alternatives "(a) could have been done without violating the securities laws or any other laws; (b) should have been done to fulfill Defendants' fiduciary obligations under ERISA; and (c) would not have been more likely to harm the BP Stock Fund than to help it." Aside from these conclusory statements, the stockholders do not specifically allege, for each proposed alternative, that a *prudent fiduciary*

could not have concluded that the alternative would do more harm than good, nor do they offer facts that would support such an allegation. This runs counter to the Supreme Court's directive that "the facts and allegations supporting" an alternative action that could satisfy *Fifth Third*'s standards "should appear in the stockholders' complaint." 136 S. Ct. at 760. *See also Rinehart v. Lehman Bros. Holdings Inc.*, 817 F.3d 56, 68 (2d Cir. 2016) (affirming a dismissal under 12(b)(6) because the plaintiffs' complaint did not "plausibly plead facts and allegations showing that a prudent fiduciary during the class period 'would not have viewed [disclosure of material nonpublic information regarding Lehman or ceasing to buy Lehman stock] as more likely to harm the fund than to help it'" (quoting *Amgen*, 136 S. Ct. at 759) (alteration in original)).

The amended complaint states that BP's stock was overvalued prior to the *Deepwater Horizon* explosion due to "numerous undisclosed safety breaches" known only to insiders. In other words, the stockholders theorize that BP stock was overpriced because BP had a greater risk exposure to potential accidents than was known to the market. Based on this fact alone, it does not seem reasonable to say that a prudent fiduciary at that time could not have concluded that (1) disclosure of such information to the public or (2) freezing trades of BP stock—both of which would likely lower the stock price—would do more harm than good. In fact, it seems that a prudent fiduciary could very easily conclude that such actions *would* do more harm than good.

Accordingly, we find that the stockholders' amended complaint is insufficient, and the district court erred in granting the stockholders' motion to amend.

IV.

For the foregoing reasons, the judgment of the district court is REVERSED, and the case is REMANDED for further proceedings.

United States District Court
For the Northern District of California

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6 IN THE UNITED STATES DISTRICT COURT
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8 FOR THE NORTHERN DISTRICT OF CALIFORNIA
9
10 COBALT PARTNERS, LP, COBALT
11 PARTNERS II, LP, COBALT OFFSHORE MASTER FUND, LP AND COBALT KC
12 PARTNERS, LP,
13 Plaintiffs,
14 v.
15 SUNEDISON, INC., AHMAD CHATILA, BRIAN WUEBBELS, MARTIN TRUONG, ALEJANDRO
16 HERNANDEZ, EMMANUEL HERNANDEZ, ANTONIO R. ALVAREZ, PETER BLACKMORE,
17 CLAYTON DALEY JR., GEORGANNE PROCTOR, STEVEN TESORIERE, JAMES B.
18 WILLIAMS, RANDY H. ZWIRN, GOLDMAN, SACHS & CO., J.P. MORGAN SECURITIES LLC,
19 MORGAN STANLEY & CO. LLC, MERRILL LYNCH, PIERCE, FENNER & SMITH
20 INCORPORATED, DEUTSCHE BANK SECURITIES INC., MACQUARIE CAPITAL
21 (USA), INC., MCS CAPITAL MARKETS LLC and DOES 1- 25, inclusive,
22 Defendants.
23 _______________________________________/
24 AND RELATED CASES.
_______________________________________/

No. C 16-02263 WHA

Related Cases:

Case No. 3:16-cv-02264-WHA
Case No. 3:16-cv-02265-WHA
Case No. 3:16-cv-02268-WHA

ORDER (1) DENYING MOTIONS TO REMAND; (2) GRANTING MOTIONS TO TRANSFER; (3) CERTIFYING ISSUE FOR INTERLOCUTORY REVIEW; AND (4) STAYING ACTIONS

25
26 **INTRODUCTION**

27 In these related securities actions, plaintiffs move for remand and defendants move for
28 transfer to the United States District Court for the Southern District of New York for referral to
bankruptcy court. For the reasons stated herein, the motions to remand are **DENIED** and the

United States District Court
For the Northern District of California

1 motions to transfer are **GRANTED**. The Court also certifies the following issue for interlocutory
2 review under 28 U.S.C. 1292(b): whether Section 22(a) of the 1933 Securities Act bars
3 removal of actions "related to" a bankruptcy action pursuant to 28 U.S.C 1452(a).

4 **STATEMENT**

5 Before the Court are four related actions brought by purchasers of securities issued by
6 defendant SunEdison, Inc. and its partially-owned affiliate TerraForm Global, Inc. ("Global").
7 At all material times, SunEdison, now bankrupt, financed, built, and operated renewable energy
8 projects across the world. Global is an affiliated company known as a "yieldco," which was
9 created to purchase and operate renewable energy projects developed by SunEdison.

10 The nub of all four lawsuits is that defendants violated various securities laws by failing
11 to disclose information related to SunEdison's debts and weakened liquidity. Specifically,
12 plaintiffs allege that defendants neglected to disclose that:

13 • SunEdison had breached the debt covenants of one of its borrowing
14 agreements and was required to post hundreds of millions of dollars
15 in additional collateral as a result.

16 • SunEdison had borrowed $169 million at an effective interest rate
17 of 15 percent to raise the funds it needed to acquire projects for
18 Global and/or to cure the debt covenant breach.

19 All four actions assert claims under Sections 11, 12, and 15 of the Securities Act of 1933
20 regarding a preferred stock offering by SunEdison, which took place on August 18, 2015. Two
21 of the lawsuits, *Omega* and *Glenview*, also bring claims for violations of the Maryland
22 Securities Act, breach of contract, and negligent misrepresentation based on a private offering
23 of Global Class D units that took place on June 9, 2015. The *Omega* complaint also asserts
24 additional claims under Section 12 and 15 and the Maryland Securities Act related to a private
25 offering of Global bonds that took place on July 31, 2015.

26 Of the four cases, only *Bloom* is a proposed class action. Plaintiffs in the other
27 individual cases, *Cobalt*, *Glenview*, and *Omega*, are investment funds. Defendants in the four
28 lawsuits are as follows:

United States District Court
For the Northern District of California

- In *Bloom*, defendants are SunEdison and nine individuals who served as its officers or directors. Since the filing of the *Bloom* complaint, the parties have stipulated to dismissal of SunEdison (which stipulation is hereby approved).
- In *Cobalt*, defendants are SunEdison, officers and directors of both SunEdison and Global, and investment banks that served as underwriters to SunEdison's preferred stock offering.
- In *Glenview*, defendants are SunEdison, Global, fourteen individuals who served as officers or directors at one or both companies, and fifteen financial institutions that underwrote one or more of the offerings at issue.
- In *Omega*, defendants are SunEdison, Global, fourteen individuals who served as officers or directors at one or both companies, and ten financial institutions that underwrote one or more of the offerings at issue.

The actions were originally filed in San Mateo County Superior Court on March 28, March 29, March 30, and April 4, 2016. On April 26, 2016, SunEdison filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York, *In re SunEdison, Inc.*, et al., Case No. 16-10992 (Bankr. S.D.N.Y.). All proceedings against SunEdison are thus stayed pursuant to 11 U.S.C. 362(a). Defendants subsequently removed all of these actions pursuant to 28 U.S.C. 1452(a) as proceedings "related to" SunEdison's bankruptcy case.

In the bankruptcy action, SunEdison filed motions to modify the automatic stay to allow insurers to make payments pursuant to insurance policies that cover securities claims against SunEdison, the yieldcos, and their officers and directors (Bartlett Decl., Exhs. 4–5). The bankruptcy court granted SunEdison's motions, permitting the insurers to make payments under the polices in connection with these and other securities actions of up to: (1) twelve million

United States District Court
For the Northern District of California

1 dollars as to Global, the other yieldcos, and their officers and directors; and (2) eight million
2 dollars as to the officers and directors of SunEdison (Bartlett Decl., Exhs. 6–7).
3 A prior order related these four actions. Another cluster of actions regarding Global's
4 IPO is proceeding before Judge Beth Labson Freeman. *See, e.g., Beltran v. TerraForm Global,*
5 *Inc. et al.*, Case No. 5:15-cv-04981 (the "Global IPO cases"). On July 27, 2016, a motion was
6 filed with the Judicial Panel on Multidistrict Litigation requesting transfer of these and ten other
7 actions to the Southern District of New York for coordinated or consolidated pretrial
8 proceedings. *See In re SunEdison, Inc. Securities Litigation*, MDL No. 2742 (Dkt. No. 1).
9 Now, plaintiffs in all four of the instant actions move to remand the actions to state
10 court. In addition, defendants in all four actions move to transfer the action to the United States
11 District Court for the Southern District of New York for referral to the bankruptcy court in that
12 district, or at least for more convenient coordination. Defendants in *Cobalt, Glenview,* and
13 *Omega* filed motions to dismiss, and these motions are set for hearing on October 13, 2016 (but
14 will be taken off calendar due to the stay discussed below).
15 This order follows full briefing, including supplemental briefing, and oral argument.
16 **ANALYSIS**
17 **1. MOTION TO REMAND.**
18 Federal courts are courts of limited jurisdiction, and a cause of action is presumed to lie
19 outside this limited jurisdiction until the party asserting jurisdiction establishes the contrary.
20 *Kokkonen v. Guardian Life Ins. Co. of Am.*, 511 U.S. 375, 377 (1994). In general, removal
21 statutes are strictly construed against removal. *Luther v. Countrywide Home Loans Servicing*
22 *LP*, 533 F.3d 1031, 1034 (9th Cir. 2008). A defendant has the burden of establishing that
23 removal is proper. *Gaus v. Miles, Inc.*, 980 F.2d 564, 566 (9th Cir. 1992). However, a plaintiff
24 seeking remand has the burden to prove that an express exception to removal exists. *Luther,*
25 533 F.3d at 1034.
26 Defendants base their removal on 28 U.S.C 1452(a), which permits removal of an action
27 that is "related to" a bankruptcy action under Title 11. Section 1452(a) states:
28 A party may remove any claim or cause of action in a civil action other than a proceeding before the United States Tax Court or a

United States District Court
For the Northern District of California

> civil action by a governmental unit to enforce such governmental unit's police or regulatory power, to the district court for the district where such civil action is pending, if such district court has jurisdiction of such claim or cause of action under section 1334 of this title.

In turn, Section 1334(b) states:

> [N]otwithstanding any Act of Congress that confers exclusive jurisdiction on a court or courts other than the district courts, the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in *or related to* cases under title 11.

Thus, an action may be removed under Section 1452(a) if it is "related to" a bankruptcy action.

Plaintiffs make three main arguments in support of their motions to remand. *First*, plaintiffs argue that removal was not proper because these actions are not "related to" the SunEdison bankruptcy action. *Second*, plaintiffs assert that Section 22(a) of the Securities Act of 1933 bars removal of the complaints.[1] *Third*, plaintiffs argue that equitable factors warrant remand under Section 1452(b).

This order analyzes each of these arguments below.

A. "Related to" Jurisdiction.

Defendants must show that the actions are "related to" a bankruptcy action for removal to be proper under Section 1452(a). Our court of appeals has adopted the Third Circuit's broad standard for determining "related to" bankruptcy jurisdiction from *Pacor, Inc. v. Higgins*, 743 F.2d 984 (3d Cir. 1984). Under that standard, an action is "related to" a bankruptcy action if "the outcome of the proceeding could conceivably have any effect on the estate being administered in bankruptcy." *In re Fietz*, 852 F.2d 455, 457 (9th Cir. 1988). "An action is related to bankruptcy if the outcome could alter the debtor's rights, liabilities, options, or freedom of action (either positively or negatively) and which in any way impacts upon the handling and administration of the bankrupt estate." *Ibid.* (quoting *Pacor*, 743 F.2d at 994).

Defendants assert three separate bases for "related to" jurisdiction: (1) the rights of the individual defendants and underwriter defendants to indemnification from SunEdison under

[1] Plaintiffs in *Bloom* concede that the Court has discretion to deny the motion for remand but nonetheless urge the Court to remand the action on equitable grounds under Section 1452(b).

United States District Court
For the Northern District of California

1 separate indemnification agreements; (2) the entitlement of the individual defendants to
2 payments under directors and officers insurance policies purchased by SunEdison; and (3) the
3 right of any defendant held liable to seek statutory contribution from SunEdison. In addition,
4 defendants in *Glenview* and *Omega* assert a fourth bases for "related to" jurisdiction:
5 SunEdison's significant ownership in Global. Defendants assert that any costs that Global
6 incurs in responding to *Glenview* and *Omega* will diminish the value of the SunEdison estate's
7 equity in Global.

8 Because this order concludes that the actions are "related to" the SunEdison bankruptcy
9 on the basis of the indemnification rights of the individual and underwriter defendants, this
10 order need not reach the other bases proffered by defendants.

11 Defendants contend that the actions are "related to" SunEdison's bankruptcy action
12 because the individual and underwriter defendants are entitled to indemnification from
13 SunEdison for the claims arising from the actions. SunEdison's Amended and Restated
14 Certificate of Incorporation provides as follows (Bartlett Decl., Exh. 1):

15 The Corporation shall indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or
16 completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the
17 right of the Corporation) by reason of the fact that he is or was a director, officer, employee or agent of the Corporation, or is or was
18 serving at the request of the Corporation as a director, officer, employee or agent of another corporation, partnership, joint
19 venture, trust or other enterprise, to the full extent authorized or permitted by law, as now or hereafter in effect, against expenses
20 (including attorneys' fees) judgments, fines and amounts paid in settlement actually and reasonably incurred by him in connection
21 with such action, suit or proceeding.

22 The Underwriting Agreements contain a similar provision (Bartlett Decl., Exh. 3):

23 The Company agrees to indemnify and hold harmless each Underwriter . . . against any losses, claims, damages or liabilities,
24 joint or several, to which they or any of them may become subject under the [Securities] Act, the Exchange Act or other U.S. federal
25 or state statutory law or regulation, at common law or otherwise . . . and will reimburse, as incurred, the Underwriters . . . for any legal
26 or other expense incurred . . . in connection with investigating, defending against or appearing as a third-party witness in
27 connection with any such loss, claim, damage, liability or action.

28

United States District Court
For the Northern District of California

The indemnification rights of the individual defendants give rise to "related to" jurisdiction. SunEdison's Amended and Restated Certificate of Incorporation requires it to indemnify the individual defendants as to any "pending" action "to the full extent authorized or permitted by law," including as to expenses such as attorney's fees. Under Delaware law, which governs SunEdison's articles of incorporation, defendants' rights to advancement of attorney's fees and costs have already accrued. *See In re RNI Wind Down Corp.*, 369 B.R. 174, 186 (Bankr. D. Del. 2007) (noting that under Delaware law, advancement is a "right whereby a potential indemnitee has the ability to force the company to pay his litigation expenses as they are incurred regardless of whether he will ultimately be entitled to indemnification"); 8 Del. C. 145(a). Indeed, the New York bankruptcy court has already authorized payment of proceeds from SunEdison's insurance policies to pay for attorney's fees related to these and other actions (Bartlett Decl., Exhs. 6–7). As such, the indemnification rights have already affected the administration of the bankruptcy estate. This order concludes that "related to" jurisdiction exists on that basis.

The indemnification rights of the underwriter defendants also give rise to "related to" jurisdiction under the "conceivability" standard. *Carpenters Pension Trust For S. California v. Ebbers*, 299 B.R. 610, 613 (C.D. Cal. 2003) (Judge Consuelo B. Marshall) ("Courts in the Ninth Circuit have held that a defendant's claim for contractual indemnity against an entity in bankruptcy gives rise to "related to" jurisdiction."); *Pac. Life Ins. Co. v. J.P. Morgan Chase & Co.*, No. SA CV 03-813GLT(ANX), 2003 WL 22025158, at *1 (C.D. Cal. June 30, 2003) (Judge Gary L. Taylor).

Plaintiffs contend that the indemnification agreements do not provide the basis for "related to" jurisdiction because, to hold SunEdison liable, defendants would need to file a second lawsuit. For support, plaintiffs cite to the Third Circuit's decision in *Pacor*. Plaintiffs' reliance on *Pacor* is misplaced, however. In *Pacor*, those plaintiffs sued a chemical distributor over work-related exposure to asbestos. In turn, the distributor filed a third-party complaint impleading the manufacturer of the asbestos. The Third Circuit concluded that the original lawsuit was *not* related to the bankruptcy of the manufacturer because "the bankruptcy estate

United States District Court
For the Northern District of California

could not be affected in any way until [the] third party action is actually brought and tried." *Pacor, Inc. v. Higgins*, 743 F.2d at 994. However, in dicta, the court distinguished a case where, as here, a *written* indemnification agreement existed, concluding that the written indemnification agreement would give rise to "related to" jurisdiction. *Id.* at 995.

This order concludes that the indemnification rights of the individual and underwriter defendants render these actions "related to" the SunEdison's bankruptcy action.

B. Section 22(a).

Plaintiffs argue that removal is barred here by Section 22(a) of the 1933 Securities Act, codified at 15 U.S.C. 77v(a). Section 22(a) provides for concurrent jurisdiction in state and federal courts over alleged violations of the Act. In addition, Section 22(a) forbids removal of actions that are brought in state court and that assert claims brought under the Act: "no case arising under this subchapter and brought in any State court of competent jurisdiction shall be removed to any court of the United States." 15 U.S.C. 77v(a). The only cases that are excepted under this removal bar are certain defined class actions.

Courts are divided over whether the removal bar of Section 22(a) trumps the bankruptcy removal provisions of Section 1452(a). *See Fed. Home Loan Bank of San Francisco v. Deutsche Bank Sec., Inc.*, No. 10-3039 SC, 2010 WL 5394742, at *5 (N.D. Cal. Dec. 20, 2010) (Judge Samuel Conti) (summarizing split of authority). Our court of appeals has not yet reached the issue. The only appellate court to address the issue, the Second Circuit, concluded that the bankruptcy removal provision of Section 1452(a) trumps Section 22(a). *California Pub. Employees' Ret. Sys. v. WorldCom, Inc.*, 368 F.3d 86, 108 (2d Cir. 2004). This order finds the Second Circuit's analysis in *WorldCom* persuasive and concludes that Section 1452(a) trumps Section 22(a)'s removal bar.

In *WorldCom*, the Second Circuit applied the statutory rule of interpretation that "a specific statute will not be controlled or nullified by a general one, regardless of the priority of enactment" unless there is a clear intention otherwise. *Id.* at 101 (quoting *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 153 (1976)). The Second Circuit concluded that Section 22(a) was *not* more specific than Section 1452(a). "[T]he class of claims covered by Section

United States District Court
For the Northern District of California

1 22(a) is no more specific than the class of claims covered by Section 1452(a). . . .Rather, just as
2 Section 1452(a) applies to many claims that are not brought under the 1933 Act, Section 22(a)
3 applies to many claims that are not "related to" a bankruptcy." *Id.* at 102.

4 The Second Circuit further noted that, even if Section 22(a) *were* more specific than
5 Section 1452(a), the Supreme Court's analysis in *Radzanower* would counsel against a
6 conclusion that Section 22(a) trumps Section 1452(a). "The Supreme Court in *Radzanower*
7 indicated that where the application of a specific statute would 'unduly interfere' with the
8 operation of a general statute that was enacted subsequent to the specific statute, the more
9 general statute controls." *Id.* at 103. The Second Circuit concluded that, "[w]ere Section 22(a)
10 construed to trump Section 1452(a), Section 22(a) could interfere with the operation of the
11 Bankruptcy Code, especially in large chapter 11 cases." *Ibid.*

12 The Second Circuit next analyzed the statutory conflict under the rule of recency. The
13 plaintiffs in *WorldCom*, like our plaintiffs here, argued that because Section 22(a) was amended
14 by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") in 1998, it trumped
15 Section 1452(a), which was enacted in 1984. The Second Circuit dismissed this argument,
16 however, concluding that SLUSA expanded federal jurisdiction over class actions but that
17 "nothing in the text or legislative history of SLUSA indicates that Congress intended to alter the
18 jurisdictional scheme applicable to *individual* actions under the 1933 Act." *Id.* at 104 (emphasis
19 in original).

20 The Second Circuit then analyzed the bankruptcy removal provision of Section 1452(a)
21 within its statutory framework of the federal jurisdictional scheme to determine if Congress
22 intended to except from it claims made nonremovable by another act of Congress. The court
23 first analyzed the general removal statute, Section 1441, which, by its terms, permits removal
24 "[e]xcept as otherwise expressly provided by Act of Congress." In contrast, Section 1452(a)
25 contains no such express exception for federal claims that are nonremovable under an Act of
26 Congress. The court concluded that the absence of such an exception in Section 1452(a)
27 "suggests that, in 1978, when it originally enacted Section 1452(a) as part of the Bankruptcy
28 Code, Congress did not intend for Section 22(a) and its analogues to bar removal of 'related to'

United States District Court
For the Northern District of California

claims." Therefore, the court concluded that Section 1452(a) trumped Section 22(a) and that individual claims brought pursuant to the Securities Act of 1933 could therefore be removed if "related to" a bankruptcy action.

Plaintiffs argue that the Second Circuit's interpretation in *WorldCom* is in conflict with the decision by our court of appeals in *Luther v. Countrywide Home Loans Servicing LP*, 533 F.3d 1031, 1034 (9th Cir. 2008). In *Luther*, our court of appeals concluded that the removal bar of Section 22(a) prevailed over the removal provisions of the Class Action Fairness Act. To reach this conclusion, our court of appeals concluded that Section 22(a) was a more specific statute versus the CAFA. "Here, the Securities Act of 1933 is the more specific statute; it applies to the narrow subject of securities cases and § 22(a) more precisely applies only to claims arising under the Securities Act of 1933. CAFA, on the other hand, applies to a 'generalized spectrum' of class actions." *Luther v. Countrywide Home Loans Servicing LP*, 533 F.3d 1031, 1034 (9th Cir. 2008).

This order disagrees with plaintiffs' assertion that *Luther* and *WorldCom* are in conflict. The fact that our court of appeals concluded that Section 22(a) trumped the removal provisions in CAFA does not mandate the conclusion that Section 22(a) also trumps Section 1452(a). *First*, the removal provisions in CAFA and Section 1452(a) are different and exist within different statutory frameworks. *Second*, even if our court of appeals were to conclude that Section 22(a) *is* more specific than Section 1452(a), our court of appeals could conclude, like the Second Circuit in *WorldCom,* that such an interpretation should be avoided under *Radzanower* because it would "interfere with the operation of the Bankruptcy Code, especially in large chapter 11 cases." *WorldCom, Inc.*, 368 F.3d at 103.

At least one other district court in this circuit has concluded that *Luther* does not mandate the conclusion that Section 22(a) trumps Section 1452(a). *Fed. Home Loan Bank of San Francisco v. Deutsche Bank Sec., Inc.*, No. 10-3039 SC, 2010 WL 5394742, at *6 (N.D. Cal. Dec. 20, 2010). In that decision, Judge Sam Conti concluded that Section 22(a) does *not* bar removal of actions "related to" a bankruptcy action under Section 1452(a).

United States District Court
For the Northern District of California

1 This order agrees with the Second Circuit in *WorldCom* and concludes that Section
2 22(a) does *not* bar removal of actions "related to" a bankruptcy action under Section 1452(a).
3 The Court certifies this issue for interlocutory review under 28 U.S.C. 1292(b).

4 **C. Equitable Factors.**

5 Under Section 1452(b), a district court "may remand such claim or cause of action on
6 any equitable ground." Plaintiffs argue that even if removal is permitted under Section 1452(a),
7 the Court should remand on equitable grounds. This order concludes that equitable factors do
8 not warrant remand here.

9 This order acknowledges that these actions will likely be litigated in the district court as
10 opposed to the bankruptcy court if transferred to New York. Nevertheless, that district court
11 there will be in a better position than a state court here to coordinate with the bankruptcy court
12 when needed. For example, discovery will likely require intervention by the bankruptcy court
13 since that court will presumably control SunEdison's documents. Settlement, too, will likely
14 require intervention by the bankruptcy court. This order concludes that the proximity of the
15 district court there to the bankruptcy court there will enable it to more easily regulate these
16 matters.

17 Plaintiffs argue that a transfer would deprive them of the ability to command live
18 testimony of nonparty witnesses who reside in California. This argument is unconvincing. The
19 Court provided plaintiffs with an extended opportunity to identify specific witnesses who reside
20 in California. Plaintiffs came up short. In their supplemental brief, plaintiffs merely asserted
21 that "SunEdison's former Chief Financial Officer ("CFO") for Latin American projects is based
22 in Belmont, CA, as is its former CFO responsible for Global Manufacturing and many members
23 of its Global Project Finance Team" (Supp. Br. 5). Plaintiffs assert that they "will not be able to
24 identify their trial witnesses before discovery" (*ibid.*). This is not convincing. Plaintiffs do not
25 need discovery to identify at least some names and positions of potential witnesses. This order
26 concludes that it is just as likely that more witnesses will testify live if the actions are
27 transferred to New York given that at least some of the underwriter defendants are based there.
28

United States District Court
For the Northern District of California

1 The absence of California claims also weighs against remand. *Cobalt* and *Bloom* assert
2 only federal securities claims. *Omega* and *Glenview* assert claims under Maryland securities
3 law and Maryland and Delaware common law. A California court will be in no better position
4 than a federal court to interpret Maryland and Delaware law. Moreover, federal securities law
5 provides the backbone of the complaints. This factor weighs against remand.

6 This order acknowledges the possibility of a comparative delay if the actions are
7 transferred to New York (versus a remand). This possibility, however, may be mitigated
8 somewhat by the ability of the district court to more easily coordinate discovery and settlement
9 issues with the bankruptcy court.

10 This order concludes that equitable factors do not favor remand here. The motions to
11 remand are therefore **DENIED**.

12 **2. MOTION TO TRANSFER.**

13 The parties dispute whether Section 1412 or Section 1404 applies to the transfer
14 motions. This order concludes that Section 1412 governs transfer here. Under Section 1412, a
15 district court "may transfer a case or proceeding under Title 11 to a district court for another
16 district in the interest of justice or for the convenience of the parties."

17 Here, the interest of justice and the convenience of the parties warrant transfer. *First*,
18 the proximity of the New York district court to the bankruptcy court will enable it to more
19 efficiently adjudicate the claims. *Second*, plaintiffs' choice of forum is undercut by the
20 apparently undisputed fact that plaintiffs do not reside in California.[2] *Finally*, the complaints do
21 not allege any California claims.

22 Little precedent exists for the removal and subsequent transfer of securities actions such
23 as these. Based on the experience level so far, this order concludes that transfer is the most
24 practical option. Experience will eventually teach us how productive (or not) the transfer proves
25 to be.

26

27 [2] At the hearing, defense counsel asserted that none of the plaintiffs reside in California. Plaintiffs did
28 not dispute that assertion at the hearing or in their supplemental briefing. Moreover, none of the complaints allege that any plaintiff resides in California. Furthermore, defendants submit declarations that the plaintiffs in *Omega*, *Glenview*, and *Cobalt* reside elsewhere according to SEC filings.

United States District Court
For the Northern District of California

The motions to transfer are **GRANTED**.

CONCLUSION

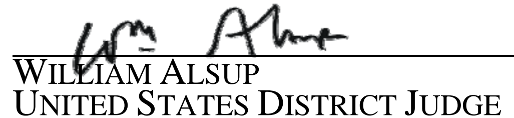
For the reasons stated herein, plaintiffs' motions to remand are **DENIED** and defendants' motions to transfer are **GRANTED**.

The Court hereby certifies the following issue for interlocutory review under Section 1292(b): whether Section 22(a) of the 1933 Securities Act bars removal of actions "related to" a bankruptcy action pursuant to Section 1452(a). The Court finds that this order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation.

This order **STAYS** these four actions until September 5, 2016, the deadline for plaintiffs to file a petition pursuant to Section 1292(b) and, if such a petition is filed, until such time as our court of appeals acts on it.

IT IS SO ORDERED.

Dated: August 26, 2016.



WILLIAM ALSUP
UNITED STATES DISTRICT JUDGE

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

CIVIL MINUTES – GENERAL

Case No.	LA CV15-01654 JAK (AJWx)	Date	August 25, 2016
Title	Jason Feola v. Edward R. Cameron, et al.		

Present: The Honorable	JOHN A. KRONSTADT, UNITED STATES DISTRICT JUDGE
Andrea Keifer	Not Reported
Deputy Clerk	Court Reporter / Recorder
Attorneys Present for Plaintiffs:	Attorneys Present for Defendants:
Not Present	Not Present

Proceedings: **(IN CHAMBERS) ORDER RE DEFENDANTS' MOTION TO DISMISS PLAINTIFFS' SECOND AMENDED COMPLAINT (DKT. 44); PLAINTIFFS' MOTION TO STRIKE THE DECLARATION OF MICHELLE VAN OPPEN (DKT. 48)**

I. Introduction

Jason Feola ("Plaintiff") brought this putative class action on behalf of all persons and entities, other than Defendants and their affiliates, who purchased or otherwise acquired the common stock of Appliance Recycling Centers of America, Inc. ("ARCA" or the "Company") from March 15, 2012 through February 11, 2015 (the "Class Period"). Subsequently Karsan Value Funds and Peter B. Miller (collectively, "Plaintiffs") were appointed as lead Plaintiffs. Dkt. 26. Plaintiffs allege that ARCA and two of its officers, Edward R. Cameron ("Cameron") and Jeffrey A. Cammerrer ("Cammerrer") (collectively, "Defendants"), violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(a) *et seq.* (the "Exchange Act") when they issued financial reports that overstated the financial position of ARCA because they did not account for certain taxes.

Defendants' prior motion to dismiss the first amended complaint ("FAC") was granted in an earlier order ("Prior Order" (Dkt. 40 at 11)) because its allegations failed adequately to allege scienter, a necessary element of Plaintiff's claims ("Viewed as a whole, the allegations are not sufficient to meet this test. The inference of scienter is no greater than the one of negligence or inadvertence." *Id.*). Plaintiffs subsequently filed a second amended complaint ("SAC") (Dkt. 41), and Defendants responded with a second motion to dismiss ("Motion"). Dkt. 44. The Motion contends, *inter alia*, that any new allegations in the SAC fail to cure the pleading deficiencies recognized in the Prior Order.

A hearing on the Motion was held on May 2, 2016, and the matter was taken under submission. Dkt. 59. For the reasons stated in this Order, the Motion is **GRANTED.**

II. Factual Background

A. ARCA's Appliance Recycling and Replacement Services

ARCA is a publicly traded company headquartered in Minneapolis, Minnesota. SAC, Dkt. 41 ¶29. It was established in 1983, and currently has more than 300 employees and generates annual revenues of approximately $100 million. *Id.* ¶ 3. ARCA sells new household appliances through retail stores and provides appliance recycling and replacement services for electric utility companies and under energy efficiency programs. *Id.* ¶¶ 2, 29. Utility companies often provide incentives for consumers to discontinue use of or replace inefficient appliances. *Id.* ¶ 39. As part of this process, some utility companies offer appliance replacement programs for certain customers. *Id.* Utilities often enter contracts with appliance replacement providers, such as ARCA, to implement these programs. *Id.* When ARCA replaces an appliance, it is paid directly by the utility company for any product and service. *Id.* ¶ 38.

In California, ARCA participates in recycling and replacement service programs for low income persons in Los Angeles. It participates in most of these programs through contracts with the Southern California Public Power Authority ("SCPPA"). *Id.* ¶ 40. A significant portion of ARCA's revenues are generated through its participation in these programs. The SAC alleges that they were the source of 32% of ARCA's total revenues in 2013 and 35% in 2014. *Id.* ¶ 42. The SAC further alleges that ARCA provided similar appliance replacement services in other states including Texas, Washington and Minnesota. *Id.* ¶ 41.

Cameron founded ARCA. *Id.* ¶ 30. He served as its Chairman, President, and Chief Executive Officer ("CEO") from its inception until 2014. *Id.* On August 13, 2014, Cameron retired from the positions of President and CEO. *Id.* Cammerrer served as ARCA's Chief Financial Officer ("CFO") from October 2012 until his resignation on November 21, 2014. *Id.* ¶31. He served as the Vice President of Accounting and Finance from March 2012 until his appointment as CFO, and as Corporate Controller from July 2008 until his appointment as Vice President of Accounting and Finance. *Id.*

B. Audit by the California Board of Equalization

In California, retailers are required to pay a tax on their sales "for the privilege of selling tangible personal property." Cal. Rev. & Tax Code § 6051. Tangible personal property is defined as "personal property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses." *Id.* § 6016. Exemptions to the required payment of the tax are specified in the statute. *Id.* §§ 6351-6423.

The SAC alleges that "[a]ppliances purchased by public utilities provided to low-income participants as part of an energy efficiency program are not listed as an exemption, and are therefore not exempt from sales tax under the California Revenue and Taxation Code." SAC, Dkt. 41 ¶46. The SAC further alleges that the California Board of Equalization ("BOE") has a "FAQ section on its website that addresses sales tax exemptions." *Id.* ¶47. "That FAQ section states that if an exemption does apply, the seller in good faith should obtain valid exemption certificates from the purchaser before invoicing the customer." *Id.*[1]

[1] The FAQ section is available at http://www.boe.ca.gov/sutax/faq426.htm. *Id.* The SAC alleges that, according to the "Wayback Machine," which is an internet archive that maintains snapshots of websites on particular dates, the

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

CIVIL MINUTES – GENERAL

Case No.	LA CV15-01654 JAK (AJWx)	Date	August 25, 2016
Title	Jason Feola v. Edward R. Cameron, et al.		

On August 6, 2014, ARCA issued a press release stating that its payment of sales and use taxes was the subject of an examination by the BOE. *Id.* ¶¶ 15, 67. The press release also stated that the examination arose from ARCA's sale of replacement parts in California from 2011 to 2013. *Id.* The press release included the following details:

> From time to time, the company is subject to sales and use tax audits that could result in additional taxes, penalties and interest owed to various taxing authorities. The California Board of Equalization is currently conducting a sales and use tax examination covering the company's California operations for 2011, 2012 and 2013. A large portion of the California operations in those years consisted of appliance replacement sales under programs conducted by utility companies on which the company did not assess, collect or remit sales tax. For several reasons, including the fact that these appliance replacement programs benefit low-income utility customers with ratepayer funds, the company believes such transactions could be exempt from taxation. It is possible that the California Board of Equalization will disagree with the company's position and assess taxes, penalties and interest in an amount that is material to its financial position and results of operations. The company intends to vigorously advance and defend its position in cooperation with local utilities and governmental regulatory entities should taxes, penalties and interest be assessed by the California Board of Equalization. At this time, the company cannot estimate a range of potential impact on its consolidated financial statements.

Id. ¶ 67.

After the press release was issued, the price per share of ARCA stock dropped $1.11, a decline of more than 27%. *Id.* ¶ 68. The stock closed at $2.99 per share on August 7, 2014. *Id.* On February 11, 2015, ARCA issued a second press release. *Id.* ¶ 69. It stated that the company anticipated a $4 million assessment by the BOE for failure to collect and remit sales taxes on appliance replacement sales. *Id.* The press release also announced that certain earlier financial statements would be restated. *Id.* The following details were provided:

> The Company believes that the outcome . . . will likely result in a Notice of Determination from the California BOE of an assessment of at least $4.0 million ($2.6 million net of income taxes), covering the entire period under audit. . . . Such assessment, however, would be subject to protest and appeal, and would not need to be funded until the matter has been fully resolved. Resolution could take up to three years. The Company anticipates that a pre-tax charge to earnings will be required and that previously issued unaudited consolidated financial statement for the fiscal quarters ended March 29, June 28 and September 27, 2014 and consolidated financial statements for the years ended December 28, 2013, December 29, 2012 and December 31, 2011 and the quarters in the years then ended will need to be restated. Such previously issued consolidated financial statements should no longer be relied upon . . . .

Id. ¶ 69.

FAQ section existed "throughout the Class Period in the same form as is now available on the California BOE website today." *Id.* ¶ 48.

On February 12, 2015, ARCA filed a Form 8-K with the Securities and Exchange Commission ("SEC"). *Id.* ¶ 70. It provided the following additional details as to the earlier financial statements:

> On February 9, 2015, the Audit Committee, after discussion with management and the Company's independent registered public accounting firm . . . concluded that the Company's previously issued audited consolidated financial statements for the years ended December 28, 2013, December 29, 2012 and December 31, 2011 and the previously issued unaudited consolidated financial statements for the fiscal quarters ended March 29, June 28, and September 27, 2014, and also including 2013, 2012 and 2011 quarterly results and the disclosures and related communications for each of those periods, require the correction of amounts previously reported and should no longer be relied upon. Also, management's report on internal controls over financial reporting for the year ended December 28, 2013 should no longer be relied upon.
>
> The Company anticipates that it will file its Annual Report on Form 10- K for the fiscal year ended January 3, 2015 (the "2014 10-K") on a timely basis. The Company will restate the financial results contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 28, 2013 and the previously unaudited financial statements and other financial information contained in the Company's Quarterly Reports on Form 10-Q for the fiscal quarters ended March 29, June 28, and September 27, 2014, along with the disclosures and related communications for these periods. The Audit Committee and the Company presently do not expect to identify any material adjustments in the restated financial statements other than the sales tax matter discussed above.
>
> The Company and the Audit Committee are reevaluating the Company's internal control over financial reporting and its disclosure controls and procedures. Management, in consultation with the Audit Committee, also has determined that material weaknesses existed in the Company's internal control over financial reporting and that disclosure controls and procedures were not effective at December 28, 2013 and through January 3, 2015. The Company intends to enhance its procedures and controls surrounding the accounting for sales and use taxes.

Id.

After the 8-K was filed, the price per share of ARCA stock fell by $0.43, which reflected a decline of more than 14%. *Id.* ¶ 71. The closing price on February 12, 2015 was $2.54 per share. *Id.*

The SAC alleges that, by not collecting sales taxes, ARCA "was able to win competitive bids in California that appeared cheaper than they would have been had ARCA's bids included the additional cost of sales tax." *Id.* ¶ 85. ARCA's annual report for the fiscal year ending January 3, 2015, explained that a main strategy of its competitors in competing with ARCA is to offer lower prices. *Id.* By not charging sales tax, the SAC alleges that "ARCA was able to reduce the price it charged its customers by at least 9.0%, which is the minimum sales tax for Los Angeles County where ARCA conducted the bulk of its business in California." *Id.*

C. Departure of ARCA Executives

On August 13, 2014, which was approximately one week after ARCA disclosed the BOE audit, Cameron retired as its President and CEO. *Id.* ¶ 96. He remained as Chairman. On November 3, 2014, approximately three months after the disclosure, ARCA announced Cammerrer's resignation as CFO, effective November 21, 2014. *Id.* ¶ 97. Cammerrer accepted a position as the CFO of a non-public company. *Id.* The SAC further alleges that, shortly after ARCA revealed the BOE audit, "all but one member of ARCA's board of directors resigned." *Id.* ¶ 22.

D. ARCA's Restated Financial Statements

On May 18, 2015, ARCA filed an amended Form 10-K (the "Restatement") with the SEC. It restated each of the Company's financial statements for the quarterly and annual periods from 2013 through the third quarter of 2014. *Id.* ¶ 100. The financial statements were signed by Cameron and Cammerrer. *Id.* ¶¶ 49-66.

The SAC alleges that the Restatement disclosed material overstatements in previously issued financial reports, due to the failure to account for sales taxes. For example, for the first quarter of 2013, due to this omission, ARCA allegedly overstated net income by 179% and earnings per share by 250%. *Id.* ¶ 52. In its financial statements for 2013 and 2014, ARCA's overstatement of operating income ranged from 20% to 193%, and net income from 4.9% to 179%. *Id.* ¶¶ 52-65.

E. Confidential Witness Statements[2]

The SAC includes purported statements by two confidential witnesses, both of whom are former ARCA employees.

1. <u>Confidential Witness 1</u>

CW1 was a "Senior Accountant for ARCA in its Minneapolis office from 2008 to 2012." *Id.* ¶ 72. CW1 reported directly to Cammerrer. *Id.* CWI allegedly stated that "she believed ARCA assessed, collected,

[2] The Motion is supported by the declaration of Michelle Van Oppen ("Van Oppen Declaration"), counsel for Defendants. Dkt. 46. Based on the descriptions of two confidential witnesses – "CW1 and CW2" -- Van Oppen states that she was able to determine their identities. *Id.* ¶ 3. Van Oppen states that she contacted both witnesses to verify whether the statements attributed to them were accurate. *Id.* She further states that both witnesses disavowed certain of the statements. *Id.* ¶¶ 4-11. Plaintiffs subsequently filed a motion to strike the Van Oppen Declaration on the grounds that: (i) it seeks to introduce new facts outside of the SAC; and (ii) it is inadmissible hearsay in violation of Fed. R. Evid. 802 ("Motion to Strike"). Dkt. 48. In opposition to the Motion to Strike, Defendants cite out of Circuit authority that permits the consideration of similar evidence proffered by defendants concerning the accuracy and reliability of allegations attributed to statements by confidential witnesses. *See* Dkt. 54 at 4. However, none of these cases presented the issue whether otherwise inadmissible hearsay evidence can be received in support of a motion to dismiss. Nor do Defendants cite to any applicable exception to the hearsay rule that would arguably permit the admission of the statements attributed to CW1 and CW 2. Therefore, the Motion to Strike is **GRANTED**. The Van Oppen Declaration is not considered for purposes of the Motion.

and remitted sales tax for its appliance replacement programs for all of the states in which ARCA offered energy efficient appliance replacement services to low income customers." *Id.* ¶ 73. In particular, CW1 is "sure that ARCA collected and paid sales tax in Washington for ARCA's appliance replacement program for low income households. She is certain because she visited the state regularly as part of her work." *Id.* ¶ 74. CW1 also stated: "'I remember because there was a problem with a bunch of the [replacement] units once and a lot of work had to be redone. That program was collecting tax, and it was such a pain because Washington went by state, city and county.'" *Id.* CW1 added: "'I know we collected [sales] taxes because I put in the figures.'" *Id.* ¶ 75. CW1 then stated: "'I had to update tax tables and I assume on everything across the board we were collecting [sales] tax. I collected the [sales] tax tables from the website and brought them into our system -- we used in-house, homebrewed accounting software -- and loaded them into the tables.'" *Id.* CW1 did this for the state of Washington. *Id.* ¶ 76. CW1 said she and the rest of the accounting team were under the impression that the Company had to pay sales taxes for appliance replacement sales in all the states where ARCA operated. *Id.* ¶ 81.

CW1 stated that that "invoices for appliance replacement sales that she saw all had a separate line item for sales tax." *Id.* ¶ 77. CW1 "recalls sales tax auditors from Minnesota, Texas and Georgia showing up unannounced during her tenure." *Id.* ¶ 79. According to CW1, "ARCA knew about exemption certificates and understood that exemptions from sales tax needed to be supported by exemption certificates." *Id.* ¶ 80. She recalls ARCA's "top executives" saying that sales tax exemption would apply if the Company was "doing something for a charity with an exemption certificate." *Id.* Nevertheless, CW1 stated, "we had to check the certificate, to make sure that they were exempt from it." *Id.* CW1 stated that ARCA's company-wide policy was to ensure that an exemption certificate was obtained from any customers that did not pay sales tax. *Id.*

Finally, CW1 stated that "Cammerrer had ultimate responsibility over payment of sales taxes, and that Cammerrer had to sign off on everything in accounting and finance, including but not limited to the payment of sales taxes." *Id.* ¶ 82.

2. Confidential Witness 2

CW2 was a "Senior Auditor and SOX [Sarbanes-Oxley Act Specialist] in ARCA's Minneapolis office from February 2009 to September 2012." *Id.* ¶ 83. CW2 reported directly to Cameron. *Id.* ¶ 34. CW2 corroborated CW1's statement that Cammerrer "handled tax payments for the Company." *Id.*

F. Additional Allegations

An anonymous SCPPA director allegedly told a private investigator retained by Plaintiffs that ARCA executives contacted him about the BOE audit. He allegedly reported that these executives told him that the management of ARCA believed that there was no need to pay sales taxes because the appliance replacement program was "publicly funded." *Id.* ¶ 88. The SCPPA director also allegedly stated that this interpretation was unique and one that he had not previously heard. *Id.*

The SAC also alleges that City Appliance & Sales, which also provides appliance replacement services

for low-income energy efficiency programs in California, told Plaintiffs' investigator that it charges sales tax on replacement appliances. *Id.* ¶ 94.

III. <u>Analysis</u>

A. Legal Standards

1. <u>Motion to Dismiss</u>

Fed. R. Civ. P. 8(a) provides that a "pleading that states a claim for relief must contain . . . a short and plain statement of the claim showing that the pleader is entitled to relief . . . ." The complaint must state facts sufficient to show that a claim for relief is plausible on its face. *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007). The complaint need not include detailed factual allegations, but must provide more than a "formulaic recitation of the elements of a cause of action." *Id.* at 555. "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. Where a complaint pleads facts that are 'merely consistent with' a defendant's liability, it stops short of the line between possibility and plausibility of entitlement to relief." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (internal quotation marks and citations omitted).

Pursuant to Fed. R. Civ. P. 12(b)(6), a party may move to dismiss for failure to state a claim. It is appropriate to grant such a motion only where the complaint lacks a cognizable legal theory or sufficient facts to support one. *Mendiondo v. Centinela Hosp. Med. Ctr.*, 521 F.3d 1097, 1104 (9th Cir. 2008). In considering a motion to dismiss, the allegations in the challenged complaint are deemed true and must be construed in the light most favorable to the non-moving party. *Cahill v. Liberty Mut. Ins. Co.*, 80 F.3d 336, 337-38 (9th Cir. 1996). However, a court need not "accept as true allegations that contradict matters properly subject to judicial notice or by exhibit. Nor is the court required to accept as true allegations that are merely conclusory, unwarranted deductions of fact, or unreasonable inferences." *In re Gilead Sciences Sec. Litig.*, 536 F.3d 1049, 1055 (9th Cir. 2008) (citing *Sprewell v. Golden State Warriors*, 266 F.3d 979, 988 (9th Cir. 2001)).

2. <u>Heightened Pleading Requirements</u>

At the pleading stage, the complaint must satisfy the dual pleading requirements of Fed. R. Civ. P. 9(b) and the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 ("PLRSA*"). In re VeriFone Holdings, Inc. Sec. Litig.*, 704 F.3d 694, 701 (9th Cir. 2012). Pursuant to Rule 9(b), claims alleging fraud are subject to a heightened pleading standard. This requires that a complaint "state with particularity the circumstances constituting fraud or mistake." Fed. R. Civ. P. 9(b). Similarly, the "more exacting pleading requirements" of the PSLRA require that the complaint plead with particularity both falsity and scienter. *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 990 (9th Cir. 2009). In pleading falsity under these standards, a complaint must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief . . . state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). To plead scienter under these standards, a complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *Id.* §

78u-4(b)(2).

B. Application

1. First Cause of Action: Violation of Section 10(b) of the Exchange Act

a) Legal Standard

Section 10(b) of the Exchange Act makes it unlawful for "any person . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or . . . for the protection of investors." 15 U.S.C. § 78j(b). SEC Rule 10b-5 implements this statute by providing that it is unlawful to "make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading."

To state a claim under Section 10(b) and Rule 10b-5, the following five elements must be alleged: (i) a material misrepresentation or omission of fact; (ii) scienter; (iii) a connection with the purchase or sale of a security; (iv) transaction and loss causation; and (v) economic loss. *Zucco*, 552 F.3d at 990.

b) Application

Plaintiffs allege that Defendants knowingly issued quarterly and annual reports, SEC filings and press releases that overstated company earnings. The basis for this contention is that the publications did not account for uncollected sales taxes. Defendants assert that the SAC fails adequately to allege scienter and material misrepresentation.

(1) Whether Plaintiff's Allegations Give Rise to a Strong Inference that Any Defendant Acted with Scienter

Scienter is "a mental state embracing intent to deceive, manipulate, or defraud." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 (2007) (internal quotation marks omitted). The PSLRA sets a relatively high bar for pleading this element. Thus, a plaintiff must state with particularity facts giving rise to a "strong inference" that the defendant acted intentionally or with deliberate recklessness. 15 U.S.C. § 78u-4(b)(2). A strong inference exists "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Tellabs*, 551 U.S. at 324. "A court must compare the malicious and innocent inferences cognizable from the facts pled in the complaint, and only allow the complaint to survive a motion to dismiss if the malicious inference is at least as compelling as any opposing innocent inference." *Zucco*, 552 F.3d at 991.

"To adequately demonstrate that the defendant acted with the required state of mind, a complaint must allege that the defendants made false or misleading statements either intentionally or with deliberate recklessness." *Id.* (internal quotation marks omitted). Deliberate recklessness is a "form of intentional or knowing misconduct." *Id.* (internal quotation marks omitted). Under this standard,

> although facts showing mere recklessness or a motive to commit fraud and opportunity to do so may provide some reasonable inference of intent, they are not sufficient to establish a strong inference of deliberate recklessness. Rather, the plaintiff must plead a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Id. (internal quotation marks and citations omitted).

When an entity is named as a defendant, an issue is presented as to who must be found to have had the requisite state of mind. *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736 (9th Cir. 2008) recently considered whether a plaintiff could demonstrate corporate scienter without a concurrent finding that any defendant director or officer acted in a manner that met the standard. *Glazer* clarified that in all but the most unusual cases, a plaintiff may not rely upon notions of "collective scienter," *i.e.,* that the state of mind of an entity defendant for purposes of pleading scienter can be inferred from the collective knowledge of some or all of its employees.

In *Glazer*, the plaintiff alleged that the defendant corporation made false statements in a merger agreement attached to a Form 10-K filed with the SEC. The merger agreement was signed by both the CEO and COO of the defendant corporation. Several months after its filing, the defendant corporation announced that it had commenced an internal investigation into allegations that certain of its employees had violated the Foreign Corrupt Practices Act by bribing government officials in Asia. The plaintiff then sued, alleging that the defendant corporation and certain of its officers falsely represented in its filing with the SEC that the company was in compliance with all material laws, that it properly accounted for all payments in its books and records and that it was not in violation of the anti-bribery provisions of the Exchange Act. The district court granted a motion to dismiss without leave to amend because, *inter alia*, the plaintiff had failed to plead facts giving rise to a strong inference of scienter in accordance with the heightened pleading requirements of the PSLRA.

The Ninth Circuit affirmed. It concluded that the plaintiff had failed "to plead scienter with respect to those individuals who actually made the false statements." *Id.* at 744. The Ninth Circuit expressly foreclosed application of collective scienter to claims arising out of a representation by a corporation in an SEC filing that it complied with applicable laws and standards of accounting. As the Ninth Circuit explained:

> If the doctrine of collective scienter excuses [the plaintiff] from pleading individual scienter with respect to these legal warranties, then it is difficult to imagine what statements would not qualify for an exception to individualized scienter pleadings. In fact, because the [SEC filing] warranted that the company was in compliance "with all laws," then under the collective scienter theory urged by [the plaintiff], so long as any employee at [the defendant corporation] had knowledge of the violation of any law, scienter could be imputed to the company as a whole. This result would be plainly inconsistent with the pleading requirements of the [PSLRA].

Id. at 745 (second alternation in original).[3]

A two-step process is used to apply these standards on a motion to dismiss. In the first step, it is determined whether any of the allegations, standing alone, are sufficient to create a strong inference of scienter. If they are, the complaint is sufficient. If they are not, the second step is applied. It requires a review of the same allegations as a whole to determine whether, when viewed collectively, they are sufficient to create a strong inference of intentional conduct or deliberate recklessness. *Zucco*, 552 F.3d at 992.

Plaintiffs contend that the following allegations in the SAC create a strong inference that Cameron and Cammerrer acted with scienter in issuing financial statements with overstated earnings: (i) the statements of CW1 and CW2; (ii) the departures of Cameron, Cammerrer and certain board members; (iii) a purported competitive advantage; (iv) the May 18, 2015 Restatement by ARCA; (v) the statements of the SCPPA director and City Appliance & Sales; and (vi) the FAQ section on the BOE website. These matters are discussed in this sequence.

(a) Statements of CW1 and CW2

The SAC includes new allegations purporting to summarize statements made by two former ARCA employees. CW1 was a "Senior Accountant for ARCA in its Minneapolis office from 2008 to 2012," (SAC, Dkt. 41 ¶ 72), and CW2 was a "Senior Auditor and SOX [Sarbanes-Oxley Act Specialist] in ARCA's Minneapolis office from February 2009 to September 2012." *Id.* ¶ 83.

In sum, CW1 stated that she and the rest of the accounting team were under the impression that the Company had to pay sales taxes for appliance replacement sales in all the states where it operated. This is because she knew that ARCA collected and paid sales tax in Washington for a similar appliance replacement program. Her view is also consistent with the contention that ARCA knew about exemption certificates and understood that exemptions from sales tax had to be supported by certificates. CW1 also

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[3] *Glazer* did not foreclose the possibility that, in usual circumstances, "some form of collective scienter pleading might be appropriate." *Id.* at 744. In connection with the possibility that "a company's public statements were so important and so dramatically false that they would create a strong inference that at least *some* corporate officials knew of the falsity upon publication," *Glazor* cited to a hypothetical offered in *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 710 (7th Cir. 2008):

> Suppose General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero. There would be a strong inference of corporate scienter, since so dramatic an announcement would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false.

Id. at 743-44. As in *Glazor*, the "facts of this case are different from the hypothetical." *Id.* at 745. Here, the SAC alleges that Cameron and Cammerrer made false statements whenever overstated financial reports were issued that did not account for uncollected taxes. Clearly, this is not a statement that is "so dramatically false" that it is analogous to the hypothetical in *Makor*.

stated that "Cammerrer had ultimate responsibility over payment of sales taxes, and that Cammerrer had to sign off on everything in accounting and finance, including but not limited to the payment of sales taxes." SAC, Dkt. 41 ¶ 82. CW2 corroborated CW1's statement that Cammerrer "handled tax payments for the Company." *Id.* ¶ 34.

The statements of the confidential witnesses do not give rise to a strong inference of scienter. *Zucco* explains that "a complaint relying on statements from confidential witnesses must pass two hurdles to satisfy the PSLRA pleading requirements. First, the confidential witnesses whose statements are introduced to establish scienter must be described with sufficient particularity to establish their reliability and personal knowledge. Second, those statements which are reported by confidential witnesses with sufficient reliability and personal knowledge must themselves be indicative of scienter." 552 F.3d at 995 (citations omitted). Here, there is no allegation that either of the confidential witnesses claims to have been involved with ARCA's decision not to charge sales tax on its California appliance sales. To the contrary, CW1's mistaken belief that ARCA collected sales tax in California demonstrates a lack of personal knowledge about the California program. Indeed, Plaintiff admits that "it is true that the CWs did not claim to have any firsthand knowledge about ARCA's decision not to collect and pay sales tax in California." Dkt. 47 at 18.

Instead, Plaintiff argues that CW1 is "certain" that ARCA collected and paid sales tax on appliance replacement sales in a different state -- Washington -- "because she personally entered the sales tax figures [for Washington] into ARCA's accounting system." *Id.* at 10. From this, Plaintiff argues that "if ARCA knew to pay, and did pay, sales tax for the same program in other states such as Washington, but failed to do so in California, the compelling inference is that ARCA made a calculated and deliberate decision not to collect sales tax in California." *Id.* at 13. But, Plaintiffs do not explain in any detail the basis for this inference. The allegation that ARCA collected sales tax on appliance replacement sales in one state outside California -- involving a different program, different customers and different state tax laws -- does not demonstrate *per se* that ARCA's failure to collect sales tax on its California appliance replacement sales was deliberate. That failure could have been the result of carelessness.

Further, the SAC does not allege that CW1 or CW2 ever communicated directly with Cameron or Cammerrer. Instead, the witnesses allegedly claimed that Cammerrer was "responsible" for sales tax payments. This allegation provides support for an inference that he was aware that ARCA was not paying sales taxes in California. His failure thoroughly to investigate tax requirements before signing off on ARCA's decision not to collect sales taxes on the program at issue here certainly supports an inference of negligence. However, this allegation does not provide clear support for the inference that Cammerrer acted with the intent to deceive, manipulate or defraud. An equally reasonable inference from the fact that Cammerrer knew that ARCA was paying taxes in certain states in which it did business and not in others, is that he may have mistakenly believed that some of them, including California, did not require the payment of sale tax.[4]

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[4] At the hearing on this Motion, defense counsel represented that ARCA has comparable appliance replacement programs in a total of six states, including California. Of those six states, defense counsel represented that ARCA only collects sales taxes in Washington. Defense counsel contends that this supports its position that ARCA believed it was not customary for states to collect sales taxes for the operative programs which, as noted, are designed to benefit low income individuals. Although this argument may ultimately be shown to have some force, it

(b) Departures of Cameron, Cammerrer, and Certain Board Members

As the Prior Order concluded, the outcome is the same as to the resignations of Cameron and Cammerrer. Neither provides a strong inference of scienter. "Although resignations, terminations, and other allegations of corporate reshuffling may in some circumstances be indicative of scienter," *Zucco*, 552 F.3d at 1002, the allegations as to the resignations here are not. There are insufficient allegations to support a reasonable inference that the resignations of Cameron and Cammerrer were suspicious and due to concerns about knowing misconduct. *Id*. In *Zucco*, the resignation of an independent accounting firm was "not enough to support a strong inference of scienter." *Id.* The resignation was "not surprising -- it had just been partially responsible for the corporation's failure to adequately control its accounting procedures." *Id.*; *see also In re U.S. Aggregates, Inc. Sec. Litig.*, 235 F.Supp.2d 1063, 1074 (N.D. Cal. 2002) ("Plaintiff can point to no particularized allegation refuting the reasonable assumption that [defendant's employee] was fired simply because the errors that led to the restatement occurred on his watch or because he failed adequately to supervise his department.").

Zucco also concluded that the resignations of chief executives during the class period failed to create an inference of scienter. 552 F.3d at 1002. ("Mere conclusory allegations that a financial manager resigns or retires during the class period or shortly before the corporation issues its restatement, without more, cannot support a strong inference of scienter. . . . Absent allegations that the resignation at issue was uncharacteristic when compared to the defendant's typical hiring and termination patterns or was accompanied by suspicious circumstances, the inference that the defendant corporation forced certain employees to resign because of its knowledge of the employee's role in the fraudulent representations will never be as cogent or as compelling as the inference that the employees resigned or were terminated for unrelated personal or business reasons.").

Here, Cameron retired as President and CEO at the age of 74, after having worked with ARCA for more than 30 years. Dkt. 31-1 at 5 (RJN Ex. A). He remained as Chairman of the Board of Directors. Collectively, these circumstances do not support an inference of suspicious circumstances associated with his resignation.[5] *See In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046, 1062-63 (9th Cir. 2014) (where "individuals remained at [a company] in some type of advisory role" following their resignations, "the most reasonable inference is that the[] departures were benign"). Cammerrer resigned three months after the Restatement, and accepted a position as CFO with another company. As with Cameron, Cammerrer was asked by the company to remain as an advisor "to assist the company with various matters to support an

is not considered for the purposes of this Motion because the underlying facts have not been pleaded or otherwise supported by evidence presented in connection with the Motion.

[5] Defendants also contend that Cameron's purchase of 20,000 shares of ARCA stock at the beginning of the class period is inconsistent with an inference of his scienter. Dkt. 31-7 at 2 (RJN Ex. G). They claim that Cameron would not have purchased shares at a price that he knew to be inflated. *See In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1424-25 (9th Cir. 1994) ("Furthermore, if, as Plaintiffs allege, the Officers knew that [the company] was heading for financial disaster, they probably would have bailed out of their substantial holdings. Each of the Officer Defendants, by contrast, held onto most of their [company] stock and incurred the same large losses as did the Plaintiffs themselves." (internal citations omitted)).

orderly transition through the first quarter of 2015." Dkt. 31-3 at 3 (RJN Ex. C). This is inconsistent with an inference that there was substantial concern about knowing misconduct.

The SAC includes new allegations -- that all but one member of ARCA's board of directors resigned during the relevant time period. However, the corresponding SEC Form 8-K, of which judicial notice can be taken, states that one of the five directors resigned, for personal reasons. Dkt. 45 (RJN Ex. I) (SEC Form 8-K announcing the resignation of Stanley Goldberg for "personal reasons"). According to the 8-K, three other directors chose not to stand for reelection at the conclusion of their terms. *Id.* (RJN Ex. K, M). Although these facts are not established by the Form 8-K, for purposes of the Motion, their averment in that filing may be considered in connection with assessing the sufficiency of the allegations as to scienter of Cameron or Cammerer. This scenario would not support scienter. Nor does the SAC allege that there is a nexus between the decisions of these board members and the conduct of Cameron or Cammerer. It is equally plausible to conclude that these directors resigned because they did not want to be involved in what could be a difficult time for ARCA that could require a substantial commitment of their time.

(c) Competitive Advantage

The SAC also includes the new allegation that "by not collecting sales tax from its customers, ARCA was able to win competitive bids in California that appeared cheaper than they would have been had ARCA's bids included the additional cost of sales tax." SAC, Dkt. 41 ¶ 85. Defendants argue that Plaintiff has not identified a single "competitive bid" on which ARCA purportedly succeeded as a result of pricing that anticipated the non-payment of sales tax. Moreover, absent additional allegations as to the scope of the profits that were earned or anticipated from contracts in California, that ARCA collected sales taxes in other states is inconsistent with the claim that its failure to do so was part of a plan to be more competitive, and win contracts. The present allegations are instead consistent with the well-established rule that the mere possibility of a motive to commit fraud cannot give rise to a strong inference of scienter. *See Silicon Graphics*, 183 F.3d at 974 ("[A]lthough facts showing . . . a motive to commit fraud and opportunity to do so may provide some reasonable inference of intent, they are not sufficient to establish a strong inference of deliberate recklessness.").

(d) The Restatement

In connection with the issuance of certain financial restatements, Defendants acknowledged that the prior versions did not comply with generally accepted accounting principles ("GAAP"). The Prior Order concluded that this admission does not give rise to a strong inference of scienter. Dkt. 40 at 9-10; *see also Zucco*, 552 F.3d at 1000 ("In general, the mere publication of a restatement is not enough to create a strong inference of scienter."); *Worlds of Wonder*, 35 F.3d at 1426-27 ("[E]ven deliberate violations of those guidelines, without more, do not amount to fraud." (internal quotation marks omitted)). The SAC has not presented any new allegations that warrant a different outcome on the Motion.

(e) Statements of the SCPPA Director and City Appliance & Sales

These allegations were also evaluated in connection with the Prior Order. There, it was determined that they did not give rise to a strong inference of scienter. Dkt. 40 at 8. The SCPPA director stated that the

reason provided by ARCA for its nonpayment of sales tax was unusual. Indeed, it is one that he had not previously heard. Although this may bear on the mental state of the director of the SCPPA, it is not sufficient to establish scienter. Thus, it does not provide a sufficient basis that, if established, would show what Defendants knew and believed about sales tax requirements at the relevant times.

Further, the language in another part of the statement by the SCPPA director could be interpreted to suggest the absence of scienter. He stated that ARCA was under the impression that it did not need to charge sales tax because the appliance replacement program was publicly funded. There is no allegation that the director ever shared his views with anyone at ARCA during the relevant time period. Nor is there any allegation that the director ever questioned why ARCA was not charging sales tax on its transactions with SCPPA. No more persuasive are the statements by an employee at City Appliance & Sales, which was a competitor of ARCA. That employee allegedly stated that this company charged tax on replacement units. That a competitor in the industry knew of and paid sales taxes is of limited force with respect to the issue as to what Defendants knew and believed.

(f) BOE FAQ Website

Finally, Plaintiffs contend that there is a strong inference of scienter because an FAQ section of the BOE website states that a seller of merchandise should obtain exemption certificates if they are appropriate. Although there are allegations that Cammerrer was generally knowledgeable about sales tax requirements in California given his background in accounting and finance, there are no allegations about his knowledge of this FAQ portion of the website. Moreover, the FAQ section states that sellers should obtain exemption certifications -- not that they must do so. *See* SAC, Dkt. 41 ¶ 47 (citing http://www.boe.ca.gov/sutax/faq426.htm) ("In good faith, you should obtain from the purchaser a timely and valid exemption certificate (partial or otherwise)"). In the context of the present allegations, this is not sufficient to provide a strong inference of scienter.

* * *

Because each set of allegations as to specific bases for scienter is insufficient, the second step in the test is applied. Thus, whether the complaint "in its entirety" gives rise to a strong inference of scienter. *Zucco*, 552 F.3d at 1006 (internal quotation marks omitted). Here, "a series of less precise allegations [may] be read together to meet the PSLRA requirement." *Id.* (internal quotation marks omitted). When conducting this holistic review, however, a court must also "take into account plausible opposing inferences that could weigh against a finding of scienter. Even if a set of allegations may create an inference of scienter greater than the sum of its parts, it must still be at least as compelling as an alternative innocent explanation." *Id.* (internal quotation marks and citations omitted).

Viewed as a whole, the allegations are not sufficient to meet this test, *i.e.*, they do not result in an inference at least as compelling as an alternative innocent explanation. The inference of scienter is no greater than the one of negligence or inadvertence. As noted in the Prior Order, the reasonable inferences include that Defendants did not know the BOE was likely to assert that sales taxes were to be charged, collected and paid by ARCA. Another reasonable inference is that Defendant thought that the pertinent transactions were exempt because they arose from appliance replacement programs benefitting low-income utility customers and were paid with ratepayer funds. The new allegations in the

SAC do not compel a different conclusion.

For these reasons, the Motion is **GRANTED WITHOUT PREJUDICE** as to the first cause of action.

2. Second Cause of Action: Violation of Section 20(a) of the Exchange Act (against Cameron and Cammerrer)

Plaintiffs' Section 20(a) control-person claims against Cameron and Cammerrer are subject to dismissal because plaintiffs have failed to state a claim under Section 10(b) for the alleged primary violation. *See, e.g., Zucco*, 552 F.3d at 990 ("Section 20(a) claims may be dismissed summarily . . . if a plaintiff fails to adequately plead a primary violation of section 10(b).").

For these reasons, the Motion is **GRANTED WITHOUT PREJUDICE** as to the second cause of action.

IV. Conclusion

For the reasons set forth in this Order, the Motion is **GRANTED**. Any amended complaint shall be filed by September 14, 2016. The date for the Scheduling Conference in this matter is deferred pending the filing of any amended complaint.

IT IS SO ORDERED.

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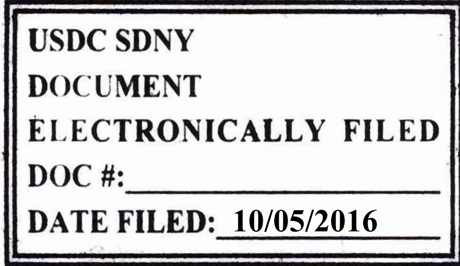

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

VICTOR PIRNIK,

Plaintiff,

-v-

FIAT CHRYSLER AUTOMOBILES, N.V., et al.,

Defendants.

15-CV-7199 (JMF)

OPINION AND ORDER

JESSE M. FURMAN, United States District Judge:

Plaintiffs in this putative securities fraud class action are investors in Defendant Fiat Chrysler Automobiles, N.V. ("FCA"), a global car company. In brief, Plaintiffs bring claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. §§ 78(b), 78(t)(a), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240, alleging that FCA — acting in part through Defendant Sergio Marchionne, the Chief Executive Officer of FCA's largest subsidiary, FCA U.S.; Defendant Richard Palmer, the Chief Financial Officer of FCA U.S.; and Defendant Scott Kunselman, the former head of Vehicle Safety and Regulatory Compliance for FCA U.S. — made false and misleading statements regarding its compliance with vehicle safety laws and improperly accounted for vehicle recall costs. Defendants now move, pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, to dismiss the operative complaint. (Docket No. 42). For the reasons that follow, Defendants' motion to dismiss is GRANTED in part and DENIED in part.

BACKGROUND

The following facts — which are taken from the Second Amended Complaint, documents it incorporates, and matters of which the Court may take judicial notice (including disclosure documents that FCA was required by law to file) — are construed in the light most favorable to Plaintiffs. *See, e.g.*, *Kleinman v. Elan Corp.*, 706 F.3d 145, 152 (2d Cir. 2013); *see also, e.g.*, *Silsby v. Icahn*, 17 F. Supp. 3d 348, 354 (S.D.N.Y. 2014).

FCA is a holding company that arose from the 2014 merger of Fiat Group Automobiles ("Fiat Group") and Chrysler Group LLC. (Docket No. 38 ("SAC") ¶ 31). FCA's subsidiary in the United States, now known as FCA U.S., is effectively a continuation of Chrysler, the well-known American car company that manufactures motor vehicles under various brand names, including Chrysler, Dodge, Fiat, Jeep, and Ram. (*Id.* ¶¶ 2, 37).[1] At all times relevant to this case, Defendant Marchionne was the CEO of FCA U.S. (and before it, Chrysler); Defendant Palmer was the CFO; and Defendant Kunselman was the head of Vehicle Safety and Regulatory Compliance. (*Id.* ¶¶ 32-34). (For clarity, and because the distinction between Chrysler and FCA U.S. is immaterial here, the Court will refer to FCA U.S. and Chrysler as simply "Chrysler.")

As a manufacturer of motor vehicles in the United States, Chrysler must comply with the National Traffic and Motor Vehicle Safety Act of 1996 (the "Safety Act"), 49 U.S.C. § 30101 *et seq.*, and its implementing regulations, which are enforced by the National Highway Traffic Safety Administration ("NHTSA"). (SAC ¶ 4). In the period leading up to the creation of FCA,

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[1] The company known as Chrysler was founded in 1925, but "changed its name over the years from DaimlerChrysler AG (1997-2007), Chrysler LLC (2007-2009), Chrysler Group LLC (2009-2014) and FCA US (2014-present)." (SAC ¶ 37). These name changes (and related corporate transformations) are not relevant for purposes of this motion and may not be relevant to the case writ large. Indeed, although the Second Amended Complaint discloses the various corporate forms that preceded FCA U.S., it generally discusses the conduct of "Chrysler" throughout, without ever defining which entity, precisely, is being referenced.

NHTSA conspicuously increased its enforcement of the Safety Act. (*Id.* ¶ 8-9). In 2010, for example, NHTSA twice levied on Toyota the maximum fine available for Safety act violations in connection with a high-profile defect involving unintended acceleration. (*Id.* ¶ 8). In June 2013, despite initial public resistance by Marchionne, Chrysler itself agreed to recall certain Jeep vehicles equipped with defective fuel tanks that could ignite in low-impact collisions. (*Id.* ¶¶ 73-74). The U.S. Secretary of Transportation Ray LaHood recounted in an interview thereafter that Marchionne had agreed to the recall after a meeting with LaHood and NHTSA Administrator David Strickland. Secretary LaHood stated that, as a result of that meeting and other discussions, Marchionne "knew" that NHTSA was "a no-nonsense organization"; "[t]he thing that really set us on a course where people understood that," he continued, "was the Toyota (sudden-acceleration recalls) — the fact that we fined them the maximum fines twice." (*Id.* ¶ 75). Finally, in May 2014, NHTSA fined General Motors ("GM") $35 million, the maximum permitted, for its failure to timely report a defect in the ignition switches of various vehicles. (*Id.* ¶ 9). In its Consent Order with GM, NHTSA expressly noted that, in the prior five years, it had fined six different vehicle manufacturers a combined total of $124.5 million. (*Id.*).

On August 12, 2014, Chrysler announced the establishment of a new office of Vehicle Safety and Regulatory Compliance that would "help intensify the Company's continuing commitment to vehicle safety and regulatory compliance." (*Id.* ¶ 184). Defendant Kunselman was assigned to head the office and report directly to Marchionne, "ensuring a high level of information flow and accountability." (*Id.* ¶¶ 11, 184, 263). At the time, Chrysler was in the midst of the recall with respect to Jeep fuel tanks. (*See id.* ¶¶ 72-88). In addition, Chrysler was one of ten vehicle manufacturers undertaking recalls of vehicles with Takata airbags, which could explode upon deployment, propelling metal fragments and debris into the passenger

compartment. (*See id.* ¶¶ 89-108). In combination, that recall "constituted the largest and most complex safety recall in U.S. history with more than 28 million [airbag] inflators under recall in the United States." (*Id.* ¶ 90).

In October 2014, Chrysler and Fiat Group merged to create FCA, and FCA began trading on the New York Stock Exchange. (*Id.* ¶ 36). On November 12, 2014, FCA filed disclosure forms with the Securities and Exchange Commission ("SEC") that contained the following representation (a representation that would be repeated in disclosures through June 2015):

> Our vehicles and the engines that power them must also comply with extensive regional, national and local laws and regulations and industry self-regulations (including those that regulate vehicle safety, end-of-life vehicles, emissions and noise). *We are substantially in compliance with the relevant global regulatory requirements affecting our facilities and products*. We constantly monitor such requirements and adjust our operations to remain in compliance.

(*Id.* ¶¶ 198, 203, 222, 234, 236 (emphasis added)). Shortly thereafter, at a United States Senate hearing prompted by the Takata airbag recall, Kunselman stated that Chrysler had "the highest recall completion rate of all major U.S.-market auto makers," that "NHTSA regards [Chrysler's] customer-notification protocols as 'industry-best,'" and that Chrysler's "average per-campaign vehicle volume is among the lowest in the industry — well below the industry average," which was a "testament to [Chrysler's] transparency and demonstrates clearly the robustness of [Chrysler's] fleet-monitoring and [Chrysler's] rapid response when issues arise." (*Id.* ¶ 200).

Naturally, FCA soon faced questions about the costs of the recalls. For example, in a January 28, 2015 earnings call, an analyst asked Defendant Palmer if Chrysler had "reflect[ed] the cost of the Takata airbag recall at year end or is this coming in 2015" and to "give . . . some sense of this industrial cost going into 2015, are there likely to be less of a headwind versus 2014"? (*Id.* ¶ 210). Palmer answered: "Yes. We have booked the Takata item in [the fourth quarter of 2014]. In 2015 . . . we expect the industrial cost headwind to be significantly less than

it was in 2014 because of the fact that all these launches with extra content have had a 12-month cycle now. So, year-over-year, they're in the numbers." (*Id.*). On the same call, Marchionne said that the prior year's recalls reflected "a changing paradigm for the auto sector" and that Chrysler was "adjusting [its] internal structures to deal with this new state of affairs." (*Id.* ¶ 212). "It is my expectation," he continued, "that this cost will come down as we progress through reconstitution of the management process of what's going on here." (*Id.*).

Notably, around the time that FCA first filed its regulatory compliance statement with the SEC and Kunselman testified before the Senate, NHTSA Administrator David Friedman sent letters to Chrysler alleging shortcomings with respect to the two high-profile recalls. (*Id.* ¶¶ 14-15). On October 29, 2014, for example, Administrator Friedman sent what appears to have been a form letter to Steve Williams, Head of Vehicle Safety Compliance and Product Analysis at Chrysler, emphasizing the "critical imperative" of "aggressive and proactive action" to remedy the "defective Takata air bags." (*Id.* ¶ 272; Docket No. 43 ("Monahan Decl."), Ex. 6). On November 25, 2014, Friedman sent directly to Marchionne a follow-up letter specific to Chrysler. "Chrysler," Friedman wrote, "has consistently maintained its position at the rear of the pack," and its "delay in notifying consumers and taking other actions necessary to address the safety defect identified is unacceptable and exacerbates the risk to motorists' safety." (SAC ¶ 15; Monahan Decl., Ex. 7). A letter from Administrator Friedman to Marchionne, dated November 19, 2014, sounded similar notes with respect to the Jeep fuel tank recall. Specifically, Friedman expressed concern "about the results of Chrysler's October 2014 recall update reports showing a woeful three percent repair rate out of more than 1.5 million affected vehicles," and asserted that Chrysler's actions were "unacceptable." (SAC ¶ 14). On November 21, 2014, Marchionne and Kunselman each sent a letter in response; Kunselman's letter acknowledged that

Chrysler's actions were "not satisfactory." (*Id.* ¶¶ 87-88). On February 26, 2015, NHTSA sent a letter to Chrysler regarding a recall with a decidedly lower profile (a transmission issue in a certain model year car); it too highlighted Chrysler's delays in executing the recall and suggested that those delays were at odds with Chrysler's Safety Act duties. (Monahan Decl., Ex. 8).

Prompted by Chrysler's apparent shortcomings, on May 18, 2015, NHTSA announced that it would hold a public hearing on July 2, 2015, to determine whether Chrysler had complied with its Safety Act duties in connection with twenty prior recall campaigns, including the three discussed in the letters. (Monahan Decl., Ex. 9). (NHTSA subsequently expanded its inquiry to include three additional Chrysler recalls, for a total of twenty-three. (*See* SAC ¶ 241).) The following day, Chrysler issued a press release titled "NHTSA Recall Scrutiny" indicating that it would respond to, and cooperate with, the regulator. (Monahan Decl., Ex. 10). At the July 2, 2015 hearing, NHTSA "found [Chrysler] frequently delayed responding to safety problems, contrary to federal law. And even when it did order a recall, the feds questioned why repair rates often were so low and slow." (SAC ¶ 245; *see also id.* ¶¶ 70, 148, 276).

On Sunday, July 26, 2015, Chrysler entered into a Consent Order with NHTSA (the "First Consent Order"), admitting that it had violated the Safety Act and agreeing to pay a record $105 million fine. (*Id.* ¶ 19). Specifically, Chrysler admitted it had failed to timely notify NHTSA and vehicle owners in connection with twenty-three recalls affecting more than eleven million vehicles and that it had failed to adequately remedy defects in connection with three of those twenty-three recalls. (*Id.*; *see* Monahan Decl., Ex. 11 at 4-5). FCA's stock price then fell $0.74, or roughly 4.9%, to close at $14.41 on July 27, 2015 — a fall that resulted in over a $950 million decline in the company's market capitalization. (SAC ¶¶ 20, 244). On a July 30, 2015 earnings call, Marchionne acknowledged that FCA had "not always been perfect in complying

with [recall] requirements" and that, over the prior "year and a half, NHTSA ha[d] begun to take a harder look at these technical compliance issues, and frankly we [had] started to do the same thing about the same time." (SAC ¶ 270; Monahan Decl., Ex. 23, at 2).

On October 27, 2015, Chrysler announced Kunselman's resignation. (SAC ¶ 250). The next day, FCA announced its results for the third quarter — *i.e.*, the quarter in which NHTSA and Chrysler entered into the First Consent Order. (*Id.* ¶ 251). FCA disclosed that it recorded "a €761 million pre-tax charge for estimated future recall campaign costs for vehicles sold in prior periods in [the North American Free Trade Agreement zone]" (which includes the United States). (*Id.*; Monahan Decl., Ex. 12, at 16). Prior to this announcement, FCA had disclosed that its "estimated future costs of [service and recall] actions are primarily based on historical claims experience for the Group's vehicles" and that its "process . . . relies upon long-term historical averages until actual data is available." (*See, e.g.*, Monahan Decl., Ex. 4, at F29). In announcing the €761 million increase in its reserves, FCA stated that in light of the "recent increases in both the cost and frequency of recall campaigns and increased regulatory activity across the industry in the U.S. and Canada, an additional actuarial analysis that gives greater weight to the more recent calendar year trends in recall campaign experience has been added to the adequacy assessment to estimate future recall costs." (Monahan Decl., Ex. 12, at 16). Following the announcement, FCA shares fell $0.69, or 4.7%, to close at $14.72. (SAC ¶ 252).

On December 8, 2015, NHTSA and Chrysler entered into an amendment to the First Consent Order (the "Second Consent Order"). In it, Chrysler admitted that it had not submitted certain early warning information to NHTSA "due to coding problems in its [early warning] system that failed to recognize when reportable information was received or updated," and because Chrysler "did not update its system to reflect new FCA brands." (Monahan Decl., Ex.

13, at 2). Chrysler agreed to pay an additional fine of $70 million. (*Id.* at 3). Later the same day, an article titled "One Reason Fiat Chrysler (FCAU) Stock Closed Down Today" explained: "Fiat Chrysler Automobiles (FCAU) stock closed lower by 0.07% to $13.80 on Thursday, after the National Highway Traffic Safety Administration (NHTSA) fined the automaker $70 million for failing to report safety data, including reports of death and injuries, consumer complaints, warranty claims, and other data." (SAC ¶ 256).

In 2015, Plaintiff Victor Pirnik filed this lawsuit against FCA, Marchionne, Kunselman, and Palmer. On December 9, 2015, the Court appointed Gary Koopman and Timothy Kidd as Lead Plaintiffs. (Docket No. 24). Thereafter, they filed the operative Second Amended Complaint, which alleges that Defendants violated Section 10(b) and Rule 10b-5 by making false and misleading statements and omissions concerning FCA's compliance with regulations and by estimating falsely the quarterly provisions for FCA's warranty and recall reserves. (*See* SAC ¶¶ 297-307). Plaintiffs also seek to hold Marchionne, Kunselman, and Palmer liable as "control persons" under Section 20(a) of the Exchange Act. (*See id.* ¶¶ 308-313).

LEGAL STANDARDS

"In reviewing a motion to dismiss pursuant to Rule 12(b)(6), the Court must accept the factual allegations set forth in the complaint as true and draw all reasonable inferences in favor of the plaintiff." *Cohen v. Avanade, Inc.*, 874 F. Supp. 2d 315, 319-20 (S.D.N.Y. 2012) (citing *Holmes v. Grubman*, 568 F.3d 329, 335 (2d Cir. 2009)). The Court will not dismiss any claims pursuant to Rule 12(b)(6) unless the plaintiff has failed to plead sufficient facts to state a claim to relief that is facially plausible, *see Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007), that is, one that contains "factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged," *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009).

More specifically, a plaintiff must allege facts showing "more than a sheer possibility that a defendant has acted unlawfully." *Id.* A complaint that offers only "labels and conclusions" or "a formulaic recitation of the elements of a cause of action will not do." *Twombly*, 550 U.S. at 555. Further, if a plaintiff has not "nudged [its] claims across the line from conceivable to plausible, [those claims] must be dismissed." *Id.* at 570.

Because they allege securities fraud, Plaintiffs must also satisfy the heightened pleading requirements of both Rule 9(b), which requires that the circumstances constituting fraud be "state[d] with particularity," Fed. R. Civ. P. 9(b), and the Private Securities Litigation Reform Act ("PSLRA"), 15 U.S.C. § 78u-4(b), which requires that scienter — that is, a defendant's "intention to deceive, manipulate, or defraud" — also be pleaded with particularity, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007) (internal quotation marks omitted). To satisfy Rule 9(b), a plaintiff "must '(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent.'" *Anschutz Corp. v. Merrill Lynch & Co.*, 690 F.3d 98, 108 (2d Cir. 2012) (quoting *Rombach v. Chang*, 355 F.3d 164, 170 (2d Cir. 2004)). To satisfy the PSLRA, a complaint must, "'with respect to each act or omission alleged to [constitute securities fraud], state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.'" *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 (2d Cir. 2007) (quoting 15 U.S.C. § 78u-4(b)(2)(A)).

DISCUSSION

As noted, Plaintiffs seek to hold FCA, Marchionne, Kunselman, and Palmer liable for securities fraud under Section 10(b) and Rule 10b-5 and to hold Marchionne, Kunselman, and Palmer liable as "control persons" under Section 20(a). Broadly speaking, Plaintiffs' claims

relate to two categories of statements. The first category includes statements concerning FCA's compliance with applicable regulations — most notably, FCA's representations of substantial regulatory compliance in its SEC filings, but also oral statements made by Marchionne and Kunselman relating to Chrysler's fulfillment of its safety and recall duties. The second category includes statements concerning the amount of funds FCA reserved to address its warranty and recall costs, including oral statements by Palmer.

To state a claim for relief under Section 10(b) and Rule 10b-5 (and, by extension, a claim under Section 20(a)), a plaintiff must plausibly allege "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 37-38 (2011) (internal quotation marks omitted); *see also, e.g.*, *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996) (noting that a plaintiff must plead a plausible primary violation of Section 10(b) to state a claim for control person liability under Section 20(a)). Here, three elements are in dispute: whether Plaintiffs adequately plead a material misrepresentation or omission, scienter, and loss causation. The Court will begin by addressing whether Plaintiffs adequately plead a material misrepresentation or omission and scienter, first in connection with Defendants' statements and omissions regarding its regulatory compliance and then in connection with Defendants' statements about FCA's warranty and recall reserves. Lastly, the Court will address Defendants' arguments regarding loss causation.

A. Defendants' Statements Regarding Regulatory Compliance

Defendants move to dismiss Plaintiffs' claims relating to FCA's compliance with applicable regulations on two grounds: first, that the statements were not false or constitute

inactionable puffery and, second, that Plaintiffs fail to adequately allege scienter. The Court will address each argument in turn.

1. Falsity

To start, Defendants argue that FCA's statements about regulatory compliance in the company's SEC filings (and the oral statements made by Marchionne and Kunselman to similar effect) were neither false nor misleading. (Docket No. 44 ("Defs.' Mem.") 24-25). "[W]hether a statement is misleading depends on the perspective of a reasonable investor: The inquiry . . . is objective." *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318, 1327 (2015) (internal quotation marks omitted). Courts "consider whether the disclosures and representations, taken together and in context, would . . . misle[a]d a reasonable investor about the nature of the securities." *In re ProShares Trust Sec. Litig.*, 728 F.3d 96, 103 (2d Cir. 2013) (internal quotation marks omitted). "Even a statement which is literally true, if susceptible to quite another interpretation by the reasonable investor, may properly be considered a material misrepresentation." *Kleinman*, 706 F.3d at 153. Finally, to the extent relevant here, "[a] statement or omission is material if there is a substantial likelihood that a reasonable shareholder would consider in important in deciding how to act." *IBEW Local Union No. 58 Pension Trust Fund & Annuity Fund v. Royal Bank of Scotland Grp., PLC*, 783 F. 3d 383, 389 (2d Cir. 2015) (internal quotation marks omitted).

Applying those standards here, the Court easily concludes that Plaintiffs plausibly allege actionable and material misrepresentations. In the sentence primarily at issue, FCA represented from November 2014 through June 2015 that it was "substantially in compliance with the relevant global regulatory requirements affecting [the company's] facilities and products." (SAC ¶¶ 198, 203, 222, 234, 236). At the time of those statements, however, FCA was allegedly *not*

"substantially in compliance" with the "regulatory requirements" of the Safety Act; after all, only months later, FCA admitted to widespread noncompliance with those requirements. *Cf., e.g., Iowa Pub. Emps.' Ret. Sys. v. MF Global, Ltd.,* 620 F.3d 137, 143, n.13 (2d Cir. 2010) ("Depending on the problem, its existence in February 2008 may support an inference that it was present six months earlier. This is sufficient to raise [the plaintiffs'] right to relief above the speculative level." (internal quotation marks omitted)). Defendants do not (and, at this stage of the litigation, could not) argue otherwise. Instead, emphasizing the vastness of FCA's "global regulatory requirements," Defendants contend that "isolated disputes concerning a handful of regulations with one U.S. regulator do[] not remotely suggest that FCA was not at any time in substantial compliance with the myriad global regulations to which it was subject." (Defs.' Mem. 24-25). That argument might have legs if the sentence at issue read that FCA was "substantially in compliance with" *substantially all of* "the relevant global regulatory requirements." But that is not what it said, nor how it would be interpreted by a reasonable investor, let alone the only interpretation to which the sentence is "susceptible." *Kleinman*, 706 F.3d at 154. Instead, a reasonable investor could, and likely *would*, read FCA's statement to mean that the company was substantially in compliance with *all* applicable regulations, including the Safety Act and vehicle safety regulations in the United States. *See, e.g.*, *Fed. Hous. Fin. Agency Nomura Holding Am., Inc.*, 104 F. Supp. 3d 441, 563 (S.D.N.Y. 2015) (finding, after a bench trial, that defendants' representations of "general compliance" were misleading because they "indicated that certain immaterial exceptions might exist," not that significant violations existed (internal quotation marks omitted)); *In re Bear Stearns Cos. Inc. Sec., Derivative, and ERISA Litig.*, 763 F. Supp. 2d 423, 459 (S.D.N.Y. 2011) (finding defendant's statement that it

was "in compliance with [the SEC's Consolidated Supervised Entity] regulatory capital requirements" to be materially false).

The statement's text and context support that conclusion. First, the only word qualifying "global regulatory requirements" is "relevant," and the Safety Act is plainly relevant (that is, applicable, to FCA). Indeed, in the preceding sentence, FCA noted it "must . . . comply with extensive regional, national and local laws and regulations and industry self-regulations (*including those that regulate vehicle safety* . . .)." (SAC ¶ 198 (emphasis added)).[2] *See Omnicare*, 135 S. Ct. at 1332 (noting that the reasonable investor interprets a statement "fairly and in context"). Second, a reasonable investor could certainly conclude that the word "substantially" modifies only the words "in compliance." That is so not only because of grammar and syntax — *i.e.*, the words are next to one another, *see id.* at 1328 (observing that "the reasonable investor expects" an SEC filing to "ha[ve] been carefully wordsmithed") — but also because the law "does not concern itself with trifles" and "substantial" compliance is usually good enough, *Amalgamated Serv. & Allied Indus. Joint Bd., Amalgamated Clothing & Textile Workers Union, AFL-CIO, CLC v. N.L.R.B.*, 815 F.2d 225, 228 (2d Cir. 1987). In fact, the next sentence equates "substantially in compliance" and "in compliance" — stating "[w]e constantly monitor *such requirements* and adjust our operations to remain *in compliance*" — dropping any qualifying language to the pledged degree of compliance. Thus, a reasonable investor could have understood FCA to be representing that it was "substantially in compliance," not with *most* requirements in *most* areas, but with *all* "such requirements," including with vehicle safety

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[2] In light of that language, the fact that the statement appeared under the heading "Environmental and Other Regulatory Matters" (*see* Defs.' Mem. 25) is of no great significance.

regulations in the United States — particularly when considered in conjunction with Marchionne's and Kunselman's statements on that topic.

FCA's argument that its misrepresentations were merely inactionable puffery fares no better. That argument has no merit with respect to FCA's specific representation discussed above. *See, e.g.*, *In re BioScrip, Inc. Sec. Litig.*, 95 F. Supp. 3d 711, 721–22 (S.D.N.Y. 2015) (holding that the statement that "the Company *believes* it is in substantial compliance with all laws, rules and regulations that affects its business and operations," even though an opinion, was actionable (emphasis added)). And with respect to Marchionne and Kunselman, Defendants do not argue for dismissal on the ground that, under *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135, 142 (2011), the individual defendants did not "make" that statement. *Compare In re UBS AG Sec. Litig.*, No. 07-CV-11225 (RJS), 2012 WL 4471265, at *10 (S.D.N.Y. Sept. 28, 2012) ("Although *Janus* might not necessarily imply that there can be only one 'maker' of a statement in the case of express or implicit attribution, the individual defendants still must have actually 'made' the statements under the new *Janus* standard to be held liable under Section 10(b)." (internal quotation marks and citations omitted)), *aff'd sub nom. City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173 (2d Cir. 2014), *with*, *City of Pontiac Gen. Emps. Ret. Sys. v. Lockheed Martin Corp.*, No. 11-CV-5026 (JSR), 2012 WL 2866425, at *13-14 (S.D.N.Y. July 13, 2012) (holding that the group pleading doctrine survives *Janus*). In any event, Marchionne's and Kunselman's "comforting [oral] statements . . . about compliance measures" — viewed in combination with FCA's representation in its SEC disclosures of substantial compliance and the reality of its *non*compliance — "could be found by a trier of fact to be . . . misleading." *Meyer v. JinkoSolar Holdings Co., Ltd*, 761 F.3d 245, 251 (2d Cir. 2014); *see also, e.g.*, *In re Vivendi Universal, S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 573

(S.D.N.Y. 2011) (finding statements concerning the company's "sound financial footing" were not puffery because they were "supported by specific statements of fact regarding Vivendi's resources and financial condition" such as "zero net debt" and "free cash flow"), *aff'd*, — F.3d —, 2016 WL 5389288 (2d Cir. Sept. 27, 2016). Accordingly, with respect to Defendants' statements concerning FCA's regulatory compliance, Plaintiffs plausibly allege actionable misrepresentations.

2. Scienter

The Court thus turns to the question of scienter. In this Circuit, a plaintiff may satisfy the scienter pleading requirement in either of two ways: "by alleging facts (1) showing that the defendants had both motive and opportunity to commit the fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness." *ATSI Commc'ns*, 493 F.3d at 99. In their opposition to Defendants' motion, Plaintiffs rely solely on the latter, so they must allege either actual intent or "conscious recklessness — *i.e.*, a state of mind approximating actual intent, and not merely a heightened form of negligence." *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 106 (2d Cir. 2015).[3] More specifically, Plaintiffs must allege conduct by

[3] There are allegations in the Second Amended Complaint that could be read to suggest reliance on a motive-and-opportunity theory. (*See* Defs.' Mem. 12 (citing SAC ¶¶ 279-85, 302)). To the extent that Plaintiffs ever relied on that theory, however, they have abandoned the theory by not responding to Defendants' arguments on the issue. (*See id.*; Defs.' Reply 3). That is just as well. Plaintiffs do not allege that any of the Defendants sold shares of FCA stock during the Class Period. *See, e.g.*, *Rombach v. Chang*, 355 F.3d 164, 177 (2d Cir. 2004) (finding "no personal interest sufficient to establish motive" where "[p]laintiffs [did] not allege that defendants sold stock or profited in any way during the relevant period"). And while they do allege that Defendants had an interest in keeping FAC's stock price high and an opportunity to commit fraud by virtue of their positions, those sorts of generic allegations are insufficient to satisfy the scienter requirement. *See, e.g.*, *South Cherry Street, LLC v. Hennessee Grp. LLC*, 573 F.3d 98, 108–09 (2d Cir. 2009) ("[I]n attempting to show that a defendant had fraudulent intent, it is not sufficient to allege goals that are possessed by virtually all corporate insiders, such as the desire to maintain a high credit rating for the corporation or otherwise sustain the appearance of

Defendants, "which is 'at the least, conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *Kalnit v. Eichler,* 264 F.3d 131, 142 (2d Cir. 2001) (quoting *In Re Carter-Wallace, Inc. Sec. Litig.,* 220 F.3d 36, 39 (2d Cir. 2000)). The inquiry is "highly fact-based." *Id.* As a general matter, however, courts have approved of claims when plaintiffs "have specifically alleged defendants' knowledge of facts or access to information contradicting their public statements. Under such circumstances, defendants knew or, more importantly, should have known that they were misrepresenting material facts related to the corporation." *Novak v. Kasaks*, 216 F.3d 300, 308 (2d Cir. 2000) (noting as well that "[a]n egregious refusal to see the obvious, or to investigate the doubtful, may in some cases give rise to an inference of . . . recklessness" (alterations in original)).

Significantly, in arguing against an inference of scienter, FCA does not really dispute that the Second Amended Complaint alleges that Marchionne and Kunselman had knowledge of the company's noncompliance with respect to at least some recalls. (Defs.' Mem. 17-18). Instead, echoing their arguments with respect to falsity, Defendants merely seek to downplay how "substantial" the known noncompliance was. Thus, for example, FCA emphasizes that NHTSA's letters to Marchionne and Kunselman concerned "just *three* U.S. recall campaigns." (Defs.' Mem. 17 (emphasis in original)). And they note that the November 25, 2015 NHTSA letter "referred only to *the single Takata airbag recall*" (Defs.' Mem. 18 (emphasis in original)) — as if the largest automotive recall in history had involved only one solitary airbag (rather than

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corporate profitability or the success of an investment, or the desire to maintain a high stock price in order to increase executive compensation." (internal quotation marks omitted)).

millions of airbags). To the extent Defendants are rearguing falsity under the guise of scienter, their argument is without merit for the reasons discussed above; and to the extent they are presenting a materiality argument in disguise, the argument is without merit because materiality "is generally not an appropriate basis on which to dismiss a complaint." *In re Vivendi Universal, S.A. Sec. Litig.*, 381 F. Supp. 2d 158, 182 (S.D.N.Y. 2003).

Along the same lines, although it may be true that "Plaintiffs do not allege facts showing that any of the Individual Defendants — the most senior executives at FCA and/or FCA US — participated in the preparation of [FCA's safety reports to NHTSA] or knew that they were submitted late" (Defs.' Mem. 19), Plaintiffs do not need to show that the individual Defendants were *personally involved* with each Safety Act violation or even aware of any *particular* violation. Instead, it is enough at this stage for Plaintiffs to allege that Defendants were aware of nonpublic facts contradicting their public representations of substantial legal compliance. Plaintiffs do so, given the three deficient recalls about which Defendants appear to concede Kunselman and Marhcionne were aware. In addition, several other considerations raise a strong inference of knowledge. For instance, in its announcement that Kunselman, "a very, very senior" individual, would head the new office devoted to vehicle safety and regulatory compliance and report directly to the CEO himself, FCA assured its regulators and (more importantly for present purposes) its investors that, when it comes to ensuring safety, the buck would stop at the C Suite. (*See* SAC ¶¶ 184, 200, 212, 263). Additionally, Plaintiffs allege that Defendants "frequent[ly]" discussed "regulatory compliance in press releases, earnings calls and SEC filings" (SAC ¶ 257) and that Marchionne himself stated, in July 2015, that "*over the last year and a half*, NHTSA has begun to take a harder look at these technical compliance issues, and frankly *we started to do the same thing about the same time*." (SAC ¶ 270 (emphases

added)). In short, in light of the Court's analysis regarding falsity, NHTSA's direct correspondence to FCA's top executives, and FCA's self-acclaimed installation of a direct chain of safety-related information and accountability to those same top executives, Plaintiffs' allegations raise an inference of scienter as to those individuals that is "cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314 (2007). Accordingly, Plaintiffs adequately allege scienter with respect to the statements concerning legal compliance.[4]

B. Defendants' Statements Regarding Recall and Warranty Provisions

The same cannot be said of Plaintiff's allegations regarding Defendants' statements relating to FCA's recall reserves. The Second Circuit has held that "determining the adequacy of *loan loss* reserves is not a matter of objective fact" but a matter of opinion. *Fait v. Regions Fin. Corp.*, 655 F.3d 105, 113 (2d Cir. 2011) (emphasis added). As a result, such reserve estimates are actionable only if they are "both false and not honestly believed when they were made." *Id.*; *see also City of Omaha v. CBS Corp.,* 679 F.3d 64, 67–68 (2d Cir. 2012) (applying the reasoning of *Fait*, which affirmed dismissal of section 11 and 12(a) claims, to section 10(b) and 20(a) claims). *Fait* involved *loan loss* reserves, but its logic applies equally here — to reserves for product warranties and recalls — unless Plaintiffs can point to "an objective standard for setting [warranty] reserves." 655 F.3d at 113. Like the plaintiffs in *Fait*, however, Plaintiffs fail to do

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4 Defendants also cite, in a single sentence and a footnote (Defs. Mem. 19-20 & n.14), two cases rejecting securities fraud claims based on alleged omissions concerning government investigations. *See In re Lions Gate Entm't Corp. Sec. Litig.*, No. 14-CV-5197 (JGK), 2016 WL 297722, at *6-7 (S.D.N.Y. 2016); *In re UBS AG Sec. Litig.*, No. 07-CV-11225 (RJS), 2012 WL 4471265, at *31 (S.D.N.Y. Sept. 28, 2012), *aff'd sub nom. City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173 (2d Cir. 2014). Those cases are inapposite here as Plaintiffs allege securities fraud based on affirmative misrepresentations of compliance, not based on the failure to disclose ongoing government investigations.

so. Although they cite the International Financial Reporting Standards, those standards required only that FCA's reserve provision be assessed quarterly and adjusted "to reflect the current best estimate." (Pls.' Opp'n 25). That is not an "objective standard" in any meaningful sense of the word "objective." *See, e.g.*, *In re NovaGold Res. Inc.*, 629 F. Supp. 2d 272, 294 (S.D.N.Y. 2009) ("[T]he word 'estimate' connotes uncertainty."). Plaintiffs also state, in a footnote and without explanation, that FCA's own reports to NHTSA supply an objective standard. (Pls.' Opp'n 27 n.5). Although those reports do contain information about the numbers and types of recalls FCA was undertaking — just as the bank in *Fiat* presumably had information on the numbers and types of the loans it was issuing — that raw data is not itself a formula for estimating adequate recall reserves. Accordingly, *Fait*'s standards apply here, and Plaintiffs must show that FCA's "opinions" — *i.e.*, its determinations of its reserve provisions — were not only "false" (*i.e.*, inaccurate) but also "not honestly believed when they were made." 655 F.3d at 113; *see also Omnicare*, 135 S. Ct. at 1326-27 (noting that a "statement of opinion does not constitute an 'untrue statement of . . . fact' simply because the stated opinion ultimately proves incorrect."); *see also In re Sanofi Sec. Litig.*, 87 F. Supp. 3d 510, 534 (S.D.N.Y. 2015) ("[W]here plaintiffs allege a false statement of opinion, the falsity and scienter requirements are essentially identical . . . ." (internal quotation marks omitted)), *aff'd sub nom. Tongue v. Sanofi*, 816 F.3d 199 (2d Cir. 2016).

Plaintiffs fail to make that showing. The only facts Plaintiffs rely on are that (1) the number of FCA vehicles recalled in the United States increased significantly from 2010 to 2015 and (2) that, while FCA *did* increase its reserve estimates during that period (*see* Defs.' Reply 10), those increases were insufficient, as evidenced by the €761 million adjustment. (Pls.' Opp'n 26). Those facts — even when combined with Palmer's statement about the adequacy of

reserves (which Plaintiffs do not even mention in arguing against dismissal (*see* SAC ¶ 210; Pls.' Opp'n 25-29)) or FCA's statement, in July 2015, that it "does not expect that the net cost of providing these additional alternatives will be material to its financial position, liquidity or results of operations" (SAC ¶ 246; *see* Pls.' Opp'n 28) — do not allege securities fraud.[5] *See, e.g.*, *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1129 (2d Cir. 1994) ("Shields claims that Citytrust filed a document in August 1989 stating that it believed its loan loss reserve was adequate. Yet the following October it turned out that the reserve was inadequate and that Citytrust would make a significant addition to it. This technique is sufficient to allege that the defendants were wrong; but misguided optimism is not a cause of action, and does not support an inference of fraud. We have rejected the legitimacy of alleging fraud by hindsight." (internal quotation marks omitted)); *NECA-IBEW Pension Trust Fund v. Bank of Am. Corp.*, No. 10-CV-440 (LAK) (HBP), 2012 WL 3191860, at *10 (S.D.N.Y. Feb. 9, 2012) ("Even had [the defendant] stated that it believed its loss reserves were adequate, '[t]hat defendants later decided to revise the amount of loan loss reserves that it deemed adequate provides absolutely no reasonable basis for concluding that defendants did not think [the] reserves were adequate at the time the registration statement and prospectus became effective.'" (quoting *In re CIT Grp. Inc. Sec. Litig.*, 349 F. Supp. 2d 685, 690–91 (S.D.N.Y. 2004))); *In re Wachovia Equity Sec. Litig.*, 753 F. Supp. 2d 326, 362 (S.D.N.Y. 2011) ("In the absence of particularized allegations that Wachovia was experiencing or internally predicting losses exceeding their set reserves, the subsequent disclosures provide no basis to conclude that Defendants recklessly misstated previous reserve levels."); *In re Fannie Mae 2008 Sec. Litig.*, 742 F. Supp. 2d 382, 412

[5] Moreover, as Defendants note without rebuttal (Defs.' Mem. 17 n.10; Defs.' Reply 10 n.8), the July 2015 statement refers only to a specific portion of the costs stemming from the First Consent Order (relating to potentially repurchasing certain vehicles), not to total costs.

(S.D.N.Y.2010) (finding no actionable misstatement of loss reserves where the defendant "*did* increase its provisions . . . throughout the Class Period" and noting that "a massive increase to . . . combined loss reserves . . . is not, in itself, an indicator that the previous reserve levels were inadequate"). Moreover, given that FCA's publicly disclosed methodology for estimating recall costs was based on "long-term historical averages" (*see, e.g.*, Monahan Decl., Ex. 4, at F29), one would expect FCA's estimates to be too low if costs drastically increased over a relatively short time frame. And as Plaintiffs themselves appear to emphasize, recall enforcement and corresponding costs underwent just such a drastic increase in the relevant time period. (*See, e.g.*, SAC ¶ 244 (quoting an analyst who described NHTSA's fine of Chrysler as a "record fine" and the vehicle buyback requirement as "unprecedented")).

In arguing against dismissal, Plaintiffs principally point, again, to the reports that FCA filed with NHTSA. (Pls.' Opp'n 26-27 & n.15). But those reports did not directly "contradict" FCA's estimates; they were not "internal analyses" of what FCA's estimates should really have been. *In re Converium Holding AG Sec. Litig.*, No. 04-CV-7897 (DLC), 2006 WL 3804619, at *13 (S.D.N.Y. Dec. 28, 2006), *reconsideration granted in part on other grounds*, 2007 WL 1041480 (S.D.N.Y. Apr. 9, 2007). In light of FCA's uncontested methodology for estimating reserve provisions, Plaintiffs fail to explain how the reports "demonstrat[e] the inaccuracy of [FCA's] public statements," *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 196 (2d Cir. 2008) — let alone how they demonstrate that FCA's estimates were not reasonably believed when made, *see Fait*, 655 F.3d at 113. Plaintiffs also cite a few cases, but the contrast between the facts of those cases and the allegations here simply underscores the inadequacies of Plaintiffs' claim. *See In re Converium*, 2006 WL 3804619, at *13 (scienter adequately pleaded where plaintiffs "allege[d] in sufficient detail . . . that the

publicly reported numbers were at odds with Converium's internal analyses" and that the "defendants believed that the internal analyses more accurately reflected the actual financial condition of the company"); *In re Veeco Instruments, Inc. Sec. Litig.*, 235 F.R.D. 220, 231 (S.D.N.Y. 2006) (scienter adequately pleaded where plaintiffs alleged, among other things, "that defendants had knowledge of or recklessly ignored a series of accounting improprieties, each of which violated [Generally Accepted Accounting Principles] and Veeco's own internal policies," including allegations from confidential witnesses about specific internal incidents where defendants "refused to permit" the updating of financial statements); *see also, e.g.*, *In re Loral Space & Commc'ns Ltd.*, No. 01-CV-4388 (JGK), 2004 WL 376442, at *10-11 (S.D.N.Y. Feb. 27, 2004) (no scienter where allegations regarding reports that purportedly "directly contradicted the defendants' projections" were not pleaded "with sufficient particularity"). Lacking internal analyses, confidential witnesses, or other particularized allegations, Plaintiffs fail to adequately allege scienter with respect to Defendants' reserve estimates and related statements. *See, e.g.*, *In re Turquoise Hill Res. Ltd. Sec. Litig.*, No. 13-CV-8846 (LGS), 2014 WL 7176187, at *7 (S.D.N.Y. Dec. 16, 2014) ("The fact of an error, even a large error, does not suggest knowledge or intent to misstate when the financial results were originally published, particularly when the error was a matter of judgment . . . ."). Accordingly, Defendants' motion must be and is granted with respect to claims based on those estimates and related statements.

C. Loss Causation

Finally, with respect to the surviving claims concerning Defendants' statements about substantial compliance, the Court addresses the argument that Plaintiffs fail to allege loss causation. (Defs.' Mem. 29-30; Defs.' Reply 12). "Loss causation is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff." *Lattanzio v.*

Deloitte & Touche LLP, 476 F.3d 147, 157 (2d Cir. 2007); *see also Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 342 (2005) (defining loss causation as "a causal connection between the material misrepresentation and the loss"). The loss causation requirement "exists because private securities fraud actions are 'available, not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause.'" *In re Omnicom Grp., Inc. Sec. Litig.,* 597 F.3d 501, 510 (2d Cir. 2010) (quoting *Dura Pharm.*, 544 U.S. at 345). A misstatement or omission "is the proximate cause of an investment loss if the risk that caused the loss was within the zone of risk concealed by the misrepresentations [or omissions] alleged by a disappointed investor." *Lattanzio*, 476 F.3d at 157 (internal quotation marks and alterations omitted). To plead loss causation, a plaintiff must allege that the alleged "misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security." *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 173 (2d Cir. 2005).

Plaintiffs' allegations satisfy those standards at this stage of the litigation. Indeed, they plausibly allege at least two "corrective disclosures" that "negatively affected the value of the security," *Lentell*, 396 F.3d at 173: the First Consent Order, in which FCA admitted that it had violated the Safety Act and agreed to pay a substantial fine (after which the value of FCA's stock declined by roughly 4.9% (SAC ¶ 244)); and the Second Consent Order, in which FCA admitted to additional violations of the Safety Act and paid another substantial fine (after which the value of FCA's stock declined by .07% (*id.* ¶ 256)). Other than rehashing their unpersuasive arguments concerning falsity (Defs.' Mem. 29), Defendants' sole argument on loss causation is that the Consent Orders were not corrective disclosures because Chrysler had issued a press release when NHTSA announced the July 2015 public hearing. (Defs.' Mem. 30). That

argument is meritless. Chrysler's four-sentence, boilerplate press release did not come close to fully revealing the information contained in the Consent Orders. It did not, for example, disclose the fact that the company had violated the Safety Act in twenty-three recall campaigns, let alone the ramifications of those violations — for example, that Chrysler would enter into a settlement with its regulator admitting to widespread violations and agreeing to various costly conditions including payment of large fines and appointment of an independent monitor. In short, given the allegations in the Second Amended Complaint, a factfinder could certainly find that the First and Second Consent Orders were corrective disclosures and not merely "negative characterization[s] of already-public information," *In re Omnicom*, 597 F.3d at 512. Accordingly, Defendants' loss causation arguments are unavailing.

CONCLUSION

For the reasons stated above, Defendants' motion to dismiss is GRANTED in part and DENIED in part. Specifically, Plaintiffs' claims based on Defendants' statements regarding FCA's substantial compliance with applicable regulations survive, but their claims based on Defendants' reserve estimates and related statements are dismissed. It follows that the claims against Palmer, which concern only the latter, must also be and are dismissed.

Two issues remain. First, Defendants' request, in a footnote, that the Court "dismiss all claims brought on behalf of purchasers of FCA stock on the Milan Stock Exchange." (Defs.' Mem. 6 n.2). As Defendants point out, "[t]he Second Circuit has squarely held that the U.S. securities laws do not apply to claims brought by purchasers of dual-listed stock on non-U.S. exchanges." (*Id.* (citing *City of Pontiac Policemen's & Firemen's Ret. Sys.*, 752 F.3d 173 at 181)). Plaintiffs offer no counter-argument in their opposition and have thus abandoned any such claims. *See, e.g.*, *Simon v. City of N.Y.*, No. 14-CV-8391 (JMF), 2015 WL 4092389, at *2

(S.D.N.Y. July 6, 2015) (citing cases). In any event, in light of the clear Second Circuit precedent on the issue, Defendants' request is granted and any claims in this putative class action brought on behalf of purchasers of FCA stock on a foreign exchange are dismissed.

Second, in a single boilerplate sentence at the end of their opposition brief, Plaintiffs request leave to amend in the event that the Court finds that the Second Amended Complaint falls short in any way. (*See* Pls.' Opp'n 31). The Second Circuit has held that a motion under Rule 15(a) of the Federal Rules of Civil Procedure — which the Court construes Plaintiffs' request to be — "should be denied only for such reasons as undue delay, bad faith, futility of the amendment, and perhaps most important, the resulting prejudice to the opposing party." *Aetna Cas. & Sur. Co. v. Aniero Concrete Co.*, 404 F.3d 566, 603 (2d Cir. 2005); *see also Loreley Fin. (Jersey) No. 3 Ltd. v. Wells Fargo Sec., LLC*, 797 F.3d 160, 190 (2d Cir. 2015) ("leav[ing] unaltered" prior case law on denial of leave to amend, including the rule that "leave may be denied where amendment would be futile"). At the same time, "the grant or denial of an opportunity to amend is within the discretion of the District Court." *Williams v. Citigroup Inc.*, 659 F.3d 208, 214 (2d Cir. 2011). Applying those principles here, the Court concludes that Plaintiffs should not be granted leave to file what would amount to their *fourth* complaint. First, in light of *Fait* and the legal standards discussed above, any amendment would likely be futile. Second, in granting leave to file the operative complaint, the Court expressly warned Plaintiffs that they would not be given another opportunity to address the problems alleged in Defendants' motion to dismiss (*see* Docket No. 34), and they give no indication that they possess facts that could cure those problems. *See, e.g.*, *Clark v. Kitt*, No. 12-CV-8061 (CS), 2014 WL 4054284, at *15 (S.D.N.Y. Aug. 15, 2014) (holding that the plaintiff's failure to remedy the complaint's deficiencies identified by an earlier motion to dismiss "is alone sufficient grounds to deny leave

to amend"); *see also, e.g.*, *Ruotolo v. City of N.Y.*, 514 F.3d 184, 191 (2d Cir. 2008) (affirming the district court's denial of leave to amend in part because of the previous opportunities that the plaintiff had received to amend the complaint).

The Clerk of Court is directed to terminate Docket No. 42 and to terminate Defendant Richard Palmer as a party.

SO ORDERED.

Date: October 5, 2016
New York, New York

FILED

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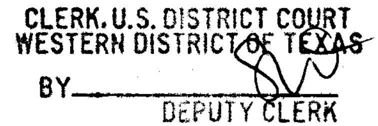

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TEXAS
AUSTIN DIVISION

CITY OF PONTIAC GENERAL EMPLOYEES' RETIREMENT SYSTEM, INDIVIDUALLY AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED, PLAINTIFF,	§	
V.	§	CAUSE NO. A-15-CV-374-LY
DELL INC.; MICHAEL S. DELL; BRIAN T. GLADDEN; AND STEPHEN J. FELICE, DEFENDANTS.	§	

ORDER ON MOTION TO DISMISS

Before the court are Defendants' Motion to Dismiss Plaintiffs' Amended Complaint filed September 8, 2015 (Doc. #74); Lead Plaintiff's Opposition to Defendants' Motion to Dismiss the Amended Complaint filed October 22, 2015 (Doc. #78); and Defendants' Reply Brief in Support of Their Motion to Dismiss Plaintiffs' Amended Complaint filed November 23, 2015 (Doc. #83). A hearing was held before the court on the motion on December 4, 2015, after which Defendants filed a letter brief on regarding a recent decision on April 21, 2016 (Doc. #89), and Lead Plaintiff filed a Response to Defendants' Notice of Recent Decision on April 26, 2016 (Doc. #92). Having considered the motion, response, reply, arguments of counsel, supplemental letter briefs, along with the applicable law in this cause, the court is of the opinion that Defendants' motion to dismiss should be denied for the reasons to follow.

I. Background

This is securities-fraud action brought on behalf of a purchasers of Dell Inc. securities[1] between February 22, 2012, and May 22, 2012 (the "Class Period"), against Defendants Dell Inc. ("Dell") and certain of its past and present officers[2] (collectively referred to as "Defendants") for violating Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78b, and Securities and Exchange Commission ("SEC") Rule 10b-5, 17 C.F.R. 240.10b-5. Dell is a global information-technology company that designs, develops, manufactures, markets, sells, and supports mobility and desktop products, including notebooks, tablets, desktop personal computers, workstations, smartphones, servers, and networking products.

The following facts are adopted from Plaintiffs' amended complaint. Plaintiffs allege that on February 21, 2012, Defendants issued a press release containing false and misleading statements and omissions regarding Dell's performance during its prior fiscal year,[3] including Dell's growth in the Asia-Pacific, Japanese, European, Middle Eastern, and African regions. Plaintiffs further allege that at that same time, Dell was experiencing weakened demand for and severe pricing pressure associated with its notebook and desktop product lines ("PCs"). Due to a significant shift in PC product demand and increasing competition from efficient low-cost PC manufacturers, the pricing pressure Dell was

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[1] The purchasers of Dell Inc. securities are represented by Lead Plaintiff City of Pontiac General Employees' Retirement System. For purposes of the motion to dismiss, the court will refer to the purchasers their representative collectively as "Plaintiffs."

[2] Defendants Stephen J. Felice, Brian T. Gladden, and Michael S. Dell.

[3] Dell's fiscal year 2012 ended on February 3, 2012, and the first quarter of fiscal year 2013 began on February 4, 2012 and ended on May 4, 2012.

experiencing was so extreme that Dell decided not to pursue higher-margin premium PC sales in certain overseas markets.

As a result, on May 22, 2012, Dell announced a half-billion-dollar shortfall in revenue relative to what Dell projected for the first quarter of 2013. Dell's operations cash flow dropped from $465 million in the first quarter of 2012 to negative $138 million in the first quarter of 2013, the first negative quarter since the first quarter of 2008. Dell attributed its revenue shortfall to its decision to forgo premium PC sales in its Asia-Pacific, Japanese, European, Middle Eastern, and African markets to avoid the negative impact on Dell's reported margins, weak demand for Dell's products, and poor sales-force productivity and execution. On May 23, 2012, one day after the revenue-shortfall announcement, the price of Dell stock declined more than 17%, the largest single day decline in Dell's stock price in over a decade on volume of more than 100 million shares. Before Dell's announcement and during the three-month-long Class Period, however, Plaintiffs allege that Dell's executives sold over 2.4 million shares of Dell stock worth approximately $41.3 million, which was nearly three-and-a-half times the amount of shares sold during all of 2011. Plaintiffs assert that these developments, which came to light over the course of the first quarter of fiscal year 2013 and had a negative impact on the final results for that quarter, were already known to Defendants and should have been disclosed as early as February 21, 2012.

This action is brought by City of Pontiac General Employees' Retirement System (the "Retirement System") on behalf of all who purchased Dell common stock during the class period—between February 22, 2012 and May 22, 2012. The Retirement System originally filed this action in the United States District Court for the Southern District of New York on May 21, 2014. The case was transferred to this court on April 30, 2015. The Retirement System filed the amended

complaint on July 27, 2015 (Doc. #72). Defendants moved to dismiss the amended complaint under Federal Rule of Civil Procedure 12(b)(6) and the Private Securities Litigation Reform Act, 15 U.S.C. §§ 78u-4, -5 (the "Reform Act") on September 8, 2015, arguing that the amended complaint fails to adequately plead the essential elements of false or misleading statements of material fact and *scienter*.

II. Analysis

A. Standard of Review

Motions to dismiss under Rule 12(b)(6) "are viewed with disfavor and are rarely granted." *Test Masters Educ. Servs., Inc. v. Singh,* 428 F.3d 559, 570 (5th Cir. 2005). Faced with a Rule 12(b)(6) motion to dismiss a Section 10(b) action, this court must accept all factual allegations in the complaint as true. *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 551 U.S. 308, 322 (2007) (citing *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit,* 507 U.S. 163, 164 (1993)). In addition, the court must also draw all reasonable inferences in the plaintiff's favor. *See Lormand v. US Unwired, Inc.*, 565 F.3d 228, 232 (5th Cir. 2009) (citing *Scheuer v. Rhodes,* 416 U.S. 232, 236 (1974); *Lovick v. Ritemoney, Ltd.,* 378 F.3d 433, 437 (5th Cir. 2004)).

This court "must assess whether the complaint contains sufficient factual matter, accepted as true, to state a claim for relief that is plausible on its face." *Spitzberg v. Hous. Am. Energy Corp.*, 758 F.3d 676, 683 (5th Cir. 2014) (citing *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007); *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009)). In determining whether a claimant has pleaded sufficient facts, only specific facts, not mere conclusory allegations or unwarranted deductions, are accepted as true and are considered. *See Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1067 (5th Cir. 1994). The issue is not whether the plaintiff will ultimately prevail, but whether the

plaintiff is entitled to offer evidence to support its claims. *See Doe v. Hillsboro Indep. Sch. Dist.*, 81 F.3d 1395, 1401–02 (5th Cir. 1996). Thus, this court may dismiss for failure to state a claim only if the court can determine with certainty that the plaintiff cannot prove any set of facts that would allow relief under the allegations in the complaint. *Hishon v. King & Spalding*, 467 U.S. 69, 73 (1984).

B. Section 10(b) Claim

Section 10(b) of the Exchange Act prohibits the use, in connection with the purchase or sale of a security, of "any device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe . . . ." 15 U.S.C. § 78j(b). SEC Rule 10b-5, in turn, makes it unlawful for any person, in connection with the purchase or sale of a security, to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10b-5. The elements of a private securities-fraud claim under Section 10(b) and Rule 10b-5 are (1) a material misrepresentation or omission; (2) *scienter*—a wrongful state of mind; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation—"a causal connection between the material misrepresentation and the loss." *Owens v. Jastrow*, 789 F.3d 529, 535 (5th Cir. 2015) (quoting *Lormand*, 565 F.3d at 238–39)).

"Securities fraud claims brought by private litigants" are "also subject to the pleading requirements imposed by the [Reform Act]." *Owens*, 789 F.3d at 535. "At a minimum, the [Reform Act] pleading standard incorporates the 'who, what, when, where, and how' requirements" of Federal Rule of Civil Procedure 9(b). *Id.* (quoting *ABC Arbitrage Plaintiffs Grp. v. Tchuruk*, 291 F.3d 336, 349–50 (5th Cir. 2002)). This means that "a plaintiff pleading a false or misleading statement or

omission as the basis for a section 10(b) and Rule 10b-5 securities-fraud claim must, to avoid dismissal pursuant to Rule 9(b) and [the Reform Act]," identify the allegedly misleading statement with particularity, explain why the statement was misleading, identify the speaker, state when and where the statement was made, and plead with particularity what the person making the misrepresentation obtained thereby. *Goldstein v. MCI WorldCom*, 340 F.3d 238, 245 (5th Cir. 2003). Additionally, to adequately plead the element of *scienter*, "the [Reform Act] requires a plaintiff to 'state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.'" *Owens*, 789 F.3d at 535 (quoting 15 U.S.C. § 78u-4(b)(2)). In the Fifth Circuit, "[t]he required state of mind [for *scienter*] is an intent to deceive, manipulate, or defraud or severe recklessness." *Lormand*, 565 F.3d at 251 (quoting *Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Grp., Inc.*, 537 F.3d 527, 533 (5th Cir. 2008)).

Defendants argue that Plaintiffs have failed to adequately plead two essential elements of a Section 10(b) securities-fraud claim: (1) material misrepresentation or omission and (2) *scienter*. The court will address each element in turn.

1. Material Misrepresentation

Defendants contend that Plaintiffs' allegations arise from statements made by Dell in a February 21, 2012 earnings press release and related conference call that took place the same day led by Gladden, Felice, and Michael Dell. Defendants assert that none of the statements are actionable because Defendants were simply disclosing accurate historical data, which does not become misleading even if less favorable results might be predictable by the company in the future. "A statement or omitted fact is 'material' if there is a substantial likelihood that a reasonable investor would consider the information important in making a decision to invest." *R&W Tech. Services Ltd.*

v. Commodity Futures Trading Com'n, 205 F.3d 165, 169 (5th Cir. 2000) (citing *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). Moreover, Defendants argue that Plaintiffs have not pleaded any facts to suggest that any forward-looking statement made on February 21, 2012 was false when made. *See Shushany v. Allwaste, Inc.*, 992 F.2d 517, 524 (5th Cir. 1993) ("Statements that are predictive in nature are actionable only if they were false when made.")

Expressions of corporate confidence, including "generalized, positive statements about [a] company's competitive strengths, experienced management, and future prospects," are immaterial and, thus, not actionable under the federal securities laws. *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 869 (5th Cir. 2003). Plaintiffs assert, however, that Gladden's statement that Dell "expect[s] [its] first quarter revenue to be approximately in line with [its] adjusted historical decline," which he made on the February 21, 2012 conference call, was used by analysts to estimate Dell would earn approximately $14.9 billion in revenue for the first quarter of 2013, which Plaintiffs allege Defendants failed to correct throughout the entire quarter, reasonably induced investors to believe that Dell had a legitimate expectation of revenues based upon the information then-available to Defendants about Dell's business. *See Plotkin v. IP Axess Inc., Etc.*, 407 F.3d 690, 697 (5th Cir. 2005) (reversing, in part, dismissal of securities case, finding complaint "adequately pleads that material omissions from [press] releases rendered those releases misleading"). Plaintiffs further allege that Defendants lacked a reasonable basis to tell investors to expect in-line revenues because "growth was stagnant, shipments were stalling and inventories were stockpiling, all of which resulted in far too much product and not enough demand for the [Dell's] PCs." Thus, Plaintiffs' argue, by misleadingly informing investors to expect results in-line with prior quarters while in possession of contrary information, Defendants "'affirmatively create[d] an impression of a state of affairs that differs in a

material way from the one that actually exists.'" *Ind. Elec. Workers' Pension Trust Fund IBEW*, 537 F.3d at 541. In addition, Plaintiffs argue that because they have sufficiently alleged facts that show that Defendants were aware of undisclosed facts that would undermine the accuracy of their forward-looking statements, the PSLRA's safe-harbor provision does not apply. *See Lormand*, 565 F.3d at 244. The court agrees.

The court concludes that, in light of Dell's specific problems, Defendants' statements and omissions regarding these problems may not be disregarded, as Plaintiffs allege in sufficient detail Defendants' failure to reveal known, material adverse facts regarding Dell's PC market and PC-sales prospects in the future.

2. Scienter

Scienter may be established by demonstrating the intent to deceive, manipulate, or defraud. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). Thus, a plaintiff may establish *scienter* by demonstrating either intent or severe recklessness. *See Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 408 (5th Cir. 2001) (defining severe recklessness as highly unreasonable omissions or misrepresentations demonstrating extreme departure from standards of ordinary care). Circumstantial evidence can support a *scienter* inference. *Id.*

Defendants argue that Plaintiffs' *scienter* allegations are based on Defendants' "beliefs" instead of personal knowledge, and that none of Plaintiffs' allegations against the Gladden, Felice, and Michael Dell are sufficient to be imputed to Dell Inc. The court's review of the amended complaint, however, reveals specific allegations as to the individual defendants regarding what they knew or recklessly disregarded, including the company's ballooning inventories and operations deficiencies within its sales divisions due in part to a significant decline in PC sales growth caused by

a shift in demand away from higher-margin premium PCs, resulting in stagnant growth, stalling shipments, and stockpiling inventories, all of which are contradictory to Gladden's February 21, 2012 statements regarding Dell's projected revenue for the first quarter of 2013. Having reviewed the facts and allegations in Plaintiffs' amended complaint *in toto*, *see Goldstein v. MCI WorldCom*, 340 F.3d 238, 247 (5th Cir. 2003), this court concludes that the omissions in Defendants' statements give rise to a strong inference of *scienter*. The court notes that the strong-inference pleading standard does not license the court to resolve disputed facts at this stage in the case. *Barrie v. Intervoice-Brite, Inc.*, 397 F.3d 249, 258 (5th Cir. 2005) (quoting *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 666 (8th Cir.2001)). Defendants' arguments are fact-based and are insufficient to support a motion to dismiss. The court finds that Plaintiffs have adequately pleaded the *scienter* element of the applicable Section 10(b) and Rule 10b-5 analysis. Therefore, the court concludes that Defendants' motion to dismiss Plaintiffs' Section 10(b) claim should be denied.

C. Section 20(a) Claim

Plaintiffs also allege control-person liability against Gladden, Felice, and Michael Dell under Section 20(a) of the Exchange Act. *See* 15 U.S.C. § 78t. "Control person liability is secondary only and cannot exist in the absence of a primary violation." *Shaw Group*, 537 F.3d at 545 (alteration in original) (quoting *Southland*, 365 F.3d at 383). Having concluded that Plaintiffs have sufficiently alleged a Section 10(b) claim, the Section 20(a) claim likewise survives Defendants' motion to dismiss.

III. Conclusion

IT IS THEREFORE ORDERED that Defendants' Motion to Dismiss Plaintiffs' Amended Complaint filed September 8, 2015 (Doc. #74) is **DENIED**.

SIGNED this 16th day of September, 2016.

LEE YEAKEL
UNITED STATES DISTRICT JUDGE

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA

JEFF RIHN, Individually and on Behalf of All Others Similarly Situated,

Plaintiff,

v.

ACADIA PHARMACEUTICALS INC., ULI HACKASELL and STEPHEN R. DAVIS,

Defendants.

STEVE A. WRIGHT AND VICKI G. WRIGHT, Individually and on Behalf of All Others Similarly Situated,

Plaintiffs,

v.

ACADIA PHARMACEUTICALS INC., ULI HACKSELL and STEPHEN R. DAVIS,

Defendants.

Case No.: 15cv00575 BTM(DHB)

ORDER DENYING MOTION TO DISMISS CONSOLIDATED CLASS ACTION COMPLAINT

Defendants Acadia Pharmaceuticals Inc. ("Acadia" or "Company"), Uli Hacksell, Stephen R. Davis, and Roger G. Mills have filed a motion to dismiss the Consolidated Class Action Complaint ("CCAC"). For the reasons discussed below,

Defendants' motion is **DENIED**.

I. FACTUAL BACKGROUND

The CCAC asserts claims for violations of (1) section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5; and (2) section 20(a) of the Securities Exchange Act. The claims are premised on allegations that Defendants knowingly and recklessly made materially false and misleading statements regarding the timing and status of Acadia's New Drug Application ("NDA") of its lead product candidate, Nuplazid (pimavanserin). These false and misleading statements allegedly artificially inflated stock prices of Acadia between November 10, 2014 and March 11, 2015 (the "Class Period").

Acadia is a biopharmaceutical company focused on the development and commercialization of medicines to address unmet medical needs in neurological and related central nervous system disorders. (CCAC ¶ 2.) Acadia has a pipeline of product candidates led by Nuplazid, which is a treatment for Parkinson's Disease Psychosis. (Id.)

In April 2013, Acadia announced that the FDA agreed that the data from the Company's pivotal Phase III -020 study was sufficient to support the filing of an NDA for Nuplazid. (CCAC ¶ 3.) The Company announced that it was targeting an NDA submission near the end of 2014. (Id.) On a conference call held on April 11, 2013, Chief Medical Officer Roger Mills explained that before Acadia could file its NDA, the Company needed to complete drug-drug interaction studies and final aspects of CMC (chemistry, manufacturing, and controls) development, including stability testing of pimavanserin registration batches. (CCAC ¶ 69.)

On November 10, 2014, Acadia announced that it was delaying its submission of the NDA for Nuplazid to the first quarter of 2015—i.e., by March 31, 2015 (the "First Delay"). (CCAC ¶ 4.) The Company explained that the decision to move back the submission was "based on additional time required to complete

preparations needed to support the [FDA's] review of Nuplazid." (CCAC ¶ 71.) On a conference call, CEO Uli Hacksell explained that although the Company had "completed the drug-drug interaction program" and had the "stability as required in our registration program," the Company needed "some more time to complete the preparations." (Id.)

In the following months, Acadia made multiple assurances that it was "on track" to submit the NDA by March 31, 2015. On December 2, 2014, CFO Stephen Davis stated that with respect to the NDA "what we've guided is the first quarter of 2015, and we remain on track for that." (CCAC ¶ 74.) On January 13, 2015, Hacksell represented that Acadia was "comfortable" with its timeline for submitting the NDA by March 31, 2015. (CCAC ¶ 75.) On February 26, 2015, in a press release, Hacksell stated that Acadia "remain[s] on track to submit our New Drug Application to the FDA in the first quarter of 2015." (CCAC ¶ 76.) In a conference call that same day, Hacksell reiterated "we remain on track to submit our NDA this quarter." (CCAC ¶ 78.) In that same conference call, Mills stated, "As Uli mentioned at the beginning of the call, we are diligently completing preparations to support the FDA review of Nuplazid and remain on track to submit our NDA this quarter." (Id.)

However, less than a week after the February 26, 2015 press release and public statements, the Company cancelled its scheduled appearance at the Cowen and Company 35th Annual Health Care Conference on March 3, 2015, and then cancelled its scheduled appearance at the 27th Annual ROTH Conference on March 10, 2015. (CCAC ¶ 79.) These cancellations fueled rumors that Acadia was going to be acquired, causing Acadia's stock price to surge 18% to $45.88 per share on March 10, 2015. (CCAC ¶ 80.)

On March 11, 2015, Acadia announced that it was delaying its NDA submission again to the second half of 2015 ("Second Delay"). (CCAC ¶ 81.) It also announced that Hacksell was resigning as CEO and that CFO Davis was

1 being appointed Interim CEO. (Id.) As a result of the news, Acadia common stock
2 dropped $9.94 per share to close at $34.82 per share on March 12, 2015, a one-
3 day decline of 22% on the volume of 15 million shares. (CCAC ¶ 99.)

4 In the press release announcing the Second Delay, Acadia explained that
5 the decision to delay the NDA submission was "based on additional time required
6 to complete the preparation of systems to support commercial manufacturing and
7 supply and, in turn, to support the U.S. Food and Drug Administration's (FDA)
8 review of Nuplazid." (Id.) On a conference call that day, Davis further explained
9 the reasons for the delay of the NDA submission:

10 In preparation for submission of the NDA, we completed an
11 assessment of our manufacturing, quality systems and procedures.
12 This is a customary, but important step in preparing for an NDA review
13 and the inspections that are part of that review. Based upon this
14 assessment, we've determined that we need to do additional work to prepare our systems to support commercial-scale manufacturing and supply.

15 I'm going to pause here and just take a second to provide some context
16 around the system that I'm describing. Moving from a clinical-stage
17 company to a commercial-stage company, as we are doing, requires
18 building infrastructure to accommodate commercial-scale operations.
19 These systems include things such as robust quality assurance
20 systems, documentation and record-keeping systems, commercial-
21 oriented Standard Operating Procedures or SOPs, systems to monitor activities of third-party suppliers, and simply the management of materials through the supply chain.

22 Many of these systems exist when you're a clinical-stage company, but
23 have to be significantly expanded and much more robust for
24 commercial-scale production. Establishing the infrastructure I've
25 described requires close coordination between our internal
26 manufacturing resources, external third-party suppliers and the quality
27 assurance functions within each organization. Because these
28 manufacturing and supply systems are subject to inspection as part of the NDA review process, it is an important that our systems be robust and ready for FDA review and of course for commercial launch.

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To be ready for that review, the systems need to be established, they have to be tested and evaluated, and frequently, they need to be tested in connection with actual production runs completed by your third-party suppliers, in other words, it's not just a paper exercise. You sometimes need to test them in real production runs.

So, this requires coordination of our schedule with the schedules and availability of others and the logistics, quite frankly, can be challenging. With that context, the assessment we've recently concluded indicates that the network of systems needed to support commercial manufacturing and supply, and again importantly, the review of our NUPLAZID NDA, requires further implementation and additional testing, work that was not part of the company's original plan. As a result of information from this assessment, we've decided to move back the planned NDA submission of NUPLAZID to the second half of 2015.

* * *

[Analyst]: . . . So I guess just wondering, your 4Q call was two weeks ago and obviously you were confident in the 1Q timeline then. Can you just help us understand what has happened between then and now and how can we be at all confident in the new timeline you guys have given?

[Davis]: It is a fair question. I will just start by saying that preparing and filing an NDA is a huge amount of work across many functions of the Company and as we got closer to the final submission date and diverse functions of the Company became coordinated, the group of us sitting around this table became aware that we had more work to do to be prepared in the areas that I mentioned. . . . . Look, I'm going to be honest. Obviously mistakes were made. The Company should have been better prepared but we have taken decisive steps to address those missteps and I am very confident in the team here.

* * *

[Analyst]: And you mentioned just a breadth of things that are involved in these quality systems and procedures, things like standards, SOPs, raw material, supply chain. Is there one or two particular areas that are

> the focus of the ongoing activity? I can't imagine that every single one of these would need work.
>
> [Davis]: No, quite frankly as I mentioned, you do a lot of these things at a clinical stage level and when you go to commercial stage, they frankly need to be more robust, there are some things that you do that are new but most of the things just have to be done at a much more industrial scale. And again speaking quite frankly, the Company didn't start the process early enough to really get those things in place. We have made very good progress I think in the last few months but this recent assessment we had indicates that we've got more work to do.

(CCAC ¶ 82.)

An NDA must include, among other things, a CMC section. (CCAC ¶ 52.) The CMC section must include analytical test methods for the drug product, specifications of the drug product and drug components, and a description of the product's manufacturing and control procedures. (CCAC ¶ 53.) As part of the NDA approval process, the Company was required to demonstrate that its manufacturing and quality assurance systems and those of its third-party contract manufacturers and suppliers complied with Current Good Manufacturing Practices ("CGMPs") set forth in 21 C.F.R. §§ 210, 211. (CCAC ¶ 54.) The FDA typically conducts a pre-approval inspection to determine whether an applicant's manufacturing facilities comply with CGMPs. (CCAC ¶¶ 59-60, Ex. C.) If manufacturing facilities are not ready for inspection, the FDA may refuse to file the application. (CCAC ¶ 63.)

According to Acadia, the manufacturing quality assurance protocols/ documentation were not ready and would not be for months. (CCAC ¶ 100.) On April 14, 2015, Davis made the following comments regarding the delay:

> We gave a fairly broad range of the second half of the year. That was conscious and intentional, and the reason for that is the work that we need to do really revolves around making certain that we are ready for preapproval inspections. In order to get to that state of readiness, there's a certain amount of work that needs to be done in collaboration

1 with our third-party suppliers, and because we are relying on other
2 people's schedules, it's important -- I felt like it was important to make certain that we had factored in a certain degree of uncertainty
3 regarding just what their schedules will entail.

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5 Just to give the broader context, to get a drug approved you need to do three things, right? One is the NDA is the primary focus of the drug
6 approval. Our NDA is ready to go, so we can check that box. We could push the button tomorrow and submit the NDA. It's about 700,000
7 pages, so as you can see it's a very substantial document. That's not atypical, by the way. The other two buckets that are required to get a
8 drug approved are passing what's referred to as preapproval
9 inspections, and they come in two forms. One is on the clinical side and we've done what most companies do. We did an extensive amount
10 of preparation, getting ourselves ready for those inspections, and we
11 did again what most companies do. We hired former FDA inspectors, had them come in and do a mock inspection and do the same kind of
12 inspection that we expect FDA to do. The results of that were that we
13 are ready to go on the clinical side.

14

15 We did the same thing on the third bucket and that is on your preapproval inspections associated with manufacturing. We
16 determined then that we have more work to do and so that's the subject of the work that we're doing now. I have said many times, I am not
17 aware of any company that has failed to get their drug approved
18 because they couldn't get a quality assurance system in place that passes a preapproval inspection.

19

20 So we will do that. It's a process that we need to get in place. I'm highly confident that we will get that in place. I think we've got the right team.
21 We've got the right plan. It's an extensive plan and a very robust team
22 working on this, and based on everything I know today, I'm confident that we will submit the NDA in the second half.

23

24 * * *

25 The remaining bucket that we need to address is getting the quality
26 assurance system in place on the GMP side of the equation. Once we have that in place, which again every company does -- I'm highly
27 confident we will -- the commercial group is ready to go.

28

(CCAC ¶ 102.)

On September 29, 2015, Davis stated: "the company just didn't start soon enough in building out the Quality Assurance system or making that transition to a commercial-grade QA system on the GMP front. We recognized that in March of this year or February this year, and began the process of building that out." (CCAC ¶ 103.)

Acadia submitted its NDA for Nuplazid on September 3, 2015, five months after March 31, 2015. (CCAC ¶ 103.) That day, the Company announced the appointment of Davis as CEO. (Id.)

II. DISCUSSION

Defendants contend that Plaintiff's claims must be dismissed because Plaintiff fails to plead falsity with particularity, fails to raise a strong inference of scienter, and fails to plead loss causation. The Court finds that Plaintiff has alleged sufficient facts that satisfy the pleading standards of Fed. R. Civ. P. 12(b)(6), Fed. R. Civ. P. 9(b), and the Private Securities Litigation Reform Act ("PSLRA").

A. Pleading Standard

Under section 10(b) of the Securities Exchange Act of 1934, it is unlawful "[t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance . . . ." 15 U.S.C. § 78j(b). Rule 10b–5, which implements section 10(b), makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10b–5(b).

To state a securities fraud claim, plaintiff must plead: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." Halliburton Co. v. Erica P. John Fund, Inc., __ U.S. __, 134 S.Ct. 2398, 2407 (2014) (internal citation and quotation omitted).

At the pleading stage, claims under section 10(b) and Rule 10b-5 must satisfy both the heightened pleading standard of Rule 9(b) as well as the pleading requirements of the PSLRA. Police Ret. Sys. of St. Louis v. Intuitive Surgical, Inc., 759 F.3d 1051, 1058 (9th Cir. 2014). Under Rule 9(b), the complaint must "state with particularity the circumstances constituting fraud." Fed. R. Civ. P. 9(b). The PSLRA imposes "more exacting pleading requirements," which require that the complaint plead with particularity both falsity and scienter. Reese v. Malone, 747 F.3d 557, 568 (9th Cir. 2014).

The PSLRA requires that the complaint "specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading." 15 U.S.C. § 78u–4(b)(1)(B). If an allegation regarding the statement or omission is made on information and belief, the complaint must "state with particularity all facts on which that belief is formed." Id. To plead scienter, the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u–4(b)(2)(A).

B. Materially False and Misleading Misrepresentations or Omissions

1. Defendants Made Materially Misleading Statements of Fact

The crux of the CCAC consists of allegations that during the Class Period, Defendants repeatedly stated that they were "on track" to submit the NDA by the March 31, 2015 deadline and were "comfortable" with the announced timeline even though Acadia had not performed a mock inspection of its manufacturing and

quality assurance systems and lacked critical information regarding these important systems.[1]

"To be actionable under the securities laws, an omission must be misleading; in other words it must affirmatively create an impression of a state of affairs that differs in a material way from the one that actually exists." Brody v. Transitional Hospitals Corp., 280 F.3d 997, 1006 (9th Cir. 2002). As recognized by the Supreme Court, "[W]hether an omission makes an expression of opinion misleading always depends on context." Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, __U.S.__, 135 S.Ct. 1318, 1329 (2015).

To satisfy the materiality requirement, the complaint must allege sufficient facts to support the inference that there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1976) (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)). "Although determining materiality in securities fraud cases should ordinarily be left to the trier of fact, conclusory allegations of law and unwarranted inferences are insufficient to defeat a motion to dismiss for failure to state a claim." Reese, 747 F.3d at 568 (quoting In re Cutera Sec. Litig., 610 F.3d 1103, 1108 (9th Cir. 2014)).

The CCAC sufficiently alleges that Defendants made materially misleading misrepresentations when they made statements during the Class Period that Acadia was "on track" to submit the NDA by March 31, 2015, as planned, and that they were "comfortable" with the timeline. According to the CCAC, as part of the NDA approval process, Acadia needed to be prepared for a pre-approval

[1] Defendants contend that the CCAC violates the PSLRA because it relies on "puzzle-pleading." Although the CCAC includes multiple block quotes, it is clear from the italicized portions of the quotes and the other allegations of the complaint what statements Plaintiff alleges are misleading and why Plaintiff believes they are misleading.

inspection by the FDA of its manufacturing facilities. (CCAC ¶¶ 59-60.) Acadia needed to be ready to demonstrate that its manufacturing and quality assurance systems and those of its third-party contract manufacturers and suppliers complied with CGMPs. (CCAC ¶ 54.) As explained by Davis, moving from a clinical-stage company to a commercial-stage company requires building infrastructure to accommodate commercial-scale operations, including robust quality assurance systems, documentation and record-keeping systems, commercial-oriented Standard Operating Procedures, systems to monitor activities of third-party suppliers, and systems for the management of materials through the supply chain. (CCAC ¶ 82.)

It appears that Acadia did not complete an assessment of its manufacturing and quality assurance systems until February or March of 2015. This assessment alerted Acadia that its network of systems needed to support commercial manufacturing and supply required further implementation and testing. (CCAC ¶ 82.) Davis admitted that the Company did not start the process early enough to transition to a commercial-grade Quality Assurance system by March 31, 2015, and should have been better prepared. (CCAC ¶¶ 82, 103.) In fact, after the Second Delay was announced, it took another five months for the manufacturing and quality assurance issues to be addressed and for the NDA to be submitted.

Based on the allegations of the CCAC, the implementation of adequate manufacturing and quality assurance systems was a significant undertaking and was a critical component of the NDA approval process. However, Acadia did not perform a mock inspection of these systems until shortly before the Second Delay was announced. Accordingly, when Defendants represented that the NDA was "on track" to be submitted by March 31, 2015, without mentioning that no meaningful assessment of the manufacturing and quality assurance systems had been conducted, Defendants created an impression of a state of affairs that differed in a material way from the one that actually existed. Defendants led the

public to believe that all appropriate steps had been taken to make sure that the NDA was ready for review by the deadline and that barring unforeseen circumstances, the NDA would be submitted by that date. In actuality, Defendants lacked information regarding whether the necessary infrastructure for commercial-scale operations was in place. Thus, Defendants' assurances that the NDA remained "on track" for submission by March 31, 2015 were materially misleading.

2. The Statements Are Not Forward-Looking

Defendants contend that the challenged statements are forward-looking and are inactionable as a matter of law. The Court disagrees.

Under the PSLRA's "safe harbor," a defendant may not be held liable for a statement that (1) is, and is identified as, a "forward-looking statement"; and (2) is accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." 15 U.S.C. § 78u-5(c)(1)(A). A "forward-looking statement" is defined as any statement regarding (1) financial projection, (2) plans and objectives of management for future operations, (3) future economic performance, or (4) the assumptions underlying or related to any of the aforementioned statements. 15 U.S.C. § 78u-5(i)(1)(A)-(D).

Although statements that Acadia "planned" on submitting the NDA by March 31, 2015, viewed in isolation, may qualify as "forward-looking," Defendants' statements that Acadia remained "on track" to submit the NDA by the deadline do not. In the context of this case, Defendants' "on track" assurances were representations about the *current* state of affairs with respect to the NDA process, which were within Defendants' knowledge and control.

In Mulligan v. Impax Lab., Inc., 36 F. Supp. 3d 942, 951 (N.D. Cal. 2014), the court rejected the defendants' argument that the following statement by the CFO regarding the company's response to a Warning Letter from the FDA was

forward-looking: "Where we are now is on track, and, therefore, I think investors can be comfortable that we're where we need to be." The court explained that this statement "is fundamentally a representation of present fact regarding the status of Impax's response to the FDA Warning Letter." Id. at 964. See also In re MGM Mirage Sec. Litig., 2013 WL 5435832, at * 7 (D. Nev. Sept. 26, 2013) (holding that statements that a construction project is "on-track" or "on-schedule" are not forward-looking "but statements relating to *current* conditions.")

Although in some instances, a statement regarding a company being "on track" might be forward-looking,[2] under the facts of this case, the statements were a representation of present conditions pertaining to the NDA process. Therefore, the PSLRA's safe harbor does not apply.

3. The Statements Are Not Non-actionable Puffery/ Corporate Optimism

Defendants claim that the challenged statements are non-actionable statements of corporate optimism. For similar reasons as discussed in the prior section, the Court disagrees.

"[V]ague, generalized assertions of corporate optimism or statements of 'mere puffing' are not actionable material misrepresentations under federal securities laws." In re Impac Mortg. Holdings, Inc. Sec. Litig., 554 F. Supp. 2d 1083, 1096 (C.D. Cal. 2008). Non-actionable "puffing" statements are "not capable of objective verification and lack a standard against which a reasonable investor could expect them to be pegged." Id. (internal citation and quotation omitted). As explained by the Ninth Circuit:

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[2] In Police Retirement Sys. of St. Louis v. Intuitive Surgical, Inc., 2012 WL 1868874, at * 11 (N.D. Cal. May 22, 2012), the statement that revenue "is on track to grow 55% this year" was explicitly introduced as a financial forecast. In City of Marysville General Employees Ret. Sys. v. Nighthawk Radiology Holdings, 2011 WL 4584778, at * 20 (D. Idaho Sept. 12 2011), the court held that NightHawk's statements that it was "on track" and "positioned" to capitalize on opportunities," when read in context, were tied to future projections based on hopes of eventually expanding business services,

> When valuing corporations . . . investors do not rely on vague statements of optimism like "good," "well-regarded," or other feel good monikers. This mildly optimistic, subjective assessment hardly amounts to a securities violation. Indeed, professional investors, and most amateur investors as well, know how to devalue the optimism of corporate executives.

Cutera, 610 F.3d at 1111 (internal citation and quotation omitted).

In determining whether statements amount to nothing more than non-actionable puffery, "the court must analyze the context in which the statements were made." In re Bridgepoint Educ., Inc. Sec. Litig., 2013 WL 5206216, at * 17 (S.D. Cal. Sept. 13, 2013). "What might be innocuous 'puffery' or mere statement of opinion standing alone may be actionable as an integral part of a representation of material fact when used to emphasize and induce reliance upon such a representation." Casella v. Webb, 883 F.2d 805, 808 (9th Cir. 1989).

As discussed above, the statements regarding Acadia remaining "on track" to submit the NDA by the deadline were representations about current conditions regarding the NDA process. They were not vague statements of optimism, but, rather, statements premised on facts. In Mulligan, the court rejected the defendants' arguments that the statements at issue were mere puffery: "[T]he vast majority of the statements identified in the FAC contain factual representations at their core—that Defendants had responded to the FDA Warning Letter by instituting various changes to the manufacturing and/or quality control procedures or processes." Mulligan, 36 F. Supp. 3d at 967. Similarly, here, Defendants' statements were factual representations regarding Acadia's preparedness for the NDA submission and were material. See Silverman v. Motorola, Inc., 2008 U.S. Dist. Lexis 76799, at *27 (N.D. Ill. Sept. 23, 2008) ("Among the puffery lies certain specific statements of present fact that could be considered material. The fact that the 'competitive' products are 'on track,' 'quite on track,' or 'keyed up,' would be

material if in fact defendants knew that those products were not on track.”)[3]

C. Scienter

Defendants argue that the CCAC fails to plead scienter with particularity, as required by the PSLRA, and impermissibly relies on speculation and conjecture. Considering all of the allegations of the CCAC collectively, the Court concludes that Plaintiff has pled sufficient facts giving rise to a strong inference of scienter.

Under the PSLRA, plaintiffs must plead “with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” 15 U.S.C. § 78u-4(b)(2)(A). A strong inference of scienter “must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.” Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 322 (2007). “The inference must be that the defendant made false or misleading statements either intentionally or with deliberate recklessness.” Reese v. Malone, 747 F.3d 557, 569 (9th Cir. 2014) (internal citation and quotation omitted). “[A]n actor is [deliberately] reckless if he had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts although he could have done so without extraordinary effort.” In re Oracle Corp. Sec. Litig., 627 F.3d 376, 390 (9th Cir. 2010) (quoting Howard v. Everex Sys., Inc., 228 F.3d 1057, 1064

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[3] Allison v. Brooktree Corp., 999 F. Supp. 1342 (S.D. Cal. 1998), cited by Defendants, is distinguishable because in that case the defendants represented, “I think we’re on the right track” in the early design stage of the BtV chipset: “In bringing any high-tech product to market, problems encountered in the early developmental stages are the norm, not the exception. Notably absent are allegations that Brooktree had encountered any insurmountable problems, or the problems were of such magnitude that Defendants knew the projected release dates to be unrealistic, or any other fact that would undermine the tentative and vague nature of these statements.” Id. at 1348. The other cases upon which Defendants rely are also distinguishable. See In re Wet Seal, Inc. Sec. Litig., 518 F. Supp. 2d 1148, 1167-68 (C.D. Cal. 2007) (statement that Wet Seal was “on track to deliver improved financial performance in the fall, in line with our turnaround plan” was puffery because it projected vague optimistic results); In re DOT Hill Sys. Corp. Sec. Litig., 594 F. Supp. 2d 1150, 1158 (S.D. Cal. 2008) (statement that integration of technology into Dot Hill’s products was “on schedule and continuing smoothly” was mere puffery—“Plaintiffs simply disagreed with defendants about how quickly the integration should have been accomplished.”)

1 (9th Cir. 2000)).

2 The Supreme Court explains that courts "must review all the allegations
3 holistically" when determining whether scienter has been adequately pled.
4 Tellabs, 551 U.S. at 326. The relevant inquiry is "whether *all* of the facts alleged,
5 taken collectively, give rise to a strong inference of scienter, not whether any
6 individual allegation, scrutinized in isolation, meets that standard." Id.

7 Allegations regarding management's role in a company may help satisfy the
8 PSLRA scienter requirement in three circumstances:

9 First, the allegations may be viewed holistically, along with other
10 allegations in the complaint, to raise a strong inference of scienter
11 under the Tellabs standard. Id. at 785–86. Second, the allegations
12 "may independently satisfy the PSLRA where they are particular and
13 suggest that defendants had actual access to the disputed
14 information," as in Daou, 411 F.3d at 1023, and Oracle, 380 F.3d at
15 1234. S. Ferry, 542 F.3d at 786. Third, in rare circumstances, such
16 allegations may be sufficient, without accompanying particularized allegations, where the nature of the relevant fact is of such prominence that it would be "absurd" to suggest that management was without knowledge of the matter. Id. (citing Berson, 527 F.3d at 988).

17 Reese, 747 F.3d at 575-76.

18 A combination of all three circumstances exist in this case. First, given the
19 facts of this case, it would be incredible to conclude that the CEO, CFO, and Chief
20 Medical Officer of Acadia were not aware of the information at issue that made
21 their "on track" representations misleading. In Mulligan, the court held that it would
22 be absurd to think that the CEO and CFO of Impax, a pharmaceutical company,
23 would be unaware of the alleged substandard conditions pervading the company's
24 manufacturing and control divisions: "[G]iven the importance of manufacturing and
25 quality control to the success of Impax and the fact that both areas of operation
26 had been flagged by the FDA, it is a logical, and strong, inference that the
27 defendants were aware of the alleged severe and pervasive problems in Impax's
28 Hayward facility." Mulligan, 36 F. Supp. 3d at 970. See also Flynn v. Sientra, Inc.,

2016 WL 3360676 (C.D. Cal. June 9, 2016) (finding that there was a strong inference that the CEO and CFO of medical aesthetics company were aware of quality control issues plaguing the company's sole manufacturer of silicone breast implants in light of the importance of manufacturing and quality control to the success of Sientra).

Nuplazid, Acadia's most advanced product candidate, was critical to the success of the company. (CCAC ¶ 112.) Furthermore, the implementation of manufacturing and quality assurance systems was an important component of the NDA process. In addition, Acadia was a relatively small company—97 employees as of December 31, 2014 (CCAC ¶ 112). It would be absurd to suggest that the CEO, CFO, and Chief Medical Officer did not know that there had been no mock inspection of its manufacturing facilities and that there had been no reliable assessment of the company's manufacturing and quality assurance systems at the time they made their statements.

The CCAC also contains allegations suggesting that Hacksell, Mills, and Davis had access to the information at issue. On March 11, 2015, the day Davis was appointed interim CEO, he stated that he was "the ultimate report for manufacturing and CMC." (CCAC ¶ 98.) It can reasonably be inferred that when Hacksell was CEO, he too was the "ultimate report" for manufacturing and CMC. Statements made by Defendants also indicate that they had knowledge regarding CMC issues pertaining to Nuplazid. Hacksell and Mills made statements regarding preparations Acadia needed to complete to support the NDA, including CMC development, and all three Defendants commented on the NDA remaining "on track." (CCAC ¶¶ 69, 71, 74, 76, 78.)

Finally, the allegations of Defendants' roles in the Company when viewed together with other allegations in the CCAC raise a strong inference of scienter. On February 26, 2015, Hacksell and Mills reiterated that Acadia remained "on track" to submit the NDA by March 31, 2015. However, less than a week later,

1 Acadia cancelled its scheduled appearance at a conference. Then on March 11,
2 2015, Acadia announced the Second Delay. Later, Davis said that Acadia
3 recognized in February or March that the quality assurance system was not ready.
4 (CCAC ¶ 103.) The issues with the manufacturing and quality assurance systems
5 were of such significance that it took an additional five months for the NDA to be
6 submitted.

7 The closeness in time of the February 26, 2015 representations and the
8 March 11, 2015 disclosure supports an inference that Hacksell and Mills were
9 deliberately reckless in claiming that the NDA remained "on track" for submission
10 by the end of the next month. "Temporal proximity of an allegedly fraudulent
11 statement or omission and a later disclosure can be circumstantial evidence of
12 scienter." Reese, 747 F.3d at 574. See also Berson v. Applied Signal Tech., Inc.,
13 527 F.3d 982, 988 n. 5 (9th Cir. 2008) (explaining that temporal proximity of
14 misleading statement and disclosure of stop-work order just two weeks later
15 bolstered the inference that the defendants knew about the order when they made
16 the statement).

17 The scope and significance of the events underlying a disclosure can also
18 support an inference of scienter. See, e.g., Berson, 527 F.3d at 988 n. 5 ("The size
19 of the contract and the prominence of the client raise a strong inference that
20 defendants would be aware of this order."); Plumbers & Pipefitters Nat. Pension
21 Fund v. Orthofix Intern. N.V., 89 F. Supp. 3d 602, 619 (S.D.N.Y. 2015) (explaining
22 that "the size of the purported fraud may also contribute to an inference of
23 scienter."). In light of the importance of the implementation of the manufacturing
24 and quality control systems to the NDA process, the significant amount of work
25 that actually remained to be done on those fronts, and the fact that no mock
26 inspection occurred until February or March of 2015, it was highly likely that
27 Defendants were aware that their "on track" assurances lacked a factual basis.

28 Viewing the allegations of the CCAC holistically, the Court concludes that

scienter has been adequately pled.[4]

D. Loss Causation

Defendants argue that Plaintiff has failed to plead loss causation because, according to Plaintiff's own allegations, the decline in Acadia's stock price upon announcement of the Second Delay was caused by the Company dispelling speculation that it was in the process of being acquired.

Loss causation is "a causal connection between the material misrepresentation and the loss." Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342 (2005). "A plaintiff is not required to show that a misrepresentation was the sole reason for the investment's decline in value in order to establish loss causation. As long as the misrepresentation is one substantial cause of the investment's decline in value, other contributing forces will not bar recovery under the loss causation requirement but will play a role in determining recoverable damages." Nuveen Mun. High Income Opportunity Fund v. City of Alameda, 730 F.3d 1111, 1119 (9th Cir. 2013) (internal citation and quotation omitted).

As pointed out by Plaintiff, the merger speculation resulted in a $6.95 per share increase on March 10, 2015, whereas the announcement of the Second Delay resulted in a $9.94 per share decrease. (CCAC ¶¶ 13, 80, 99.) These facts arguably establish that the price of Acadia stock was artificially inflated in part for reasons separate from the merger rumors—i.e., Defendants' misleading statements regarding the NDA being on track for submission by March 31, 2015.

The Court finds that Plaintiff has adequately alleged loss causation and denies the motion to dismiss on this ground.

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[4] Plaintiff makes additional arguments in support of his position that the CCAC adequately pleads scienter, including arguments pertaining to Defendants' financial gains from stock sales and incentive compensation, and the timing of Hacksell's resignation as CEO. The Court does not find it necessary to reach these arguments and overrules as moot Plaintiff's objection to Defendants' request for judicial notice of alleged hearsay concerning Defendants' trading plans in SEC filings.

E. Section 20(a) Claim

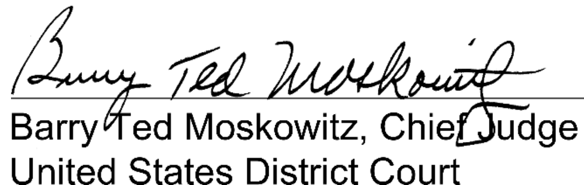
To state a claim under section 20(a), a plaintiff must establish (1) a primary violation of federal securities law, and (2) that the defendant exercised actual power or control over the primary violator. See Howard v. Everex Sys., 228 F.3d 1057, 1065 (9th Cir. 2000). Defendants argue that Plaintiff has failed to state a claim under section 20(a) because Plaintiff has failed to plead a primary violation of section 10(b). However, because the Court has found that Plaintiff has sufficiently pled a claim for violation of section 10(b), Plaintiff's section 20(a) claim survives dismissal as well.

III. CONCLUSION

For the reasons discussed above, Defendants' motion to dismiss the CCAC is **DENIED**. Defendants shall file an answer to the CCAC within 20 days of the entry of this Order.

IT IS SO ORDERED.

Dated: September 19, 2016



Barry Ted Moskowitz, Chief Judge
United States District Court

UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

WASHTENAW COUNTY EMPLOYEES' RETIREMENT SYSTEM, Individually and on Behalf of All Others Similarly Situated	)	Case No. 15-cv-3187
Plaintiff,	)	Judge Sharon Johnson Coleman
v.	)	
WALGREEN CO., GREGORY D. WASSON, and WADE MIQUELON,	)	
Defendants.		

MEMORANDUM OPINION AND ORDER

Industriens Pensionsforsikring A/S, acting as lead plaintiff on behalf of itself and all others similarly situated, brings this class action against the defendants Walgreen Co. ("Walgreens"), former Walgreens CEO Gregory D. Wasson, and former Walgreens CFO Wade Miquelon, alleging violations of sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The defendants, in separate motions filed by Walgreens and Wasson [55] and by Miquelon [57], now move to dismiss Washtenaw's complaint for failure to state a claim. For the reasons set forth herein, those motions are granted in part and denied in part.

Background

The following is a general overview of the voluminous allegations contained in the amended complaint and its attachments, which are taken as true for the purposes of this motion.

Walgreens is a retail drugstore chain that sells prescription and non-prescription drugs. Prescription drugs represent Walgreens' largest class of products and are the lead driver of its revenue and profit. At the times relevant here Gregory D. Wasson was Walgreens' CEO and a director on the company's Board of Directors and Wade Miquelon was Walgreens' CFO.

The substantial majority of prescription drugs that Walgreens sold were generic versions of branded drugs ("generic drugs"). Because generic drugs cost less to produce than branded drugs, their sale generated a higher profit margin. That profit margin, however, was dependent on the difference between the cost to procure the generic drug and the reimbursement rate that Walgreens received for supplying a customer with the drug.

Drug prices varied widely depending on a number of factors including (1) whether the drug was branded or generic, (2) how many companies were producing the drug (if it was a generic), (3) the relative supply and demand for the drug, (4) adverse regulatory actions impacting the drug or its manufacturing facility, or (5) consolidations of drug manufacturers and their drug portfolios. Drug manufacturers also retained significant power to set their own prices. Historically, the competitive generic drug marketplace had caused a deflationary trend in drug prices. Between 2010 and 2013 that trend began to reverse as drug manufacturers began testing price inflation strategies for mature products. By 2013 and 2014 third party metrics reflected this inflationary trend and Walgreens' primary competitors had acknowledged that generic drug costs were increasing.

The vast majority of Walgreens' prescription drug sales were "third party sales" in which the purchaser paid a copay and a pharmacy benefit manager (PBM), private insurance company, or governmental entity reimbursed Walgreens for the remainder of the drug's cost. PBMs constituted the vast majority of the third party sales market. Walgreens' contracts with several major PBMs provided for fixed maximum rates of reimbursement for each drug over the term of the contract and contained no mechanism by which the maximum rates could be altered to respond to price variations. Thus, if generic drug prices increased Walgreens would be forced to absorb the additional costs of those drugs.

In 2011, Walgreens, under Wasson's leadership, walked away from contract negotiations with Express Scripts, one of the largest PBMs. The decision was costly; Walgreens' inability to fill

Express Scripts customer's prescriptions caused it to lose millions of customers to its rivals and caused its stock price to drop by over 25%. Although Walgreens and Express Scripts ultimately negotiated a new contract in July 2012, thereafter many investors began to question Wasson's management ability.

In June 2012, Walgreens announced that it was entering into a strategic transaction with international "pharmacy-led health and beauty group" Alliance Boots GmbH ("Alliance") to create the largest pharmacy company in the world. At the time, Alliance was led by CEO Stefano Pessina. During the first step of the deal, Walgreens acquired a 45% equity ownership stake in Alliance. As part of that transaction, Pessina acquired control of 8% of Walgreens common stock, making him Walgreens' largest shareholder. During the second step, which required shareholder approval, Walgreens was to acquire the remaining Alliance stock in exchange for cash and shares of Walgreens' stock. As part of this process, Walgreens announced a set of goals for FY 2016 reflecting the expected benefits of the new partnership, including generating $1 billion in combined synergies and between $9 and $9.5 billion in adjusted earnings before interest and taxes ("EBIT"). The EBIT goal was especially important to investors because it was the only metric gauging the potential profitability of the combined companies. From September 2012 through June 2013, the defendants continued to express optimism regarding the EBIT goal and to dismiss analysts' concerns regarding threats to that goal.

In late 2013, however, Walgreens' internal long range planning process revealed that the EBIT goal was tracking at under $8.5 billion.[1] Miquelon, in a verified complaint filed in a separate action ("the Miquelon complaint"), admitted that by the end of 2013 the company had identified the sources of that deficit as (1) the unprecedented level of generic drug price inflation that the industry

[1] Each year, Walgreens conducts a long range plan encompassing the next three fiscal years. The process of developing the long range plan begins in March and extends through the end of June, at which point the final results are submitted for the Board of Directors' approval at the annual board meeting. (Dkt. 47-1, ¶ 61).

was experiencing and (2) reimbursement contracts that failed to provide meaningful inflationary relief. Nonetheless, Walgreens restated the EBIT goal when it reported its first quarter results for 2014. During the conference call announcing the quarterly results, Miquelon admitted that Walgreens was tracking "a bit below" the EBIT goal, but asserted that the company was prepared to mitigate the risks to achieving the goal and that it had the right tools at its disposal to meet the target. During that call, Miquelon also reassured analysts that "[q]uarter by quarter we look at [the FY2016 goals], and say are these still realistic based upon all the risk and opportunities we have internally. If we ever feel that's not the case, we'll certainly tell you." By March 2014, the EBIT goal was tracking around $7.5 billion dollars, $2 billion less than the high end of the EBIT goal.[2]

The class period, which runs from March to June 2014, encompasses the announcement of Walgreens second quarter results and third quarter results and public statements made in the interim. During that time, the defendants continued to issue statements that allegedly downplayed the risk to the EBIT goal. Yet Miquelon's verified complaint established that by March 2014, when Walgreens issued its second quarter results, the company was aware of the systematic inflation of generic drug prices.

On April 9, 2014, Miquelon shared an interim long range planning update with Walgreens' Board of Directors suggesting that Walgreens would realize $7.5 billion in EBIT in 2016. Also in April, activist investors began to push aggressively for Walgreens to execute a tax inversion (by moving the company overseas) and expressed a desire that the Alliance management team take on a greater leadership role in the combined companies, sparking speculation that Wasson was losing control of Walgreens. In May, Wasson told Miquelon that if Walgreens did not proceed with the tax

[2] The defendants challenge this figure, asserting that Miquelon's previously mentioned verified complaint does not reflect that the defendants were aware the EBIT goal was tracking in this range during March 2014. Exhibits to a complaint, however, do not control over allegations made within the complaint when, as here, the document does not itself form the basis for the allegation. *N. Ind. Gun & Outdoor Shows, Inc. v. City of South Bend*, 163 F.3d 449, 455 (7th Cir. 1998). Accordingly, where the complaint in this action and the Miquelon complaint conflict, the former must govern.

inversion he believed that the activist investors would force him out of his position. Around that time, Wasson also met with Miquelon to offer him a new position within the combined company. Miquelon declined the new position, and elected to leave Walgreens after Step 2 of the Alliance transaction was complete.

By June 2014, Miquelon had finalized his estimate and conclusively determined that the EBIT goal was tracking at $7.2 to $7.5 billion. Miquelon informed Wasson of the scope of the shortfall in mid-June and advocated for publically withdrawing the EBIT goal during the next quarterly call on June 24th. Wasson argued that the scheduled earnings call should be delayed—so that the withdrawal of the EBIT goal could be bundled with favorable news—and pressured Miquelon to raise the earnings-per-share estimate well-beyond that which could be supported by the EBIT tracking numbers.

On June 24, 2014, Walgreens issued its third quarter report and withdrew its FY 2016 earnings targets, attributing the decision to "Step 2 considerations" and "current business performance." Walgreens, however, did not disclose the extent of the EBIT shortfall until August 6, 2014 when Walgreens confirmed that the expected 2016 EBIT was projected to be around $7.2 billion. The disclosure of this shortfall caused Walgreens stock to plummet over 14% in a single day. In subsequent appearances in support of Step 2, Wasson and Pessina attributed the "unexpected" shortfall to bad forecasting, lax controls in the financial department, and poor communication between departments. Their statements cast Miquelon as being responsible for these errors and implied that he had been pressured to leave due to the purported forecasting error. Miquelon subsequently filed the previously referenced verified complaint, suing Walgreens for breach of contract, defamation, and tortious interference with prospective economic advantage.

On August 6, Walgreens announced that it was exercising its option to purchase the remaining 55% of Alliance Boots, thus completing Step 2 of the Walgreens–Alliance Boots

transaction. Walgreens' September 2014 announcement of its fourth quarter results explicitly acknowledged, for the first time, the detrimental impact that reimbursement pressures and generic drug price inflation were having on its profit margins. Several months later Wasson resigned and Pessina replaced him as the CEO of Walgreens.

Legal Standard

A motion to dismiss pursuant to Rule 12(b)(6) for failure to state a claim tests the sufficiency of the complaint, not its merits. When considering dismissal of a complaint, the court accepts all well pleaded factual allegations as true and draws all reasonable inferences in favor of the plaintiff. *Ashcroft v. Iqbal*, 556 U.S. 662, 678, 129 S.Ct. 1937, 173 L.Ed.2d 868 (2009) (quoting *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570, 127 S.Ct. 1955, 167 L.Ed.2d 929 (2007)). Rule 9(b), however, requires plaintiffs to plead with particularity the circumstances constituting fraud. Fed. R. Civ. P. 9(b). Particularity in pleading fraud, including securities fraud, means alleging the "who, what, when, where, and how: the first paragraph of any newspaper story." *DiLeo v. Ernst & Young,* 901 F.2d 624, 627 (7th Cir. 1990).

Section 10(b) of the Securities Exchange Act makes it unlawful for any person to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b). S.E.C. Rule 10b-5 implements this provision by making it illegal to make any untrue statement of a material fact or to fail to state a material fact necessary in order to prevent statements made from being misleading in light of the circumstances under which they were made. 17 C.F.R. § 240.10b-5(b). Accordingly, in order to plead that the defendants made material misrepresentations or omissions in violation of section 10(b) and rule 10b-5, the plaintiffs must allege "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the

misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta,* 552 U.S. 148, 157, 128 S.Ct. 761, 169 L.Ed.2d 627 (2008). The Private Securities Litigation Reform Act (PSLRA) requires that the complaint specify each statement alleged to be misleading and the reason or reasons why that statement is misleading. 15 US.C. § 78u-4(b)(1).

The PSLRA, moreover, contains a safe harbor provision that heightens the pleading requirements for forward looking statements. 15 U.S.C. § 78u-5(c). A plaintiff alleging that a forward-looking statement contains a misrepresentation or omission must establish a strong inference that the forward-looking statement was made with actual knowledge by the speaker that the statement was false or misleading. 15 U.S.C. § 78u-5(c)(1)(B). In order to establish a "strong inference," the pleadings must demonstrate that a reasonable person would deem the inference of scienter to be at least as compelling as any opposing inference that one could draw from the facts alleged. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 324, 127 S.Ct. 2499, 168 L.Ed.2d 179 (2007). Additionally, a defendant cannot be liable for any forward-looking statement that is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially. 15 U.S.C. § 78u-5(c)(1)(A)(i).

The plaintiff also alleges that the defendants violated Section 20(a) of the Securities Exchange Act. Section 20(a) provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable (including to the Commission in any action brought under paragraph (1) or (3) of section 78u(d) of this title), unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constitution the violation or cause of action.

15 U.S.C. § 78t(a). In order to allege a section 20(a) claim, the plaintiff must therefore allege (1) a primary securities violation; (2) that the individual defendant exercised general control over the individual or organization that committed the violation; and (3) that the individual defendant "possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated, whether or not that power was exercised." *Harrison v. Dean Witter Reynolds, Inc.,* 974 F.2d 873, 881 (7th Cir. 1992); *Zurich Capital Markets, Inc. v. Coglianese*, 388 F. Supp. 2d 847, 866 (N.D. Ill. 2004) (St. Eve, J.).

Discussion

March 2014 Statements

On March 25, 2014 Walgreens issued its second quarter report and Wasson and Miquelon held a conference call with investors to present the report and to answer questions about it. During that call, Miquelon stated:

> [We] reviewed [the] fiscal-year 2016 goals internally and performance to date with respect to four of our five goals remains on track with or slightly ahead of our expectations.
>
> ***
>
> As stated on our last call our adjusted operating income goal of $9 billion to $9.5 billion is currently tracking below the CAGR required to meet this goal and below our initial expectations. We continue to recognize that there are risks to achieving this goal; however, we remain focused on delivering it.
>
> And as I also stated we have identified a range of further opportunities including benefits from our AmerisourceBergen relationship, incremental Alliance Boots synergies, business expansion and new initiatives and cost savings which can all help mitigate these risks. The asset optimization program that Greg described highlights our focus on efficiencies while the increase in our fiscal-year 2014 synergy estimate demonstrates that we are driving additional synergies with Alliance Boots and AmerisourceBergen.

(Dkt. 47 ¶ 158). Additionally, a slide accompanying the defendants' presentation listed the five previously announced FY2016 goals, including the EBIT goal of $9 to $9.5 billion. The plaintiff contends that these statements are false and misleading because they reaffirm the 2016 EBIT goal, despite the defendants' knowledge that that goal was tracking at least $1.5 billion below target. The plaintiff alleges that by late 2013 Walgreens had identified a shortfall of $500–$600 million with respect to the EBIT target and that, by April 2014, the company had accumulated an additional $1 billion in risk to the EBIT target. The plaintiff further alleges that the defendants knew that the largest source of the EBIT shortfall was the systematic reversion to an inflationary generic drug price trend.

As an initial matter, this Court rejects the characterization of these statements as a reaffirmation of the goal. Although the defendants did state what the EBIT goal was and renew their commitment to attempt to attain that goal, they also expressly acknowledged that they were not currently on track to attain it. Thus, their statements were not misleading about the current status of the goal. Moreover, the defendants' statements were not actionable based on the theory that the EBIT goal might be unobtainable because the plaintiff has not plausibly alleged that the goal was in fact unobtainable. *Cf. Lindelow v. Hill,* No. 00 C 3727, 2001 WL 830956, at *4 (N.D. Ill. July 20, 2001) (Holderman, J.) (recognizing statements of "strategy" and "goals" to be actionable where the defendants knew or recklessly ignored the fact that the stated goals were unobtainable). And the plaintiff has not alleged facts establishing that the defendant's future looking statement that they "remained committed" to achieving the EBIT goal was false or misleading. The defendants also were not obligated to provide additional information or internal forecasts about the extent of the shortfall once it was disclosed. *See Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 516 (7th Cir 1989) (recognizing that firms have no obligation to reveal in-house estimates that are in the process of consideration and revision); *see also City of Livonia Emps.' Ret. Sys. and Local 295/Local 851 v. Boeing*

Co., 711 F.3d 754, 759 (7th Cir. 2013) ("There is no duty of total corporate transparency—no rule that every hitch or glitch, every pratfall, in a company's operations must be disclosed in 'real time,' forming a running commentary, a baring of the corporate innards, day and night.").

The plaintiff also contends that the above statement was misleading because it acknowledged efforts to mitigate the risk to the 2016 EBIT goal but failed to recognize that those efforts would be insufficient to counteract the severe scope of the EBIT shortfall. Here, however, the defendants' statement was that there were measures to "mitigate" the risk, not to "eliminate" it. *See* Black's Law Dictionary 1154 (10th ed. 2014) (defining "mitigate" as "[t]o make less severe or intense; to make less harmful, unpleasant, or seriously bad."). Thus, in order for their statement to be false or misleading the plaintiff must allege facts demonstrating that the defendants' measures were unable to in any way reduce the EBIT shortfall. The plaintiff has alleged no facts suggesting this to be the case. Additionally, because this is a forward-looking statement, the plaintiff must also allege facts creating a strong inference that the defendants had actual knowledge of the falsity of their statements. Here, the plaintiff has made no such allegation, and therefore fails to state a claim.

During the conference call, Miquelon addressed Walgreens' softening profit margins, stating "[w]hile we always experience some level of reimbursement pressure the most significant factor affecting the pharmacy margin was dramatically slower rate [sic.] of new generic introductions year over year." (Dkt. 47 ¶ 157). Walgreens second quarter form 10-Q similarly stated that "[r]etail pharmacy margins were negatively impacted by a significant reduction in the number of brand to generic drug conversions and lower market driven reimbursements." (Dkt. 47 ¶ 163). The plaintiff contends that these statements were misleading because they misattributed the EBIT shortfall to the lack of new generic drug conversions instead of generic drug price inflation and unfavorable contract terms.

These statements are adequately alleged to be false or misleading. Miquelon's statement that "we always experience some level of reimbursement pressure" portrayed the reimbursement pressures that Walgreens felt as routine. But the plaintiff has plausibly alleged that those reimbursement pressures, caused by unprecedented, systematic generic drug price inflation and detrimentally structured contracts, were anything but routine and were already recognized to be the primary cause behind the EBIT shortfall. Thus, the representation that reimbursement pressures were routine and that the primary factor impacting pharmacy margins was the reduction in brand-to-generic drug conversions is sufficiently alleged to be false or misleading. *In re Gen. Elec. Co. Sec. Litig.*, 857 F. Supp. 2d 367, 386 (S.D.N.Y. 2012) (recognizing that although there is no "duty to disclose any and all related material whenever a company speaks on a given topic", a duty to disclose arises "when silence would make other statements misleading or false") (internal quotations omitted); *see City of Sterling Heights Gen. Emps.' Ret. Sys. v. Hospira, Inc.*, No. 11 C 8332, 2013 WL 566805, at *20 (N.D. Ill. Feb. 13, 2013) (St. Eve, J.) (recognizing that statements denying systematic regulatory compliance issues were actionable where the compliance problems that the defendant had experienced were plausibly alleged to be systematic in nature); *see also Sapssov v. Health Mgmt. Assocs., Inc.*, 22 F. Supp. 3d 1210, 1227 (M.D. Fla. 2014) (recognizing that, because an executive put the source of a company's success at issue, the failure to disclose the true source of the revenue could give rise to liability under section 10(b)).

This Court is not persuaded otherwise by the defendants' assertion that generic drug price inflation was a well-known and universally recognized market trend that they therefore had no obligation to disclose. *See Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 759 (7th Cir. 2007) ("The securities laws do not require firms to 'disclose' information that is already in the public domain."); *Garden City Empls.' Ret. Sys. v. Anixter Int'l, Inc.,* No. 09-CV-5641, 2012 WL 1068761, at *5 (N.D. Ill. Mar. 29, 2012) (Dow, J.) ("Defendants do not commit securities fraud by failing to specifically alert

investors to the general conditions of certain segments of the market.”). Ordinarily, the defendants’ are correct that they would not be required to alert investors to the existence of price inflation in particular sectors of the marketplace. Here, however, the defendants are not alleged to have failed to disclose relevant market information. Rather, they are alleged to have misrepresented that they were only experiencing routine reimbursement pressures and that the primary factor impacting pharmacy margins was the reduction in brand-to-generic conversions. These misrepresentations created a duty to disclose the existence of generic drug price inflation where none would have otherwise existed. Moreover, the defendants’ argument completely ignores the plaintiff’s allegation that the impact of the generic drug price inflation was uniquely magnified as a result of the terms of Walgreens’ reimbursement contracts and that its detrimental impact was therefore specific to Walgreens.

The plaintiff further alleges that three additional statements are false and misleading because they failed to disclose that generic drug price inflation was already “unprecedented” and “systematic.” In the press release issued on March 25, 2014, Wasson emphasized Walgreens’ “solid top-line growth” in the quarter “driven by record quarterly sales and record second-quarter prescriptions filled.” (Dkt. 47 ¶ 153). This past-looking statement, however, is unrelated to generic drug price inflation and therefore created no obligation to disclose the existence of that trend.

Wasson also represented that Walgreens expected that “the generic drug headwind that affected the first half will ease and turn around by the end of the year.” (*Id.*).

During the March 25, 2014 conference call, Miquelon similarly stated that:

> Taking a look at our adjusted gross margin trends this quarter's 140 basis point decrease was versus [a] 120 basis point increase a year ago. In essence, the benefit of the generic wave last year reversed itself this year. We expect this impact to continue to moderate in the third and fourth quarter and become a tailwind to some degree in the fourth quarter of fiscal 2014.

(*Id.* ¶ 156). As previously stated, these future-looking statements require that the plaintiff allege facts creating a strong inference that the defendants had actual knowledge of the falsity of their statements. Here, the plaintiff put forth facts showing that by the end of 2013 generic drug inflation was a recognized trend market-wide and that Miquelon had come to realize that the inflation might be systematic in nature. The plaintiff further alleges that Walgreens was entangled in unfavorable contracts that offered it no meaningful relief from increasing generic drug prices. Taken collectively, the plaintiff's allegations are adequate to establish a strong inference of actual knowledge of falsity with respect to the defendants' statements that the generic drug headwind would turn into a tailwind in 2014.

The defendants, however, contend that this statement is subject to the second prong of the PSLRA's safe harbor provision because it was accompanied by meaningful cautionary statements. Specifically, the defendants point to Walgreens' FY13 10-K form, which listed thirty-eight separate business-specific risk factors and provided a brief descriptive account of how those factors could impact Walgreens' business. Cautionary language is meaningful if it "puts an investor on notice of the danger of the investment to make an intelligent decision about it according to her own preferences for risk and reward." *Stavros v. Exelon Corp.*, 266 F. Supp. 2d 833, 843 (N.D. Ill. 2003) (Castillo, J.) (internal quotation marks omitted) (quoting *Harris v. Ivax Corp.*, 182 F.3d 799, 807 (11th Cir. 1999)). Cautionary language therefore must be more than a boilerplate warning, and must be tailored to the risks that accompany the particular projections. *Asher v. Baxter Int'l, Inc.*, 377 F.3d 727, 732 (7th Cir. 2004). Cautionary language, however, need not delve into minutiae in order to identify the risk at issue. *Plumbers and Pipefitters Local Union No. 630 Pension-Annuity Trust Fund v. Allscripts-Misys Healthcare Solutions, Inc.*, 778 F. Supp. 2d 858, 875 (N.D. Ill. 2011) (Castillo, J.). Here, Walgreens disclosed the risk that "[c]hanges in pharmaceutical manufacturers' pricing . . . could also

significantly reduce our profitability."[3] (Dkt. 56-6). The defendants thus adequately disclosed the risk that generic drug price inflation would undermine their predictions that the current headwind would become a tailwind later in 2014. Accordingly, the defendants' cautionary statements were adequate and their future-looking statements predicting that the generic drug headwind would turn around were not actionable.

The March 2014 press release additionally quoted Wasson as stating, with regards to the Alliance Boots synergy goal, that the "joint synergy program with Alliance Boots is expected to exceed its second-year estimate." (Dkt. 47 ¶ 154). The plaintiff contends that this statement is misleading because the representation that Walgreens would "exceed" its Alliance Boots synergy goal concealed the fact that the synergies were dwarfed by the "massive" EBIT shortfall (the expected synergies from the merger formed part of the basis for the EBIT goal). The fact that there was a "massive" EBIT shortfall, however, does not render the defendants' statement about synergies untrue, and no reasonable investor would misinterpret the defendants' unrelated statements as denying or minimizing the existence of an EBIT shortfall in light of the defendants' express acknowledgement that there was a shortfall.

Similarly, the plaintiff contends that two additional statements are misleading because they do not disclose the concessions (in the form of lower co-pays and reimbursements than typically agreed to by preferred pharmacies) that Walgreens made to attain the additional Medicare Part D market share. The press release issued on March 25, 2014 stated that Walgreens "saw strong growth in prescriptions filled for Medicare Part D patients, which increased 16 percent in the second quarter compared with last year's quarter, while the Company's Part D market share increased 0.8 percentage point in February compared with the same month a year ago." (Dkt. 47 ¶ 155).

[3] A court may take judicial notice of matters of public record without converting a 12(b)(6) motion into a motion for summary judgment. *Palay v. United States,* 349 F.3d 418, 425 n. 5 (7th Cir. 2003).

Similarly, during the conference call Wasson touted the growth of Walgreens' Medicare Part D program:

> Looking ahead our Medicare Part D program is accelerating our momentum in pharmacy. In the quarter our Med D volume was up year-over-year with significant growth in new customers on top of strong performance in fiscal 2013. Our Part D market share for the quarter increased 80 basis points compared to the same period last year.

(*Id.* ¶ 161). Miquelon further added that "[o]ur pharmacy business is well positioned in patient segments which is . . . Part D customers . . . and we continue to drive real efficiencies in both our pharmacy operations and in procurement." (*Id.* ¶ 162). No reasonable investor, however, would be misled by those statements because they do not address the issue of compensation or provide any reason to believe that Walgreens had not made pricing concessions in order to obtain its increased market share. These statements meant what they said; nothing more, nothing less. *Constr. Workers Pension Fund—Lake Cnty. and Vicinity v. Navistar Int'l Corp.*, 114 F. Supp. 3d 633, 655 (N.D. Ill. 2015) (Ellis, J.).

April and May 2014

In April and May 2014 the plaintiff alleges that, between issuing the March and June quarterly reports, the defendants made multiple false and misleading statements to analysts that were subsequently reported to investors.

The plaintiff's allegations arise from a report issued by J.P. Morgan describing a conference call with Wasson, statements that Walgreens' head of investor relations made at a Barclay's conference and subsequent reports on those statements, and a Morgan Stanley report on a conference call with Wasson and Miquelon. Under Rule 10b-5, however, a statement may only be "made" by the "person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135, 142, 131 S.Ct. 2296, 180 L.Ed.2d 166 (2011). "Without control, a person or entity can merely

suggest what to say, not 'make' a statement in its own right." *Id.* Accordingly, the defendants contend that they cannot be held liable for statements conveyed through analysts' reports.

A statement must be attributable to a defendant in order to constitute a statement made by that defendant. *Glickenhaus & Co. v. Household Int'l, Inc.*, 787 F.3d 408, 426 (7th Cir. 2015); *see also Janus*, 564 U.S. at 142 ("[I]n the ordinary case, attribution within a statement . . . is strong evidence that a statement was made by – and only by – the party to whom it is attributed."). Thus, statements contained in analysts' reports are only actionable when they are attributed to a particular speaker. *See Fulton Cnty. Empls.' Ret. Sys. v. MGIC Inv. Corp.*, No. 8 C 458, 2010 WL 601364, at *6 (E.D. Wis. Feb. 18, 2010) (rejecting a claim against the defendant based on a statement that mostly "consist[ed] of conclusions that the analysts drew after meeting with [the CEO], rather than direct quotes from [the CEO]" because the statement could not be attributed to the CEO or the company), *affirmed* 675 F.3d 1047 (7th Cir. 2012).

On April 17, 2014, J.P. Morgan hosted a conference call with Wasson. J.P. Morgan's report on the call stated that "[m]anagement indicated that it is extremely confident the $1 billion synergy target is achievable and pointed to additional opportunity beyond that based on opportunities they have identified." (Dkt. 47, ¶ 172). It further reported that, as to reimbursement pressure, "management noted that it is seeing nothing unusual at this point" and that management "cited multiple opportunities" to offset general reimbursement headwinds, including "[o]ngoing increases in generic utilization [which] can drive improving margins" and "working more closely with manufacturers." (*Id.*, ¶ 173). Although these statements do not explicitly identify Wasson as the speaker, they clearly are attributed to him and can therefore be treated as his statements for purposes of the PSLRA.

Plaintiff contends that Wasson's statements to J.P. Morgan are actionable because they misled investors by expressing confidence regarding the synergy target without disclosing the EBIT

shortfall. As previously discussed, however, this allegation is not actionable because such optimism would not lead a reasonable investor to conclude that the EBIT goal was on track, especially in light of the defendants' prior statements to the contrary. The plaintiff further contends that these same statements were misleading because they misrepresented that there was "nothing unusual at this point" with respect to reimbursement pressures. The statements are actionable in this respect, because the plaintiff has alleged that Wasson was aware of systematic generic drug price inflation at the time of his statements. Wasson's statement that nothing unusual was occurring with respect to reimbursement pressures has therefore been plausibly alleged to be false or misleading.

On April 30, 2014, Walgreens' Head of Investor Relations, Rick Hans, appeared at the Barclays Retail and Consumer Discretionary Conference on behalf of Walgreens. Asked a question about the impact of generics on Walgreens' profit margins, Hans stated:

> This year, we've had kind of a dearth of new generics. So, that has caused a big mismatch, it's kind of that peak to trough that we've talked about with relative to the introduction of new generics and that had an impact on the margin.
>
> ***
>
> So, a year ago in the first half of the year, we had about [130 basis point] lift in the margin, primarily due to generics. This year in the first half, we had [135 basis point] drop in the margin, again primarily due to generics, but also due to some stuff we've been doing on the front end with regards to promotion.

(Dkt. 47, ¶ 176). Hans also addressed the EBIT goal, stating:

> But as far as the – how this relates to our goals for FY16, it's a little complicated in that. We had a – we had embedded in those goals some benefits from a different distribution model, and I won't go into it, but we had a different distribution model in mind. So that now came out, now with AmerisourceBergen which we think was better than the old model, gets plugged in, some of that is not new to the EBIT goal is my point. Do you follow my thinking on this? So, some of it is incremental, but some of it is actually embedded in our goals . . . I mean, we don't really want to get into really spelling out exactly what the synergies are. I think the numbers will flow through cost of goods and everyone will see it just in our performance.

(Dkt. 47, ¶ 177). The plaintiff contends that these statements were false or misleading because they attributed declining gross margins to the introduction of new generics and not to generic drug price inflation and promoted improved synergies while intentionally failing to disclose the scope of the EBIT shortfall. The plaintiff, however, has made no allegations concerning Hans' state of mind at the time that he appeared at the Barclays conference as is required to state a claim under section 10(b). *Stoneridge Inv. Partners, LLC*, 552 U.S. at 157. Accordingly, the plaintiff's allegations with respect to Hans fail to state a claim on which relief may be granted.

Finally, on May 16, 2014, Wasson and Miquelon participated in Morgan Stanley's "management conference call series." In its report on the call, Morgan Stanley stated that "WAG has not seen any unusual activity, but purchasing JV leaves it in better shape than peers to cope with generic price increases." (*Id.*, ¶ 181). Because this statement does not identify the speaker or describe a statement that one of the defendants actually made, it is insufficiently pled. *See Fulton Cty. Employees' Retirement Sys.,* 2010 WL 601364, at *6.

June 2014

On June 24, 2014, Walgreens released its third quarter report and Wasson and Miquelon held a conference call with investors to discuss the results and to answer any questions. The press release that Walgreens' issued stated that:

> As a result of the many step two considerations and current business performance, the company is withdrawing its fiscal year 2016 goals that were previously announced in 2012. Specifically, once key decisions have been made on the above matters, Walgreens anticipates being in a position to hold an investor call, which is expected to occur by late July or early August. At that time, the company expects to provide a new set of goals and metrics for the proposed combined enterprise for fiscal year 2016.

(Dkt. 47, ¶ 186). Wasson also addressed the withdrawal of the EBIT target, explaining :

> Let me speak directly to 2 of the prior goals. Regarding our adjusted operating income goal of $9 billion to $9.5 billion, on previous calls, we noted we were tracking below the CAGR required to meet the goal. We now no longer expect to reach that goal. On our combined synergy goals I noted earlier, we are tracking ahead of that goal and we expect to exceed the $1 billion amount by the end of fiscal 2016. As noted above, some of the opportunities we are pursuing are below the operating income line on the income statement and decisions about those will be reflected in our new goals and metrics.

(*Id.*, ¶ 189; Dkt. 47-1).[4] Miquelon, in his remarks, further stated that "[t]he tough year-over-year generic impact margin comparison has continued to dissipate throughout fiscal year 2014 and expected [sic.] to turn positive in the fourth quarter of 2014 given the increase in generic impact on pharmacy sales comps expected in that period." (Dkt. 47, ¶ 192). Miquelon closed by reiterating that:

> As a result of the many Step 2 considerations in current business performance we are withdrawing the fiscal year 2016 goals that were previously announced in 2012. Once key decisions have been made on the above matters Walgreens anticipates being in a position to hold an investor call, which is expected to occur by late July or early August. Many of the areas under consideration are interdependent and so we believe that the prudent course is to share the scope of our decisions and related financial objectives and metrics together all at that time.
>
> In summary, our strategies remain sound in the fundamentals of our business in particular with respect to top-line growth has continued to strengthen. While we have gross profit reimbursement pressure in the traditional pharmacy, as mentioned, we also have significant opportunities to drive additional cost efficiency and also turn the front end of our business into a very meaningful profit pillar.
>
> Our Alliance Boots and AmerisourceBergen partnerships also continue to go well. And we are beginning to move beyond the cost-only synergy phase to one where we are starting to share and exploit organizational capabilities to strengthen our core business and find new levers to create value for shareholders.

[4] This Court notes that the plaintiff's complaint selectively edited Wasson's remarks to leave out his express statement that Walgreens no longer expected to reach the EBIT goal. Accordingly, this Court fills in the missing portion of the statements from the Miquelon Complaint, which the plaintiff has incorporated into its own complaint and which is therefore properly before this Court. *See Geinosky v. City of Chicago*, 675 F.3d 743, 745 n. 1 (7th Cir. 2012).

(*Id.*, ¶ 192). The plaintiff contends that these statements were false and misleading because Walgreens did not withdraw the EBIT target as a result of the "many Step 2 considerations" but instead as a result of the EBIT shortfall, concealed the scope of the EBIT shortfall, and waited to withdraw the EBIT goal until the announcement could be coupled with good news. The defendants, in turn, contend that these statements were not false or misleading because they explicitly state that the withdrawal was the result of "Step two considerations" *and* "current business performance" and because the plaintiff has not made specific allegations that Step two considerations did not cause the goals' withdrawal.

It is undisputed that the EBIT goals' withdrawal resulted, at least in part, from the defendants' "current business performance," a factor that the defendants disclosed. [5] During the conference call Wasson expressly stated that Walgreens no longer expected to reach the 2016 EBIT goal. Although the defendants' decision to attribute the withdrawal to Step 2 considerations *and* business performance might have obscured the reasons for the withdrawal to some extent, it could not have obscured the fact that Walgreens was expressly abandoning the EBIT goal. Thus, the defendants' statements regarding their reasons for withdrawing the EBIT goal have not been plausible alleged to be false or misleading with respect to the EBIT goal.

The plaintiff also contends that the defendants made a number of false and misleading statements that, although they disclosed the existence of the EBIT shortfall, failed to address its extent and misleadingly downplayed that extent by implying that there was meaningful potential to make up, mitigate, or offset that shortfall. During his statement on June 24, 2014, for instance, Miquelon noted that:

> Purchasing synergies in the pharmacy and front end did partially offset this margin pressure. Front-end margin increased in the quarter benefiting from mix and promotional adjustments. And we

[5] The plaintiff also appears to concede that the 2016 goals needed to be withdrawn and updated in light of the acceleration of the Walgreens—Alliance Boots transaction.

> still expect the rate of generic drug introductions to increase in the fourth quarter to the point that it should not be a drag on margin year over year.

(Dkt. 47, ¶ 191). After their prepared remarks, the defendants answered questions from analysts. George Hill, a Deutsche Bank analyst, asked how far off the original expected range the new EBIT target would be. Wasson responded that Walgreens was "working on a whole host of things to try to continue to drive value . . . . We are going to be looking at different goals and metrics both above the line and below the line." (*Id.*, ¶ 193). Miquelon added:

> Yes, I think that's right. I think we are still aggressively driving all the [EBIT] opportunities but as Greg said we have opportunities below the line as well in terms of how we thing about structure, cap structure, refinancing and the like. And so we are making sure at this point in time that we look at everything interdependently as a web of choices and we maximize value as best we can.

(*Id.*, ¶ 194). When asked about the "big picture" with respect to profits, Wasson responded:

> . . . . I don't necessarily think that we should assume that the US business cannot continue to grow on profitability. I think the work that Alex and Mark and team are doing on the front end of the business we think we actually had tremendous opportunity to grow EBIT in operating margin on the front end of the business.
>
> We are beginning to get more confidence than just that. And I think that is obviously going to help us with the overall business. I think in the pharmacy business the good thing is that we are growing top line for the first time consistently in a long time with some of those strategic decisions I talked about.
>
> We are absolutely winning in the Part D space . . . .
>
> We do have obviously the pharmacy margin pressure that we talked about. But I think Kermit and team and he can maybe allude to a little bit how we think we'll go at that.
>
> We think with our contracting strategy going forward with the generic inflation that we are seeing versus historical deflation we're going to start taking that into consideration in our contracting. He is going at cost-of-fill reduction with a vengeance.
>
> And I think with Bern and Jeff Berkowitz and John out in Bern, we are positioned better than anyone to be able to get at cost. As far as

> the cost opportunities, I think there is a little of both. I think that there is opportunity to get at cost, to your point, that's more maybe more cyclical.

(*Id.*, ¶ 196). In response to a question about what could have been done already about the declining profit margins versus the opportunity going forward, Wasson responded:

> Now with that said, we also think that as we look at the current Walgreen business and opportunities, in addition with the merger of the two that there are going to be even greater opportunities and different ways of looking at that. So we are absolutely focused on the core business. We have made significant reductions.
>
> Some of that has been absorbed, as I said, because of the pressure on the margin. We are identifying additional opportunities and we are going to combine those with the opportunities we have at Step 2.

(*Id.*, ¶ 197).

Near the end of the call, a Credit Suisse analyst asked whether the defendants were "optimistic that the below-the-line considerations may potentially offset the shortfall on the [2016] EBIT, or even more than offset the shortfall on the [2016] EBIT." (*Id.*, ¶ 202) In response, Wasson stated "I'm hesitant to go there. I think, as I said, we just have too many moving parts right now that we are working through. There is potential, obviously, and that's what we are looking through from all of those how they come together." (*Id.*). Miquelon echoed that response, stating "Yes, there's a lot of opportunity but I think the key is making the right choices so they all interplay with each other for the best long-term value creation for shareholders. And we are looking at everything." (*Id.*, ¶ 203).

The tone of these statements is resoundingly optimistic, which is perhaps in seeming conflict with the substantial EBIT shortfall alleged. The majority of the optimistic statements, however, concerned profit margins, synergies, or other metrics, not the EBIT goal itself. Those statements have not been plausibly alleged to be false or misleading because, as discussed above, they would not influence a reasonable investor's assumptions regarding the scope of the EBIT shortfall. This is

especially so here because Wasson expressly stated that Walgreens no longer expected to meet the EBIT goal, thus signaling that even these anticipated positive outcomes were unlikely to eliminate the shortfall. Similarly, the defendants' statements concerning their ability to "grow" EBIT are not actionable because the plaintiff has not alleged facts establishing that the defendants had actual knowledge that they would be unable to increase their EBIT (this Court notes that increasing EBIT, absent more, does not reflect on whether or not the EBIT goal would be met). The plaintiff, furthermore, has not alleged facts to establish that Wasson's representation to the Credit Suisse analyst that "there is potential, obviously" for below-the-line considerations to offset the EBIT shortfall was in and of itself false or misleading.

The plaintiff also contends that the defendants' falsely represented that the generic drug price inflation issue was "unanticipated" or "unexpected." For instance, when asked when and to what extent generic inflation had impacted Walgreens' margins, Wasson answered that:

> . . . I think certainly generic inflation kind of runs through a lot of this, meaning that it shows up in the contracts.
>
> Certainly we are thinking about deflation and now we are seeing some inflation. We are also just playing COGS. We are certainly doing everything we can with Bern to offset that.
>
> But I think in the work of magnitude I think probably generic inflation is specifically and probably more important because we did not quite anticipate it. A lot of the other strategic decisions we certainly anticipated. We know exactly what our contract arrangements with some of the commercial plans are, we know what our Part D preferred physicians cost us as far as gross margin.
>
> This was really snuck up on the industry and us. And now I do think, as I said, I can't think of anyone that is better positioned than us to offset this because of what we are doing at Bern . . . .

(*Id.*, ¶ 198). Kermit Crawford followed up, adding "[g]eneric inflation was higher than we expected compared to the normal deflation that we planned for and we saw the full impact of that in the third quarter versus the second quarter." (*Id.*, ¶ 199). A Goldman Sachs analyst subsequently asked

whether any of the profit margin pressures indicated unanticipated "structural change." Miquelon answered that "the thing that probably wasn't fully anticipated probably was just what we have seen in some inflation on drugs." (*Id.*, ¶ 200).

The plaintiff contends that these statements are false because the defendants knew of unprecedented generic drug price inflation in 2013. The defendants' statements, however, do not identify when they were surprised. The plaintiff appears to assume, with no basis in the statements, that they describe the events of the last quarter, (aka "we were surprised during the last three months by this trend"). Because no language in the statements so limits their term, however, the defendants plausibly could have been stating that generic drug price inflation was unexpected a year ago, or, even more likely, that it was unexpected when the EBIT goal was set in 2012. Moreover, the plaintiff has not plausibly alleged how these misrepresentations of the defendants' past knowledge were connected with the purchase or sale of a security or that they induced reliance by investors. Accordingly, plaintiff has failed to state an actionable claim with respect to these statements.

The plaintiff also alleges that the defendants' statements that their "procurement synergies" would offset the impact of generic price inflation and that "we are positioned better than anyone to be able to get at cost" were false. The plaintiff claims that the defendants knew that the ABC distribution agreement would not benefit Walgreens until FY2015 and then would only be sufficient to maintain the margins at their current rate due to Walgreens' inability to pass increased generic drug costs on to third parties. The statements that the plaintiff challenges, however, do not state when the ABC distribution agreement would benefit Walgreens or that it would allow Walgreens to increase its profit margins. Rather, they said only that the ABC agreement would offset price inflation and that Walgreens is the best positioned to respond to drug cost increases. Because the

plaintiff has not alleged facts establishing that either of these statements as false or misleading, these statements are not actionable.

Finally, the plaintiff alleges that, like in May, the defendants' positive remarks about Walgreens' growing Medicare Part D business were materially misleading because Walgreens had to make pricing concessions in order to garner increased Medicare Part D market share. As previously noted, however, it is not false and misleading to note that market share increased without disclosing that that increase was brought about through price concessions. *See Allscripts*, 778 F. sup. 2d at 878 (finding that a defendant's statement was not misleading because "in its actual context a reasonable investor would not arrive at the conclusion Plaintiff proposes").

S-K 303(a) Violations

The plaintiff further contends that the defendants failed to comply with Item 303 of Regulation S-K by failing to disclose material known trends in their second quarter 2014 form 10-Q. Within this district, however, it has been recognized that S-K 303(a) does not give rise to a private right of action under Rule 10b. *Anderson v. Abbott Labs.*, 140 F. Supp. 2d 894, 909 (N.D. Ill. 2001) (Moran, J.), *see also Kriendler v. Chemical Waste Mgmt., Inc.*, 877 F. Supp. 1140, 1157 (N.D. Ill. 1995) (Castillo, J.) (adopting the rule that violations of SK-303 cannot be imported as a surrogate for analysis under section 10(b) and rule 10b-5). Because the plaintiffs' amended complaint does not allege that the statements contained in the Form 10-Q are independently actionable under section 10(b) or rule 10b-5, this claim must fail.

Scienter

The defendants next argue that plaintiff has failed to adequately allege scienter with respect to Wasson and Miquelon. Scienter is defined as "an intent to deceive, demonstrated by knowledge of the statement's falsity or reckless disregard of a substantial risk that the statement is false." *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 756 (7th Cir. 2007). In order to survive a motion to

dismiss, all of the facts alleged, taken collectively, must give rise to a strong inference of scienter. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322–23, 127 S.Ct. 2499, 168 L.Ed.2d 179 (2007). In determining whether the alleged facts give rise to a strong inference of scienter, the court must take into account plausible opposing inferences. *Id.* at 323. A complaint can survive "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged. *Id.*

Here, the alleged false or misleading statements that this Court has found to be adequately pled with respect to falsity concern the existence and nature of generic drug price inflation and reimbursement pressures. The allegations reflect that drug sales constituted the majority of Walgreens' sales, and that the bulk of drug sales involved generic drugs. The allegations also reflect that almost all drug sales were subject to a third-party-payer contract which set a cap on the amount of reimbursement that Walgreens could receive. Wasson and Miquelon were regularly informed of inflation and pricing trends in the generic drug market and third party reimbursement trends, both of which had a substantial impact on Walgreens profits. Additionally, Miquelon admitted that Walgreens' management was aware of generic drug price inflation by the class period.

Although the plaintiff makes lengthy allegations as to motive, none of those allegations apply to, or even appear to address, those limited issues remaining. It would be counterintuitive for the defendants to seek to hide the impact of generic drug price inflation on Walgreens when both parties appear to agree that generic drug price inflation was a recognized market trend. Nor do the plaintiff's myriad allegations of self-interest and corporate intrigue seem applicable when, as here, the defendants openly disclosed far more damaging information such as that Walgreens was targeted to miss the EBIT goal.

Absence of motive, however, is not fatal to allegations of scienter. *Id.* at 325. The relevant question is only whether, "when the allegations are accepted as true and taken collectively, would a

reasonable person deem the inference of scienter at least as strong as any opposing inference?" *Id.* at 326. Here, in light of the allegations establishing the defendants' knowledge that generic drug price inflation was a systematic trend and that Walgreens' contracts contained reimbursement-caps that would cut into profits if drug prices increased, the inference of scienter is at least as strong as any reasonable opposing inference. *See Fla. State Bd. of Admin. v. Green Tree Fin. Corp.,* 270 F.3d 645, 665 (8th Cir. 2001) ("One of the classic fact patterns giving rise to a strong inference of scienter is that defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate.").

Remaining Issues

The defendants do not challenge whether the plaintiff has sufficiently alleged the remaining prongs of the Rule 10b-5 analysis. Nor does Wasson challenge the allegations underlying the plaintiff's Section 20(a) claims. Miquelon, however, contends that he cannot be held liable under section 20(a) because as CFO he reported directly to Wasson and therefore did not control Wasson or any of his alleged misstatements. Section 20(a) of the Act provides that every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extend as such controlled person to any person whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constitution the violation or cause of action. 15 U.S.C. § 78t(a). Accordingly, this Court agrees that Miquelon cannot be liable under section 20(a) for statements that Wasson made directly. Miquelon, however, may nonetheless be liable under section 20(a) for statements issued by Walgreens or subordinate employees that Miquelon supervised. *Id.*

Conclusion

For the foregoing reasons, the defendants' motions to dismiss are denied with respect to the alleged statements set forth in paragraphs 157, 163, and 173 of the amended complaint, and granted as to all other claims.

SO ORDERED.

Sharon Johnson Coleman
United States District Court Judge

DATED: September 30, 2016

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
FAYETTEVILLE DIVISION

CITY OF PONTIAC GENERAL EMPLOYEES' RETIREMENT SYSTEM,
Individually and on Behalf of All Others Similarly Situated — PLAINTIFF

v. — CASE NO. 5:12-cv-5162

WAL-MART STORES, INC., and MICHAEL T. DUKE — DEFENDANTS

ORDER

Before the Court is Plaintiff's Motion for Class Certification. (ECF No. 229). Defendants have filed a Response. (ECF No. 244). Plaintiff has filed a Reply. (ECF No. 252). Defendants have filed an Amended Sur-Reply (ECF No. 274), and Plaintiff has filed a Response to the Amended Sur-Reply. (ECF No. 277). The Court finds this matter ripe for consideration.

I. BACKGROUND

Plaintiff alleges that Defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Securities and Exchange Commission ("SEC") Rule 10b-5 by (1) making materially false and misleading statements and (2) failing to disclose material adverse facts known to Defendants that would have made the statements made by them not misleading.[1] Plaintiff alleges that statements in a Report on Defendants' Form 10-Q filed with the SEC on

[1] Section 10(b) of the Act makes it unlawful "to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78(j)(b). "SEC Rule 10b-5 implements [§ 10(b)] by making it unlawful to, among other things, 'make any untrue statements made, in the light of the circumstances under which they were made, not misleading.'" *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 36 (2011) (quoting 17 C.F.R. § 240.10b-5(b)). Section 20(a) of the Act imposes secondary liability on every person "who, directly or indirectly, controls any person liable under any provision of this chapter or any rule or regulation thereunder." 15 U.S.C. § 78t(a).

December 8, 2011, artificially inflated and maintained Wal-Mart's publicly traded stock price until the alleged misstatements were disclosed by an article published in the *New York Times* on April 20, 2012. Plaintiff moves the Court to certify its claims relating to the alleged misstatements made on Form 10-Q.

On December 8, 2011, Defendants filed with the SEC a Report on Form 10-Q that stated the following:

> During fiscal 2012, the Company began conducting a voluntary internal review of its policies, procedures and internal controls pertaining to its global anti-corruption compliance program. As a result of information obtained during that review and from other sources, the Company has begun an internal investigation into whether certain matters, including permitting, licensing and inspections, were in compliance with the U.S. Foreign Corrupt Practices Act. The Company has engaged outside counsel and other advisors to assist in the review of these matters and has implemented, and is continuing to implement, appropriate remedial measures. The Company has voluntarily disclosed its internal investigation to the U.S. Department of Justice and the Securities and Exchange Commission. We cannot reasonably estimate the potential liability, if any, related to these measures. However, based on the facts currently known, we do not believe that these matters will have a material adverse effect on our business, financial condition, results of operations or cash flows.

On April 21, 2012, the *New York Times* published an article describing how Wal-Mart de Mexico, Wal-Mart's largest subsidiary, orchestrated a bribery scheme to obtain building permits throughout Mexico. The article reported that in 2005, Wal-Mart investigators discovered evidence of widespread bribery. It was further reported that Defendants covered up the suspected bribery scheme by rejecting an outside firm's proposed independent internal investigation and then assigning the investigation to the office implicated in the suspected bribery scheme, Wal-Mart de Mexico's General Counsel's Office. According to the newspaper article, Wal-Mart closed its investigation in 2006.

Plaintiff alleges that Defendants learned that the *New York Times* was investigating the suspected bribery scheme in late 2011. Plaintiff further alleges that, upon learning of the *New York*

Times investigation, Defendants filed a Form 10-Q that was designed to deceive the investing public about (1) the timing of, and circumstances leading to, their awareness of the suspected bribery scheme; (2) their response to the alleged bribery scheme; and (3) the possibility that the *New York Times* would soon reveal facts regarding the alleged bribery scheme that Defendants had concealed for years. According to Plaintiff, some of the differences between what Defendants represented and what they omitted are as follows: (1) Defendants actually learned about the alleged bribery scheme in 2005, not 2011; (2) Defendants learned about the alleged bribery scheme from a former in-house attorney and not from a voluntary internal review; (3) Defendants began an illegitimate internal investigation into the alleged bribery scheme in 2006, not 2011; (4) Defendants did not implement any remedial measures until at least 2011 despite having learned of the alleged bribery scheme in 2005; (5) Defendants closed their inquiry into the alleged bribery scheme in 2006 after rejecting a proposal from outside counsel to assist in the internal investigation; and (6) Defendants withheld all information about the alleged bribery scheme from the DOJ and the SEC from 2005-2011. Generally, Plaintiff alleges that Defendants' Form 10-Q contained statements that gave investors the false impression that they did not need to fear that Defendants had covered up the alleged bribery scheme.

Plaintiff asserts that the omitted and/or misleading information in the Form 10-Q concealed Wal-Mart's true worth and thus Wal-Mart was overvalued throughout the class period, which is defined as December 8, 2011, the date Wal-Mart filed its Form 10-Q, to April 20, 2012, the day before the *New York Times* article was published.[2] According to Plaintiff, after the *New York Times* article was published, the market recognized Wal-Mart's lower value and promptly removed the artificial inflation from its share price, which fell nearly 10% over the three days that

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[2] Plaintiff alleges that Wal-Mart was facing billions of dollars in estimated expenses and losses, including penalties of over $2 billion, $1.3 billion in decreased growth, and investigation and legal fees of $2.76 billion.

followed the *Times* investigation.[3] Plaintiff alleges that weeks later Wal-Mart's stock price increased due to a quarterly performance surprise, but investors never recovered what they had paid for Wal-Mart's stock during the class period.

Plaintiff moves the Court for an order certifying this case as a class action pursuant to Federal Rule of Civil Procedure 23 on behalf of the following proposed class of investors:

> All persons or entities who purchased or otherwise acquired the publicly traded common stock of Wal-Mart Stores, Inc. ("Walmart") between December 8, 2011 and April 20, 2012 (the "Class Period"), and who were damaged by defendants' alleged violations of §§10(b) and 20(a) of the Securities Exchange Act of 1934. Excluded from the Class are defendants and Duke's family, the officers and directors of the Company, at all relevant times, members of their immediate families and their legal representatives, heirs, successors, or assigns, and any entity in which defendants have or had a controlling interest.

(ECF No. 229). Plaintiff further moves the Court to appoint Plaintiff as class representative and appoint the law firm of Robbins Geller Rudman & Dowd LLP as class counsel and the law firm of Patton Tidwell & Culbertson as liaison counsel.

II. DISCUSSION

Class certification is governed by Rule 23 of the Federal Rules of Civil Procedure. The decision whether to certify a class action is within the broad discretion of the district court. *In re Milk Prods. Antitrust Litig.*, 195 F.3d 430,436 (8th Cir. 1999). In determining whether to certify a class action, "the question is not whether the plaintiff or plaintiffs have stated a cause of action or will prevail on the merits, but rather whether the requirements of Rule 23 are met." *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 178 (1974) (internal citations omitted). The plaintiff moving for class certification has the burden of showing that the Rule 23 requirements are met. *Coleman v. Watt*, 40 F.3d 255, 259 (8th Cir. 1994). "To be certified as a class, plaintiffs must meet all of the

[3] Wal-Mart's share price had modestly risen after December 8, 2011, to close at $62.45 on April 20, 2012. On April 23, 2012, the first trading day after the publication of the *New York Times* article, Wal-Mart's stock price fell $2.91 per share to close at $59.54 per share. The stock continued to drop on April 24, 2012, to close at $57.77 per share on volume of 30 million shares, and fell to $57.36 on April 25, 2012, on volume of 28 million shares.

requirements of Rule 23(a) and must satisfy one of the three subsections of Rule 23(b)." *In re St. Jude Med., Inc.*, 425 F.3d 1116, 1119 (8th Cir. 2005).

A. Rule 23(a)

The Rule 23(a) requirements are met if: (1) the class is so numerous that joinder of all members is impracticable; (2) there are questions of law or fact common to the class; (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class; and (4) the representative parties will fairly and adequately protect the interests of the class. Fed. R. Civ. P. 23(a). These requirements for class certification under Rule 23(a) are commonly referred to as "numerosity, commonality, typicality, and adequacy of representation." *Gen. Tel. Co. v. EEOC*, 446 U.S. 318, 330 (1980). The only disputed Rule 23(a) factor in this case is typicality.

1. Numerosity

The first prerequisite to class certification under Rule 23(a), commonly referred to as the numerosity requirement, is that "the class is so numerous that joinder of all members is impracticable." Fed. R. Civ. P. 23(a)(1). There are "[n]o arbitrary rules regarding the necessary size of classes." *Paxton v. Union Nat. Bank*, 688 F.2d 552, 559 (8th Cir. 1982). Instead, the court considers numerous factors to determine whether numerosity is satisfied. *Id.* The number of persons in the proposed class is the "most obvious" factor in this determination. *Id.* In addition, the court may consider other factors in its inquiry such as "the nature of the action, the size of the individual claims, the inconvenience of trying individual suits, and any other factor relevant to the practicability of joining all the putative class members." *Id.* at 559-60.

In the present case, it is undisputed that the numerosity requirement has been satisfied. Plaintiff seeks to certify a class that includes all persons or entities that purchased Wal-Mart stock during the proposed class period. Plaintiff has established that Wal-Mart had over three billion

shares of outstanding stock during this period. Plaintiff has also established that these shares were owned by thousands of persons and were traded on the New York Stock Exchange. The numerosity requirement is generally satisfied in class actions involving nationally traded securities. *In re SciMed Sec. Litig*., No. 3-91-575, 1993 WL 616692, at *3 (D. Minn. Sept. 29, 1993). Accordingly, the Court concludes that joinder of all the proposed class members is impracticable and thus the numerosity requirement under Rule 23(a)(1) has been satisfied.

2. Commonality

The second prerequisite under Rule 23(a) is the commonality requirement. "Commonality requires the plaintiff to demonstrate that the class members 'have suffered the same injury.'" *Wal-Mart Stores, Inc. v. Dukes*, 564 U.S. 338, 349 (2011) (quoting *Gen. Telephone Co. of Southwest v. Falcon*, 457 U.S. 147, 157 (1982)). It is not required that every question of law or fact be common to every member of the class. *Paxton*, 688 F.2d at 561. "Rather, it may be satisfied when the legal question 'linking the class members is substantially related to the resolution of the litigation.'" *DeBoer v. Mellon Mortg. Co.*, 64 F.3d 1171, 1174 (8th Cir. 1995) (quoting *Am. Fin. Sys., Inc. v. Harlow*, 65 F.R.D. 94, 107 (D. Md. 1974)).

Plaintiff's satisfaction of the commonality requirement is also undisputed. The Court finds that members of the proposed class share issues in the case that involve identical claims and common evidence, including: (1) whether Defendants engaged in a scheme to defraud; (2) whether Defendants knowingly or recklessly made material misrepresentations or omitted material information in their public statements; (3) whether the price of Wal-Mart common stock artificially inflated during the class period; and (4) the extent of damages sustained by Class members and the appropriate measure of damages. (ECF No. 230, p. 9). Therefore, the Court concludes that the commonality requirement under Rule 23(a)(2) is satisfied.

3. Typicality

The third perquisite of Rule 23(a) is the typicality requirement. To meet this prerequisite, the claims or defenses of the representative parties must be typical of the claims or defenses of the proposed class. Fed. R. Civ. P. 23(a)(3). Typicality requires a showing "'that there are other members of the class who have the same or similar grievances as the plaintiff.'" *Chaffin v. Rheem Mfg. Co.*, 904 F.2d 1269, 1275 (8th Cir. 1990) (quoting *Donaldson v. Pillsbury Co.*, 554 F.2d 825, 830 (8th Cir. 1977)). Factual variations amongst plaintiffs will not preclude class certification "if the claim arises from the same event or course of conduct as the class claims, and gives rise to the same legal or remedial theory." *Alpern v. UtiliCorp United*, 84 F.3d 1525, 1540 (8th Cir. 1996). In the context of securities fraud class actions, typicality is found when "named [p]laintiffs allege that they and all investors were damaged by the alleged scheme to mislead investors." *Minn. Firefighters' Relief Ass'n v. Medtronic, Inc.*, 278 F.R.D. 454, 457 (D. Minn. 2011).

To have claims typical of a class, named plaintiffs must have standing to pursue the relief sought. *In Re Milk Prods. Antitrust Litig.*, 195 F.3d 430, 437 (8th Cir. 1999). To have standing, as required by Article III of the Constitution, there must be "injury in fact to the plaintiff that is fairly traceable to the challenged action of the defendant, and likely to be redressed by a favorable decision." *Braden v. Wal-Mart Stores, Inc.*, 588 F.3d 585, 591 (8th Cir. 2009) (citing *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560 (1992)). Defendants argue that Plaintiff's claims are not typical of the class because it lacks standing to bring the suit. Defendants contend that Plaintiff lacks standing because it suffered no loss on its trades in Wal-Mart stock. Thus, according to Defendants, Plaintiff has not suffered an injury in fact. Defendants also argue that Plaintiff's purported lack of losses subjects it to unique defenses not affecting absent class members.

Defendants argue that Plaintiff's own bank statements reflect gains on every one of

Plaintiff's Wal-Mart stock sales during 2011 and 2012, and thus Plaintiff suffered no loss on these sales. These period bank statements, however, do not calculate losses or gains on class period purchases, which is the relevant inquiry here. Instead, the bank statements calculate gains and losses on all Wal-Mart shares Plaintiff bought and sold, including pre-class period holdings. Plaintiff has filed a memorandum in which it demonstrates that, under the "last-in-first-out" ("LIFO") methodology, it suffered losses on Wal-Mart stock sales during the class period.

In an argument relegated to a footnote, Defendants assert that the "LIFO method does not apply here" and thus the Court should employ the "first-in-first-out" ("FIFO") methodology to measure Plaintiff's losses. "In the context of a securities class action, FIFO and LIFO refer to methods used for matching purchases and sales of stock during the class period in order to measure a class member's damages." *Ellenburg v. JA Solar Holdings Co., Ltd.*, 262 F.R.D. 262, 265 (S.D.N.Y. 2009) (citing *In re AOL Time Warner, Inc.*, No. 02 Civ. 5575, 2006 WL 903236, at *17 (S.D.N.Y. Apr. 6, 2006)). "Under FIFO, stocks acquired first are assumed to have been sold first in the calculation of losses; under LIFO, stocks acquired most recently are assumed to have been the first sold."[4] *Bo Young Cha v. Kinross Gold Corp.*, 12 Civ. 1203, 2012 WL 2025850, at *3 (S.D.N.Y. May 31, 2012).

Each party in this case endorses the methodology that enhances its respective position regarding loss measurement. It is undisputed that, using a LIFO calculation, Plaintiff can show that it suffered damages as defined by 15 U.S.C. §78u-4(e)(2). It is also undisputed that, using a FIFO calculation, Plaintiff cannot show that it suffered damages as defined by the statute. Both the LIFO

[4] "Under FIFO, a plaintiff's sales of defendant's shares during the class period are matched first against any pre-existing holdings of shares." *Johnson v. Dana Corp.*, 236 F.R.D. 349, 352 (N.D. Ohio 2006). "The net gains or losses from those transactions are excluded from damage calculations." *Id.* "[U]nder LIFO, a plaintiff's sales of defendant's share[s] during the class period are matched first against the plaintiff's most recent purchase of defendant's shares and gains or losses from those transactions are considered in damage calculations." *Id.*

and FIFO methods have been accepted by Courts for assessing class period damages and for appointing lead plaintiffs.

Defendants in the present case conclusively state that the LIFO method does not apply. Defendants, however, do not provide any reason as to why the FIFO method is preferable in this case. In fact, several courts have expressed that the current majority view is that securities fraud losses should be calculated using LIFO. *E.g.*, *Khunt v. Alibaba Group Holding, Ltd.*, Nos. 15 Civ. 00759, 15 Civ. 00811, 15 Civ. 00991, 15 Civ. 010405, 102 F. Supp. 3d 523, 531 (S.D.N.Y. 2015) ("[M]ore recently, courts have preferred LIFO and have generally rejected FIFO as an appropriate means of calculated losses in securities fraud cases."); *In re K-V Pharmaceutical Co. Sec. Litig.*, 11 CV 01816, 2012 WL 1570118, at *4 (E.D. Mo. May 3, 2012) (The LIFO methodology is "most accepted by courts."); *Bo Young Cha*, 2012 WL 2025850, at *3 ("[T]he overwhelming trend both in this district and nationwide has been to use LIFO to calculate . . . losses" in securities fraud cases.); *In re Organogenesis Sec. Litig.*, 241 F.R.D. 397, 402 (D. Mass. 2007) ("Like other courts that have examined the issue, this court concludes as a matter of law that LIFO is the preferred approach for assessing class period damage."); *Hill v. The Tribune Co.*, No. 05 C 2602, 2005 WL 3299144, at *3 (N.D. Ill. Oct. 13, 2005) ("The current majority view . . . is that securities fraud losses should be calculated using LIFO").

Courts routinely accept calculations of harm under the LIFO methodology, and the Court finds no reason to reject Plaintiff's calculation of its losses under this methodology. Defendants have failed to show that the FIFO method is preferable in this case. Plaintiff purchased Wal-Mart securities during the class period, held shares at the time of the corrective disclosures, and has alleged an injury-in-fact under the widely-accepted LIFO methodology. Thus, the Court concludes that Plaintiff has standing to bring its claims, which are typical of the claims of the proposed class.

Accordingly, the typicality requirement under Rule 23(a)(3) is satisfied.

4. Adequacy of Representation

The final requirement of Rule 23(a) is that "the representative parties will fairly and adequately protect the interests of the class." Fed. R. Civ. P. 23(a)(4). In determining whether the representation meets this standard, the court must consider: (1) whether the class representatives have common interests with the members of the class; and (2) whether the class representatives will vigorously prosecute the interests of the class through qualified counsel. *Paxton*, 688 F.2d 562–63.

Defendants have not contested the adequacy of Plaintiff's counsel, and the Court finds that Plaintiff's counsel has sufficient experience handling similar securities class actions to adequately represent the class. Defendants also do not contest that Plaintiff, the proposed class representative, will be capable of vigorously prosecuting this action. Accordingly, the Court concludes that the proposed plaintiff class representative satisfies the adequacy requirement of Rule 23(a)(4).

B. Rule 23(b)(3)

Once the Court determines that Rule 23(a)'s requirements are met, Plaintiff must also show that the class meets the definition of at least one type of class under Rule 23(b). *Avritt v. Reliastar Life Ins. Co.*, 615 F.3d 1023, 1029 (8th Cir. 2010). In this case, Plaintiff is seeking certification under Rule 23(b)(3). Therefore, Plaintiff must demonstrate that "the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy." Fed. R. Civ. P. 23(b)(3).

1. Predominance

"The Rule 23(b)(3) predominance inquiry" is meant to "test[] whether proposed classes are

sufficiently cohesive to warrant an adjudication by representation." *Amchem Products, Inc. v. Windsor*, 521 U.S. 591, 623 (1997). The Supreme Court has indicated that "[p]redominance is a test readily met in certain cases alleging consumer or securities fraud or violations of the antitrust laws." *Id.*at 625. "The predominance inquiry requires an analysis of whether a prima facie showing of liability can be proved by common evidence or whether this showing varies from member to member." *Halvorson v. Auto-Owners Ins. Co.*, 718 F.3d 773, 778 (8th Cir. 2013) (citing *Avritt*, 615 F.3d at 1029); *see also Ebert v. Gen. Mills, Inc.*, 823 F.3d 472, 478-79 (8th Cir. 2016). Thus, the question of predominance begins with the elements of the underlying cause of action. *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 804, 809 (2011). Section 10(b) and Rule 10b-5 claims require the claimant to prove "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." *Amgen Inc. v. Conn. Ret. Plans and Trust Fund*, 133 S. Ct. 1184, 1208 (2013) (internal quotation omitted). Rule 23(b)(3)'s predominance requirement also applies to questions of damages, which must be capable of measurement on a class-wide basis, and a plaintiff must show a linkage between its theory of liability and theory of damages. *Comcast Corp. v. Behrend*, 133 S. Ct. 1426, 1433 (2013).

Defendants do not dispute that Plaintiff's claims present common questions concerning falsity, materiality, scienter, reliance, and loss causation, which are capable of being proved by common evidence. Instead, Defendants argue that Plaintiff has failed to demonstrate predominance because one of Plaintiff's two proposed damages methodologies, the "the build-up methodology," fails to measure damages on a class-wide basis, is at odds with Plaintiff's theory of liability, and has never been used in a securities class action.

Plaintiff offers two alternative methodologies for measuring damages on a class-wide basis: (1) the share-price methodology; and (2) the build-up methodology. According to Plaintiff, the share-price methodology would establish damages by reference to the market price and the build-up methodology would establish damages by reference to losses that Defendants allegedly fraudulently concealed from investors. Defendants do not dispute that class-wide damages could be demonstrated by the share-price methodology; however, Defendants argue that Plaintiff should be required to proceed only under this methodology. Essentially, Defendants move the Court to preclude Plaintiff from using the build-up methodology to calculate damages in this case.

It is not necessary or appropriate for the Court to consider at this time whether to preclude the build-up methodology. First, to the extent damages are relevant to the predominance inquiry, Defendants concede that the share-price methodology is capable of calculating class-wide damages consistent with Plaintiff's theory of liability. Second, Defendants' argument that Plaintiff should be precluded from using the build-up methodology is premature. Fact discovery is ongoing and will not be complete until February 28, 2017. Plaintiff should not be forced at this stage in the litigation to elect one of its two alternative damages methodologies, given that both parties agree that the share-price methodology comports with Rule 23(b)(3). Class certification is not dependent on the Court's resolution of whether the build-up methodology appropriately measures damages on a class-wide basis. Accordingly, the Court concludes that this case raises common liability issues that could be proved by common evidence, and thus the predominance requirement of Rule 23(b)(3) is satisfied.

2. Superiority

Rule 23(b)(3) also requires the Court to find that proceeding as a class is a superior method of adjudication. Fed. R. Civ. P. 23(b)(3). There are four relevant factors for the Court to consider

when deciding whether a class action is superior to other available methods for fairly and efficiently adjudicating the controversy:

> (A) the class members' interests in individually controlling the prosecution or defense of separate actions;
> (B) the extent and nature of any litigation concerning the controversy already begun by or against class members;
> (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; and
> (D) the likely difficulties in managing a class action.

Id.

Plaintiff's satisfaction of the superiority requirement is undisputed. Judicial economy and the best interests of the class members favor class certification. Because the class members seek a determination on the same issues, a class action would enhance judicial economy and efficiency. The individual class members' damages are relatively small, indicating little interest in individually controlling the prosecution of this action. Plaintiff has indicated that there are no other securities actions pending against Defendants involving Wal-Mart's common stock. Concentrating the claims in Defendants' home forum with uniform decisions is desirable, and the Court does not anticipate unreasonable difficulty in managing the class action. Accordingly, the Court finds that the class action method is the superior method to litigate these claims.

III. CONCLUSION

For the reasons discussed herein, Plaintiff's Motion for Class Certification (ECF No. 229) is **GRANTED**. The City of Pontiac General Employees' Retirement System (PGERS) is named as class representative. The Court approves the law firm of Robbins Geller Rudman and Dowd LLP as class counsel and the law firm of Patton Tidwell & Culbertson as liaison counsel.

IT IS SO ORDERED, this 20th day of September, 2016.

/s/ Susan O. Hickey
Susan O. Hickey
United States District Judge

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

IN RE:

BofI HOLDING, INC. SECURITIES LITIGATION.

Case No. 3:15-CV-02324-GPC-KSC

CLASS ACTION

ORDER:

DENYING IN PART AND GRANTING IN PART DEFENDANTS' MOTION TO DISMISS

[ECF No. 37]

GRANTING DEFENDANTS' MOTION TO SEAL

[ECF No. 42]

DENYING PLAINTIFFS' MOTION TO STRIKE

[ECF No. 45]

GRANTING PLAINTIFFS' MOTION TO SEAL

[ECF No. 46]

Plaintiffs, purchasers of BofI's common stock, have sued BofI and a number of its corporate officers for misrepresenting the risk involved in investing in its internet bank. On February 1, 2016, the Court consolidated two related securities class actions, *Golden*

v. BofI Holding Inc., et al, Case No. 15-cv-02324-GPC-KSC (S.D. Cal.) and *Hazan v. BofI Holding, Inc. et al*, Case No. 15-cv-02486-GPC-KSC (S.D. Cal). ECF No. 23. At that time, the Court appointed Houston Municipal Employees Pension System (HMEPS) as lead plaintiff of the class action suit pursuant to 15 U.S.C. § 78u–4(a)(3). *Id.* HMEPS then filed a Consolidated Amended Class Action Complaint on April 11, 2016. ECF No. 26. The Consolidated Amended Class Action Complaint ("CAC" or "the Complaint") asserts 1) violations of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder and 2) violations of Section 20(a) of the Exchange Act. ECF No. 26. Presently before the Court is a motion to dismiss filed by Defendants BofI Holding Inc., Gregory Garrabrants, Andrew J. Micheletti, Paul J. Grinberg, Nicholas A. Mosich, and James S. Argalas (collectively "Defendants"). ECF No. 26. Defendants seek to dismiss both of Plaintiffs' claims on the theory that Plaintiffs have failed to meet the heightened pleading standards of the Private Securities Litigation Reform Act ("PSLRA"), which requires that Section 10(b) claims plead both fraudulent misrepresentation and scienter with particularity. ECF No. 37-1 at 8.[1]

BACKGROUND

Founded in 1999, BofI[2] is a federally-chartered internet bank that operates from its headquarters in San Diego, California. *See* CAC ¶ 3. BofI is not your run-of-the-mill bank. Instead of relying on brick-and-mortar branches to generate business, BofI offers its products through retail distribution channels, such as websites, online advertising, a call center of salespeople, referrals from financial advisory firms, and referrals from affinity groups. *Id.* BofI is in the business of providing consumer and business products, including checking, savings, and time-deposit accounts, and services, such as financing for residential and commercial real estate, business, and vehicles. *Id.* ¶¶ 2-3. BofI is also in the business of consumer and business lending. *Id.* ¶ 30. BofI engages in Single

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[1] All page numbers cited herein follow CM/ECF's internal pagination.
[2] "BofI" will refer to both the holding company and its subsidiary, BofI Federal Bank. *Id.* ¶ 2.

1 Family Mortgage Secured Lending, MultiFamily Mortgage Secured Lending,
2 Commercial Real Estate Secured and Commercial Lending, Specialty Financial
3 Factoring, Prepaid Cards, and Auto, RV, and other consumer-related lending. *Id.* ¶ 30.

4 BofI has grown tremendously in recent years. *Id.* ¶ 5. Over the last five years,
5 total deposits increased to $5.2 billion, signaling 235% growth, and net income increased
6 from $20.6 million in fiscal year 2011 to $82.7 million in fiscal year 2015. *Id.*
7 Development of the bank's loan portfolio propelled BofI's growth during these years.
8 *Id.* ¶ 42. From 2011 to 2015, BofI's loan portfolio grew from $1.33 billion to $5 billion,
9 representing 274% in growth. *Id.* By the end of calendar year 2015, BofI had a loan
10 portfolio worth $5.715 billion. *Id.* ¶ 30. From September 4, 2013 to February 3, 2016
11 (the putative "Class Period"), Plaintiff HMEPS and other class members similarly
12 situated purchased BofI's common stock. *Id.* ¶ 1. During the Class Period BofI's stock
13 reached a high of $142.54 per share, representing a 1,100% increase over its initial public
14 offering of $11.50 per share in 2005. *Id.* ¶ 6. As of January 22, 2016, HMEPS had
15 63,032,258 in common stock shares outstanding. *Id.* ¶ 32.

16 On October 13, 2015, *The New York Times* reported that a formal internal auditor
17 at BofI had filed a federal whistleblower lawsuit ("the *Erhart* Case")[3] alleging that BofI
18 was engaged in widespread misconduct. *Id.* ¶ 20. After the *Erhart* Case was filed, the
19 price of BofI's stock fell by $10.72 per share (or $42.87 per share on a pre-split adjusted
20 basis), or 30.2%, and closed at $24.78 on October 14, 2016. *Id.* ¶ 21. The total capital
21 loss amounted to $675 million. *Id.* The price of Defendants' stock then continued to
22 decrease through February 3, 2016 (i.e., the last day of the Class Period). *Id.* ¶ 22.
23 Plaintiffs now allege that the decline in the market value of BofI's securities caused
24 Plaintiffs to suffer significant damages. *Id.*
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28

[3] *Erhart v. BofI Holding, Inc.*, Case No. 15-cv-2287-BAS-NLS (S.D. Cal).

In addition to BofI, Plaintiffs have named five individuals as defendants in this action, all of whom served as BofI executives throughout the Class Period. Gregory Garrabrants is the CEO, President, and Director of BofI. *Id.* ¶ 33. He has held the CEO position since 2007 and been President and Director since 2008. *Id.* Andrew J. Micheletti is BofI's Executive Vice President and Chief Financial Officer, and has held those positions throughout the Class Period. *Id.* ¶ 34. Paul J. Grinberg is a member of BofI's Board of Directors and has been the Chairman of the Board Audit Committee, the Board Compensation Committee, and a member of the Board Nominating Committee for the Class Period. *Id.* ¶ 35. Nicholas A. Mosich has served as the Vice Chairman of BofI's Board of Directors and as a member of the Board Audit Committee throughout the Class Period. *Id.* ¶ 36. James S. Argalas served as a member of the Board of Directors and a member of the Board Audit Committee throughout the Class Period. *Id.* ¶ 37.

1. Defendants' Alleged Fraudulent Scheme

The tenor of Plaintiffs' claims is that Defendants materially misrepresented the risk of investing in BofI by engaging in knowing and reckless conduct that rendered the bank a "materially-less safe investment than investors were led to believe." *Id.* ¶ 23. The Defendants, Plaintiffs allege, sold themselves as offering "significant cost savings and operation efficiencies derived from its purported branchless business model, as well as low loan losses." *Id.* ¶ 7. Yet while Defendants touted themselves as a "careful, prudent institution" and emphasized their "conservative loan-underwriting standards," Plaintiffs allege that the bank actually had a "troubled identity that resorted to lax lending practices and other unlawful conduct to fraudulently boost its loan volume and earnings." *Id.* ¶¶ 1 & 8. By way of numerous false and misleading representations, BofI allegedly concealed the actual risk of loss present on its ledger and deceived investors as to its true financial condition. In their more than 140-page complaint, Plaintiffs point to copious facts as evidence that BofI statements, and their omissions, were false and misleading when made. The gravamen of the allegations concerns Defendants' deviations from BofI's

loan underwriting standards, inadequate internal control and audit measures, undisclosed related-party transactions, and other violations of the federal securities laws.

2. Defendants' False and Misleading Statements

Plaintiffs have identified four types of misleading statements made by BofI: 1) earnings calls; 2) SEC filings; 3) conference calls about the results in SEC filings; and 4) press releases about the results in SEC filings. *Id.* ¶¶ 45, 244-362. With regard to the SEC filings, Plaintiffs have specifically identified Defendants' 2013 Form 10-K, 2014 Form 10-K, and 2015 Form 10-K as misleading, *id.* ¶¶ 253, 306, & 359, as well as Defendants' 10-Q forms for Quarters 1 through 3 of 2014, Quarters 1 through 3 of 2015, and Quarter 1 of 2016, *id.* ¶¶ 259, 272, 286, 312, 325, 337, 384. Most of the press releases and conference calls that Plaintiffs have identified refer specifically to BofI's financial earnings as published in the respective SEC filings. The statements made in response to the *Erhart* allegations are denials of the allegations made by the plaintiff in the *Erhart* case.[4]

a. Earnings Calls

CEO Garrabrants described Defendants' lending practices in a series of earnings calls held on August 7, 2014, April 30, 2015, and October 29, 2015, respectively, as follows:

1) "we continue to originate only full documentation, high credit quality, low loan-to-value, jumbo single-family mortgages and have not reduced our loan rates for these products," "we believe that we can continue to grow our [C & I loan] portfolio at similar yields in this coming year as we have in the prior year and maintain our conservative credit guidelines," and "[w]e are pleased with the increase in the credit quality at the bank."
2) "[w]e continue to maintain our conservative underwriting criteria and have not loosened credit quality to enhance yields or increase loan volumes," and "[r]isk is not hidden in the tail of the portfolio."

[4] The Court will not recount these statements in any depth because Defendants' other statements were sufficient for the Court to reach a decision.

3) BofI's "portfolio credit quality is very strong," "[o]ur strong credit discipline and low loan-to-value portfolio have resulted in consistently low-credit losses and servicing costs."

Id. ¶ 45.

b. 10-K Filings

The three 10-Ks that Defendants filed with the SEC during the Class Period made many of the same representations about credit quality and loan underwriting as indicated in the earnings calls above. They also address risk in BofI's loan portfolio and in its off-balance sheets. Because the representations made in Defendants' 2013 Form 10-K, 2014 Form 10-K, and 2015 Form 10-K are essentially identical, the Court will treat the 2013 Form 10-K as illustrative. *Compare id.* ¶¶ 244-53 *with id.* ¶¶ 299-306 *and id.* ¶¶ 352-59. The annual report included in Defendants' 2013 Form 10-K detailed BofI's loan underwriting standards as follows:

> We individually underwrite the loans that we originate and all loans that we purchase. Our loan underwriting policies and procedures are written and adopted by our board of directors and our loan committee. Each loan, regardless of how it is originated, must meet underwriting criteria set forth in our lending policies and the requirements of applicable lending regulations of our federal regulators.
>
> In the underwriting process we consider the borrower's credit score, credit history, documented income, existing and new debt obligations, the value of the collateral, and other internal and external factors. For all multifamily and commercial loans, we rely primarily on the cash flow from the underlying property as the expected source of repayment, but we also endeavor to obtain personal guarantees from all borrowers or substantial principals of the borrower. In evaluating multifamily and commercial loans, we review the value and condition of the underlying property, as well as the financial condition, credit history and qualifications of the borrower. In evaluating the borrower's qualifications, we consider primarily the borrower's other financial resources, experience in owning or managing similar properties and payment history with us or other financial institutions. In evaluating the underlying property, we consider primarily the net operating income of the property before debt service and depreciation, the ratio of net operating income to debt service and the ratio of the

1 loan amount to the appraised value.

2 *Id.* ¶ 248. The 2013 Form 10-K also indicated that its "allowance for loan losses is
3 maintained at a level estimated to provide for probable incurred losses in the loan
4 portfolio"; that BofI was committed to "maintaining the allowance for loan losses at a
5 level that is considered to be commensurate with estimated probable incurred credit
6 losses in the portfolio"; and that "management performs an ongoing assessment of the
7 risks inherent in the portfolio." *Id.* ¶ 245. The report went on to address BofI's off-
8 balance sheet activities.

9
10 > Credit-Related Financial Instruments. The Company is a party to
11 > credit-related financial instruments with off-balance- sheet risk in the
12 > normal course of business to meet the financing needs of its
> customers. . . .
13
14 > The Company's exposure to credit loss is represented by the
15 > contractual amount of these commitments. The Company follows the
> same credit policies in making commitments as it does for onbalance-
> sheet instruments.

16 *Id.* ¶ 249. Elaborating on the company's off-balance sheet commitments, the filing also
17 stated that "[t]he fair value of off-balance sheet items is not considered material" and that
18 it has "no commitments to purchase loans, investment securities or any other unused lines
19 of credit." *Id.* ¶ 250. Defendants Garrabrants and Micheletti certified BofI's 2013, 2014
20 and 2015 Form 10-Ks pursuant to Sections 302 and 906 of the Sarbanes-Oxley Act of
21 2002 ("SOX"). *Id.* ¶¶ 251, 305, 358

22 **c. 10-Q Filings**

23 As stated previously, Plaintiffs identified seven of Defendants' Form 10-Qs
24 submitted during the Class Period as false and misleading. *Id.* ¶¶ 259, 272, 286, 312,
25 325, 337, 384. The representations made in those documents are substantially similar in
26 kind to those made in the Form 10-Ks.

27
28

Defendants' 2014 Form 10-Q explained that "[t]he Company's goal is to maintain the allowance for loan losses (sometimes referred to as the allowance) at a level that is considered to be commensurate with estimated probable incurred credit losses in the portfolio" and that "the Company believes that the allowance for loan losses is adequate . . . ." *Id.* ¶ 255. The form also described Defendants' off-balance commitments and explained that it had "no commitments to purchase loans, investment securities or any other unused lines of credit" and that "[t]he fair value of off-balance sheet items is not considered material." *Id.* ¶ 257. Nearly identical statements were made in the remaining 10-Qs. *See id.* ¶¶ 254-59, 267-72, 281-86, 307-12, 320-25, 333-37.

BoFI's Q1 2016 filing, unlike the other quarter filings, also made reference to ongoing "Legal Proceedings." *Id.* ¶ 381.

> . . . from time to time we may be a party to other claims or litigation that arise in the ordinary course of business, such as claims to enforce liens, claims involving the origination and servicing of loans, and other issues related to the business of the Bank. None of such matters are expected to have a material adverse effect on the Company's financial condition, results of operations or business. *Id.* ¶ 381.

Defendants Garrabrants and Micheletti certified BofI's 10-Q forms for Quarters 1 through 3 of 2014, Quarters 1 through 3 of 2015, and Quarter 1 of 2016 pursuant to SOX. *Id.* ¶¶ 258, 271, 285, 311, 324, 336, 383.

d. Conference Calls

During the Class Period, BofI held regular conference calls with analysts and investors to discuss the outcomes reported in the most recent Form 10-Q. *See, e.g.*, *id.* ¶ 262. Each time, Defendant Micheletti "reiterated the financial results" and Defendant Garrabrants made statements concerning one or more of the following topics: BofI's credit quality, underwriting standards, risk management, as well as internal and external compliance.

In an earnings call for Q1 2014 held on November 5, 2013, Garrabrants stated that "[w]e are pleased with the increase in the credit quality at the bank," a refrain also uttered

1 in the earnings call identified above. *Id.* ¶ 263. He made similar remarks during
2 subsequent conference calls. *See id.* ¶¶ 276, 290, 296, 317. In the same November 5
3 call, Garrabrants also remarked, with respect to BofI's operations and risk management,
4 that "[w]e continue to make investments in our people, systems, and processes to ensure
5 that we will appropriately manage our risk, and remain on sound regulatory footing as we
6 enjoy the continued success of what we believe is the right business banking model for
7 the future." *Id.* ¶ 264. He continued by discussing BofI's loan underwriting standards:

8 > . . . We've always done full documentation loans. I don't believe in low
9 > documentation, and no documentation loans. From my perspective, I want
> to see everything. If we're making a judgment and a trade off [sic] about a
10 > particular aspect of something, that's fine. But we can do that with the
11 > holistic picture, and have that picture documented.

Id. ¶ 265.

12 On an earnings call held on February 5, 2014 for Q2 2014, Garrabrants commented
13 as follows on the growth in BofI's Commercial & Industrial (C&I) loans, "the vast
14 majority of those loans are loans that have been self originated by the bank, sourced by
15 our team and they are a significant portion of those [sic] are lender financed loans that are
16 backed by hard collateral, receivables, real estate or other loans." *Id.* ¶ 277. He went on
17 to reiterate his comments from November 5 about fully documenting loans, "in our case,
18 we never did no documentation loans. We always collected every piece of documentation
19 that we possibly could including tax returns from the IRS and everything else, so that
20 really didn't change anything that we did." *Id.* ¶ 278.

21 On May 6, 2014 BofI held a Q3 2014 conference call. *Id.* ¶ 289. At that time
22 Garrabrants remarked that "[w]e remain highly focused on credit quality at the Bank and
23 have not sacrificed credit quality to increase originations nor loosen our underwriting
24 standards[.]" *Id.* ¶ 290. He added that "[o]ur current level of loan loss reserve reflects
25 the low-risk and low loan-to-value ratio in the current portfolio." *Id.* ¶ 291.

26 On August 7, 2014, Garrabrants made the following statements during a Q4 and
27 fiscal year conference call. *Id.* ¶ 295. "[W]e continue to originate only full
28 documentation, high credit quality, low loan-to-value, jumbo single-family mortgages

and have not reduced our loan rates for these products." *Id.* ¶ 296. He added, "we believe that we can continue to grow our portfolio at similar yields in this coming year as we have in the prior year and maintain our conservative credit guidelines." *Id.* Garrabrants also addressed BofI's compliance programs, and specifically, its Bank Secrecy Act (BSA) and Anti-Money Laundering (AML) programs. *Id.* ¶ 297.

> We have made significant investments in our overall compliance infrastructure over the past several quarters, including BSA and AML compliance. We believe that we are on the same page with our regulators about their expectations.
>
> * * *
>
> We have spent a significant amount of money on BSA/AML compliance upgrades and new systems and new personnel. We have also been beefing up our compliance teams.
>
> * * *
>
> But we want to make sure we stay ahead of our risk management needs and make sure that certainly we stay out of BSA trouble and things like that.

Id.

On November 4, 2014 during a Q1 2015 conference call, Garrabrants made the similar refrain of: "[w]e continue to have an unwavering focus on credit quality of the bank and have not sacrificed credit quality to increase origination." *Id.* ¶ 318. He went on to add, "[o]ur strong credit discipline and low loan to value ratio of portfolio has resulted in consistently low credit losses and servicing costs." *Id.*

During a Q2 2015 conference call on January 29, 2015, Garrabrants made the following remark about BofI's compliance infrastructure.

> We have invested significantly in our regulatory and compliance infrastructure, management and personnel to meet heightened regulatory demands and prepare ourselves for our relationship with H&R Block.
> . . . "[w]e're investing in a new BSA system, which we think is going to be a lot more – better at detecting suspicious activity and those sorts of things.

Id. ¶ 330.

On April 30, 2015, during a conference call for Q3 2015, Garrabrants emphasized the qualities of BofI's loan underwriting standards: "We continue to maintain our

conservative underwriting criteria and have not loosened credit quality to enhance yields or increase loan volumes. . . Risk is not hidden in the tail for the portfolio. Only 8% of the single-family has a loan-to-value ratio greater than 70%, less than 1% greater than 80% and no loans with a loan-to-value ratio of greater than 90%. . . ." *Id.* ¶ 341.

During the conference calls on July 30, 2015 for Q4 2015 and October 29, 2015 for Q1 2016, Garrabrants made similar remarks to ones he made previously about credit quality and loan origination: "portfolio credit quality is very strong. Our strong credit discipline and low loan-to-value portfolio have resulted in consistently low-credit losses and servicing costs," *id.* ¶ 388; "[w]e continue to maintain our conservative underwriting criteria and have not loosened credit quality to increase loan volume," *id.*; "[c]urrently, the vast majority of our C&I loan book is sole sourced, originated and agented by us," *id.* ¶ 347.

e. Press Releases

Plaintiffs' allegations also rely on press releases elaborating on BofI's financial condition as detailed in Defendants' SEC filings. *See, e.g.*, *id.* ¶ 260. The press releases identified by Plaintiffs mostly reiterated issues previously addressed by Defendants' earnings calls, SEC filings, and conference calls. Plaintiffs highlight that all of the press releases emphasized that BofI had had "record" financial results for the respective calendar filing. *See, e.g.*, *id.* ¶ 273. The press releases quoted Garrabrants as making comments such as "[w]e achieved our loan growth without reducing our credit standards while improving our net interest margin," *id.* ¶ 293, and "[s]trong loan growth was achieved while maintaining high quality credit standards," *id.* ¶ 314.

<u>DISCUSSION</u>

LEGAL STANDARD

1. Rule 12(b)(6) Standard

Federal Rule of Civil Procedure ("Rule") 12(b)(6) permits dismissal for "failure to state a claim upon which relief can be granted." Fed. R. Civ. P. 12(b)(6). Dismissal under Rule 12(b)(6) is appropriate where the complaint lacks a cognizable legal theory or

sufficient facts to support a cognizable legal theory. *See Balistreri v. Pacifica Police Dep't.*, 901 F.2d 696, 699 (9th Cir. 1990). Under Rule 8(a)(2), the plaintiff is required only to set forth a "short and plain statement of the claim showing that the pleader is entitled to relief," and "give the defendant fair notice of what the . . . claim is and the grounds upon which it rests." *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 555 (2007).

A complaint may survive a motion to dismiss only if, taking all well-pleaded factual allegations as true, it contains enough facts to "state a claim to relief that is plausible on its face." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Twombly*, 550 U.S. at 570). "A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Id.* "Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice." *Id.* "In sum, for a complaint to survive a motion to dismiss, the non-conclusory factual content, and reasonable inferences from that content, must be plausibly suggestive of a claim entitling the plaintiff to relief." *Moss v. U.S. Secret Serv.*, 572 F.3d 962, 969 (9th Cir. 2009) (citations omitted).

Any complaint alleging fraud must also comply with Rule 9(b), which requires the complaint to state with particularity the circumstances constituting fraud. Fed. R. Civ. P. 9(b). Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally. *Id.* To satisfy the heightened pleading requirements, the plaintiff must set forth "the time, place, and specific content of the false representations as well as the identities of the parties to the misrepresentation." *Odom v. Microsoft Corp.*, 486 F.3d 541, 553 (9th Cir. 2007) (internal citations omitted). In addition, the complaint must indicate "what is false or misleading about a statement, and why it is false" and "be specific enough to give defendants notice of the particular misconduct that they can defend against the charge and not just deny that they have done anything wrong." *Vess v. Ciba –Geigy Corp. USA*, 317 F.3d 1097, 1107 (9th Cir. 2003) (internal citations omitted).

In the event that the Court does grant a motion to dismiss, Rule 15 provides that leave to amend should be freely granted when justice so requires. Accordingly, when a court dismisses a complaint for failure to state a claim, "leave to amend should be granted unless the court determines that the allegation of other facts consistent with the challenged pleading could not possibly cure the deficiency." *DeSoto v. Yellow Freight Sys., Inc.*, 957 F.2d 655, 658 (9th Cir. 1992) (internal citations omitted). Amendment, therefore, may be denied if it would be futile. *See id.*

2. Falsity and Scienter

To survive the motion to dismiss, Plaintiffs' claims must also meet the heightened pleading requirements of the Private Securities Litigation Reform Act ("PSLRA"). In 1995, Congress enacted the PSLRA to curb abuses of securities fraud litigation. *Amgen, Inc. v. Conn. Retirement Plans & Trust Funds*, 133 S. Ct. 1184, 1200 (2013). These include "nuisance filings, targeting of deep-pocket defendants, vexatious discovery request and manipulation by class action lawyers." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 320 (2007). In response to these abuses, the PSLRA imposed a heightened pleading requirement for securities fraud actions brought under § 10(b) and Rule 10b-5, requiring that falsity and scienter be plead with particularity. *Amgen*, 133 S. Ct. at 1200; *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 990 (9th Cir. 2009).

Under the PSLRA's heightened pleading instructions, a complaint alleging that the defendant made a false or misleading statement must: "(1) 'specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading,' 15 U.S.C. § 78u–4(b)(1); and (2) 'state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind,' § 78u–4(b)(2)." *Tellabs, Inc.*, 551 U.S. at 321. "It does not suffice that a reasonable fact finder plausibly could infer . . . the requisite state of mind." *Id.* at 313. Rather, the inference of scienter must be "cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Id.* at 313.

Alleged Violations

1. Section 10(b) of the 1934 Securities Act and Rule 10b–5

Section 10(b) of the Securities Exchange Act makes it unlawful for "any person . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or . . . for the protection of investors." 15 U.S.C. § 78j(b). Rule 10b–5 implements this provision by making it unlawful to "make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading . . . ." 17 C.F.R. § 240.10b–5(b). Rule 10b-5 also makes it unlawful for any person "[t]o employ any device, scheme, or artifice to defraud" or "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b–5(a), (c).

To state a securities fraud claim under 10(b) of the Act and Rule 10b-5, a plaintiff must show (1) a material misrepresentation or omission, (2) scienter, (3) in connection with the purchase or sale of a security, (4) reliance, (5) economic loss, and (6) loss causation. *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005). A complaint alleging claims under section 10(b) and Rule 10b-5 must satisfy the pleading requirements of both the PSLRA and Rule 9(b). *In re Verifone Holdings, Inc. Sec. Litig.*, 704 F.3d 694, 701 (9th Cir. 2012). In order for an omission to be actionable under the securities laws, that omission must affirmatively create an impression that the state of affairs differs materially from the actual state of the matter. *Brody v. Transitional Hosps. Corp.*, 280 F.3d 997, 1006 (9th Cir. 2002).

A. Materially False and Misleading Statements

Plaintiffs' complaint alleges that BofI's public statements about its financial results, lending practices, off-balance sheet activities, and internal controls were false and misleading when made because Defendants were engaged in a course of conduct that

1 deviated from its loan underwriting standards, relied upon inadequate internal and audit
2 controls, and failed to disclose related-party loans, among other misconduct. They have
3 identified material statements made by Defendants in 10-K and 10-Q filings, earnings
4 calls, press releases, and quarterly conference calls as misleading or false, CAC ¶¶ 244-
5 362, and they have stated with tremendous care why those statements are misleading and
6 false, *id.* ¶¶ 41-243. Notwithstanding the Complaint's length and detail, there are those
7 misrepresentations that fall short of the PSLRA's heightened standards. Yet because
8 Plaintiffs need only plead a single materially false misrepresentation to survive a motion
9 to dismiss, the Court need not dwell on those aspects of the Complaint here. *See Feyko v.*
10 *Yuhe Intern., Inc.*, 2013 WL 816409 *4 n.2 (C.D. Cal. Mar. 5, 2013) (noting that, in order
11 to survive the motion to dismiss, the plaintiff need only allege a single material
12 misrepresentation); *Cunha v. Hansen Natural Corp.*, 2011 WL 8993148 *4 (C.D. Cal.
13 May 12, 2011) (stating that there it "no reason that it [the court] must address parts of the
14 CAC that *do not* work" (emphasis in original)). Defendants argue that Plaintiffs have
15 failed to identify a single affirmative statement by Defendants that was actually rendered
16 false or misleading by Plaintiffs' allegations. ECF No. 41 at 4. The Court disagrees.
17 Plaintiffs have plead that a material misrepresentation has occurred. Indeed, they have
18 plead more than just one.

19 Examples of Plaintiffs' particularized pleadings include Defendants'
20 representations that:

21 1) "We continue to maintain our conservative underwriting criteria and have
22 not loosened credit quality to enhance yields or increase loan volumes,"
id. ¶ 45;
23 2) "Each loan, regardless of how it is originated, must meet underwriting
24 criteria set forth in our lending policies and the requirements of
applicable lending regulations of our federal regulators," *id.* ¶ 248;
25 3) "[W]e continue to originate only full documentation, high credit quality,
26 low loan-to-value, jumbo single-family mortgages and have not reduced
our loan rates for these products," *id.* ¶ 296;
27
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4) "[W]e will appropriately manage our risk, and remain on sound regulatory footing as we enjoy the continued success of what we believe is the right business banking model for the future," *id.* ¶ 264;
5) "We have made significant investments in our overall compliance infrastructure over the past several quarters, including BSA and AML compliance. We believe that we are on the same page with our regulators about their expectations," *id.* ¶ 297;
6) "We have spent a significant amount of money on BSA/AML compliance upgrades and new systems and new personnel. We have also been beefing up our compliance teams," *id.*

Defendants do not persuasively dispute the alleged falsity of these, and other, statements identified in Plaintiffs' Complaint. One of Defendants' arguments is that statements discussing BofI's "conservative credit guidelines" or applauding the "increase in credit quality at the bank" are not actionable under 10(b) because they are "corporate puffery." *See* ECF No. 37-1 at 20 n. 6; *see also* ECF No. 40 at 41 (citing to *Lloyd v. CVB Fin. Corp.,* 811 F.3d 1200, 1206-07 (9th Cir. 2016)). As the Ninth Circuit explained in *Newcal Indus., Inc. v. Ikon Office Solution*, a statement is merely puffery when it is "extremely unlikely to induce consumer reliance." 513 F.3d 1038, 1053 (9th Cir. 2008). The Court finds, however, that taking a few of Plaintiffs' allegations out of context and labeling them as puffery is not sufficient to undermine Plaintiffs' detailed allegations that BofI's actual lending practices fell short of the standards BofI represented to investors. In *In re New Century*, the court found that statements describing the defendant as having "higher credit quality," "strict underwriting and risk management disciplines," and "improved underwriting controls and appraisal review process" were not mere puffery and were sufficient to plead falsity with particularity. 588 F. Supp. 2d 1206, 1225 (C.D. Cal. 2008). Moreover, Plaintiffs' allegations are unlike those that were dismissed as puffery in *Lloyd v. CVB Fin. Corp*., 811 F.3d at 1206-07. There, the court characterized the plaintiff's allegations that its credit metrics were "superior" to those of its peers, that it had "strong credit culture," and that the company had "limited its exposure to problem credits" as puffery because the statements were vague and optimistic. *See id.* By contrast, Plaintiffs' allegations are neither aspirational nor general. They allege that

Defendants repeatedly represented, in a variety of forums, that it continued to adhere to conservative loan underwriting practices and that it had not loosened credit guidelines in order to increase loan volume, when the defendants had, in fact, resorted to lax lending practices. *Cf. Atlas v. Accredited Home Lenders Holding Co.*, 556 F. Supp. 2d 1142, 1155 (S.D. Cal. 2008) ("[A]s a mortgage lender . . . underwriting practices would be among the most important information looked to by investors."). Thus, because Plaintiffs' claims ring of those in *In re New Century* as opposed to those in *Lloyd*, Defendants' argument that Plaintiffs' claims are mere puffery is unavailing.

Defendants' other strategy is to dismiss Plaintiffs' allegations as the unreliable speculation of confidential witnesses, all former BofI employees, ex-employee Charles Matthew Erhart, and anonymous bloggers. ECF No. 37-1 at 16-17. As an initial matter, the Court need not address the reliability of Erhart or the articles posted on *Seeking Alpha*, *see e.g.,* CAC ¶¶ 70, 77, 89, as Plaintiffs have adequately plead misrepresentations that rely on neither source. What's more, the Court is satisfied that Plaintiffs have described the confidential witnesses with sufficient detail to provide an adequate basis for attributing facts reported by the witness to the witness' personal knowledge. *See Zucco*, 552 F.3d at 995. In *Zucco*, the Ninth Circuit summed up the confidential witness inquiry as a two-pronged test requiring plaintiffs to establish the reliability and personal knowledge of confidential witnesses cited in the allegations. *See Zucco*, 552 F.3d at 991. In *Daou*, the plaintiffs met this requirement by describing each of the confidential witnesses' job descriptions and responsibilities, and in some instances, their job title and the title of the person to whom they reported. *See In re Daou Systems, Inc.*, 411 F.3d 1006, 1016 (9th Cir. 2005). Here, Plaintiffs have done exactly that. They have identified each confidential witness by title and job description, and in quite a few instances included the name of the individual to whom they reported. *See* CAC ¶¶ 52, 60, 66, 123, 133, 134, 146, 163, 164, 234. Accordingly, the Court finds no reliability issue with the confidential witness' allegations.

The Complaint sets forth numerous allegations made by confidential witnesses that corroborate Plaintiffs' claims that BofI was engaging in "lax lending practices" and failing to enforce adequate compliance measures. Accordingly, Plaintiffs have stated the "reason or reasons" why at least some of Defendants' representations, including those illustrated above, were false and misleading. *See* 15 U.S.C. § 78u–4(b)(1). Confidential Witness ("CW") 1, a former BofI senior underwriter, described being pressured by senior management to underwrite loans that CW 1 felt uncomfortable approving, refusing to recommend highly-leveraged loans that senior management ultimately approved, and noting that it "started to become very rare that we would deny a loan." CAC ¶¶ 52-59. Other confidential witnesses corroborated these allegations. CW 2, another former senior underwriter, described how BofI approved a multi-million dollar mortgage with suspicious repayment terms for a property that, in CW 2's estimation, had been grossly over-appraised in order to inflate the loan-to-value ratio. *Id.* ¶¶ 61-64. CW 10, a former senior underwriter[5], gave further credence to these allegations by stating that BofI's executive management funded many loans that CW 10 had declined to sign off on. *Id.* ¶ 66.

The Complaint also sets forth detailed allegations concerning Defendants' inadequate internal procedures and audit programs. Plaintiffs allege that BofI failed to operate an effective audit program as required by federal law and regulation. *Id.* ¶ 165.

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[5] According to Plaintiffs, CW 10 worked at BofI just before the start of the Class Period. CAC ¶ 66. Defendants point to the Ninth Circuit's decision *In re NVIDIA* as support for the argument that the Court should dismiss the allegations of employees who worked at BofI before the Class Period. *See* ECF No. 37-1 at 17. The Court is unpersuaded by this argument. In *In re NVIDIA*, the Ninth Circuit dismissed plaintiffs' 10(b) allegations that NVIDIA, a technology company specializing in graphic processing units, had strategically delayed disclosing a product defect to the detriment of the company's investors. *See In re NVIDIA*, 768 F.3d at 1056-57. One of the many reasons the court gave for dismissing plaintiffs' allegations was that some of the confidential witnesses had stopped working at NVIDIA "long before" the product defect arose. *Id.* at 1061. Here, unlike in *In re NVIDIA*, Plaintiffs allege that defendants engaged in a pattern of misrepresenting and misleading investors over a number of years. They do not point to one, isolated event as the source of misrepresentation, as did the plaintiffs in *In re NVIDIA*, but to a course of conduct. Thus, insofar as CW 10 corroborates other allegations that BofI was engaged in a pattern of misconduct during the Class Period, the Court finds that testimony relevant.

Plaintiffs described what laws and regulations require of BofI's audit procedures and then explained how many of BofI's observed practices fell short of those standards. For example, in the Complaint, Plaintiffs explained how guidance issued by the Office of the Comptroller of Currency (OCC) underscores the importance of maintaining independent auditors whose internal audit activities are not overseen by chief financial officers or the like. *Id.* ¶ 169. To demonstrate that BofI violated such guidance, Plaintiffs pointed to the allegations of CW 7, a former BofI lending compliance officer. CW 7 explained that Garrabrants had interfered with the audit committee's duties by "cleaning up" loan documents given to OCC examiners after CW 7 had identified them as problematic. *Id.* ¶ 174. CW 9, who stopped working at BofI just prior to the Class Period, made similar allegations of BofI's less-than-independent audit committee. *Id.* ¶¶ 173 & 175. As for staffing needs, CW 3 noted that BofI's Third Party Risk Department was understaffed with only three persons, *id.* ¶ 161, and CW 7 described BofI's internal controls as "nonexistent." *Id.* ¶ 162.

Standing alone, these allegations demonstrate why at least some of Defendants' statements were misleading or false at the time they were made. For example, Defendants represented that they had "not loosened credit quality to enhance yields or increase loan volumes." Yet that statement was made false or misleading by allegations that senior management was pressuring underwriters to approve loans they were uncomfortable with, that senior management frequently approved loans against the recommendation of underwriters, and that at least one loan-to-value ratio had been fabricated. Defendants also represented that "[w]e have made significant investments in our overall compliance infrastructure over the past several quarters, including BSA and AML compliance." And that statement was made false or misleading by the allegation that Garrabrants was interfering with auditor duties in contravention of OCC guidance, that internal controls were "nonexistent," and that the Third Party Risk Department was understaffed.

The Court's conclusion that Plaintiffs have plead a material representation is, moreover, consistent with other cases that have found similar allegations as sufficient to withstand scrutiny under the PSLRA. *See Atlas*, 556 F. Supp. 2d at 1142, 1149-53,1154-55 (S.D. Cal. 2008) (concluding that plaintiffs allegations regarding defendants' loan underwriting standards, alleged manipulation of reserve amounts, and improper accounting were sufficient to meet the 10(b) particularity standard); *In re New Century*, 588 F. Supp. at 1225-27 (C.D. Cal. 2008) (holding that defendants' false and misleading public statements about the strong credit quality and strict underwriting practices of the issuer were actionable under 10(b)); *In re Countrywide Fin. Corp. Deriv. Litig.*, 554 F. Supp. 2d 1044, 1057 (C.D. Cal. 2008) (concluding that plaintiffs had sufficiently plead defendants' misrepresentation of the rigor of their loan origination process, the quality of its loans, and the company's financial situation). Here, Plaintiffs have made analogous allegations against BofI concerning their lax lending practices, inadequate internal controls, and general failure to disclose the actual financial condition of the bank. Accordingly, Plaintiffs have plead a materially false representation with sufficient particularity to survive the PSLRA's heightened standard.

B. Materiality

The Court further concludes that BofI's mispresentations were material. The materiality of Defendants' statements is underscored by the very fact that Defendants repeatedly highlighted BofI's conservative loan underwriting standards, and to some extent its sophisticated controls, in myriad conference calls and press releases throughout the Class Period. *See Atlas*, 556 F. Supp. 2d at 1155 (S.D. Cal. 2008) (finding that materiality was demonstrated through Defendants' emphasis on underwriting policies and press releases and other public statements).

C. Scienter

Plaintiffs must plead scienter with particularity to survive a motion to dismiss a 10(b) claim. Scienter encompasses the intent to deceive, manipulate, and defraud. *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d at 1053 (quoting *Ernst & Ernst v. Hochfelder*, 425

U.S. 185, 193 n.12, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976)). To satisfy the requisite state of mind in the Ninth Circuit, "a complaint must 'allege that the defendant[ ] made false or misleading statements either intentionally or with deliberate recklessness.'" *Zucco*, 552 F.3d at 991 (citation omitted). Recklessness involves "a highly unreasonable omission, involving . . . an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *In re NVIDIA*, 768 F.3d at 1053 (internal citations omitted). Facts showing mere recklessness or a motive to commit fraud and opportunity to do so, provide some reasonable inference of intent, but are not sufficient to establish a strong inference of deliberate recklessness. *In re VeriFone*, 704 F.3d at 701. Thus, to establish a strong inference of deliberate recklessness, plaintiffs must "state facts that come closer to demonstrating intent, as opposed to mere motive or opportunity." *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999) (abrogated on other grounds by *South Ferry LP, No. 2 v. Killinger*, 542 F.3d 776, 784 (9th Cir. 2008)).

i. Holistic Review

As stated above, a complaint brought under the PSLRA is well-plead if the facts give rise to a "strong inference" that the defendants acted with the requisite state of mind. In assessing the sufficiency of allegations under 10(b)(5) a district court must view the allegations holistically, not in isolation. *In re VeriFone*, 704 F.3d at 702-03 (discussing in-depth holistic review as required by the Supreme Court in *Matrixx Initiatives, Inc. v. Siracusano,* 131 S. Ct. 1309, 1324 (2011)). That is not to say that the court cannot, if it chooses, "engage in an individualized discussion of the complaint's allegations," but rather that it should not "unduly focus on the weakness of individual allegations to the exclusion of the whole picture." *Id.* At this stage, the court must test for allegations of scienter sufficient to justify the case to proceed against the defendant. *New Mexico State Inv. Council v. Ernst & Young LLP*, 641 F.3d 1089, 1103 (9th Cir. 2011).

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ii. Defendants' Scienter

In order for a 10(b) claim to lie against BofI, the Court must find a strong inference of scienter for the corporate defendant. Generally speaking, such an inference must be made by pleading scienter as to the individual executive or director who made the misstatement.[6] *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736, 743 (9th Cir. 2008). In assessing the scienter of corporate officers, the Ninth Circuit has often spoken in terms of what is not enough to create a strong inference that a corporate officer acted with scienter. In *South Ferry* the Ninth Circuit tackled the question of whether and when the "core operations inference" – that is, the inference that key company officers have knowledge of facts critical to a business' core operations or important transactions – is sufficient to meet the strict pleading standards of the PSLRA. 542 F.3d at 781. There, the court concluded that an officers' position within a company was not sufficient, on its own, to create a strong inference of scienter, but that a kind of "core inference plus" would be sufficient. *Id.* at 784-85. By way of example, the *South Ferry* court noted that Plaintiffs might be able to meet the PSLRA requirement by relying on the core operations inference and by alleging that specific information had been conveyed to management relating to the fraud. *Id.* at 785. In *Zucco*, the Ninth Circuit made clear that SOX certifications are not sufficient "without more" to satisfy the PSLRA requirements. *Zucco*, 552 F.3d at 1004. Finally, in *In re Rigel Pharm., Inc. Sec. Regulation*, the Ninth Circuit concluded that allegations of "routine corporate objectives" or executive compensation based upon corporate goals, were not sufficient by themselves to create a strong inference of scienter, despite the element of motive involved. *See* 697 F.3d 869, 884 (9th Cir. 2012).

[6] The Ninth Circuit has left open the possibility that a plaintiff, given certain circumstances, might be able to establish corporate scienter by pleading collective scienter on the part of the company's employees. *See Glazer*, 549 F.3d at 744. However, because Plaintiffs have not raised the issue of whether the Court should consider finding collective scienter, it will not address the question here.

To undermine Plaintiffs' allegations of scienter, Defendants attack their opponents' allegations one-by-one. *See* ECF No. 37-1 at 28-31. Defendants argue that based on the Ninth Circuit precedent expounded in *South Ferry*, *Zucco*, and *In re Rigel*, Plaintiffs cannot properly infer scienter from the Defendants' positions within BofI; from the fact that Defendants Garrabrants and Micheletti signed SOX certifications; or from the fact that defendants were eligible for cash bonuses during the Class Period. *Id.* Yet in light of the Supreme Court's mandate in *Matrixx* to view allegations of scienter holistically, Defendants' piecemeal argument fails to persuasively make the case that Plaintiffs have not satisfied the PSLRA's heightened standard. Given the holistic nature of the Court's inquiry, the Court concludes that Plaintiffs' allegations of false and misleading statements do give rise to a strong inference of scienter. As the Ninth Circuit stated in *In re Read-Rite Corp. Sec. Litig.*, falsity and scienter are "a single inquiry, because falsity and scienter are generally inferred from the same set of facts." 335 F.3d 843, 846 (9th Cir. 2003). Thus, just as the Court is persuaded that Plaintiffs have alleged falsity with particularity, the Court is also satisfied that Plaintiffs have alleged scienter with particularity. Specifically, the Court finds that Plaintiffs have sufficiently alleged scienter as to Defendant Garrabrants and, thus, they have successfully alleged it as to BofI as well.

iii. Garrabrants

The complaint sets forth a number of facts from which the Court can infer that CEO Gregory Garrabrants knew that BofI was deviating from its stated lending practices and failing to maintain adequate internal and audit controls. For one, Plaintiffs' allegations indicate that Garrabrants was actually complicit in misconduct. Confidential Witness 7, who had once attended a meeting with Garrabrants to discuss negative audit findings, stated that Garrabrants not only brushed his findings "under the rug," CAC

¶ 147, but "cleaned up" audit reports that he disagreed with.[7] *Id.* ¶ 174. Then, according to a former BofI Assistant Vice President/Senior Processor of Income Property Lending Operations, Garrabrants had instructed employees to do no further background checks on foreign nationals if their name did not appear on the Office of Foreign Asset Control (OFAC) list. *Id.* ¶ 134. Confidential witnesses who worked at BofI before the Class Period made similar allegations of Garrabrants' complicity. *See id.* ¶ 133 (stating that Garrabrants had instructed BofI's Executive Vice President and Chief Credit Officer to underwrite loans even though they were missing TINs); *id.* ¶ 173 (stating that Garrabrants interfered with the audit committee's duties). Plaintiffs' allegations also set forth facts indicating that Defendant was aware – or should have been aware – of misconduct occurring at the bank. The Complaint contains allegations of a third party risk officer who stated that Garrabrants had said the officer's tombstone would read "died understaffed," in response to the officer's assertion that they needed more people in the Bank Secrecy Act department. *Id.* ¶ 124. Plaintiffs also alleged that a senior underwriter even went so far as to leave concerns about a multi-million dollar loan directly with Garrabrants' assistant, in order to explain why her boss should not have recommended that Garrabrants approve a specific loan over her objection. *Id.* ¶¶ 61-64.

Viewing these allegations holistically, and in light of the fact that Garrabrants was the CEO of BofI throughout the Class Period, had signed the SOX certifications on the company's quarterly and yearly earnings throughout the Class Period, and made repeated representations that BofI had sound underwriting and audit procedures during the Class Period, the Court finds that Plaintiffs have alleged a strong inference of scienter as to Garrabrants. The opposing inference that Defendants would have the Court adopt – that

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[7] Defendants' argument that this allegation actually "contradicts the notion that BofI's lending practices were lax" because the OCC did not take action after the reports were filed, is unconvincing. ECF No. 37-1 at 12 (internal citations omitted). For one, it is no surprise that a regulatory body would take no action as to a report that was intentionally altered so as to not raise suspicion. More importantly, Defendants' argument fails to address Plaintiffs' argument that Garrabrants should not have been interfering in the auditor's duties in the first place.

is, that the confidential witnesses are nothing more than "disgruntled" and "low-level" employees making unsubstantiated statements, *see* ECF No. 41 at 4-5 & ECF No. 37 at 17 – is not as strong as the inference that Garrabrants knowingly misrepresented BofI as having conservative credit guidelines, adequate internal controls, and as being in compliance with regulatory obligations. Accordingly, Plaintiffs have sufficiently plead scienter so as to survive Defendants' motion to dismiss.

iv. Micheletti, Grinberg, Mosich, and Argalas

As stated previously, a complaint must allege as to each defendant that he or she made a false or misleading statement either intentionally or with deliberate recklessness in order to plead a 10(b) claim. *See Zucco*, 552 F.3d at 991. Accordingly, Defendants are right to point out that Plaintiffs' Complaint "is all but silent with respect to Mr. Micheletti and the Audit Committee Defendants." ECF No. 41 at 13. Indeed, neither Plaintiffs' Complaint, *see generally* CAC ¶¶ 407-17, nor response brief, ECF No. 40 at 25-31, identify specific statements or omissions made by the remaining individual defendants, or set forth facts demonstrating that the defendants were nonetheless aware of the falsity of representations being made by BofI. Instead, Plaintiffs ask the Court to infer scienter from the audit committee members' positions, from allegations of motive, and from the factual allegations pleaded as a whole.

The Court, however, is not persuaded by Plaintiffs' argument that it can draw a strong inference of scienter from the audit committee members' failure to recognize BofI's accounting errors, as was the conclusion in *Thomas v. Megaship Semiconductor Corp.*, No. 14-CV-01160-JST, 2016 WL 845288 (N.D. Cal. Mar. 4, 2016). The facts of that case indicate that the magnitude of the error missed by the audit committee members was so large that net income was inflated by 500% and total revenue by $121.7 million. *Id.* at *6. By contrast, here, Defendants' misconduct concealed, rather than revealed, the presence of illicit goings-on, thus belying any inference that audit committee members would have necessarily been aware of significant reporting errors.

1 The Court is also not persuaded by Plaintiffs' argument that the individual
2 defendants had motive to commit fraud because they had benefitted from related-party
3 loans. *See* ECF No. 40 at 29 n. 26. In *Neborsky v. Valley Forge Composite Techs., Inc.*,
4 the case Plaintiffs cite, the court found that the defendant's motive and opportunity to
5 commit fraud was persuasive because the defendant had an unusually high monetary
6 stake in the alleged misrepresentations. *See* No. 13-CV-2307-MMA BGS, 2014 WL
7 3767011 *8 (S.D. Cal. July 29, 2014) (noting that the defendant had advanced $491,257
8 to the defendant company, held over 31% of the company's stock, and controlled the
9 SEC filings, press releases, and other corporate documents of the company). Here,
10 Plaintiffs ask us to infer that the remaining individual defendants knew that BofI was
11 engaged in widespread misconduct simply because they benefitted from a single loan that
12 was allegedly made on more favorable terms than those offered to the public. CAC
13 ¶¶ 414-15. The Court declines to make that leap with Plaintiffs.
14 Even viewing Plaintiffs' scienter allegations holistically, the Court finds that
15 Plaintiffs have not adequately plead that the remaining individual defendants had the
16 requisite scienter. There simply are too few facts from which to infer that the remaining
17 defendants were aware of the falsity of BofI's many misrepresentations. Plaintiffs also
18 fail to proffer any theory of scienter that might, nonetheless, give rise to an inference that
19 the remaining defendants acted with the appropriate state of mind. *See Berson v. Applied*
20 *Signal Tech., Inc.*, 527 F.3d 982, 987-88 (9th Cir. 2008) (finding a strong inference that
21 the company's CEO and CFO were aware of stop-work orders because they were heavily
22 involved in the day-to-day operations of the company); *see also Nursing Home Pension*
23 *Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1231 (9th Cir. 2004) (finding that
24 plaintiffs' specific allegations that the defendant CEO had access to and frequently
25 monitored a database detailing the company's financial condition was sufficient to infer
26 scienter). Because Plaintiffs have not set forth sufficient allegations from which the
27 Court can infer a strong inference of scienter on the parts of Defendants Micheletti,
28

1 Grinberg, Mosich, and Argalas, the Court GRANTS Defendants' motion to dismiss as to
2 those defendants.
3 **2. Section 20(a) of the Securities Act**
4 To plead a violation of Section 20(a) of the Securities Act Plaintiff must prove a 1)
5 primary violation of the securities laws and 2) demonstrate that the defendant exercised
6 actual power over the primary violator. *See In re NVIDIA*, 768 F. 3d at 1052. In other
7 words, Section 20(a) imposes liability on a "controlling person." *Id.*; 15 U.S.C. § 78t(a).
8 The question of whether a defendant is a controlling person is an "intensely factual
9 question, involving scrutiny of the defendant's participation in the day-to-day affairs of
10 the corporation and the defendant's power to control corporate actions." *Howard v.*
11 *Everex Sys., Inc.*, 228 F.3d 1057, 1065 (9th Cir. 2000).
12 Defendant asks the Court to dismiss the 20(a) claim as to all defendants because
13 Plaintiff's have failed to plead a primary violation of the securities laws. ECF No. 37-1
14 at 25. Plaintiffs counter by making the conclusory assertion that its 10(b) allegations are
15 sufficient to demonstrate that there was a primary securities violation and, therefore,
16 those allegations are also sufficient to establish that the individual defendants are
17 controlling persons. *See* ECF No. 40 at 31. Because the Court has determined that the
18 allegations against Defendants Micheletti, Grinberg, Mosich, and Argalas should be
19 dismissed, the Court need only address whether Garrabrants is rightly deemed a
20 "controlling person." Given Garrabrants ability to control and influence BofI by virtue of
21 his position as CEO, President, and Director of BofI, his involvement with the false
22 statements at the center of this dispute, and his alleged oversight over much of the
23 company's daily operations, the Court finds Garrabrants to be a "controlling person" for
24 purposes of Section 20(a). *See Howard*, 228 F.3d at 1065-66 (finding that allegations
25 that the company's CEO and Chairman's day-to-day management of the company and
26 the fact that he reviewed and signed the company's financial statements was sufficient to
27 plead "control person" liability). Accordingly, Plaintiffs have sufficiently plead a
28 violation of Section 20(a) so as to survive the motion to dismiss.

Defendants' Request for Judicial Notice

Generally, a court cannot consider matters outside of the complaint on a Rule 12(b)(6) motion to dismiss, unless those matters are: 1) authenticated documents that have been incorporated by the complaint or 2) facts subject to judicial notice. *Lee v. City of Los Angeles*, 250 F.3d 668, 689-90 (9th Cir. 2001). Documents may be incorporated into a complaint when the plaintiff "refers extensively" to the document or when the document forms the basis of the plaintiff's claims. *U.S. v. Ritchie*, 342 F.3d 903, 908 (9th Cir. 2003). Courts may take judicial notice of adjudicative facts that are "not subject to reasonable dispute." Fed. R. Evid. 201(b). Indisputable facts are those that are "generally known" or that "can be accurately and readily determined from sources whose accuracy cannot be reasonably questioned." *Id.*

Here, Defendants have requested that the Court take judicial notice of eight exhibits in connection with Defendants' motion to dismiss. The first is a declaration of Jonathan Ball, the former Vice President of Internal Audit at BofI. ECF No. 37-2 at 2. Five are filings made with the SEC. ECF No. 37-2 at 2. The remaining two are requests to take judicial notice of a *Seeking Alpha* article and a BofI press release, respectively. Plaintiffs have opposed judicial notice of the Ball declaration and oppose judicially noticing the SEC filings for the truth of the matter asserted. ECF No. 40-1 at 4-5. Plaintiffs have not opposed the two remaining requests as Defendants made those requests in a supplemental memorandum attached to its reply to Plaintiffs opposition to the motion to dismiss. *See* ECF No. 41-2.

SEC filings are the proper subjects of judicial notice as they are not subject to reasonable dispute. *See Dreiling v. American Exp. Co.*, 458 F.3d 942, 946 n.2 (9th Cir. 2006); *see also In re New Century*, 588 F. Supp. 2d at 1219-20 (taking judicial notice of the SEC filings submitted by Defendants). Accordingly, the Court will GRANT defendants' request to take judicial notice of the SEC filings, but the Court will not, as Plaintiffs request, consider these documents for the truth of the matters asserted therein. *See In re Bare Escentuals, Inc. Sec. Litig.*, 745 F. Supp. 2d 1052, 1067 (N.D. Cal. 2010)

(granting defendants' request to take judicial notice of SEC filings, but specifying that they will not "where inappropriate" be considered for the truth of the matter asserted."); *see also Curry v. Hansen Medical, Inc.*, 2012 WL 3242447 *3 (N.D. Cal. Aug. 10, 2012) (taking judicial notice of SEC filings, "but not for the truth of the matters asserted therein.")

Because the Court did not rely on the other documents included in Defendants' request, the Court will DENY Defendants' request to take judicial notice of the Ball Declaration, the *Seeking Alpha* article, and the BofI press release.[8] *See In re Washington Mutual, Inc. Sec., Derivative & ERISA Litig.*, 259 F.R.D. 490, 495 (W.D. Wash. 2009); *see also In re Immune Response Sec. Litig.*, 375 F. Supp. 2d 983, 996 (S.D. Cal. 2005) (denying defendants' request for judicial notice in part because the court did not rely on the document and found them irrelevant in deciding the motion to dismiss).

Plaintiffs' and Defendants' Motions to Seal

Courts have recognized a "general right to inspect and copy public records and documents, including judicial records and documents." *Nixon v. Warner Commc'ns, Inc.,* 435 U.S. 589, 597 & n. 7 (1978). Nonetheless, access to judicial records is not absolute. A narrow range of documents is not subject to the right of public access at all because the records have "traditionally been kept secret for important policy reasons." *Times Mirror Co. v. United States,* 873 F.2d 1210, 1219 (9th Cir.1989). Unless a particular court record is one "traditionally kept secret," a "strong presumption in favor of access" is the starting point. *Foltz v. State Farm Mut. Auto. Ins. Co.,* 331 F.3d 1122, 1135 (9th Cir. 2003) (citing *Hagestad v. Tragesser,* 49 F.3d 1430, 1434 (9th Cir.1995)). A party

[8] For similar reasons, the Court also DENIES Plaintiffs' Motion to Strike, ECF No. 51. The Court did not rely on the declarations of Confidential Witnesses 6 and 8, as offered by Defendants in ECF No. 42 or otherwise, in reaching its decision. Accordingly, the Court finds it proper to deny Plaintiffs' motion to strike. *See Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 2003 WL 23208956 *1 n.1 (N.D. Cal. Mar. 24, 2003), *rev'd on other grounds*, 380 F.3d 1226 (9th Cir. 2004) (dismissing as moot plaintiffs' motion to strike defendants' appendix of confidential witness allegations because the court did not rely on the appendix in reaching its motion to dismiss).

1 seeking to seal a judicial record then bears the burden of overcoming this strong
2 presumption by meeting the "compelling reasons" standard. *Id.* at 1135. That is, the
3 party must "articulate[ ] compelling reasons supported by specific factual findings," *id.*
4 (citing *San Jose Mercury News, Inc. v. U.S. Dist. Ct.,* 187 F.3d 1096, 1102-03 (9th
5 Cir.1999)), that outweigh the general history of access and the public policies favoring
6 disclosure, such as the "public interest in understanding the judicial process," *id.* (quoting
7 *Hagestad,* 49 F.3d at 1434). In turn, the court must "conscientiously balance[ ] the
8 competing interests" of the public and the party who seeks to keep certain judicial records
9 secret. *Foltz,* 331 F.3d at 1135. After considering these interests, if the court decides to
10 seal certain judicial records, it must "base its decision on a compelling reason and
11 articulate the factual basis for its ruling, without relying on hypothesis or conjecture."
12 *Hagestad,* 49 F.3d at 1434 (citing *Valley Broadcasting Co. v. U.S. Dist. Ct.,* 798 F.2d
13 1289, 1295 (9th Cir.1986)).

14 In general, "compelling reasons" sufficient to outweigh the public's interest in
15 disclosure and justify sealing court records exist when "court files might have become a
16 vehicle for improper purposes," such as the use of records to gratify private spite,
17 promote public scandal, circulate libelous statements, or release trade secrets. *Nixon,* 435
18 U.S. at 598. Yet the mere fact that the production of records may lead to a litigant's
19 embarrassment, incrimination, or exposure to further litigation will not, without more,
20 compel the court to seal its records. *Foltz,* 331 F.3d at 1136.

21 In the instant case, the motions to seal seek to protect the identities of two
22 confidential witnesses referenced in the Complaint and in Defendants' reply to Plaintiffs'
23 opposition to the motion to dismiss. *See* ECF Nos. 26 & 41. The Court is aware that
24 confidential witnesses have become a staple of securities litigation. *See* Justin Scheck,
25 *Securities Lawyers Spar Over Use of Confidential Witnesses*, THE RECORDER (Apr. 11,
26 2005), http://www.therecorder.com/id=900005426901/Securities-Lawyers-Spar-Over-
27 Use-of-Confidential-Witnesses?slreturn=20160826203048. The combination of the
28 PSLRA's strict pleading requirements and discovery stay, *see* 15 U.S.C. § 78u–4(3)(B)

("all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss"), explains why the use of confidential witnesses has become so common. *See* Gideon Mark, Confidential Witnesses in Securities Litigation, 36 J. Corp. L. 551, 554-55 (2011). Confidential witnesses are typically current or former employees, customers, or suppliers, who are fearful of retaliation if their identities are disclosed. *Id.*

Here, the confidential witnesses identified in Plaintiffs' and Defendants' motions to seal are former BofI employees who reportedly fear such retaliation and potential harassment. *See, e.g.*, ECF No. 39 at 19-20; *see also Plumbers & Pipefitters Local Union No. 630 Pension-Annuity Trust Fund v. Arbitron, Inc.*, 278 F.R.D. 335, 344 (S.D.N.Y. 2011) (noting that a confidential witness "may have a legitimate interest in non-disclosure, where revealing his or her name may lead to retaliation in a current or future job."). Plaintiffs have alleged that the confidential witnesses in this case complained of a "fear-based" culture at BofI "where dissent was not tolerated and fears of retaliation were fueled by constant reminders from upper management, primarily Garrabrants, that employees would be 'destroyed' for not following management directives." ECF No. 40 at 8. Plaintiffs have further claimed that such fears have begun to play out through Defendants' alleged efforts to "deceive and intimidate CWs in this action into self-identifying themselves and divulging attorney work-product," through Defendants' "recent initiation of criminal proceedings" against a CW who left the company three years ago, and through Defendants' counterclaims against the whistleblower in the *Erhart* Case. *Id.* Accordingly, because the Court finds the above-mentioned grounds to be compelling reasons that outweigh the public's interest in disclosure, the Court GRANTS the Plaintiffs' and Defendants' motions to seal.

CONCLUSION

For the foregoing reasons, **IT IS HEREBY ORDERED** that:

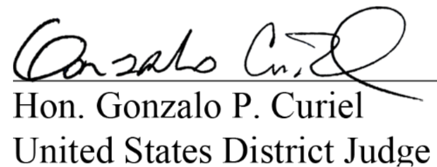
1. Defendants' Motion to Dismiss, ECF No. 37, be **DENIED** as to Defendant BofI and Defendant Gregory Garrabrants, and be **GRANTED** as to Defendants Andrew

J. Micheletti, Paul J. Grinberg, Nicholas A. Mosich, and James S. Argalas **with leave to amend.**

2. Defendants' Motion to Seal, ECF No. 42, and Plaintiffs' Motion to Seal, ECF. No. 46, be **GRANTED**.
3. Plaintiffs' Motion to Strike, ECF No. 45, be **DENIED**.

IT IS SO ORDERED.

Dated: September 27, 2016



Hon. Gonzalo P. Curiel
United States District Judge

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF ARIZONA

Vanguard Specialized Funds, et al.,

Plaintiffs,

v.

VEREIT Incorporated, et al.,

Defendants.

No. CV-15-02157-PHX-ROS

OPINION

This securities fraud case is now before the Court on Defendants' motion to transfer and seven separate motions to dismiss. The Court will deny the transfer motion, as well as the bulk of the motions to dismiss.

FACTUAL BACKGROUND[1]

A. Parties

Plaintiffs are a collection of trusts and investment companies affiliated with The Vanguard Group, Inc. (collectively, "Vanguard"). (Doc. 1 at ¶ 22). They acquired common stock of Defendant American Realty Capital Properties, Inc. ("ARCP" or "the

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[1] Most of the facts described below are drawn from the Complaint. Some, as noted, are drawn from public documents referred to in the Complaint such as ARCP's SEC filings, a verified complaint filed by Defendant McAlister in a separate case, and other court documents from related litigation, of all of which the Court takes judicial notice. *See Johnson v. Fed. Home Loan Mortgage Corp.*, 793 F.3d 1005, 1007 (9th Cir. 2015) ("[I]n ruling on a Rule 12(b)(6) motion, we may consider extrinsic evidence not attached to the complaint if the document's authenticity is not contested and the plaintiff's complaint necessarily relies on it."). The Court takes all allegations in the Complaint as true and construes them in the light most favorable to Plaintiffs. However, when matters subject to judicial notice are contrary to allegations, the Court need not accept those allegations as true. *Sprewell v. Golden State Warriors*, 266 F.3d 979, 988 (9th Cir. 2001), *as amended on denial of reh'g*, 275 F.3d 1187 (9th Cir. 2001).

1 Company"),[2] and stock of Scottsdale-based Cole Real Estate Investments, Inc. that was
2 later converted into ARCP stock as a result of a merger. (*Id.* at ¶ 23). ARCP is one of the
3 largest real-estate investment trusts ("REITs") in the world. (*Id.* at ¶ 1). ARCP conducted
4 substantially all its business through its operating partnership, Defendant ARC Properties
5 Operating Partnership L.P. ("the OP," collectively "ARCP/OP").[3] (*Id.* at ¶ 25). ARCP
6 owned nearly all equity interests in the OP and was its sole general partner. (*Id*). Both
7 ARCP and the OP are now headquartered in Phoenix. (*Id.* at ¶¶ 24-25). Plaintiffs sue
8 ARCP/OP for inflating the value of ARCP stock in a manner described below.

9 Plaintiffs also sue various former ARCP executives, (collectively, "the
10 Executives"). Defendant Nicholas S. Schorsch ("Schorsch") founded ARCP in 2010 and
11 acted as Chief Executive Officer ("CEO") and Chairman. (*Id.* at ¶ 26). Defendant Brian
12 S. Block ("Block") served as ARCP's Chief Financial Officer ("CFO") and Executive
13 Vice President ("EVP") beginning in December 2010. (*Id.* at ¶ 27). On November 4,
14 2013, Defendant Lisa Pavelka McAlister ("McAlister") began working as Senior Vice
15 President ("SVP") and Chief Accounting Officer ("CAO"). (*Id.* at ¶ 29). Three days later,
16 Defendant Lisa Beeson ("Beeson") started as Chief Operating Officer ("COO"). (*Id.* at ¶
17 30). In December 2013, Defendant David S. Kay ("Kay") became President of ARCP.
18 (*Id.* at ¶ 28). In January 2014, Block added the titles Treasurer and Secretary. (*Id.* at ¶
19 27).

20 The Executives held these various positions until October 1, 2014. On that date,
21 Schorsch resigned as CEO (but stayed on as Chairman), and Kay stepped down as
22 President and replaced Schorsch as CEO, while also taking a position on the Board. (*Id.*
23 at ¶¶ 26, 28). Beeson replaced Kay as President, while maintaining her position as COO.
24 (*Id.* at ¶ 30). In an October 29, 2014 press release discussed below, ARCP announced the
25 departure of Block and McAlister. (*Id.* at ¶¶ 27, 29, 78). On December 15, 2014, ARCP

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27 [2] ARCP is now called VEREIT, Inc., and is so named in the case caption.

28 [3] The OP is now called VEREIT Operating Partnership L.P., and is so named in the case caption.

announced the complete resignations of Schorsch, Kay, and Beeson. (*Id*. at ¶¶ 26, 28, 30, 85).

Finally, Plaintiffs also sue three similarly-named companies. Defendant ARC Properties Advisors LLC ("ARC Advisors") was ARCP's "external manager" until January 8, 2014. (*Id*. at ¶ 32). This means ARC Advisors provided ARCP, which had no direct employees, with its management team. (*Id*). ARC Advisors was owned and controlled by Defendant AR Capital LLC ("AR Capital") and Defendant RCAP Holdings, LLC ("RCS Capital"). (*Id*). Schorsch and Block part-owned and/or controlled AR Capital (*id*. at ¶ 33), and Schorsch was Chairman and CEO of RCS Capital. (*Id*. at ¶ 34).[4] ARC Advisors and AR Capital both have principal offices at the same Park Avenue address in New York, NY. (*Id*. at ¶¶ 32-33, 35). The Court will refer to these entities collectively as the "ARC Defendants." Plaintiffs allege ARCP paid the ARC Defendants over $1 billion over an undefined three-and-a-half year period for various supposed services. (*Id*. at ¶¶ 60-61). Plaintiffs claim these payments, or at least part of them, were part of "Defendants' fraudulent scheme to deceive shareholders in order to tax the Company with hundreds of millions of dollars in improper fees and services, thus lining the pockets of Schorsch, Block and other senior executives." (*Id*. at ¶ 62).

B. Adjusted Funds from Operations or "AFFO"

The core of Plaintiffs' claims concerns a metric called "adjusted funds from operations" or "AFFO." which is explained in the Complaint. ARCP promoted AFFO as a useful metric for investors, and ARCP would regularly point to its increasing AFFO as a reason to invest in the Company. (*Id*. at ¶ 45). It included the metric in all of its filings with the Securities and Exchange Commission ("SEC"). (*Id*. at ¶ 43). Specifically, it argued its AFFO was important for investors to evaluate the sustainability of its performance as compared with that of other similar companies, because AFFO adjusted

[4] Pursuant to a stipulation, Plaintiffs' claims against Defendant RCS Capital Corporation ("RCAP") have been dismissed. (Doc. 125).

1 for the Company's high level of merger and acquisition activity. (*Id*. at ¶ 42). For
2 example, in its 2013 Form 10-K[5], it stated:

3 By providing AFFO, we believe we are presenting useful information that
4 assists investors and analysts to better assess the sustainability of our
5 ongoing operating performance without the impacts of transactions that are
6 not related to the ongoing profitability of our portfolio of properties. We
7 also believe that AFFO is a recognized measure of sustainable operating
8 performance by the REIT industry. Further, we believe AFFO is useful in
9 comparing the sustainability of our operating performance with the sustainability of the operating performance of other real estate companies that are not as involved in activities which are excluded from our calculation.

10 (*Id*).

11 Plaintiffs acknowledge AFFO can be a useful metric for real estate-centric
12 businesses:

13 FFO [funds from operations] and AFFO are useful metrics for investors
14 because net income under GAAP [U.S. Generally Accepted Accounting
15 Principles] is calculated based on the assumption that assets will depreciate
16 over time, and that assumption is not necessarily true of real estate. FFO
17 excludes from net income gains (or losses) from sales of property, as well
18 as depreciation and amortization of real estate, in order to provide a
19 measure of operating profits that accounts for the fact that real estate
20 frequently increases in value over time rather than depreciating. AFFO, in turn, is calculated based on FFO with adjustments to make it a more accurate measure of the cash generated by a REIT, and its capacity to pay dividends to investors.

21 (*Id*. at ¶ 69). However, they allege ARCP inflated its reported AFFO in various ways. For
22 example, in calculating AFFO for properties that ARCP did not entirely own, the correct
23 methodology was to "mak[e] adjustments that are attributable only to the REIT's
24 proportional interest in the property." (*Id*. at ¶ 70). Since ARCP owned 96.1% of the OP,
25 it should have attributed a small share of the AFFO adjustments to the non-controlling

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[5] A Form 10-K is an annual report filed with the SEC, while a Form 10Q is a quarterly report. U.S. Securities and Exchange Commission, *Fast Answers: Form 10-K*, https://www.sec.gov/answers/form10k.htm; U.S. Securities and Exchange Commission, *Fast Answers: Form 10-Q*, https://www.sec.gov/answers/form10q.htm.

interests that owned the remainder. (*Id*. at ¶ 71). Instead, it "added back depreciation and other costs to its net income associated with the Operating Partnership as if it owned the Operating Partnership in its entirety," resulting in AFFO figures that were rosier than they should have been. (*Id*).

C. Cole Merger

Under Schorsch's leadership, ARCP's business model was to acquire freestanding, single-tenant commercial properties subject to so-called "net leases," in which the tenant bears costs like maintenance, taxes, and insurance, normally paid by a landlord. (*Id*. at ¶ 38). The Company went on an acquisition binge, growing to hold over $20.5 billion in assets by 2013, three years after Schorsch founded it. (*Id*. at ¶ 53). These acquisitions included a merger with Arizona-based rival Cole Real Estate Investments, Inc. ("Cole") for $11.2 billion. (*Id*. at ¶ 2). This deal, which Schorsch called "an epic transaction," represented ARCP's largest merger. (*Id*. at ¶¶ 55-56). The Company's SEC filings said the merger would result in "AFFO Growth." (*Id*. at ¶ 56). The merger agreement provided that Cole shareholders, including at least some of the Plaintiffs, could exchange their shares for 1.0929 shares of ARCP common stock, or $13.82 per share. (*Id*. at ¶ 55). Those Plaintiffs voted in favor of the merger and afterwards exchanged their Cole shares for ARCP shares. (*Id*. at ¶ 59).

D. October 29, 2014 Disclosures

On the morning of October 29, 2014, ARCP issued a press release announcing the conclusion of the Company's Audit Committee that its financial statements for the year 2013 and the first two quarters of 2014 "should no longer be relied upon" by investors because of errors in the AFFO calculations reported in those statements. (*Id*. at ¶ 76). Specifically, the Audit Committee found ARCP had incorrectly included certain amounts in its calculations, and that "this error was identified but intentionally not corrected, and other AFFO and financial statement errors were intentionally made, resulting in an overstatement of AFFO and an understatement of the Company's net loss for the three and six months end[ing] June 30, 2014." (*Id*. at ¶ 77).

The Committee also announced Defendants Block and McAlister would be leaving ARCP. (*Id.* at ¶ 78). ARCP stated "[t]he Audit Committee has indicated that nothing has come to its attention that leads it to believe that there are any errors in the Company's previously issued audited consolidated financial statements for [2013]," but had "expanded its investigation to encompass the Company's audited financial statements for this period in light of the fact that the Company's former Chief Financial Officer [Defendant Block] and former Chief Accounting Officer [Defendant McAlister] had key roles in the preparation of those financial statements." (Doc. 100-1 at 17). ARCP pledged to re-evaluate its internal controls to remedy any deficiencies with them. (Doc. 1 at ¶ 79). It then held a conference call in which Defendant Kay discussed the Audit Committee's findings. (*Id.* at ¶ 80).

Analysts and credit-rating agencies reacted negatively to the news. (*Id.* at ¶¶ 81-82). The FBI and U.S. Attorney's Office for the Southern District of New York ("S.D.N.Y.") opened a criminal investigation into the matter. (*Id.* at ¶ 83). ARCP's stock price fell from $12.38 on October 28, 2014, to $10.00 on October 29, 2014. (*Id.* at ¶ 84).

E. Schorsch, Kay, and Beeson Resign

On December 15, 2014, ARCP announced Defendants Schorsch, Kay, and Beeson had all resigned, and "made clear that the Company's Board of Directors wanted no further dealings with these executives." (*Id.* at ¶ 85). ARCP also announced it would unwind its relationships with Schorsch-affiliated entities. (*Id*).

F. McAlister Sues ARCP, Schorsch, and Kay

On December 18, 2014, Defendant McAlister filed a verified complaint ("McAlister complaint") in New York state court alleging Defendants ARCP, Schorsch, and Kay had defamed her in the October 29 press release. (*Id.* at ¶ 11; Doc. 75-2 at 5-15; Doc. 75-3 at 1-4). The Complaint in the case before the Court draws some allegations from the McAlister complaint. For example, McAlister alleged that beginning in February 2014, she "repeatedly informed" Defendants Schorsch and Kay and other unnamed managers about the incorrect method used in calculating AFFO for the fourth quarter of 2013, and possibly before that, "without any apparent justification or basis."

(Doc. 75-2 at ¶¶1-2). Further, she alleged this methodology was ordered by Schorsch and Kay, and was in place until July 28, 2014, when Schorsch directed Defendant Block to "take steps that would cover up the improper change in accounting," including an accounting change that while "not improper in and of itself . . . made it more difficult for stockholders to see the fraudulent" calculations going on. (*Id*. at ¶ 3).

G. March 2, 2015 Disclosures

On March 2, 2015, ARCP issued a press release and held an investor conference announcing the results of the Audit Committee's expanded investigation. (Doc. 1 at ¶ 87). ARCP admitted its internal controls for financial reporting and disclosure were deficient, and that as a result, it had overstated AFFO for "2011, 2012, 2013 (including each fiscal quarter of 2013) and the first two quarters of 2014." (*Id*. at ¶ 88). Since the Company was founded in 2010, this period amounted to essentially its entire history. These overstatements were as follows: 7.8% in 2011, 2.3% in 2012, 22.8% in 2013, 35% in the first quarter of 2014, and 10.4% in the second quarter of 2014. (*Id*). As a result of the investigation, ARCP amended its 2013 annual report and the first and second quarterly reports for 2014.

The Audit Committee also "identified certain payments made by the Company to [Defendant] ARC Properties Advisors and certain of its affiliates that were not sufficiently documented or otherwise warrant scrutiny." (*Id*. at ¶ 89). In addition, the Committee found that during ARCP's transition to self-management it had approved equity awards to certain of the Executives that "were inconsistent with the terms authorized by the Compensation Committee." (*Id*. at ¶ 90). Finally, ARCP acknowledged ongoing investigations by the SEC, the US Attorney's Office for S.D.N.Y. and the Secretary of the Commonwealth of Massachusetts. (*Id*. at ¶ 91).

PROCEDURAL HISTORY

A. Plaintiffs' Claims

Plaintiffs bring eight counts against various groups of Defendants. Counts 1 and 2 are brought under the Arizona Consumer Fraud Act ("ACFA"), which provides:

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> The act, use or employment by any person of any deception, deceptive or unfair act or practice, fraud, false pretense, false promise, misrepresentation, or concealment, suppression or omission of any material fact with intent that others rely on such concealment, suppression or omission, in connection with the sale or advertisement of any merchandise whether or not any person has in fact been misled, deceived or damaged thereby, is declared to be an unlawful practice.

A.R.S. § 44-1522(A). Count 1 alleges all Defendants violated of ACFA, which resulted in Plaintiffs paying artificially inflated prices for ARCP stock, while Count 2 asserts aiding and abetting liability against all Defendants other than ARCP.

In Count 3, Plaintiffs claim ARCP/OP and the Executives violated Section 10(b) of the 1934 Securities Exchange Act ("Exchange Act") and its implementing SEC Rule 10b-5. Section 10(b) makes it unlawful to:

> [U]se or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). Rule 10b-5 implements Section 10(b) by making it unlawful to:

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. §240.10b-5. "The basic elements of a Rule 10b–5 claim, therefore, are: (1) a material misrepresentation or omission of fact, (2) scienter, (3) a connection with the purchase or sale of a security, (4) transaction and loss causation, and (5) economic loss." *In re Daou Sys., Inc.*, 411 F.3d 1006, 1014 (9th Cir. 2005). The heightened pleading

standard of Rule 9(b) applies to each of the elements. *Oregon Pub. Employees Ret. Fund v. Apollo Grp. Inc.*, 774 F.3d 598, 605 (9th Cir. 2014).

In Counts 4, 6, and 7, the group of Plaintiffs who received ARCP shares in exchange for Cole shares (collectively, the "Cole Exchange Plaintiffs")[6] assert various claims arising out of the Cole Merger and Defendants' statements regarding the merger.

In Count 4, Plaintiffs claim ARCP/OP, Schorsch and Block violated Exchange Act Section 14(a) and SEC Rule 14a-9:

> Section 14(a) of the Exchange Act makes it unlawful to solicit a proxy "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78n(a). Rule 14a-9 prohibits the solicitation of a proxy by means of a proxy statement that contains a statement that "is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading." 17 C.F.R. § 240.14a-9(a). "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 449, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976). "In addition, a Section 14(a), Rule 14a-9 plaintiff must demonstrate that the misstatement or omission was made with the requisite level of culpability and that it was an essential link in the accomplishment of the proposed transaction." *Desaigoudar,* 223 F.3d at 1022 (footnote and citation omitted).

Seinfeld v. Bartz, 322 F.3d 693, 696–97 (9th Cir. 2003).

Count 6 alleges ARCP and all Executives except McAlister violated Section 11 of the Securities Act of 1933 ("Securities Act"). Section 11 authorizes actions for untrue statements or omissions of material fact in registration statements. 15 U.S.C. § 77k. Specifically, an action can be brought against anyone who signs the registration statement, who was a director of or partner in the issuer, anyone named as having prepared the statement, and every underwriter. *Id*. "The plaintiff in a § 11 claim must demonstrate (1) that the registration statement contained an omission or misrepresentation, and (2) that the omission or misrepresentation was material, that is, it

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[6] The group is delineated in the Complaint at ¶ 199.

1 would have misled a reasonable investor about the nature of his or her investment. . . . No
2 scienter is required for liability under § 11; defendants will be liable for innocent or
3 negligent material misstatements or omissions." *In re Daou*, 411 F.3d at 1027 (citations
4 and internal quotation marks omitted).[7]

5 Count 7 alleges ARCP/OP and all Executives except McAlister violated Section
6 12(a)(2) of the Securities Act. Section 12(a)(2) creates liability against anyone who:

7 offers or sells a security (whether or not exempted by the provisions
8 of section 77c of this title, other than paragraphs (2) and (14) of subsection
(a) of said section), by the use of any means or instruments of
9 transportation or communication in interstate commerce or of the mails, by
10 means of a prospectus or oral communication, which includes an untrue
statement of a material fact or omits to state a material fact necessary in
11 order to make the statements, in the light of the circumstances under which
12 they were made, not misleading (the purchaser not knowing of such untruth
or omission), and who shall not sustain the burden of proof that he did not
13 know, and in the exercise of reasonable care could not have known, of such
untruth or omission . . .
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15 15 U.S.C. § 77*l*(a)(2). "To establish liability under section 12(a)(2), a plaintiff must
16 allege that the defendants did more than simply urge another to purchase a security;
17 rather, the plaintiff must show that the defendants solicited purchase of the securities for
18 their own financial gain." *In re Daou*, 411 F.3d at 1029. Plaintiffs must also allege they
19 suffered a loss, but causation "is not a necessary element of a prima facie case." *Id.* But
20 section 12(a)(2) requires no scienter. *Miller v. Thane Int'l, Inc.*, 519 F.3d 879, 886 (9th
21 Cir. 2008).[8]

22 Finally, Counts 5 and 8 charge the OP, the Executives, and the ARC Defendants
23 with liability as "controlling persons" of ARCP, under Exchange Act Section 20(a) and
24 Securities Act Section 15. The former says any person who:

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26 [7] Plaintiffs "expressly disclaim any allegation that could be construed as alleging
27 fraud or intentional or reckless misconduct, as this claim is based solely on claims of
strict liability and/or negligence." (Doc. 1 at ¶ 299).
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[8] Plaintiffs make the same disclaimer as to intent as in Count 6. (Doc. 1 at ¶ 308).

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> directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable (including to the Commission in any action brought under paragraph (1) or (3) of section 78u(d) of this title), unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a). The latter similarly says any person who:

> by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77*l* of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to belie0ve in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77*o*(a).[9]

The controlling person analysis is the same under both sections. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1578 (9th Cir. 1990). Plaintiffs must allege both a primary violation of the underlying securities laws, and that Defendants "exercised actual power over the primary violator." *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046, 1052 (9th Cir. 2014).

B. Motion to Transfer

In addition to the various motions to dismiss, Defendants move to transfer venue to S.D.N.Y. (Doc. 74). Defendants describe nineteen actions pending there before Judge Hellerstein regarding the alleged misstatements revealed in the October 29, 2014 press release, and state Judge Hellerstein has already resolved one set of motions to dismiss in those cases. (*Id.* at 2-3). In fact, Defendants state this case is one of only two proceeding outside S.D.N.Y., the other in Maryland state court. (*Id.* at 3).

[9] Count 8 contains the same disclaimer as Counts 6 and 7.

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C. Motions to Dismiss

The principal motion to dismiss is made by ARCP and the OP (collectively "ACRP/OP"). (Doc. 75). They seek dismissal of the ACFA claims (Counts 1 and 2) because choice of law rules dictate applying non-Arizona law, which does not provide a remedy; that if Arizona law does apply, Plaintiffs have not pled a sufficient connection to Arizona; and that ACFA does not provide for aiding and abetting liability. They also argue Counts 3, 4, 6, and 7 (the securities law claims aside from controlling person liability) must be dismissed to the extent they are based on any alleged misstatements revealed for the first time in the March 2015 disclosures, because Plaintiffs have not adequately alleged loss causation resulting from the disclosures. They also argue Plaintiffs failed to plead facts giving rise to a strong inference of scienter as to any but a select group of misstatements, and so any claims regarding other alleged misstatements must be dismissed. Finally, it is argued that Counts 5 and 8 ("controlling person claims") must be dismissed for failure to adequately plead ARCP/OP controlled ARCP. The ARC Defendants raise similar arguments. (Doc. 80).

Executives Schorsch (Doc. 89), Beeson (Doc. 83), and Kay (Doc. 81) also filed substantial motions. Defendants Kay and Beeson argue Plaintiffs have not sufficiently pled she had the required scienter for Count 3. Kay also moves to strike certain of Plaintiffs' allegations, and argues after they are stricken the Complaint contains insufficient allegations of control to support the controlling person claims. Defendant Schorsch argues Count 7 should be dismissed against him for Plaintiffs' failure to adequately plead he was a statutory seller. The motions by Defendants McAlister (Doc. 84) and Block (Doc. 87) simply adopt the arguments and reasoning of other motions.

DISCUSSION

I. Transfer Motion is Denied

Defendants seek to transfer the case to S.D.N.Y. "For the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought or to any district or division to which all parties have consented." 28 U.S.C. § 1404(a). This statute requires

two inquiries. First, whether the action could have been brought in the proposed transferee district. To deny a transfer, the Court need not find definitely that the action could not have been brought elsewhere; transfer is inappropriate where even a "real issue" exists as to whether the plaintiff could have brought the case in the transferee forum. *Shutte v. Armco Steel Corp.*, 431 F.2d 22, 24 (3d Cir. 1970). If an action might have been brought in S.D.N.Y., the Court must examine whether considerations of convenience and justice support transferring the action. A district court has "broad discretion" in deciding whether to transfer. *Commodity Futures Trading Comm'n v. Savage*, 611 F.2d 270, 279 (9th Cir. 1979).

Plaintiffs say they could not have brought this case in S.D.N.Y. because the Securities Litigation Uniform Standards Act ("SLUSA") would deprive S.D.N.Y. of jurisdiction over Plaintiffs' state law claims. SLUSA provides:

(b) Class action limitations

> No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—
>
> **(1)** an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security . . .

15 U.S.C § 77p(b).

> "Covered class action" is defined to include:
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> **(ii)** any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which—
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> . . .
>
> **(II)** the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

15 U.S.C. § 77p(f)(2)(A). Thus, under SLUSA, where several lawsuits are "joined, consolidated, or otherwise proceed as a single action for any purpose," none of those suits can include a state law claim asserting "an untrue statement or omission of a material fact

in connection with the purchase or sale of a covered security." This is commonly referred to as "SLUSA preemption." *See*, *e.g.*, *Northstar Fin. Advisors Inc. v. Schwab Investments*, 779 F.3d 1036, 1050 (9th Cir.), *as amended on denial of reh'g and reh'g en banc* (Apr. 28, 2015).[10]

Plaintiffs note Defendant ARCP has argued in S.D.N.Y. that cases with coordinated briefing or discovery schedules are sufficiently consolidated to be subject to SLUSA preemption. (Doc. 97, Exh. A at 19-21, Exh. B. at 46-47). Defendants point out Judge Hellerstein denied ARCP's motions for SLUSA preemption. However, Judge Hellerstein's ruling against Defendant ARCP was only preliminary ("I have too many other things to do"), made from the bench, and without prejudice to a renewed motion. (Doc. 97, Exh. C. at 53-56). The Court is mindful of the unusual circumstances in this case, where ARCP is arguing here that it will fail to win SLUSA preemption in S.D.N.Y., even though it has already pursued that argument and successfully preserved its right to seek dismissal on that basis. If this case were transferred to S.D.N.Y, Defendants do not deny they would immediately move for dismissal of the ACFA claims.

Thus, the Court must decide whether SLUSA might realistically preempt state law claims where cases are placed on coordinated briefing or discovery schedules. For the purpose of this analysis, the Court assumes S.D.N.Y. would choose to coordinate this case with the others pending before it.

Plaintiffs cite several S.D.N.Y. decisions in which courts found SLUSA preempted claims because of similar levels of coordination. The most expansive is *Amorosa v. Ernst & Young LLP*, 672 F. Supp. 2d 493 (S.D.N.Y. 2009), which held the assignment of a case to the same judge handling related litigation was by itself sufficient to make the case a "covered class action." *Id.* at 517-18. In another, *In re Fannie Mae 2008 Sec. Litig.*, 891 F. Supp. 2d 458 (S.D.N.Y. 2012), the court held proceeding on the same motion schedule was sufficient to trigger SLUSA preemption. *Id.* at 480. These

[10] The Supreme Court has clarified that this description is not quite appropriate because "SLUSA does not actually pre-empt any state cause of action. It simply denies plaintiffs the right to use the class-action device to vindicate certain claims." *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 87 (2006).

cases, coupled with Judge Hellerstein's ruling ARCP could renew its motion, suggest the prospect of preemption is not at all remote. Because SLUSA would likely prohibit Plaintiffs from pursuing any state law claims in S.D.N.Y., this case could not have been brought there. And because "[s]ection 1404(a) only authorizes the transfer of an entire action, not individual claims, " *Almont Ambulatory Surgery Ctr., LLC v. UnitedHealth Grp., Inc.*, 99 F. Supp. 3d 1110, 1163 (C.D. Cal. 2015) (quoting *Chrysler Credit Corp. v. Country Chrysler, Inc.,* 928 F.2d 1509, 1518 (10th Cir. 1991)), the Court will deny the transfer.[11]

II. ACFA Claims (Counts 1 and 2)

ARCP/OP and the ARC Defendants raise various arguments as to Plaintiffs' ACFA claims. The Court will address them in turn.

a. Conflict of Laws

ARCP/OP argue ACFA does not apply because Arizona conflict of law principles dictate the application of the law of some other state, either New York, Pennsylvania, or Delaware. This argument fails for two reasons. First, ARCP/OP does not indicate which state's law it is properly to be applied. "Arizona courts apply the principles of the Restatement (Second) of Conflict of Laws (1971) to determine the controlling law for multistate torts." *Bates v. Superior Court of State of Ariz., In & For Maricopa Cnty.*, 156 Ariz. 46, 48 (1988). Restatement § 148 applies to torts of fraud and misrepresentation. It says where a defendant's misrepresentations and the plaintiff's reliance upon them occur in separate states, the following factors must be examined to determine which state has the most significant relationship: where the plaintiff received and acted in reliance upon the misrepresentations, where the defendant made them, and the parties' domicile (for individuals) or principle place of business and place of incorporation (for corporations). § 148(2).[12]

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[11] The Court, like Judge Hellerstein, has too much to do. However, the Court will keep this case.

[12] The comments in the Restatement provide further guidance on weighing these various factors. The place Plaintiffs received the misrepresentations "constitutes

This is a "necessarily fact intensive" inquiry, *Callies v. United Heritage Prop. & Cas. Ins. Co.*, No. 1 CA-CV 13-0189, 2014 WL 1048846, at *5 n.9 (Ariz. App. Mar. 18, 2014), and the Court has only the allegations in the Complaint upon which to base the analysis. ARCP/OP correctly note Plaintiffs do not allege they received or acted upon any alleged misrepresentation in Arizona. However, the Complaint does not give any indication at all as to where Plaintiffs allege they received or acted upon Defendants' alleged misrepresentations, nor for that matter, where Defendants' made such alleged misrepresentations. The Complaint does not allege where any of the Plaintiffs has its principal place of business, although it does state Plaintiffs are all incorporated in either Delaware or Pennsylvania. Plaintiffs allege ARCP/OP have their principal places of business in Arizona, which ARCP/OP admit, although they insist they only relocated here from New York after the alleged events giving rise to Plaintiffs' claims. The Complaint alleges two of the three ARC Defendants had their principal offices in New York (Doc. 1 at ¶¶ 32-33, 35), but does not allege the Executives' domiciles.

In sum, the factual record is far too thin to allow the Court to perform a meaningful conflict of laws analysis. This is unsurprising, since the case is only at the motion to dismiss stage. *Callies*, 2014 WL 1048846, at *5 n.9. ARCP/OP implicitly recognize as much, in that their motion spends only one paragraph on a truncated analysis of the applicable factors. (Doc. 75 at 21-22).[13] The motion is denied on this point.[14]

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approximately as important a contact as does the place where [Defendants] made the representations. On the other hand, this place is not so important a contact as is the place where [Plaintiffs] acted in reliance on [Defendants'] representations." § 148, *comment g*. However, Plaintiffs' "action in reliance provides a more important contact when it is confined to a single state than when it is divided among two or more." *Id*., *comment f*. Residence or principle place of business are of "substantial significance," and "the principal place of business is a more important contact than the place of incorporation." *Id*., *comment i*.

[13] The cases ARCP/OP cite resolving a conflict of laws issue at the motion to dismiss stage are inapposite because in each there were many more relevant allegations than there are here. *See Gradient Analytics, Inc. v. Biovail Corp.*, No. CV-10-0335-PHX-FJM, 2010 WL 2991573, at *4-6 (D. Ariz. July 26, 2010) (in a malicious prosecution

b. Connection to Arizona

In a related argument, ARCP/OP seek dismissal of the ACFA claims because they "lack a meaningful nexus with Arizona." (Doc. 75 at 24). They rely primarily upon one paragraph from an Arizona Court of Appeals case:

> The Consumer Fraud Act applies to acts committed within Arizona in violation of its provisions. Victims need not be Arizona residents in order for the state to enforce its statutes against a person or persons conducting business within the state. Arizona has the legitimate interest in insuring that local business is conducted honestly.

State ex rel. Corbin v. Goodrich, 151 Ariz. 118, 124 (App. 1986). The *Goodrich* court went on to hold ACFA applied to the sale of securities to Arizona residents over the phone by a Michigan company. *Id.* Thus, it did not hold ACFA applied only to acts committed *entirely* within Arizona, as ARCP/OP imply.[15]

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case, the complaint alleged where the prosecution took place); *CLN Properties, Inc. v. Republic Servs., Inc.*, 688 F. Supp. 2d 892, 897 (D. Ariz. 2010) (in a contract case, the Complaint alleged where the contracts were created, negotiated, and to be performed); *Smith ex rel. Estates of Boston Chicken, Inc. v. Arthur Andersen L.L.P.*, 175 F. Supp. 2d 1180, 1197 (D. Ariz. 2001) (broadly describing the relevant conduct as having mostly occurred in another forum).

[14] Plaintiffs argue the conflict of laws analysis is unnecessary because ACFA is a "blue sky law" and such laws are never in conflict. *See In re Countrywide Fin. Corp. Mortgage-Backed Sec. Litig.*, No. 2:11-CV-10414 MRP, 2012 WL 1322884, at *2 (C.D. Cal. Apr. 16, 2012) ("[i]f a transaction touches multiple states, it follows that multiple Blue Sky laws may apply simultaneously"). Yet, every case the Court has found discussing Arizona's "blue sky laws" cited to the ASA, not the ACFA. *See*, *e.g.*, *Shorey v. Arizona Corp. Comm'n*, 238 Ariz. 253, 257 (App. 2015), *review denied* (Apr. 11, 2016) ("The Arizona Securities Act (ASA), A.R.S. §§ 44–1801 through –2055, constitutes Arizona's 'blue-sky laws.'"); *see also Shivers v. Amerco*, 670 F.2d 826, 831 (9th Cir. 1982); *Little v. First California Co.*, No. CIV. 74-71 PHX., 1977 WL 1055, at *1 (D. Ariz. Oct. 17, 1977); *Jennings v. Woods*, 194 Ariz. 314, 322-23 (1999). Thus, while it is true that ACFA "provide[s] an additional avenue of relief to those aggrieved by securities act violations," *State ex rel. Corbin v. Pickrell*, 136 Ariz. 589, 592 (Ariz. 1983), the Court is unpersuaded that this exempts ACFA claims from conflict of laws questions whenever alleged securities fraud is the factual basis.

Further, Plaintiffs allege acts that have a substantial connection to Arizona, such as the Cole Merger and ARCP's subsequent operation out of Cole's former offices in Phoenix. (Doc. 1 at ¶ 21(c)). Plaintiffs allege they have an office employing over 2,000 people in Arizona, and that some of their investors who suffered from the alleged fraud are Arizona residents. (*Id.* at ¶ 21(e)-(f)). These allegations fit with "the purpose of the Consumer Fraud Act, which is to protect the public from deceptive acts." *State ex rel. Babbitt v. Goodyear Tire & Rubber Co.*, 128 Ariz. 483, 486 (App. 1981).

Finally, ARCP/OP argue Plaintiffs cannot bring an ACFA claim because they are not consumers. (Doc. 75 at 25 n.26). "[T]he legislature intended the consumer fraud act to provide an additional avenue of relief to those aggrieved by securities act violations." *State ex rel. Corbin v. Pickrell*, 136 Ariz. 589, 592 (Ariz. 1983). "As a result, any fraud in the sale of securities is also actionable under the Arizona Consumer Fraud Act." *Kingsley Capital Mgmt., LLC v. Sly*, No. CV-10-02243-PHX-NVW, 2013 WL 3967615, at *12 (D. Ariz. Aug. 2, 2013) (discussing *Pickrell*).

c. ARC Defendants' Motion

The ARC Defendants argue Plaintiffs have not pled the elements of an ACFA claim as to each of them individually, but instead relied on group pleading. While Rule 9(b) does not permit complete group pleading without any differentiation between defendants, "there is no absolute requirement that where several defendants are sued in connection with an alleged fraudulent scheme, the complaint must identify *false statements* made by each and every defendant." *Swartz v. KPMG LLP*, 476 F.3d 756, 764 (9th Cir. 2007) (emphasis in original). Instead, the Complaint must "identif[y] the role of [each] defendant[ ] in the alleged fraudulent scheme." *Id.* (quoting *Moore v. Kayport Package Express, Inc.*, 885 F.2d 531, 541 (9th Cir.1989)). As described, *supra* at 1-3, the Complaint does outline the relationships between the ARC Defendants, the Executives

[15] In reply, ARCP/OP seem to indicate that applying ACFA here would violate the Dormant Commerce Clause. (Doc. 106 at 19 n.20). This argument will not be considered because it was first raised in reply. *Menchaca v. Maricopa Cmty. Coll. Dist.*, 595 F. Supp. 2d 1063, 1073 n.6 (D. Ariz. 2009).

who controlled them, and ARCP/OP. These allegations are sufficient to meet the burden under Rule 9(b). Count 1 will proceed.

d. Aiding and Abetting Liability

Defendants argue Count 2 must be dismissed because ACFA does not support aiding and abetting liability. They rely upon a recent Arizona Supreme Court case holding there is no aiding and abetting liability under the Arizona Securities Act ("ASA"), A.R.S. § 44-1801 to § 44-2126. *See Sell v. Gama*, 231 Ariz. 323 (2013). In that case, the Arizona Supreme Court placed great emphasis on the fact that other Arizona statutes expressly recognize aiding and abetting liability, while the ASA does not. *Id*. at 328 ¶¶ 20-21. ACFA is similarly silent on the subject. The court also noted, "aiding and abetting liability reaches persons who do not engage in the proscribed activities at all . . . ." *Id*. at 326 ¶ 11 (quoting *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994)). Since ACFA only prohibits the "act, use or employment" of various fraudulent techniques, § 44-1522(a), that skepticism towards expanding liability seems equally applicable here. Following *Sell*, it appears unlikely Arizona courts would permit an aiding and abetting claim under ACFA to go forward.

Plaintiffs counter that ACFA explicitly states the Arizona legislature's intent that "the courts may use as a guide interpretations given by the federal trade commission and the federal courts to [the FTC Act]." A.R.S. § 44-1522(c). The Commission has said "[i]t is well established that one who puts into the hands of others the means by which such others may deceive the public is equally as responsible for the resulting deception." *In Re Litton Indus., Inc.*, 97 F.T.C. 1 (1981) (collecting cases). Regardless, Plaintiffs concede Count 2 is "unnecessary" because Count 1 already asserts a primary ACFA violation against all Defendants. (Doc. 99 at 82 n.54). Count 2 will be dismissed and Plaintiffs' request for leave to amend the Complaint to delete Count 2 (*id*.) is moot.

III. Loss Causation (Counts 3, 4, 6, and 7)

ACRP/OP argue Plaintiffs do not sufficiently plead loss causation, a necessary element for Counts 3 and 4. *Oregon Pub. Employees Ret. Fund v. Apollo Grp. Inc.*, 774 F.3d 598, 603 (9th Cir. 2014) (required under Exchange Act Section 10(b)); *New York*

City Employees' Ret. Sys. v. Jobs, 593 F.3d 1018, 1022 (9th Cir. 2010) *overruled on other grounds by Lacey v. Maricopa Cnty.*, 693 F.3d 896 (9th Cir. 2012) (required under Section 14(a)). "Loss causation is established if the market learns of a defendant's fraudulent act or practice, the market reacts to the fraudulent act or practice, and a plaintiff suffers a loss as a result of the market's reaction." *In re Oracle Corp. Sec. Litig.*, 627 F.3d 376, 392 (9th Cir. 2010). Allegations of loss causation are subject to the heightened pleading standards of Rule 9(b). *Oregon Pub.*, 774 F.3d at 605.

Loss causation is not a required element for Counts 6 and 7; its clear absence is an affirmative defense. Therefore, these Counts may be dismissed only if "it is evident on the face of the complaint that loss causation could not be established." *In re Charles Schwab Corp. Sec. Litig.*, 257 F.R.D. 534, 548 (N.D. Cal. 2009) (Count 7); *see also In re Shoretel Inc., Sec. Litig.*, No. C 08-00271 CRB, 2009 WL 248326, at *4-5 (N.D. Cal. Feb. 2, 2009).

ARCP/OP argue Plaintiffs cannot establish loss causation based on any misstatements not disclosed in the October 2014 press release. While Plaintiffs allege ARCP's stock price fell immediately after the October 2014 disclosures, suggesting the market reacted to the disclosures therein, they also allege the price *rose* slightly in the days following the March 2015 disclosures, and ARCP/OP argue this is "fatal" to Plaintiffs' claims. They emphasize the October 2014 disclosures stated, "[n]othing has come to the attention of the Audit Committee that leads it to believe" there were errors in pre-2014 reports. However, this ignores ARCP's warning to investors not to rely upon past financial reports, and the announcement that the Audit Committee's investigation could prompt "further required adjustments." Plaintiffs argue the market did not react (or did not react negatively) to the March 2015 disclosures and restatements because investors were warned earlier that none of ARCP's past financial reports were reliable.

The Ninth Circuit has recently found loss causation adequately pled on such a theory. *Lloyd v. CVB Fin. Corp.*, 811 F.3d 1200 (9th Cir. 2016). In that case, the announcement of an investigation and subsequent stock price drop was followed by a disclosure related to that investigation which triggered only a "minimal effect" on the

stock price. *Id.* at 1210. The Court held this was sufficient to allege loss causation because the earlier drop plausibly "reflected, at least in part, the market's concerns" about the subject of the investigation. *Id.* Thus, Plaintiffs have adequately pled loss causation as to the earlier financial reports. The same is true of the March 2015 revelation that ineffective internal controls led to the implementation of an unauthorized executive compensation scheme and insufficiently documented deals with the ARC Defendants. The October 2014 press release stated the investigation would look into internal controls, so the *Lloyd* analysis applies. Further, the market could reasonably have inferred that a company that had filed admittedly questionable financial reports since its founding might not have sound internal controls.

Since Plaintiffs have adequately pled loss causation, ARCP/OP's motion is denied on that point.

IV. Scienter (Count 3)

For their securities fraud claims, Plaintiffs "must 'allege that the defendants made false or misleading statements either intentionally or with deliberate recklessness.'" *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 991 (9th Cir. 2009), *as amended* (Feb. 10, 2009) (quoting *In re Daou*, 411 F.3d at 1014-15). They must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C.A. § 78u-4(b)(2)(A). The Supreme Court has explained what is required to make an inference "strong":

> It does not suffice that a reasonable factfinder plausibly could infer from the complaint's allegations the requisite state of mind. Rather, to determine whether a complaint's scienter allegations can survive threshold inspection for sufficiency, a court . . . must engage in a comparative evaluation; it must consider, not only inferences urged by the plaintiff . . . but also competing inferences rationally drawn from the facts alleged. An inference of fraudulent intent may be plausible, yet less cogent than other, nonculpable explanations for the defendant's conduct. To qualify as "strong" . . . an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.

Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007). This is a holistic inquiry into "whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." *Id.* at 323; *see also S. Ferry LP, No. 2 v. Killinger*, 542 F.3d 776, 784 (9th Cir. 2008) ("[t]he Supreme Court's reasoning in Tellabs permits a series of less precise allegations to be read together to meet the PSLRA requirement"). The ultimate question is, "[w]hen the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter at least as strong as any opposing inference?" *Id.* at 326.[16]

a. Defendant Kay's Motion to Strike

Defendant Kay first moves to strike a number of allegations that are drawn from the McAlister complaint. The McAlister complaint was verified and based on personal knowledge, meaning it could have been used in the McAlister litigation as an affidavit opposing summary judgment. *Schroeder v. McDonald*, 55 F.3d 454, 460 (9th Cir. 1995).

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[16] At times, the Ninth Circuit has required courts follow a two-step process in which the Court first decides whether any of the allegations, standing alone, is sufficient to create a strong inference, and if not, conducts a holistic review. *See*, *e.g.*, *New Mexico State Inv. Council v. Ernst & Young LLP*, 641 F.3d 1089, 1095 (9th Cir. 2011). However, the Ninth Circuit itself has not always followed this procedure, and sometimes proceeds directly to the holistic review. *See*, *e.g.*, *Reese v. Malone*, 747 F.3d 557, 569-72 (9th Cir. 2014); *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1051-53 (9th Cir. 2011). The Ninth Circuit has recognized this inconsistency, and reaffirmed that Supreme Court precedent requires a holistic review, while also holding the two-step analysis "remains permissible." *In re VeriFone Holdings, Inc. Sec. Litig.*, 704 F.3d 694, 702-03 (9th Cir. 2012). It also noted the often-limited utility of the two-step approach:

> In cases where an individual allegation meets the scienter pleading requirement, whether we employ a dual analysis is most likely surplusage because the individual and the holistic analyses yield the same conclusion. Also, as a practical matter, some grouping and discussion of individualized allegations may be appropriate during a holistic analysis.

Id. at 702. The Court will follow the example of *VeriFone*, and "approach this case through a holistic review . . . [but] . . . not simply ignore the individual allegations and the inferences drawn from them." *Id.* at 703.

The allegations drawn from the McAlister complaint are not wholly detached from the rest of the allegations in the Complaint, but instead form a coherent narrative. This is sufficient to suggest a reasonable belief that they may find "evidentiary support after a reasonable opportunity for further investigation or discovery." Fed. R. Civ. P. 11(b).

Kay argues the McAlister complaint is unreliable for several reasons: the proximity between filing the complaint and her firing from ARCP, her identification by ARCP and Kay as at least partly responsible for the AFFO misreporting (the core of her defamation claim), her financial motive for filing a complaint, and her voluntary dismissal of the complaint. (Doc. 81 at 11-14). If courts treated as unreliable any defamation complaint that was filed soon after the alleged defamation occurred, set forth a claim based on actual events, and sought damages, defamation effectively would no longer exist as a cause of action. As Kay surely knows, there are many reasons for a plaintiff to withdraw their complaint that do not speak to its underlying merit. The motion to strike will be denied.

b. Defendants Kay and Beeson's Motions to Dismiss

Defendants Kay and Beeson argue Count 3 must be dismissed for Plaintiffs' failure to adequately plead they possessed the requisite scienter. Defendant Kay's motion is largely predicated on the McAlister complaint allegations being stricken, but he also argues three facts should be sufficient to overcome any inference of scienter: 1) he had no prior connection to ARCP, Schorsch, or the ARC Defendants before joining ARCP as President in December 2013, 2) he made large purchases of ARCP stock during his employment and was compensated largely with stock, and 3) ARCP itself never identified Kay as involved in the alleged misrepresentations. (Doc. 81 at 11-14). Beeson also relies on the latter two facts.

It is true the Complaint alleges no connection between Defendant Kay and the other Defendants before he joined ARCP, but that weighs only slightly against the plausibility of scienter – the Court does not expect every fraud is committed by old friends. The stock purchases are not pled in the Complaint and are therefore not properly before the Court at this time, Fed. R. Civ. P. 12(d), but even if they were, the purchase

1 and acceptance of stock as compensation at allegedly inflated values is consistent with
2 scienter if Kay and Beeson "believed they could have continued to hide the fraud."
3 *Kyung Cho v. UCBH Holdings, Inc.*, 890 F. Supp. 2d 1190, 1202 n.2 (N.D. Cal. 2012).
4 Finally, it is true ARCP did not point to Kay or Beeson as participants in the alleged
5 fraud, even while it has done so with Defendants Block and McAlister. However, the
6 same can be said of Defendant Schorsch, the alleged mastermind of the entire scheme.
7 ARCP's selective finger pointing might signal Defendants Block and McAlister are the
8 only Executives at fault, or it might be an effort to deflect blame. It is not enough to
9 defeat the pleading of scienter.

10 Kay might prevail if Plaintiffs had made only general allegations as to his
11 knowledge and actions, but Plaintiffs say more. They allege he and Schorsch ordered
12 McAlister to calculate AFFO improperly (Doc. 1 at ¶ 11), and not to correct false
13 financial statements (*id*. at ¶ 73), while promoting ARCP's AFFO to potential investors
14 (*id*. at ¶ 45). Plaintiffs also allege Kay and Schorsch ordered Block and McAlister to alter
15 the method used to calculate AFFO to make it more difficult for investors to discover the
16 fraud. (*Id*. at ¶ 74). These allegations are more than enough to create a cogent inference
17 of scienter, and Kay's motion is denied on this point.[17]

18 Plaintiffs' allegations against Beeson are not nearly as robust, so the question is
19 much closer as to her. Plaintiffs emphasize her role as Chief Operating Officer (*id*. at ¶¶
20 30, 260), and point to her various optimistic statements about ARCP's operations and
21 prospects (*id*. at ¶¶ 202, 219, 224, 232). They allege Beeson was one of the people
22 McAlister told about the AFFO miscalculations in February 2014. (*Id*. at ¶ 260).[18] If
23 McAlister did tell Beeson about the miscalculations, the Complaint does not allege
24 Beeson understood them to be fraudulent, or what Beeson did with this information.
25 Finally, Plaintiffs point to the timing of Beeson's departure – and that of the other

26 [17] Kay moves to dismiss Counts 6 and 7 for the same reason. His motion is
27 therefore denied as to those Counts as well.

28 [18] It is unclear what the basis for this allegation is, since it does not appear to be
drawn from the McAlister complaint.

Executives – from ARCP as suggestive of her intentional involvement. (*Id*. at ¶ 260(h)). "Where a resignation occurs slightly before or after the defendant corporation issues a restatement, a plaintiff must plead facts refuting the reasonable assumption that the resignation occurred as a result of restatement's issuance itself in order for a resignation to be strongly indicative of scienter." *Zucco*, 552 F.3d at 1002. In other words, when a company announces some trouble and the corresponding firing or resignation of certain employees, the most natural inference is that the employees were let go for their performance, rather than something more nefarious. *Id*. Plaintiffs have pled adequate facts to refute this inference. Therefore, Count 3 against Beeson will be dismissed for failure to adequately plead scienter.

c. ARCP/OP's Motions to Dismiss

ARCP/OP do not challenge the sufficiency of Plaintiffs' pleadings with respect to the matters disclosed on October 29, 2014, namely that ARCP intentionally misreported AFFO in the first and second quarters of 2014. However, ARCP argues Plaintiffs have not pled enough facts to support scienter for the misrepresentations preceding the first quarter 2014 filing. (Doc. 75 at 15-20). For that reason, ARCP moves to dismiss Count 3 to the extent it relates to conduct predating that filing and not disclosed in the October 2014 disclosures. (*Id*. at 26).

Plaintiffs frame the inquiry correctly: is an inference that the same Company and Executives that is alleged to have intentionally or with deliberate recklessness made misstatements as to the first and second quarters of 2014 were also intentional or deliberately reckless in making misstatements before 2014 "at least as strong as any opposing inference?" *Tellabs*, 551 U.S. at 326. (Doc. 99 at 37). To limit Count 3 in the manner ARCP suggests, the Court would have to find the stronger inference is that Defendants acted intentionally or with deliberate recklessness beginning only in 2014.

Two basic allegations stand out as the most relevant: 1) the misreporting of AFFO was present in each reporting period starting with ACRP's founding, and 2) certain Executives allegedly took steps to cover up the errors once McAlister discovered them. ARCP only mentions the former, arguing the March 2015 admission that AFFO had been

misreported from ARCP's inception is insufficient without "specific allegations that the defendants had actual knowledge of relevant facts from which scienter could be inferred." *In re U.S. Aggregates, Inc. Sec. Litig.*, 235 F. Supp. 2d 1063, 1073 (N.D. Cal. 2002); (Doc. 75 at 17). The alleged cover-up (Doc. 1 at ¶ 74) is such a fact. Combined with the Executives' regular touting of AFFO as a reason to invest in ARCP (*e.g.*, *id*. at ¶ 45), that ARCP knew it was misreporting AFFO the entire time is at least as plausible an inference from these facts as anything else. ARCP/OP's motion is denied on this point.

VII. Statutory Seller (Count 7)

Defendant Schorsch argues Plaintiffs have failed to plead he was a "statutory seller" for the purposes of Count 7. Section 12(a)(2) of the Securities Act imposes liability both on "the owner who passe[s] title, or other interest in the security, to the buyer for value," (which Plaintiffs admit Schorsch did not do) and one "who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner" (which Plaintiffs say Schorsch did). *Pinter v. Dahl*, 486 U.S. 622, 642, 647 (1988). The extension of liability to solicitors is part of Congress' intent that liability under Section 12(a)(2) be *in terrorem*. *Id*. at 646. As the Supreme Court explained, solicitation is an important part of many securities transactions:

> The solicitation of a buyer is perhaps the most critical stage of the selling transaction. It is the first stage of a traditional securities sale to involve the buyer, and it is directed at producing the sale. In addition, brokers and other solicitors are well positioned to control the flow of information to a potential purchaser, and, in fact, such persons are the participants in the selling transaction who most often disseminate material information to investors.

Id. However, the Court declined to extend liability to persons whose actions are only a "substantial factor" is causing a transaction to take place. *Id*. at 649-654. It did so largely because such a test would "extend [section 12] liability to participants only remotely related to the relevant aspects of the sales transactions. Indeed, it might expose securities professionals, such as accountants and lawyers, whose involvement is only the performance of their professional services." *Id*. at 651.

1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28

A few decisions from other circuits, but not from the Ninth Circuit, have added glosses to these statements. For example, the Third Circuit says "[t]he purchaser must demonstrate direct and active participation in the solicitation of the immediate sale to hold the issuer liable as a [§ 12(a)(2)] seller." *Craftmatic Sec. Litig. v. Kraftsow*, 890 F.2d 628, 636 (3d Cir. 1989). The Fifth Circuit says "preparing a prospectus and conducting a road show" are insufficient to convert an issuer into a statutory seller, *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.,* 238 F.3d 363, 370 (5th Cir. 2001), and that "[t]o count as 'solicitation,' the seller must, at a minimum, directly communicate with the buyer." *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 871 (5th Cir. 2003).

As a preliminary matter, Schorsch argues Rule 9(b) applies to Plaintiffs' statutory seller allegations, while Plaintiffs insist it is limited to misrepresentations, and Schorsch's alleged solicitation is subject to the ordinary requirements of Rule 8(a). No circuit court has addressed this question directly. "Where averments of fraud are made in a claim in which fraud is not an element, an inadequate averment of fraud does not mean that no claim has been stated. The proper route is to *disregard* averments of fraud not meeting Rule 9(b)'s standard and then ask whether a claim has been stated." *Vess*, 317 F.3d at 1105 (quoting *Lone Star Ladies,* 238 F.3d at 368 (emphasis added in *Vess*)). The present scenario is not quite the one imagined in *Vess* and *Lone Star Ladies*; Schorsch's arguments are not aimed at allegations of fraud, but the allegations of solicitation. However, since the acts creating statutory seller liability can be committed negligently, *see Miller*, 519 F.3d at 886, the rationale of *Vess* points to Rule 9(b) being inapplicable to Plaintiffs' statutory seller allegations.

Proceeding to the allegations in the Complaint, the parties essentially agree on which allegations are relevant. First, Plaintiffs allege Schorsch, along with ARCP/OP, Kay, Block, and Beeson, "were statutory sellers who sold and assisted in the sale of securities to Plaintiffs by means of the defective Prospectus and did so for personal gain." (*Id.* at ¶ 312). This conclusory allegation adds nothing, since "a formulaic recitation of the elements of a cause of action will not do." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 555 (2007). Plaintiffs also allege Schorsch "signed or authorized the signing of the

Registration Statement and Prospectus, and participated in the preparation and dissemination of the Registration Statement and Prospectus." (*Id.* at ¶ 303). The Ninth Circuit has not addressed whether this type of allegation, without more, is sufficient, but Schorsch cites the apparently unanimous decisions of other circuits holding it is not. *See Rosenzweig*, 332 F.3d at 871; *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1216 (1st Cir. 1996); *Craftmatic*, 890 F.2d at 636. The picture is different when looking at district courts in the Ninth Circuit, which the parties' collected cases show are divided on the question. (Doc. 89 at 6-7; Doc. 99 at 55-56). Regardless, signing these documents is not Schorsch's *only* alleged participation in these transactions.

Plaintiffs' other allegations center on Schorsch's alleged promotion of the Cole Merger to investors, via press releases (*id.* at ¶¶ 159-60, 200), and conference call (*id.* at ¶¶ 161-62). For example, on a conference call held the day ARCP and Cole announced their merger, Schorsch allegedly said:

> This is an epic transaction, great companies combining in a win-win to the shareholders, the employees and the broker dealer systems that we work with. The portfolios just fit. They fit very, very well. We are a much stronger company.

(*Id.* at ¶ 161). Plaintiffs also allege other, more specific statements by Schorsch about ARCP's "leverage" and "acquisition pipeline," that can be reasonably understood as marketing to investors. (*Id.* at ¶ 162). Schorsch calls these statements "hornbook inactionable statements under the securities laws: forward-looking statements, puffery, general statements of corporate optimism, statements of opinion or belief, and true statements of historical performance." (Doc. 89 at 8). But those critiques are actually indicative that Schorsch was trying to market ARCP to investors, since "speech found to be puffery almost always seeks to encourage consumption." David A. Hoffman, *The Best Puffery Article Ever*, 91 Iowa L. Rev. 1395, 1400 (2006). Schorsch's critiques might be relevant to whether his statements qualify as material misrepresentations, if that were the issue before the Court, but it is not. *See*, *e.g.*, Restatement (Third) of Torts: Liab. for Econ. Harm § 9 cmt. d (Tentative Draft No. 2, 2014) (describing puffery as excluded from liability by fraud's materiality element); Hoffman, 91 Iowa L. Rev. at 1400

("'puffery' is that it is a defense to a charge of misleading purchasers of goods, investments, or services").

Ultimately, however, Plaintiffs make no effort to distinguish the cases holding participation in a "road show" is insufficient. *See Lone Star Ladies*, 238 F.3d at 370; *In re CytRx Corp. Sec. Litig.*, No. CV141956GHKPJWX, 2015 WL 5031232, at *15 (C.D. Cal. July 13, 2015). Notably, *Lone Star Ladies* held conducting a road show, even in combination with preparing a prospectus, was not enough. *Id.* at 370. Plaintiffs say these cases "do not diminish the significance of the alleged promotion in press releases and on investor calls," (Doc. 99 at 56 n. 35) but give no reason why that should be so. Conference calls with investors are analogous to road shows, and the Court sees no reason they should be treated any differently. Lacking any more "direct and active participation in the solicitation of [an] immediate sale," *Craftmatic*, 890 F.2d at 636, Plaintiffs' allegations are insufficient to plead Schorsch is a statutory seller. Defendants Beeson and Block joined Schorsch's motion on this point. (Doc. 83 at 7; Doc. 87 at 2-3 n.2). The allegations against Block are similar to those against Schorsch, and those against Beeson are far less specific. Count 7 will therefore be dismissed against each of these three Executives.

VI. Controlling Person Liability (Counts 5 and 8)

For Counts 5 and 8, Plaintiffs must allege both a primary violation of the underlying securities laws, and that Defendants "exercised actual power over the primary violator." *In re NVIDIA*, 768 F.3d at 1052; *Hollinger*, 914 F.2d at 1578 (standards are the same for both Counts).[19] "Whether [a defendant] is a controlling person 'is an intensely

[19] Various Defendants argue the Rule 9(b) pleading standards should apply to Plaintiffs' controlling person allegations, but they do not, for the same reason they do not apply to the statutory seller allegations. *See supra* at 27. Further, since "culpable participation" is not an element of controlling person liability, *Hollinger*, 914 F.2d at 1575, the "circumstances constituting fraud" are best understood as limited to the primary violator's actions, not those of the controlling person. The ARC Defendants argue culpable participation is an element of Count 8, if not Count 5, but *Hollinger* stated "[a]lthough § 15 is not identical to § 20(a), the controlling person analysis is the same." *Id.* at 1578. One case the ARC Defendants cite to the contrary, *In re White Elec. Designs*

factual question,' involving scrutiny of the defendant's participation in the day-to-day affairs of the corporation and the defendant's power to control corporate actions." *Kaplan v. Rose*, 49 F.3d 1363, 1382 (9th Cir. 1994) (quoting *Arthur Children's Trust v. Keim,* 994 F.2d 1390, 1396–97 (9th Cir.1993)). Under SEC regulations, "control" is "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405. "[S]ome indicia" of "control over the management and policies" or "day-to-day affairs" of the allegedly-controlled entity is a necessary element. *Paracor Fin., Inc. v. Gen. Elec. Capital Corp.*, 96 F.3d 1151, 1163 (9th Cir. 1996) (internal quotation marks omitted). "[T]raditional indicia of control" include a prior lending relationship, stock ownership, and having a seat on the board of the controlled entity. *Id*. at 1162.[20]

The Court proceeds first to the claims against the ARC Defendants. A few allegations factor into the analysis for each Defendant. For example, Schorsch allegedly held leadership positions in each of the ARC Defendants. However, this would only be relevant if Plaintiffs alleged Schorsch used those positions to control ARCP, rather than his own influence within the Company, so it alone adds nothing to the analysis. Further, the Court will ignore conclusory allegations such as that a Defendant "had the power to influence and control, and did influence and control, directly or indirectly, the decision-making of ARCP." (Doc. 1 at ¶ 320); *Twombly*, 550 U.S. at 555. On the other hand, ARCP in (unspecified) SEC filings, allegedly described ARC Advisors and its parent companies (which are alleged to be AR Capital and RCS Capital, *supra* at 3) as having "the power to direct the activities of ARCP through advisory/management agreements."

Corp. Sec. Lit., 416 F. Supp. 2d 754, 765 (D. Ariz. 2006), relied on pre-*Hollinger* case law, while the other, *New York City Employees' Ret. Sys. v. Berry*, 616 F. Supp. 2d 987, 1002 (N.D. Cal. 2009), did not affirmatively state culpable participation is an element. Regardless, this Court is bound by *Hollinger*.

[20] Various Defendants move to dismiss Counts 5 and 8 for failure to plead a primary violation. Since Plaintiffs' primary claims under the securities laws will not be dismissed, these arguments fail.

(Doc. 1 at ¶ 32). Although the Complaint says nothing else about the filings, this alleged public admission goes a long way towards pleading control. Still, whether Plaintiffs have pled enough depends on the allegations against each Defendant.

a. ARC Advisors

Plaintiffs allege "ARC Advisors provided ARCP with its management team, support personnel and resources necessary to implement and execute ARCP's business and growth strategies," and that ARCP "had no employees" of its own. (*Id.* at ¶ 32). ARC Advisors argues this is not enough, in part because the Complaint does not identify the personnel it allegedly provided ARCP. (Doc. 80 at 16). This is mistaken. The Complaint specifically states, "ARCP's CEO, President and CIO were all employed by ARC Advisors." (Doc. 1 at ¶ 32). This also undercuts ARC Advisors' argument that the Complaint does not allege ARC Advisors had any control over ARCP's strategies. It may be the case that the CEO and President had no control over such matters, but that mere possibility does not defeat Plaintiffs' adequate pleading.[21] Further, ARC Advisors' argument that the ARCP Board exercised some control over ARCP does not vitiate Plaintiffs' allegations of ARC Advisors' own control.

Finally, the Court will not, as ARC Advisors argues, dismiss the controlling person claims against ARC Advisors simply because the Complaint alleges, "ARCP purportedly transitioned to self-management on January 8, 2014." (*Id.* at ¶ 32). First, the Complaint also alleges, "ARCP continued to rely on ARC Advisors for at least 60 days, extendable indefinitely at ARCP's discretion, to provide the same services that had previously been provided to ARCP under the old management agreement." (*Id*). Second, the underlying premise of ARC Advisors' argument (that the Complaint does not allege any primary violations before January 8, 2014) has been rejected by the Court. Plaintiffs have sufficiently pled controlling person liability as to ARC Advisors.

[21] In reply, ARC Advisors note the Complaint does not state these employees acted on ARC Advisors' behalf. (Doc. 104 at 13). However, since the very nature of the alleged relationship between ARC Advisors and ARCP was that the former provided management staff to ARCP, it would be strange to infer that the staff did not work on ARC Advisors' behalf in some sense.

b. AR Capital and RCS Capital

As noted, AR Capital and RCS Capital are alleged to be parent companies of ARC Advisors. However, the Complaint does not allege if or how AR Capital had control over ARC Advisors. As for AR Capital's relationship to ARCP, Plaintiffs only allege the former "purported to provide management and advisory services to ARCP." (*Id*. at ¶ 33). They do not allege AR Capital *actually provided* these services. Plaintiffs allege RCS Capital was ARCP's financial advisor on the Cole Merger, and in the course of that work attended ARCP board meetings and participated in discussions about the sale of Cole shares. (*Id*. at ¶ 64).[22] This alone does not amount to control.

Because AR Capital's and RCS Capital's alleged relationships with ARCP are more attenuated than that between ARC Advisors and ARCP, and because the other allegations of AR Capital's and RCS Capital's control are sparser, this is a much closer question than it was for ARC Advisors. However, ARCP's alleged admission that ARC Advisors and its parent companies (including AR Capital and RCS Capital) directed ARCP's activities, combined with the "intensely factual" nature of the inquiry, *Kaplan*, 49 F.3d at 1382, are sufficient to permit Plaintiffs discovery on this issue. The Court finds Plaintiffs have adequately pled controlling person liability as to AR Capital and RCS Capital.

c. The Operating Partnership

The OP argues because it was almost entirely owned by ARCP, the OP's general partner, it *per se* could not control ARCP. (Doc. 75 at 20-21). In other words, it says the allegations support the idea that ARCP controlled the OP, but not the opposite. Plaintiffs say they named the OP in Counts 5 and 8 because it was the entity that conducted

[22] The ARC Defendants argue this allegation confuses RCS Capital for another entity, a division of Realty Capital Securities, LLC because ARCP labelled that entity "RCS Capital" in its SEC filings related to the Cole Merger. (Doc. 80 at 21-22). The Court has examined the SEC filings Defendants point to (Doc. 80-2 at 5-6, 24-25), and it appears the ARC Defendants may be correct. However, since the Complaint does not state the source of the information in the allegation at ¶ 64, it is not clear the allegation is based upon a misreading of the SEC filings, and it may be based on other evidence. The Court thus takes the allegation as true. *Sprewell*, 266 F.3d at 988.

ARCP's business. (Doc. 99 at 70). That is not the allegation in the Complaint, which says ARCP's business is conducted *through* the OP. (Doc. 1 at ¶ 25). Exchange Act Section 20(a) and Securities Act Section 15 refer to whoever "controls any person" liable under the securities laws, not the entity through which that person conducts its business. The controlling person claims, Counts 5 and 8, against the OP will therefore be dismissed.

d. Kay

Kay is the only Executive to argue Plaintiffs fail to state a controlling person claim against him for reasons other than failure to state a primary violation. (Doc. 81 at 15-17).[23] His motion is largely predicated on the allegations from the McAlister complaint being stricken, and the Court has determined they will not be. Those allegations include that Kay instructed McAlister and Block not to correct the AFFO miscalculations (Doc. 1 at ¶ 73) and to take steps to cover them up (Doc. 1 at ¶ 74). That is plainly enough to plead control. In addition, Kay is alleged to have reviewed and signed ARCP's SEC filings, and to have participated in conference calls discussing those reports with analysts. (Doc. 1 at ¶ 28). Thus, Plaintiffs have sufficiently pled Kay was a controlling person of ARCP.

Kay moves to dismiss the controlling person claims insofar as they involve misstatements made prior to his joining ARCP in December 2013. Plaintiffs admit, as they must, they cannot hold Kay responsible for controlling ARCP before it went to work there. (Doc. 99 at 62).

Accordingly,

IT IS ORDERED the motion to transfer venue (Doc. 74) is **DENIED**.

IT IS FURTHER ORDERED the motions to dismiss filed by the ARC Defendants (Doc. 80), Kay (Doc. 81), and McAlister (Doc. 84) are **DENIED** in their entirety.

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[23] Beeson purports to incorporate the arguments in all of the other Defendants' motions on every claim against her. (Doc. 83 at 7). The Court appreciates the gesture by Beeson and other Defendants to avoid needless repetition. However, it necessarily limits the Court's ability to assess the merits of Beeson's motion. The Court will deny the motion as to the controlling person claims.

IT IS FURTHER ORDERED RCAP's motion to dismiss (Doc. 85) is **DENIED AS MOOT**.

IT IS FURTHER ORDERED the motions to dismiss filed by ARCP/OP (Doc. 75), Beeson (Doc. 83), Block (Doc. 87), and Schorsch (Doc. 89) are **GRANTED IN PART AND DENIED IN PART**. The following Counts are **DISMISSED**: Count 2 in its entirety, Count 3 as against Beeson, Count 5 as against the OP, Count 7 as against Beeson, Block, and Schorsch, and Count 8 as against the OP. Plaintiffs are granted **LEAVE TO AMEND** correcting the deficiencies in these claims identified above, no later than November 4, 2016.

Dated this 3rd day of October, 2016.

Honorable Roslyn O. Silver
Senior United States District Judge

UNITED STATES DISTRICT COURT

DISTRICT OF MINNESOTA

Gary and Caryl Luis, Stephanie Edwards and Murray MacLeod, Mary Moravec, and Judith and Delton Nack, individually and on behalf of all others similarly situated, Plaintiffs, v. RBC Capital Markets, LLC, Defendant.	Case No. 16-cv-00175 (SRN/JSM) **MEMORANDUM OPINION AND ORDER**

Charles E. Scarlett and Scott D. Hirsch, Scarlett & Hirsch, P.A., 7777 Glades Road, Suite 200, Boca Raton, Florida 33434, Daniel E. Gustafson, Daniel C. Hedlund, David A. Goodwin, and Eric S. Taubel, Gustafson Gluek PLLC, 120 South Sixth Street, Suite 2600, Minneapolis, Minnesota 55402, for Plaintiffs.

Alex J. Kaplan, Andrew W. Stern, and Rituraj K. Ghai, Sidley Austin LLP, 787 Seventh Avenue, New York, New York 10019, Clifford M. Greene and Sybil L. Dunlop, Greene Espel PLLP, 222 South Ninth Street, Suite 2200, Minneapolis, Minnesota 55402, for Defendant.

SUSAN RICHARD NELSON, United States District Judge

I. INTRODUCTION

This action arises from allegations that Defendant RBC Capital Markets, LLC ("RBC") improperly marketed and sold certain investment products to Plaintiffs between January 1, 2008 and the present date, in violation of Minnesota statutory and common law. In response, RBC now moves the Court to dismiss the Complaint, arguing that

Plaintiffs' claims are precluded by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), or, in the alternative, that they are pleaded with insufficient particularity to meet the heightened standards of Fed. R. Civ. P. 9(b). For the reasons set forth below, the Court agrees with RBC that Plaintiffs' claims are barred by SLUSA. Accordingly, RBC's Motion to Dismiss [Doc. No. 21] is granted in part, and denied as moot in part, and Plaintiffs' Complaint [Doc. No. 1] is dismissed.

II. BACKGROUND

A. The Parties

Plaintiffs in this matter are seven retired and semi-retired individuals who invested in proprietary reverse convertible notes ("RCNs") sold by RBC, and suffered significant losses when those notes declined precipitously in value. (Compl. ¶¶ 13-17.) They commenced this action on behalf of themselves and the following putative class:

> [A]ll persons and entities to whom Defendant sold [RCNs] from January 1, 2008 to the present, whose risk tolerance did not permit investment in reverse convertible notes and whose stated and written instructions to RBC did not authorize selling put options.

(*Id.* at ¶ 79.) Plaintiffs estimate that the putative class may ultimately consist of "several thousand" individuals. (*Id.* at ¶ 82.)

Defendant RBC is a Minnesota limited liability company and a registered broker-dealer, which acted as the agent for the sale of the RCNs underlying this dispute. (*Id.* at ¶

17; Kaplan Aff. [Doc. No. 24], Ex. 1 at 5.)[1] RBC is a subsidiary of non-party Royal Bank of Canada, which issued the RCNs. (Kaplan Aff., Ex. 1 at 2.)

B. Underlying Factual Allegations

At the heart of the Complaint is the allegation that RBC sold RCNs—complex structured securities that are "inherently risky"—to individuals who did not understand the nature of those investments, and who had previously indicated to RBC that they had a low tolerance for investment risk. (Compl. ¶¶ 1, 3-4.) Although the parties dispute the exact nature of RCNs, they are, at bottom, a form of bond, consisting of a high-yield, short-term note of the issuer that is linked to the performance of an unrelated reference asset—generally a stock or basket of stocks. (Compl., Ex. C at 2-3.) RCNs thus contain two components—a debt instrument paying an above market interest rate (occasionally as high as 30%), and a derivative, in the form of a put option, "that gives the issuer the right to repay principal to the investor in the form of a set amount of the underlying asset . . . if the price of the underlying asset dips below a predetermined price (often referred to as the 'knock-in' level)." (*Id.*) It is this underlying option that gives RCNs greater risk than a traditional bond, as an investor may ultimately lose all of his or her principal investment and be left with only a depreciated asset in return. (*Id.* at 3.) According to the Financial Industry Regulatory Authority ("FINRA"), the complex nature of RCNs can make them difficult to evaluate as an investment, and unsuitable for unsophisticated investors. (*Id.* at 2-3, 9-10.)

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[1] All references to page numbers in this Opinion are those assigned by the CM/ECF system.

Because RCNs are so risky, Plaintiffs allege that RBC had a duty to only market them to investors who fully understood and accepted the risks involved. (Compl. ¶ 2.) In violation of this duty, however, the Complaint alleges that RBC engaged in a series of actions designed to hide the true risk of these products from investors, while pushing them on individuals who had expressly indicated an unwillingness to partake in options trading. (*See, e.g.*, *id.* at ¶¶ 106, 118.) Several specific allegations are illustrative, including that RBC: (1) "intentionally failed" to screen customers to make sure RCNs comported with their stated investment goals (*Id.* at ¶ 36); (2) knowingly mislabeled RCNs as "fixed-income investments" on account documents provided to investors (*Id.* at ¶¶ 51, 106); (3) omitted important information regarding the volatility of the stocks underlying the RCNs (*Id.* at ¶¶ 60, 61, 63); (4) failed to follow its internal guidelines for marketing RCNs (*Id.* at ¶¶ 67, 68); and (5) had been the subject of legal and regulatory action relating to the allegedly improper marketing of RCNs, notice of which it failed to provide to investors. (*Id.* at ¶¶ 7-12, 65, 115.) Plaintiffs allege that they relied on these and other misrepresentations and omissions in purchasing RCNs, and that, as a "direct and proximate result of RBC's actions, omissions, and misrepresentations, [they] suffered enormous financial losses." (*Id.* at ¶ 123.)

C. Plaintiffs' Claims

The Complaint asserts seven individual claims against RBC stemming from the alleged inappropriate marketing of RCNs, all of which are founded in state law. Four of the claims (Counts 1, 4, 5, and 7) allege fraud in some form, including common law fraud, fraudulent concealment, and violation of two provisions of the Minnesota

Securities Act (Minn. Stat. §§ 80A.68(1) and 80A.68(3)), which courts have recognized to be state-law analogues of SEC Rule 10b-5. *See Merry v. Prestige Capital Markets, Ltd.*, 944 F. Supp. 2d 702, 709 (D. Minn. 2013); *Minneapolis Emps. Ret. Fund v. Allison-Williams Co.*, 519 N.W.2d 176, 179 (Minn. 1994); 17 C.F.R. § 240.10b-5. The remaining claims (Counts 2, 3, and 6) are for common law negligence, breach of fiduciary duty, and breach of contract, respectively. With minor variations, the relevance of which will be discussed below, each of Plaintiffs' claims relies on the same set of allegations, including that RBC intentionally failed to follow customers' expressed instructions regarding investment risk, misrepresented the nature and safety of RCNs as investments, and omitted material information regarding legal and regulatory actions relating to RCNs. (*See* Compl. ¶¶ 95, 99, 103, 106, 108, 111, 115, 118-121.)

III. DISCUSSION

A. Standard of Review

Under Rule 12(b)(6) of the Federal Rules of Civil Procedure, dismissal is warranted where a plaintiff "fail[s] to state a claim upon which relief can be granted." In evaluating a motion to dismiss, the court "must take the well-pleaded allegations of the complaint as true, and construe the complaint, and all reasonable inferences arising therefrom, most favorably to the pleader." *Morton v. Becker*, 793 F.2d 185, 187 (8th Cir. 1986). Although the complaint need not contain "detailed factual allegations," it must plead facts sufficient "to raise a right to relief above the speculative level." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 555 (2007). Thus, to survive a motion to dismiss, the plaintiff's "obligation to provide the grounds of his entitlement to relief requires more

than labels and conclusions." *Benton v. Merrill Lynch & Co., Inc.*, 524 F.3d 866, 870 (8th Cir. 2008) (quotations and citation omitted). Rather, "the complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quotation and citation omitted). While ordinarily only the facts alleged in the complaint are considered in deciding a motion to dismiss, "materials attached to the complaint as exhibits may be considered," *Morton*, 793 F.2d at 187, as well as "documents whose contents are alleged in [the] complaint and whose authenticity no party questions, but which are not physically attached to the pleading." *Kusner v. Beverly Enters., Inc.*, 317 F.3d 820, 831 (8th Cir. 2003) (quotation and citation omitted).

B. SLUSA

As previously noted, RBC contends that Plaintiffs' Complaint must be dismissed for two independent reasons. The first raised is that the each of the claims asserted in the Complaint is barred by SLUSA, which precludes[2] maintenance—in either federal or state court—of any "covered class action" based on state law and alleging either (a) a "misrepresentation or omission of a material fact" in connection with the purchase or sale of a covered security, or (b) the use or employment of any "manipulative or deceptive device or contrivance" in connection with the purchase or sale of a covered security. *See*

[2] Although SLUSA is frequently referred to as a preemption statute, it is more properly labeled a preclusion statute, as it "does not itself displace state law with federal law but makes some state-law claims nonactionable through the class-action device in federal as well as state court." *Kircher v. Putnam Funds Tr.*, 547 U.S. 633, 637 n.1 (2006).

15 U.S.C. §§ 77p(b)-(c), 78bb)f(1)-(2). Proper application of SLUSA requires some understanding of its origins, which the Court will briefly recite here.

In the early 1990s, Congress became concerned with "perceived abuses of the class-action vehicle in litigation involving nationally traded securities." *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81 (2006). In particular, legislative reports identified nuisance filings targeting "deep-pocketed defendants" in the financial industry as representing a serious threat to "the entire U.S. economy." *Id.* (quotation and citation omitted). The ability of these so-called "strike suits" to extract "extortionate settlements" on weak or non-existent facts under then-current pleading standards led to the passage in 1995 of the Private Securities Litigation Reform Act ("PSLRA"). *Id.*; *see also* 15 U.S.C. §§ 77z-1, 78u-4. That act dramatically narrowed the range of securities suits that could successfully survive a motion to dismiss by, among other things, introducing heightened pleading requirements for class actions alleging fraud in the sale of national securities. *See* 15 U.S.C. §§ 78u-4; *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107 (2d Cir. 2001).

The PSLRA had an unintended effect however—while the act was successful in discouraging frivolous (and occasionally non-frivolous) securities fraud class actions in federal court, it also caused a rush of class action filings in state court, based on state law, in an attempt by the plaintiffs' bar to avoid the new restrictions entirely. *Dabit*, 547 U.S. at 82; *Lander*, 251 F.3d at 107. "To stem this shift from Federal to State courts, and prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [PSLRA]," including its heightened pleading

standards, Congress enacted SLUSA in 1998. *Dabit*, 547 U.S. at 82 (quotations and citation omitted); *Sofonia v. Principal Life Ins. Co.*, 465 F.3d 873, 876 (8th Cir. 2006).

In light of SLUSA's origin—as a law designed to prevent "end-running" the PSLRA—courts have interpreted its reach in an expansive fashion. The Supreme Court has declared that its passage reinforces Congress' resolve that "[t]he magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated." *Dabit*, 547 U.S. at 78. Likewise, the Eighth Circuit has noted that "SLUSA should be read with the 'presumption that Congress envisioned a broad construction,' so that the most troublesome class actions would be subject to the PSLRA's procedural reforms." *Siepel v. Bank of Am., N.A.*, 526 F.3d 1122, 1127 (8th Cir. 2008) (quoting *Dabit*, 547 U.S. at 86). Thus, SLUSA has even been read to "pre-empt[] state-law class-action claims for which federal law provides no private remedy." *Dabit*, 547 U.S. at 74. Taken together, these and other cases suggest that courts should err on the side of finding in favor of preclusion under SLUSA when the issue is a close one.

The Eighth Circuit has developed a four-factor test for determining when a claim is precluded by SLUSA. Under this test, a party seeking to invoke SLUSA's application must show that: (1) the action is a "covered class action;" (2) the action purports to be based on state law; (3) the action alleges that the defendant misrepresented or omitted a material fact (or used or employed a manipulative or deceptive device or contrivance); and (4) the action alleges that the defendant's misrepresentations or omissions of material fact were made "in connection with the purchase or sale of a covered security." *See*

Sofonia, 465 F.3d at 876; *Green v. Ameritrade, Inc.*, 279 F.3d 590, 596 (8th Cir. 2002). Here, there is no real question that the first two factors are present. Under SLUSA, a "covered class action" is essentially any lawsuit "in which damages are sought on behalf of more than 50 people." *Dabit*, 547 U.S. at 83; *see also* 15 U.S.C. §§ 77p(f)(2)(A)(i)(I), 78bb(f)(5)(B)(i)(I). Plaintiffs' Complaint contends that the putative class may number "several thousand or more," and they seek damages on behalf of themselves and the putative class members. (*See* Compl. at 2, ¶¶ 82, 88.) Thus, Plaintiffs' action is a "covered class action" for SLUSA purposes. Likewise, because all seven individual claims brought by Plaintiffs sound in Minnesota statutory and common law, this action "purports to be based on state law."

The applicability of the second two factors of the SLUSA preclusion test presents thornier issues, however, and is vigorously contested by the parties. Accordingly, each will be addressed at length below.

1. Plaintiffs' Complaint Generally Alleges Misrepresentations and Omissions of Material Fact by RBC

As noted, SLUSA's third element generally requires that the action allege "false statements or omissions of material fact" made in connection with the purchase or sale of a covered security. *See Siepel v. Bank of Am., N.A.*, 239 F.R.D. 557, 567 (E.D. Mo. 2006) (citing *Dudek*, 295 F.3d at 879). In analyzing this requirement, courts in this circuit look to the "gravamen" of the Plaintiff's complaint. *See Dudek*, 295 F.3d at 879; *see also Black's Law Dictionary* (10th ed. 2014) (defining "gravamen" as "[t]he substantial point or essence of a claim, grievance, or complaint"). Thus, the court does

not "rely on the names of the causes of action that the plaintiff alleges. Instead [it] look[s] at the substance of the allegations, based on a fair reading. SLUSA preemption is based on the conduct alleged, not the words used to describe the conduct." *Kutten v. Bank of Am., N.A.*, 530 F.3d 669, 670-71 (8th Cir. 2008).

Mindful of this instruction, courts in this circuit (as well as the Supreme Court), have unhesitatingly barred claims that are facially unrelated to misrepresentations—such as those for breach of contract, breach of fiduciary duty, and negligence—when, at bottom, the essence of the complaint was an allegation of fraud. *See, e.g.*, *Dabit*, 547 U.S. at 75 (finding breach of fiduciary duty and breach of covenant of good faith and fair dealing claims to be barred by SLUSA); *Kutten*, 530 F.3d at 670-71 (same, as to claims for breach of fiduciary duty, breach of contract, and violations of state investor protection statutes); *Prof'l Mgmt. Assocs., Inc. Emps.' Profit Sharing Plan v. KPMG LLP*, 335 F.3d 800, 803 (8th Cir. 2003) (same, as to claim for common law negligence).

Here, a fair reading of Plaintiffs' Complaint gives rise to the unavoidable conclusion that it is suffused with allegations of misrepresentations and omissions. Specifically, Plaintiffs repeatedly allege that RBC intentionally misrepresented the safety and appropriateness of RCNs as investment options (Compl. ¶¶ 36, 60, 61, 63), intentionally failed to notify prospective customers of various legal and regulatory actions RBC had been subject to regarding the sale of RCNs (*Id.* at ¶¶ 7-12, 65, 115), intentionally mislabeled RCNs as "fixed income" securities when they were not so (*Id.* at ¶¶ 51, 106), and failed to follow client instructions regarding risk tolerance and option trading in a manner that was "knowing," and done with intent to "defraud[]." Indeed,

there is no avoiding the fact that the majority of Plaintiffs' claims sound in fraud, thereby explicitly requiring allegations of material misrepresentations and omissions as essential elements of the causes of action. *See, e.g.*, *Specialized Tours, Inc. v. Hagen*, 392 N.W.2d 520, 532 (Minn. 1986) (listing elements of a claim of common law fraud).

The fact that Plaintiffs also plead claims for common law negligence, breach of fiduciary duty, and breach of contract—claims that do not require proof of misrepresentation or omission as part of the cause of action—does not save either the Complaint generally or these claims individually. As previously noted, when measuring SLUSA's reach, courts are not constrained by the label given to the claim so long as the allegations themselves implicate misrepresentations or omissions. *See Kutten*, 530 F.3d 670-71; *Dudek*, 295 F.3d at 879. At bottom, these claims, like those directly asserting fraud, center in on RBC's alleged failures to follow client instructions, to make clients aware of material information, and to be truthful. (*See* Compl. ¶¶ 98, 103, 115.) Mere artful pleading cannot change this reality. Thus, for instance, rephrasing the duty to avoid material omissions as a breach of contract does not change the nature of the underlying wrong. *See, e.g.*, *Jaspers v. Prime Vest Fin. Servs., Inc.*, No. 10-cv-853 (DWF/RLE), 2010 WL 3463389, at *6 (D. Minn. Aug. 30, 2010) ("Whether couched as broken promises or as a different state-law cause of action, however, the heart of these allegations is a misrepresentation.").[3]

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[3] Plaintiffs also cannot avoid the fact that each of their claims incorporates by reference all previous allegations—significantly impeding any attempt to cabin off their non-fraud claims. The Eighth Circuit has made clear that this fact is of more than passing importance: in *Prof'l Mgmt Assocs.*, the Court concluded that a claim of negligence

The Eighth Circuit's opinion in *Dudek* considered facts similar to those before the Court, making its holding particularly relevant. There, plaintiffs alleged that defendants had "affirmatively misl[ed] prospective customers into believing that deferred annuities m[ight] be appropriate investments for placement into qualified retirement plans, and fail[ed] to disclose the inappropriateness and unsuitability of such investments." 295 F.3d at 879. Although ultimately plaintiffs only asserted claims based on contract, quasi-contract, and fiduciary law, the court had little difficult in concluding that the "overall target" of the complaint remained "the unlawful marketing of tax-deferred annuities, either by misrepresenting their suitability for tax-deferred retirement plans, or by failing to disclose their unsuitability for such accounts." *Id.* at 879-80. At bottom, the Eighth Circuit concluded that the gravamen of the complaint was tied to allegations "that defendants misstated or omitted material facts in connection with the purchase and sale of the tax-deferred annuities." *Id.* at 880. Accordingly, the court determined that the claims were barred by SLUSA. For the same reasons, this Court concludes that Plaintiffs' Complaint alleges that RBC misrepresented or omitted material facts,[4] and that SLUSA's third factor is met here.

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containing "no [direct] allegation of a misrepresentation or omission" was nonetheless preempted by SLUSA, because the plaintiff's allegations regarding the defendant's misrepresentations were "incorporated by reference in the negligence count," thus making that claim "essentially a securities fraud claim." 335 F.3d at 803; *see also Jaspers*, 2010 WL 3463389, at *6 (noting that "[a]ll of Plaintiffs' allegations regarding Defendants' representations are incorporated by reference in the individual counts of the Complaint").

[4] Plaintiffs contend in their brief that to the extent fraudulent acts are alleged in the complaint, those acts "occurred *after* the purchase of the RCNs," and thus cannot be factored into the SLUSA analysis. (Pl.'s Resp in Opp to Def.'s Mot. to Dismiss [Doc.

2. RBC's Alleged Misrepresentations and Omissions were Made in Connection with the Purchase or Sale of a Covered Security

The fourth factor of the SLUSA test requires that the Complaint allege that the defendant's misrepresentations or omissions of material fact were made "in connection with the purchase or sale of a covered security." *Sofonia*, 465 F.3d at 876 (quotation and citation omitted). In its own right, this factor encompasses two sub-factors, commonly referred to as the "in connection with" prong, and the "covered security" prong. Because in this matter the parties primarily dispute the "covered security" prong, and because resolution of that issue heavily informs the Court's "in connection with" analysis, the Court will take the two sub-factors in reverse order, and begin with a consideration of whether the RCNs are "covered securities" for purposes of SLUSA.

SLUSA defines a "covered security" as a security that meets one of three requirements: (A) it may be one that is "listed, or authorized for listing" on certain national stock exchanges (e.g. the New York Stock Exchange or NASDAQ); (B) it may be listed on a national securities exchange that has listing standards that are "substantially similar" to the listing standards of one of the stock exchanges enumerated in subparagraph (A); or (C) it may be "a security of the same issuer that is equal in seniority

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No. 32] ("Pl.'s Resp. in Opp."), at 32 (emphasis original).) This assertion finds no support in the text of the Complaint, and Plaintiffs provide no citations to defend it. Indeed, the Court notes that several allegations *directly contradict* this statement. (*See, e.g.*, Compl. ¶¶ 96 ("RBC's false representations related to the [RCNs] were material and susceptible of knowledge, which RBC possessed. Those representations induced Plaintiffs and members of the putative class to act *based on those representations*, i.e., purchasing [RCNs]."), 109 ("RBC's materially misleading conduct and omissions *caused* Plaintiffs to purchase the inherently risky [RCNs] . . . .) (emphasis added).) Thus, the Court need not address the legal effect—if any—of Plaintiffs' argument here.

or that is a senior security to a security described in subparagraph (A) or (B)." 15 U.S.C. § 77r(b)(1)(A)-(C).

In their briefing, Plaintiffs contend that there is no "covered security" here for purposes of SLUSA because, although the performance of an RCN is tied to the value of an underlying "reference stock," that stock itself is not part of the initial investment. (*See* Pl.'s Resp. in Opp. at 9.) Indeed, as Plaintiffs point out, the goal of investing in an RCN is to *avoid* taking possession of the reference stock—the purchaser is essentially betting that the knock-in level listed in the RCN will never be reached. (*Id.* at 18-19.) Although each Plaintiff in this case subsequently received possession of the reference stock when his or her RCN "knocked in," that event did not occur until well after the purchase of the RCN was completed. (*Id.* at 10.) Thus, even though the underlying reference stocks would qualify as covered securities under SLUSA, Plaintiffs contend that the RCNs themselves—which are indisputably not traded on a national exchange of any kind—do not. By Plaintiffs' reading of 15 U.S.C. § 77r(b)(1), therefore, SLUSA's fourth factor cannot be met here.

By way of response, RBC asserts that Plaintiffs have simply missed the relevant statutory provision that qualifies RCNs as "covered securities." While Plaintiffs look to the first two subparagraphs of § 77r(b)(1), RBC directs the Court to subparagraph (C), which declares a security to be "covered" if it is "a security of the same issuer that is equal in seniority or that is a senior security to a security described in subparagraph (A) or (B)." 15 U.S.C. § 77r(b)(1)(C). As RBC notes, RCNs are debt securities "issued" by Royal Bank of Canada (RBC's parent entity), and Royal Bank of Canada stock is

indisputably traded on a national stock exchange. (*See* Def.'s Reply Mem. in Supp. of Mot. to Dismiss [Doc. No. 36] ("Def.'s Reply Mem."), at 3.) Because the RCNs are "senior unsecured debt obligations" that "rank equally with all of [the issuer's] other unsecured and unsubordinated debt," they are, according to RBC, "covered securities" for purposes of SLUSA. (*Id.*)

Curiously, given that SLUSA has now been in force for nearly two decades, courts have almost never had cause to interpret the scope of subparagraph (C), and no federal court appears to have yet done so. For three primary reasons, however this Court agrees with RBC's application of that section here.

First, the starting point for any statutory analysis is the text of the statute itself. *Desert Palace, Inc. v. Costa*, 539 U.S. 90, 98 (2003). As the Supreme Court has noted "time and again," courts must "presume that a legislature says in a statute what it means and means in a statute what it says there." *Barnhart v. Sigmon Coal Co.*, 534 U.S. 438, 461-62 (2002) (quotation and citation omitted). Here, that presumption leads inevitably to the conclusion that RCNs are "covered securities." When broken down to its constituent parts, subparagraph (C) requires that four elements be met: there must be (1) a "security" of (2) the "same issuer" that is (3) at least equal in seniority to (4) a "security described in subparagraphs (A) or (B)." In this instance, the parties raise no dispute that RCNs are "securities" as defined by 15 U.S.C. § 77b(a)(1). Likewise, there is no dispute that they are issued by Royal Bank of Canada, the "same issuer" of a security described in subparagraph (A) of the statute. Finally, the prospectuses attached to Plaintiffs'

Complaint indicate clearly that the RCNs are of at least equal seniority to Royal Bank of Canada's common stock. Thus, every element of subparagraph (C) is met here.

Second, it is difficult to read subparagraph (C) in a way that at once excludes RCNs from the realm of "covered securities" but does not otherwise undercut that section as one of independent significance. *See Hibbs v. Winn*, 542 U.S. 88, 101 (2004) ("A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant.") (quotation and citation omitted); *United States v. Menasche*, 348 U.S. 528, 538-39 (1955) ("It is our duty to give effect, if possible, to every clause and word of a statute, rather than to emasculate an entire section . . . .") (quotation and citation omitted). At oral argument, Plaintiffs contended that the statutory text could be read to cover only "securities that are not fixed-rate debt instruments." (Hr'g Tr. [Doc. No. 40] at 15:4-5.) But nothing in the language of the text requires (or even suggests) such a reading, and Plaintiffs provided no authority for their conclusion.[5] In the Court's view, a more tenable alternative reading would be to conclude that subparagraph (C) only applies where the defendant was also the issuer of the covered securities, which is not the case here. But several courts, including the Supreme Court, have found that SLUSA precludes actions against non-issuers in the context of securities "covered" by subparagraphs (A) and (B), and the Court sees nothing

[5] At oral argument, Plaintiffs stated that their preferred reading of subparagraph (C) could be reached inferentially from the First Circuit's holding in *Hidalgo-Vélez v. San Juan Asset Mgmt., Inc.*, 758 F.3d 98 (1st Cir. 2014), but at no point does that case discuss subparagraph (C), nor does it go much farther in its analysis of the "covered security" prong than to note that the defendants "have not asserted" that the investments at issue were covered securities. 758 F.3d at 108.

in the statutory text that suggests subparagraph (C) should be treated differently. *See Dabit*, 547 U.S. at 71 (finding SLUSA precluded action against defendant non-issuer).

Third, what little case law that does exist applying subparagraph (C) supports RBC's interpretation. While apparently no federal court has yet considered that portion of the statute, at least two state courts have done so. First, in *BT Sec. Corp. v. W.R. Huff Asset Mgmt. Co.*, 891 So. 2d. 310 (Ala. 2004), the Alabama Supreme Court noted that the plaintiff had conceded that the "high-yield subordinated notes" at issue in that case qualified as "covered securities" under subparagraph (C) because they were issued by a company that was listed on the NASDAQ stock exchange, and were senior to that company's stock. 891 So. 2d at 314. Of particular note, this case also involved a situation where the issuer of the covered securities was not a defendant in the underlying action. *Id.* at 312. Second, a California state district court concluded—in a prior litigation involving RBC's sale of RCNs—that RCNs were indeed covered securities for substantially the same reasons asserted by RBC in the present matter. (*See* Kaplan Aff., Ex. 6 (Tr. of Hr'g on Def.'s Mot. for Summ. J., *Wander v. RBC Wealth Mgm't*, Cal. Super. Ct. (May 30, 2012)) at 40.) Although Plaintiffs contend that the California decision should carry no weight with this Court because, among other things, counsel in that case failed to make an appearance at the summary judgment hearing, the matter was apparently briefed and the court rendered a reasoned decision. (*See* Goodwin Decl. [Doc No. 33], Ex. B at 3.)

Finally, and for reasons previously discussed, the Court concludes that RBC's interpretation of subparagraph (C) is in keeping both with the Congressional purpose in

enacting SLUSA, and with the broad scope given to its preclusive effect by the Supreme Court. *See, e.g.*, *Dabit*, 547 U.S. at 78; *Siepel*, 526 F.3d at 1127. Plaintiffs invite the Court to read SLUSA as meant to apply only where "nationally traded securities" are involved. (*See* Pl.'s Resp. in Opp. at 14.) But to do so would be to ignore both the text of the statute and the legislative history behind it. *See* H.R. Rep. No. 104-622, at 30 (noting that subparagraph (C) of 15 U.S.C. § 77r(b)(1) "is intended to afford to issuers of debt securities the *same benefits of preemption* as are enjoyed by issuers of equity securities.") (emphasis added). The Court will not artificially narrow the plain language of the statute.

For all of the above reasons, the Court concludes that RCNs qualify as "covered securities" for purposes of SLUSA.[6] It now turns to the last consideration of the SLUSA preclusion test: whether RBC's misrepresentations or omissions were made "in connection with" the purchase or sale of those covered securities. *Sofonia*, 465 F.3d at 876. That issue may be briefly disposed of.

As with the rest of the statute, courts have interpreted the "in connection with" requirement broadly. *See Siepel*, 526 F.3d at 1127 (declaring that the "in connection with" prong should be "construed flexibly, not technically or restrictively"); *Jaspers*, 2010 WL 3463389, at *7. Thus, the Supreme Court has made clear that all that need be alleged is that the defendant's misconduct "coincide" with a securities transaction. *Dabit*,

[6] Because the Court concludes that RCNs qualify as "covered securities" under 15 U.S.C. § 77r(b)(1)(C), it need not consider RBC's alternative argument that they also qualify under § 77r(b)(1)(A). (*See* Def.'s Mem. in Supp. of Mot. to Dismiss [Doc. No. 23] ("Def.'s Mem. in Supp.") at 18-19; Def.'s Reply Mem. at 5-6.)

545 U.S. at 85. More specifically, the Court has stated that "[a] fraudulent misrepresentation or omission is . . . made 'in connection with' such a 'purchase or sale of a covered security' [if] it is material to a decision by one or more individuals . . . to buy or sell a 'covered security.'" *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058, 1066 (2014). Here, Plaintiffs' own allegations repeatedly state that RBC's misrepresentations and omissions directly induced their purchase of RCNs—a covered security. (*See* Compl. ¶¶ 96, 109, 112, 122, 123.) By any measure of strictness, therefore, let alone the "flexible" standard promulgated by the Supreme Court, RBC's alleged misdeeds were "in connection with" the purchase of covered securities.

IV. CONCLUSION

In light of the above reasoning, the Court concludes that the claims alleged in Plaintiffs' Complaint are indeed precluded by SLUSA, and must be dismissed.[7] Accordingly, it declines to address RBC's alternate argument that Plaintiffs have failed to plead their claims with the requisite particularity. *See* Fed. R. Civ. P. 9(b). Because "ordinarily . . . dismissal [under SLUSA] should be without prejudice in order to allow the plaintiff to plead a claim sounding only in state law if possible," *Dabit v. Merrill*

[7] Both in their brief and by Notice of Supplemental Authority [Doc. No. 41], Plaintiffs advise the Court that the weight of authority supports finding that non-precluded claims survive a motion to dismiss on SLUSA grounds even where other claims are found precluded. *See, e.g.*, *Proctor v. Vishay Intertechnology Inc.*, 584 F.3d 1208, 1228 (9th Cir. 2009); *In re Lord Abbett Mut. Funds Fee Litig.*, 553 F.3d 248, 254-55 (3d Cir. 2009); *In re Kingate Mgmt. Ltd. Litig.*, No. 09-cv-5386 (DAB), 2016 WL 5339538 (S.D.N.Y. Sept. 21, 2016). *But cf. Kutten v. Bank of Am., N.A.*, No. 06-0937 (PAM), 2007 WL 2485001, at *9 (E.D. Mo. Aug. 29, 2007); *Siepel*, 239 F.R.D. at 570 n.11. Because the Court finds here that all claims are independently preempted by SLUSA, however, these cases are not relevant to its analysis.

Lynch, Pierce, Fenner & Smith, Inc., 395 F.3d 25, 47 (2d Cir. 2005) (Sotomayor, J.), *rev'd on other grounds*, 547 U.S. at 71, the Court's decision is without prejudice.

THEREFORE, IT IS HEREBY ORDERED THAT:

1. Defendant's Motion to Dismiss [Doc. No. 21] is **GRANTED** in part, and **DENIED** as moot in part; and

2. Plaintiffs' Complaint [Doc. No. 1] is **DISMISSED** without prejudice.

LET JUDGMENT BE ENTERED ACCORDINGLY.

Dated: October 13, 2016

s/Susan Richard Nelson________
SUSAN RICHARD NELSON
United States District Judge

NOT FOR PUBLICATION

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

In Re CommVault Systems, Inc. Securities Litigation,	Civil Action No. 14-cv-5628 (PGS) **MEMORANDUM AND ORDER**

SHERIDAN, U.S.D.J.

This matter comes before the Court on two motions, both filed by Defendants: (1) Motion to Dismiss the Second Amended Complaint (ECF No. 76); and (2) Motion to Strike the Expert Declarations attached to Plaintiffs' Seconded Amended Complaint (ECF No. 77).

Factual & Procedural Background:

On September 10, 2014, Lead Plaintiff, Arkansas Teacher Retirement Systems (hereinafter "Plaintiff" or "Arkansas Teacher")), commenced this securities class action by filing a Complaint. (ECF No. 1). On March 19, 2015, Plaintiff filed a First Amended Complaint. (ECF No. 40). On December 17, 2015, this Court granted Defendants' Motion to Dismiss the First Amended Complaint. (ECF No. 65). Specifically, the Court ruled that while Plaintiff alleged sufficient facts pertaining to the confidential witnesses (*see* ECF No. 75, T2:1-8:6 of Court's Decision), Plaintiff's "cookie jar" accounting theory was not sufficiently alleged. In so ruling, the Court determined that the allegation that Defendants violated GAAP through its "cookie jar" accounting is "an issue [that] requires some technical support in the pleading in

order to support the allegation." T8:25-9:2. Moreover, the Court reasoned that the "plaintiffs could demonstrate that the earnings that were allegedly deferred could be shown to have been earned in prior quarters. As such, the deferred reporting of sales must be supported by appropriate facts." T9:15-19.

On February 5, 2016, Plaintiff filed its Second Amended Complaint ("SAC") (ECF No. 70), which Defendants now seek to dismiss. In the SAC, Plaintiff relied upon the declarations of Harvey L. Pitt, the former Chairman of the Securities and Exchange Commission, and Harris Devor, a Certified Public Accountant, both of whom explained what the First Amended Complaint described loosely as "cookie jar accounting," and constitutes a GAAP violation. However, Defendants have filed a motion to strike the expert declarations attached to Plaintiff's SAC.

By way of background, CommVault is a provider of data and information management software, which derives about half of its annual revenue from licensing its software applications. (SAC ¶¶ 24-25). Defendant N. Robert Hammer (hereinafter "Hammer") was, at all relevant times during the class period, CommVault's Chairman, President and Chief Executive Officer (CEO). (SAC ¶ 21). During the class period, Hammer reviewed, approved, and signed CommVault's filings with the SEC. (Id.). Defendant Brian Carolan ("Carolan") was, at all relevant times during the class period, CommVault's Vice President and Chief Financial Officer (CFO) (*Id.* at ¶ 22). Carolan, like Hammer (collectively the "Individual Defendants"), reviewed and signed CommVault's filings with the SEC. (*Id.* at ¶ 23).

Beginning in 2003, CommVault entered into a business partnership with Dell, which continued, leading up to and after CommVault issued its initial public offering in 2006. (*Id.* at ¶ 6). Beginning in fiscal year 2007 through the beginning of the class period, CommVault relied

on Dell for approximately 20% of its total revenue. (*Id.*). Dell served as both a reseller and original equipment manufacturing partner to CommVault, meaning that Dell sold CommVault's software as a stand-alone product or as integrated into Dell hardware. (*Id.*). During its partnership with Dell, from 2006 through 2012, CommVault's revenue quadrupled, growing from $109,472,000 to $406,639,000. (*Id.* at ¶ 7). Before the beginning of the class period, CommVault told investors to expect annual revenue to increase from approximately $500 million in fiscal year 2013 to $1 billion over the next few years. (*Id.*). Analysts predicted that, in order to meet that goal, CommVault must grow by at least 20% year-over-year until fiscal year 2017. (*Id.*).

In the latter half of 2012, Dell acquired certain CommVault competitors, including Quest Software, which ultimately ended the partnership between the companies. (*Id.* at ¶ 7).

Plaintiffs allege that Defendants knew or recklessly disregarded that CommVault would not be able to meet 20% year-over-year revenue growth targets without Dell. (*Id.* at ¶ 8). Nonetheless, Defendants falsely reassured the investing public that they had replaced Dell with other business partners and that the loss of revenue from Dell had not and would not affect CommVault's achievement of its revenue target numbers. (*Id.*). Moreover, instead of adjusting their forecasts and disclosing the truth to investors, Defendants fraudulently concealed the decline in CommVault's business and manipulated their financial results (cookie jar accounting) in violation of Generally Accepted Accounting Principles (hereinafter "GAAP"). Specifically, instead of recognizing millions of dollars in software revenue that CommVault had earned in prior periods, Defendants deferred the earnings to later periods to show continued financial growth. It is alleged that this cookie jar accounting practice began at the end of fiscal year 2013, when the class period began and when CommVault announced their financial results. (*Id.* at ¶

27). Because the within motion deals primarily with Plaintiff's cookie-jar accounting theory, the Court hones in on these allegations:

CommVault is obligated under the relevant GAAP and other accounting provisions and guidance to recognize software revenue when certain criteria are met. In the fourth quarter of fiscal 2013, CommVault achieved historic software revenue growth. Instead of recognizing software revenue on particular licensing transactions in that quarter, Defendants improperly created a "cookie jar" of deferred software revenue which had grown to $9.2 million by the end of fiscal year 2013. (*Id.* at ¶27). Former SEC Chairman Arthur Levitt described "cookie jars" as one of the main "gimmicks" used by public companies to manipulate their earnings: "they stash accruals in cookie jars during the good times and reach into them when needed in the bad times." The practice became popular in the 1990s and 2000s as the economic environment provided opportunities for companies to manipulate their earnings to produce more linear, stable results. (*Id.* at ¶ 28). The practice of deferring the recognition of revenues to a later period in order to manipulate earnings is a GAAP violation. *See* Devor Decl. ¶22; Pitt Decl. ¶15. As referenced in the accounting literature described below and explained in the accompanying Pitt and Devor Declarations, when companies misleadingly shift revenue or earnings from one period to another for the purpose of making the latter period look better, it violates GAAP. This practice is known as "cookie jar" accounting, "earnings management" or "smoothing," and constitutes an improper manipulation of the subject financial statements. The use of such accounting manipulations is often tied to an entity's need to achieve or report predetermined financial results or stable earnings. (SAC ¶ 29). The establishment and/or manipulation of so-called "cushion" or "cookie jar" reserves has been identified as an accounting practice where entities improperly use portions of the results from periods of good financial performance to set aside amounts (e.g., through the

creation of accruals or reserves) that can be reversed in future periods, when profits may be lower than management or market expectations. (*Id.* at ¶ 30). Creating a cookie jar to move revenue from one period to another is misleading because recognizing revenue and earnings in the proper periods is critical to the transparency of financial statements. Indeed, the accounting literature places significant emphasis on the fact that one of the goals of financial statements based on accrual accounting (as CommVault's were at all relevant times) "is to account in the periods in which they occur for the effects on an entity of transactions and other events and circumstances" through the use of the "matching principle" – matching revenues to the period to which they relate. *See* Devor Decl. ¶¶19-20 (citing FASCON 6). Moreover, accounting guidance requires that in order for financial information to be reliable, it must "faithfully represent[] what it purports to represent." Devor Decl. ¶16 (citing FASCON 2). (SAC ¶ 31).

"In view of such principles, it would be improper under GAAP to defer the recording of revenues to a later period if such revenue is both (1) realized and realizable and (2) earned, especially if the purpose of such is to manipulate earnings …." Devor Decl. ¶22. Here, "Plaintiff alleges that Defendants employed such a practice during the Class Period and that, by virtue of such, were able to report revenue growth measures that equaled estimates that had been communicated to the public." Devor Decl. ¶26. Accordingly, Devor concludes that "CommVault improperly utilized what is known in the accounting and investing worlds as 'cookie jar' accounting, in violation of GAAP." Devor Decl. ¶39. (SAC ¶ 32). Similarly as former Chairman Pitt explains, the use of a "cookie jar" to improperly smooth earnings creates "a fictitious or materially misleading picture of a company's actual results of operation . . . , and investors and shareholders are deceived." Pitt Decl. ¶15. (SAC ¶ 33).

In the fourth quarter of fiscal 2013, CommVault achieved historic software revenue

growth, and deferred record amounts of software revenue. Specifically, from the beginning of fiscal 2011 through the third quarter of fiscal 2013, the Company's balance in its deferred software revenue account was as low as $722,000 and was never greater than $3.1 million. (SAC ¶ 51). In the fourth quarter of fiscal 2013, CommVault's deferred software revenue jumped from $3.1 million to nearly $9.2 million. At the outset of the Class Period, Defendants improperly deferred revenue recognition on certain license sales to create a $9.2 million "cookie jar" reserve that they would use during the Class Period to hide from investors the fact that CommVault was unable to generate enough software revenue to meet its revenue growth targets. (*Id.* at ¶51).

Plaintiff also relies on confidential witnesses to corroborate its "cookie jar" accounting theory. For example, CW1 confirmed that "CommVault was skimming revenue off deferred revenue just to make the numbers look good." (SAC ¶52). CW4 similarly confirmed that when the Company had enough revenue for the current quarter, it would roll some over to the next quarter so that the next quarter would look good. (*Id.*) By deferring recognition of the software revenue put into its "cookie jar" until the second and third quarters of fiscal 2014, and then falsely attributing its ability to meet software revenue targets to "pure software license growth," Defendants were able to create the illusion that CommVault was still a high growth Company, notwithstanding the loss of its partnerships with Dell. (*Id.*).

Plaintiff also contends that the fluctuations in CommVault's deferred software balance reinforce this theme. (*Id.* at ¶ 53). CommVault's deferred software revenue balance increased during the otherwise excellent fourth quarter of 2013, and decreased during the second and third quarters of 2014, which, without the recognition of deferred software revenue from the "cookie jar," would not have met the 20% year-over-year growth threshold. Devor also noted this in his Declaration, indicating that the above witness statements are consistent with both his

understanding of a cookie jar accounting scheme and with the "growth and decline of the deferred revenue balances reflected in CommVault's public filings during the relevant timeframe." Devor Decl. ¶34. (*Id.* at ¶53).

This "cookie-jar" accounting caused a substantive increase in CommVault's deferred software revenue balance, increasing it by over $6 million, nearly three times greater than any other deferred software revenue increase in the previous five fiscal years. Plaintiffs allege that Defendants use of the cookie jar was to create the illusion that CommVault was meeting its 20% year-over-year growth targets. These accounting manipulations concealed from investors the revenue deficiency caused by the loss of its partnership with Dell and the resulting sales force attrition.

Plaintiffs allege further that the Individual Defendants made false and misleading statements in SEC filings, conference calls, and industry conferences with securities analysts regarding CommVault's ability to replace its Dell business and the impact of deferred revenue as an indicator of growth. Specifically, Plaintiffs allege that Defendants repeatedly downplayed the impact of deferred revenue, and told investors that there is no connection between CommVault's recognition of deferred revenue and its software revenue growth.

Finally, before the opening of the market of April 25, 2014, investors learned the truth about CommVault's decelerating software revenue and how the loss of its Dell partnership was a direct cause of the deceleration. (SAC ¶ 150). On that day, CommVault announced that its fiscal fourth quarter profit had declined 7.8% and its software revenue decelerated to 10% year-over-year, half of the 20% growth investors expected. (Id.). Despite CommVault's insistence that deferred revenue was a meaningless indicator of growth, without recognition of deferred software licensing revenue, the company could no longer conceal the revenue growth

deceleration that it had been steadily experiencing due to the loss of its partnership with Dell. (Id.) Once the disclosure of the deceleration was made, the price of CommVault stock fell from $68.58 per share to $47.56 per share, over 30%, wiping out nearly $1 billion of market value (SAC ¶ 152).

Legal Standard & Analysis:

Motion To Strike

Because the Motion to Strike could potentially impact the adequacy of the allegations of the Complaint, the Court will first address this motion. Defendants contend that it is improper at the pleading stage for Plaintiffs to include the declarations of experts in order to "fill factual voids" in the Complaint. Defendants rely primarily on two cases, *DeMarco v. Depo Tech Corp.*, 149 F.Supp.2d 1212 (S.D.Ca. 2001) and *Rose v. Bartle*, 871 F.2d 331 (3d Cir. 1989), for the proposition that such declarations are improper.

Plaintiff counters that it included these declarations in response to the Court's ruling that "technical support" was needed in the pleading in order to adequately allege that Defendants' cookie-jar accounting was improper. Moreover, Plaintiffs contend that striking a pleading is a particularly harsh remedy, which is not warranted in this case. Plaintiffs rely on a number of cases for the proposition that it is proper in securities fraud cases to rely upon expert testimony in the pleading stage.

Rule 10(c) provides in pertinent part: "A copy of any written instrument which is an exhibit to a pleading is a part hereof for all purposes." Fed. R. Civ. P. 10(c); *DeMarco v. DepoTech Corp.*, 149 F.Supp.2d 1212, 1220 (S.D.Ca. 2001). A "written instrument" within the meaning of Rule 10(c) "is a document evidencing legal rights or duties or giving formal expression to a legal act or agreement, such as a deed, will, bond, lease, insurance policy or

security agreement." *Murphy v. Cadillac Rubber & Plastics, Inc.,* 946 F.Supp. 1108, 1115 (W.D.N.Y.1996). Within this District, in *In re: Enzymotec Securities Litigation*, the Court permitted the use of expert declarations specifically in the context of a securities fraud case. 2015 WL 8784065 at * 19 (D.N.J. Dec. 15, 2015). Specifically, the Court found that "[a]lthough the declaration of an outside expert . . . is admittedly not as strong as a confidential witness, the declaration of [the expert] only serves to supplement the allegations contained in the Amended Complaint." *Id.* (relying on *Pub. Employees Ret. Sys. of Mississippi, Puerto Rico Teachers Ret. Sys. v. Amedisys*, 796 F.3d 313, 323 (5th Cir. 2014) *cert. denied sub nom. Amedisys, Inc. v. Pub. Employees' Ret. Sys. of Mississippi*, 135 S.Ct. 2892 (2015) (noting use of declaration of outside expert)).

Here, the Court finds that the declarations of Harvey L. Pitt, the former Chairman of the Securities and Exchange Commission, and Harris Devor, a Certified Public Accountant, are proper at the pleading stage, especially because the Court specifically indicated that technical support was required to support the GAAP violation. Moreover, the declarations are adequately incorporated into the Complaint, and as such, only serve to supplement the factual basis alleged. More specifically, Plaintiffs do not rely exclusively on these expert declarations, but instead allege facts (*i.e.* highlight the amount of deferred revenue and include confidential witness testimony) in support of the "cookie jar" accounting theory. Accordingly, Defendants' Motion to Strike the Expert Declarations is denied.

<u>Motion to Dismiss Pursuant to Rule 12(b)(6)</u>

Defendants seek dismissal of Plaintiff's Second Amended Complaint. On a motion to dismiss for failure to state a claim pursuant to Fed. R. Civ. P. 12(b)(6), the Court is required to accept as true all allegations in the Complaint and all reasonable inferences that can be drawn

therefrom, and to view them in the light most favorable to the non-moving party. *See Oshiver v. Levin, Fishbein, Sedran & Berman,* 38 F.3d 1380, 1384 (3d Cir. 1994). "To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'" *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570, 127 S. Ct. 1955, 167 L. Ed. 2d 929 (2007)). While a court will accept well-pleaded allegations as true for the purposes of the motion, it will not accept bald assertions, unsupported conclusions, unwarranted inferences, or sweeping legal conclusions cast in the form of factual allegations. *Iqbal*, 556 U.S. at 678-79; *see also Morse v. Lower Merion School District*, 132 F.3d 902, 906 (3d Cir. 1997). A complaint should be dismissed only if the well-pleaded alleged facts, taken as true, fail to state a claim. *See In re Warfarin Sodium*, 214 F.3d 395, 397-98 (3d Cir. 2000). The question is whether the claimant can prove any set of facts consistent with his or her allegations that will entitle him or her to relief, not whether that person will ultimately prevail. *Semerenko v. Cendant Corp*., 223 F.3d 165, 173 (3d Cir.), *cert. denied, Forbes v. Semerenko*, 531 U.S. 1149, 121 S. Ct. 1091 (2001). The pleader is required to 'set forth sufficient information to outline the elements of his claim or to permit inferences to be drawn that these elements exist.'" *Kost v. Kozakewicz*, 1 F.3d 176, 183 (3d Cir. 1993) (quoting 5A Wright & Miller, Fed. Practice & Procedure: Civil 2d § 1357 at 340). "While a complaint attacked by a Rule 12(b)(6) motion to dismiss does not need detailed factual allegations, a plaintiff's obligation to provide the 'grounds' of his 'entitle[ment] to relief' requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do, ... Factual allegations must be enough to raise a right to relief above the speculative level, . . . on the assumption that all the allegations in the complaint are true (even if doubtful in fact), ..." *Twombly*, 550 U.S. at 555, 127 S. Ct. at 1964-65 (internal citations and quotations omitted).

1. Heightened Pleading Pursuant to Rule 9(b) & the PLSRA

Securities fraud claims are subject to the heightened pleading requirements of Fed. R. Civ. P. 9(b). Rule 9(b) provides, in relevant part: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." Fed. R. Civ. P. 9(b). This particularity requirement has been rigorously applied in securities fraud cases. See, e.g., *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1417 (3d Cir.1997). Plaintiffs asserting securities fraud claims must specify "the who, what, when, where, and how: the first paragraph of any newspaper story." *In re Advanta Corp. Sec. Litig.*, 80 F.3d 525, 534 (3d Cir.1999) (quotations and citation omitted). "Although Rule 9(b) falls short of requiring every material detail of the fraud such as date, location, and time, plaintiffs must use 'alternative means of injecting precision and some measure of substantiation into their allegations of fraud.'" *In re Rockefeller Center Properties, Inc., Sec. Litig.*, 311 F.3d 198, 216 (3d Cir.2002) (quoting *In re Nice Sys., Ltd. Sec. Litig.*, 135 F.Supp.2d 551, 577 (D.N.J.2001)). The rigid requirements of Rule 9(b) may be relaxed if it is shown that the requisite factual information is peculiarly within the defendants' knowledge or control. See *In re Exxon Mobil Corp. Sec. Litig.*, 387 F.Supp.2d 407, 427 (D.N.J.2005) ("In order to receive the benefit of the relaxed standard, at the very least plaintiffs must allege that the necessary information lies within the defendants' control.") (internal quotations and citation omitted). Failure to meet the threshold pleading requirements of Rule 9(b) justifies dismissal apart from Rule 12(b)(6). See *California Public Employees' Retirement System v. Chubb Corp.*, 394 F.3d 126, 145 (3d Cir.2004).

In addition to Rule 9(b), plaintiffs alleging securities fraud must also comply with the heightened pleading requirements of the Private Securities Litigation Reform Act ("PSLRA"), 15 U.S.C. §78u-4(b). See, e.g., *Rockefeller*, 311 F.3d at 217. The PSLRA "imposes another layer of

factual particularity to allegations of securities fraud." *Id.* at 217. A complaint that fails to comply with the requirements of the PSLRA must be dismissed. 15 U.S .C. § 78u-4(b)(3)(A). The PSLRA requires that a complaint which asserts a Section 10(b) claim must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

2. Violations of Section 10(b) and Rule 10b-5

Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful "to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange...any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b). Among the rules and regulations promulgated under Section 10(b), Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,...
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

In a securities fraud action brought pursuant to Section 10(b) and Rule 10b-5, the basic elements to be alleged by a plaintiff are: (1) a material misrepresentation or omission by the

defendant; (2) scienter, i.e., a wrongful state of mind on the part of the defendant; (3) in connection with the purchase or sale of a security; (4) reliance, often referred to in fraud-on-the-market cases as "transaction causation;" (5) economic loss; and (6) "loss causation," i.e., a causal connection between the material misrepresentation and the loss. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 125 S.Ct. 1627, 1631, 161 L.Ed.2d 577 (2005).

With respect to allegations of misleading statements and omissions, such as those made under Rule 10b-5(b), the PSLRA requires plaintiffs to "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity the facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). This provision requires plaintiffs to set forth the details of allegedly fraudulent statements or omissions, including "who was involved, where the events took place, when the events took place, and why any statements were misleading." *Rockefeller*, 311 F.3d at 217. Plaintiffs are not required to "plead with particularity every single fact upon which their beliefs concerning false or misleading statements are based. Rather, plaintiffs need only plead with particularity *sufficient* facts to support those facts." *California Public Employees' Retirement Systems v. Chubb Corp.*, 394 F.3d 126, 146 (3d Cir. 2004) (emphasis in original).

Although the PSLRA is "silent regarding the source of the plaintiff's facts" when "plaintiffs rely on confidential personal sources . . . they need not name their sources as long as the . . . facts provide an adequate basis for believing that the defendants' statements were false." *Id.* at 146-47. When assessing the particularity of the allegations made regarding confidential informants, the court must examine "the detail provided by the confidential sources, the sources' basis of knowledge, the reliability of the sources, the corroborative nature of other facts alleged,

including from other sources, the coherence and plausibility of the allegations, and similar indicia." *Id.* at 147. A plaintiff's failure to aver "when any of [the confidential witnesses] were employed by [Defendant] . . . the dates that [the] sources acquired the information, or how any of [the] former employees had access to such information" is insufficient because it forces the court to speculate "whether the anonymous sources obtained the information they purport to possess by firsthand knowledge or rumor." *Id.* at 148.

In applying these standards, Plaintiff's Complaint meets the PSLRA's particularity standards for allegations made on "information and belief." As this Court previously ruled, Plaintiffs "have sufficiently alleged the confidential witnesses, their dates of employment, their job description and their relevant responsibility [and] to whom they reported." ECF No. 75, T6:5-8. Moreover, the Court discounted Defendants' argument that the CW's, as low level employees, would not have first-hand knowledge of the information and were relying on gossip. Specifically, this Court previously found that "employees in the marketing departments, especially at the level of the confidential witnesses, most likely had the firsthand knowledge as to the impact occurring on the ground, and whether CommVault could meet its growth targets." T7:18-21. Moreover, "the sales force would know the pulse of the company, and would often communicate among the different sales territories in order to facilitate leads and to learn about problems the company was experiencing . . . [T]hey were most likely relying upon sales activity." T7:23-8:4.

As to the GAAP violations and "cookie jar" accounting, the Court finds that the SAC adequately addresses the shortfalls in the FAC, and sufficiently alleges this theory. As *USA Today* defined, cookie jar accounting is a practice "in which a company uses generous reserves from a good year against losses that might be incurred in bad years." Not only does Plaintiff supplement the factual allegations with the expert declarations, but the Complaint also

adequately explained the requirements under GAAP and why "cookie jar" accounting is improper. (SAC ¶¶ 34-47). Moreover, Plaintiff identifies CommVault's internal accounting methods. (SAC ¶¶48-53). Defendants take issue with the tax upon which the CW's relied to show a GAAP violation. Specifically, Defendants assert that these CW's lack first-hand knowledge of accounting, and that the Complaint fails to link the allegations of deferring commissions with the alleged GAAP violation. However, when considering the Complaint as a whole, Plaintiff has set forth a plausible claim. For example, CW1 confirmed that "CommVault was skimming revenue off deferred revenue just to make the numbers look good." CW4 similarly confirmed that when the Company had enough revenue for the current quarter, it would roll some over to the next quarter so that the next quarter would look good. By deferring recognition of the software revenue put into its "cookie jar" until the second and third quarters of fiscal 2014, and then falsely attributing its ability to meet software revenue targets to "pure software license growth,"

Defendants were able to create the illusion that CommVault was still a high growth Company, notwithstanding the loss of its partnerships with Dell. (SAC ¶ 52). These allegations, coupled with the confidential witnesses and the cookie jar accounting allegations are sufficient pleading stage.

In sum, the allegations regarding the loss of Dell, juxtaposed with Defendants' representations to the investing public that they had replaced Dell's business, are sufficient to make out a claim that Defendants made false or materially misleading statements.

Materiality

Defendants assert that Plaintiff has not shown that Defendants made materially misleading statements regarding deferred software revenue or CommVault's relationship with

Dell. With respect to the first element, that is, the materiality of the statement or omission, there must be a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of the information available. *In re Advanta Corp.*, 180 F.3d at 538 (internal quotation omitted). Moreover, "the materiality of disclosed information may be measured post hoc by looking at the movement, in the period immediately following disclosure, of the price of the firm's stock." *In re Able Laboratories*, 2008 WL 1967509 at *14 (D.N.J 2008) (citing *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d at 1425).

Here, Plaintiff alleges that CommVault's stock was traded on the NASDAQ (FAC ¶ 16) and that the stock price plunged from $68.58 per share to $47.56 per share, or over 30%, wiping out nearly $1 billion of market value (SAC ¶ 16) after CommVault disclosed that it was unable to replace its Dell business and meet its growth targets of 20% year-over-year. The SAC also identified numerous statements made during the class period that allegedly were misstatements or omissions of material facts related to CommVault's partnership with Dell and ability to meet growth targets. Specifically, Defendants touted the strength of the Dell relationship in May 8, 2012 (SAC ¶ 60) and as late as May 2013 wherein Defendants represented that "we have successfully shifted most of our SMB [small and medium business] business to non-Dell distribution partners." (SAC ¶ 65). When CommVault's inability to replace the Dell revenue completely was disclosed prior to the market opening on April 25, 2014, the market reacted quickly and adversely. Alleging, as the SAC does here, the significant decrease in stock price immediately following CommVault's disclosure, satisfied the pleading standard for materiality.

<u>Scienter</u>

With respect to claims that require proof that the defendants acted with a particular state of mind, such as those made under any of the three subsections of Rule 10b-5, the PSLRA requires that "the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity the facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). In order to determine whether a complaint's scienter allegations can survive a threshold inspection for sufficiency, a court must "engage in a comparative evaluation; it must consider not only inference urged by the plaintiff but also competing inferences rationally drawn from the facts alleged." *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499, 2504-05 (2007). In making this determination, "courts must consider the complaint in its entirety. . . The inquiry is whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." *Id.* at 2509. In actions under Rule 10b-5, a plaintiff may establish the requisite strong inference of scienter by stating either: "(1) facts which show that defendants had both motive and opportunity to commit fraud"; or (2) "by setting forth facts that constitute circumstantial evidence of either recklessness or conscious behavior." *Advanta*, *supra,* 180 F.3d at 534-35. Recklessness involves "not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *In re Advanta Corp.*, 180 F.3d at 535 (internal quotation omitted).

Here, Plaintiff has alleged sufficient facts giving rise to the strong inference that, throughout the class period, Defendants knew or recklessly disregarded that, contrary to their

repeated public statements, CommVault was experiencing decelerating software growth due to the loss of its partnership with Dell, and that the company improperly deferred software revenue to hide from investors the truth about decelerating revenue growth. When examining the complaint holistically, it raises a strong inference of Defendants' scienter. Initially, the fact that the allegations of fraud pertain the CommVault's core business, that is, software licensing revenue, may impute knowledge on the Defendants. *In re Campbell Soup Co Sec. Lit.*, 145 F.Supp.2d 574, 599 (D.N.J. 2001). Moreover, Plaintiffs have alleged significant circumstantial evidence giving rise to a strong inference of scienter. For example, the 2013 Chicago meeting, openly discussing the loss of Dell's business, indicates that Defendants knew that replacing Dell would be a challenge. Moreover, Defendants emphatic and repeated denial of the impact of the loss of Dell and the effect of deferred revenue on growth demonstrates that, at minimum, they were reckless in disregarding investor's concerns on these issues. Finally, Hammer's sale of his stock demonstrates that he an opportunity to commit fraud. Specifically, Plaintiffs allege that Hammer sold more than 268,500 shares of CommVault during the class period, for proceeds of more than $18.6 million. To the extent that Defendants contend that this was merely an exercise of options that were set to expire, this is a factual question outside the Complaint. Moreover, Plaintiff goes further and alleged the temporal proximity between Hammer's representations that the deferred revenue was unrelated to growth. Specifically, on February 11, 2014, Hammer represented that deferred revenue would not impact growth, and two days later, Hammer sold 44,630 shares for proceeds of over $3 million. (SAC ¶ 173). Four days after that, on February 18, 2014, Hammer sold another 68,851 shares for proceeds of nearly $5 million. (*Id.*) On March 5, 2014, Hammer sold another 148,339 shares for over $10 million. (*Id.*)

Accordingly, Plaintiffs have alleged sufficient facts giving rise to a strong inference of scienter.

Loss Causation

With regard to loss causation, the PSLRA requires plaintiffs in securities actions to carry the burden of "proving that the act or omission of the defendant...caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). The Third Circuit has addressed this issue and found that plaintiffs must show that there is both: (1) a sufficient causal connection between the alleged loss and the alleged misrepresentations; and (2) that the stock price dropped in response to the disclosure of the alleged misrepresentations. *Semerenko v. Cendant Corp.*, 223 F.3d 165, 183-87 (3d Cir.2000). If a plaintiff cannot demonstrate a causal nexus exists between the stock price drop identified, and the misleading statement or omissions of which the plaintiff complains, a plaintiff has failed carry the burden of proving proximate causation and the claims must be dismissed. *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S.Ct. 1627,1634 (2005). The "causation issue becomes most critical at the proof stage. Whether the plaintiff has proven causation is usually reserved for the trier of fact." *EP Medsystems, Inc. v. EchoCath, Inc.*, 235 F.3d 865, 884 (3d Cir.2000). The Court must view the allegations "in a light most favorable to the Section 10(b) plaintiff" and avoid making determinations on factual issues during a motion to dismiss. *In re MobileMedia Securities Litig.*, 28 F.Supp.2d 901, 940 (D.N.J.1998).

Here, the parties do not dispute loss causation, and, as already provided, CommVault's stock price plunged from $68.58 per share to $47.56 per share, or over 30%, wiping out nearly $1 billion of market value (SAC ¶ 265) after CommVault disclosed that it was unable to replace its Dell business and meet its growth targets of 20% year-over-year. Therefore, Plaintiff have sufficiently pled loss causation.

For all of the foregoing reason, Defendants' Motion to Dismiss is denied.

ORDER

IT IS on this 30th day of September, 2016;

ORDERED that the Motion to Dismiss the Second Amended Complaint (ECF No. 76) is denied; and it is further;

ORDERED that the Motion to Strike the Expert Declarations attached to Plaintiffs' Seconded Amended Complaint (ECF No. 77) is denied.

s/Peter G. Sheridan
PETER G. SHERIDAN, U.S.D.J.

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8 **UNITED STATES DISTRICT COURT**
9 **FOR THE CENTRAL DISTRICT OF CALIFORNIA**
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HSINGCHING HSU, Plaintiffs, v. **PUMA BIOTECHNOLOGY, INC. ET AL.** Defendants.	CASE NO. SACV 15-0865 AG (JCGx) **ORDER DENYING MOTION TO DISMISS**

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Lead Plaintiff Norfolk County Council, as administering authority of the Norfolk Pension Fund, and others filed this lawsuit under the Securities Exchange Act of 1934 ("Exchange Act") and Securities and Exchange Commission Rule 10b-5. Defendants Puma Biotechnology, Inc., Alan H. Auerbach, and Charles R. Eyler (collectively, "Puma") filed a motion to dismiss the case ("Motion to Dismiss") under Federal Rule of Civil Procedure 9(b) ("Rule 9(b)"), Federal Rule of Civil Procedure 12(b)(6) ("Rule 12(b)(6)"), and the Private Securities Litigation Reform Act ("PSLRA").

The Court DENIES the Motion to Dismiss.

1. BACKGROUND

In 2013—the most recent year numbers are available—232,924 people in the United States were diagnosed with breast cancer. Breast Cancer Statistics, Centers for Disease Control and Prevention, http://www.cdc.gov/cancer/breast/statistics/index.htm (last visited September 30, 2016). That year, 41,324 people in the United States died from breast cancer. *Id.* The disease is the most common cancer among women in our country. *See id.* And as they often do, statistics fail to give us the right measure of heartbreak. Breast cancer radically reshapes the lives of our mothers and daughters, sons and fathers, brothers and sisters, husbands and wives, friends and family, every day of every year, in every corner of every country. The disease's impact far too often includes (but never ends with) the loss of those who we love most.

Some of the science behind this sickness is relevant here. In particular, this case revolves around statements about a potential treatment for a subset of breast cancers that are called HER2-positive breast cancers. A fourth or fifth of breast cancer patients are HER2-positive: they have cells that make too many copies of a cell surface receptor called human epidermal growth factor receptor 2, or HER2 for short. These HER2 receptors promote cell

division and proliferation, which results in HER2-positive breast cancer spreading more aggressively than other types of breast cancer. There are drugs that combat overexpression of the HER2 gene, but most patients develop resistance to them after a year. So up until now, there generally haven't been any drugs that patients with HER2-positive breast cancer can use after a year on the existing drugs.

Puma hoped to change this. It's a pharmaceutical company that acquires and develops new drugs. Puma has focused its efforts almost entirely on drug PB272, also called neratinib. Neratinib is an "extended adjuvant treatment." "Extended" refers to neratinib's viability as a long-term treatment beyond the year window that existing drugs cover. "Adjuvant therapy" means that neratinib is a therapy given after an initial treatment (such as surgery) to help suppress further formation of cancerous tumors. Neratinib is supposed to irreversibly bind to the HER2 receptor, and eventually slow down or stop out-of-control cell growth.

There was a clinical trial of neratinib called the ExteNET trial. This case concerns Puma's statements about the results of that trial. In short, Norfolk County Council and other investors accuse Puma and its executives of making false or misleading statements about the ExteNET trial results, and accordingly filed this putative class action.

The alleged misstatements are basically about two things. First, there's the DFS rate. The success of the ExteNET neratinib trial was primarily measured by the percentage of disease free survival ("DFS") among patients taking neratinib versus those taking a placebo. Norfolk County Council says Puma lied to or misled investors and others about the absolute DFS rates coming out of the ExteNET trial and the improvement in DFS between the neratinib group and the placebo group. Second, there are the Kaplan-Meier curves. These are used to identify trends in DFS rates over time—here, for example, between the neratinib group and the placebo group. What's the DFS difference between the two groups after two years? Four years? Eight years? The Kaplan-Meier curves would tell you. A widening

difference between the neratinib group and the placebo group over time could suggest that the drug is effective. Norfolk County Council says Puma lied to or misled investors and others about whether that the gap was widening over time, when it was really narrowing.

Finally, there's a money side to medicine too, of course. A few figures are relevant here. During a public offering, Puma sold $218.5 million in Puma stock. Defendants Auerbach and Eyler—both Puma executives—earned more than $23 million in performance-based compensation. If neratinib makes it to the market, it's expected to cost $6,500 a month, or $78,000 a year.

2. LEGAL STANDARD

A court will grant a motion to dismiss if the complaint does not allege claims upon which relief can be granted. Fed. R. Civ. P. 12(b)(6). A complaint must contain "a short and plain statement of the claim showing that the pleader is entitled to relief." Fed. R. Civ. P. 8(a)(2). A claim to relief must be plausible on its face. *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007). "A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009).

Securities fraud claims like the ones in this case require more. Specifically, they "must satisfy the heightened pleading requirements of both Federal Rule of Civil Procedure 9(b) and the [PSLRA]." *In re Rigel Pharm., Inc. Sec. Litig.*, 697 F.3d 869, 876 (9th Cir. 2012). Rule 9(b) "requires particularized allegations of the circumstances constituting fraud, including identifying the statements at issue and setting forth what is false or misleading . . . about the statement and why the statements were false or misleading at the time they were made." *Id.* The PSLRA requires "plaintiffs to state with particularity both the facts constituting the alleged violation and the facts evidencing" that the defendants had the required state of

mind. *Id.*

In analyzing the complaint's sufficiency, a court must "accept[] all factual allegations in the complaint as true and constru[e] them in the light most favorable to the nonmoving party." *Skilstaf, Inc. v. CVS Caremark Corp.*, 669 F.3d 1005, 1014 (9th Cir. 2012).

3. WHAT (ELSE) SHOULD THE COURT CONSIDER?

The Court has accordingly accepted all the facts alleged in the complaint as true. But there are remaining questions about what else the Court can consider in its analysis of the Motion to Dismiss.

Typically, a court can only consider what's in the complaint when it is deciding a Rule 12(b)(6) motion to dismiss a complaint. *See Lee v. City of Los Angeles*, 250 F.3d 668, 688 (9th Cir. 2001). And typically, if a court considers more than what's in the complaint, the motion gets converted into a Federal Rule of Civil Procedure 56 ("Rule 56") motion for summary judgment. *See* Fed. R. Civ. P. 12(d). This conversion can muddy the analysis for clients, counsel, and courts alike, by implicating rules and requirements that don't otherwise apply to motions to dismiss. *See, e.g.*, L.R. 56-1 (requiring that a party moving for summary judgment file a separate "Statement of Uncontroverted Facts and Conclusions of Law"); *see also Kramer v. Time Warner Inc.*, 937 F.2d 767, 773 (2d Cir. 1991) ("If a district court wishes to consider additional material, Rule 12(b) requires it to treat the motion as one for summary judgment under Rule 56, giving the party opposing the motion notice and an opportunity to conduct necessary discovery and to submit pertinent material.").

But there are a couple of doctrines that allow a court to consider material outside of the complaint without turning a Rule 12(b)(6) motion to dismiss into a Rule 56 motion for summary judgment: judicial notice and incorporation by reference. *United States v. Ritchie*, 342

F.3d 903, 908 (9th Cir. 2003); *see also In re Rigel Pharm., Inc. Sec. Litig.*, 697 F.3d at 876 (holding that a court deciding a motion to dismiss for failure to state a claim is "generally limited to the face of the complaint, materials incorporated into the complaint by reference, and matters of which [the court] may take judicial notice").

3.1 Judicial Notice

First, judicial notice. Judicial notice is an explicitly limited doctrine that's supposed to be used to allow a court to consider "a fact that is not subject to reasonable dispute because it: (1) is generally known within the trial court's territorial jurisdiction; or (2) can be accurately and readily determined from sources whose accuracy cannot reasonably be questioned." Fed. R. Evid. 201. For example, a court might take judicial notice that January 4, 1986, was a Saturday, or that a party filed a brief opposing a motion in a state court case, or that a particular document was recorded with the county recorder's office. *See Lee*, 250 F.3d at 690 (discussing judicial notice of undisputed matters of public record); *see also Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579, 592 n.11 (1993) (discussing judicial notice of "firmly established" scientific laws); *Barnes v. Indep. Auto. Dealers Ass'n of Cal. Health & Welfare Benefit Plan*, 64 F.3d 1389, 1395 (9th Cir. 1995) (discussing judicial notice of "[w]ell-known medical facts").

Judicial notice functions like an evidentiary exception in two different ways. First, judicial notice can be a substitute for the presentation of evidence. As a general rule, a party asserting a fact bears the burden of proving that fact with evidence. But judicial notice lets a party skip this production (and the accompanying authentication) for certain facts. *See Castillo-Villagra v. INS*, 972 F.2d 1017, 1026 (9th Cir. 1992) ("Notice is a way to establish the existence of facts without evidence."). Second, as noted, judicial notice can be a workaround for the exclusion of evidence. As a general rule, parties can't present (and courts can't consider) evidence outside of the complaint when deciding a Rule 12(b)(6) motion to

dismiss. *See Hal Roach Studios, Inc. v. Richard Feiner & Co.*, 896 F.2d 1542, 1555 n.19 (9th Cir. 1989). But "[f]acts subject to judicial notice may be considered on a motion to dismiss." *Maiman v. Talbott*, No. SACV 09-0012 AG (ANx), 2011 WL 13065750, at *2 (C.D. Cal. Aug. 29, 2011) (citing *Mullis v. U.S. Bankr. Ct.*, 828 F.2d 1385 (9th Cir. 1987)).

Unfortunately, too many attorneys don't understand judicial notice. Some take judicial notice literally, as a command. "Hey! Judge! Look!" They use judicial notice to get a court's attention like a businessman who's running late and trying to whistle down a taxi on a crowded downtown street. But courts aren't cabbies, and judicial notice isn't appropriately used this way. Other attorneys ask courts to judicially notice things that don't need to be judicially noticed, like a controlling piece of law. Or attorneys ask courts to judicially notice things that aren't appropriate for judicial notice, like emails between the parties' counsel. All of these misuses misconstrue the narrow doctrine.

3.2 Incorporation by Reference

There's also the doctrine of incorporation by reference. As this Court has previously noted, "[a]lthough often conflated, the doctrine of incorporation by reference is distinct from judicial notice." *Gammel v. Hewlett Packard Co.*, 905 F. Supp. 2d 1052, 1061 (C.D. Cal. 2012). Further confusing things, different courts and counsel use "incorporation by reference" to encompass at least three different approaches to extrinsic evidence.

In its most limited and literal form, incorporation by reference allows a court deciding a Rule 12(b)(6) motion to dismiss to consider materials attached to the complaint that are referenced in the complaint. *Hal Roach Studios*, 896 F.2d at 1555 n.19. This application of the doctrine echoes Federal Rule of Civil Procedure 10, which states in relevant part that "[a] copy of a written instrument that is an exhibit to a pleading is a part of the pleading for all purposes." Fed. R. Civ. P. 10(c).

1 Incorporation by reference has also been used to allow a court deciding a Rule
2 12(b)(6) motion to dismiss to consider a document that isn't attached to the complaint if the
3 complaint "necessarily relies" on it and "(1) the complaint refers to the document; (2) the
4 document is central to the plaintiff's claim; and (3) no party questions the authenticity of the
5 copy attached to the 12(b)(6) motion." *Marder v. Lopez*, 450 F.3d 445, 448 (9th Cir. 2006).
6 The Ninth Circuit has suggested the complaint must refer to the document "extensively."
7 *Ritchie*, 342 F.3d at 908.
8
9 In its most expansive form, incorporation by reference has been used to get a court
10 considering a Rule 12(b)(6) motion to dismiss to consider materials that are neither attached
11 to nor mentioned in the complaint. Specifically, the Ninth Circuit has
12
13 > extended the "incorporation by reference" doctrine to situations in which the
14 > plaintiff's claim depends on the contents of a document, the defendant attaches
15 > the document to its motion to dismiss, and the parties do not dispute the
16 > authenticity of the document, even though the plaintiff does not explicitly allege
17 > the contents of that document in the complaint.
18
19 *Knievel v. ESPN*, 393 F.3d 1068, 1076 (9th Cir. 2005). In this way, the incorporation by
20 reference doctrine has become the incorporation without reference doctrine.
21
22 **3.3 The Impact on Access to Justice**
23
24 This last interpretation of the incorporation by reference doctrine and the incorrect
25 use of judicial notice merit more discussion. Although these are two distinct doctrines with
26 different legal requirements, they both can be used to get a court to consider extrinsic
27 evidence on a Rule 12(b)(6) motion to dismiss. For a plaintiff, this consideration can mean
28 having the courthouse doors slammed shut, such that there's no discovery, no further

motion practice, no cross-examination, and no jury trial. For a defendant, this consideration can mean avoiding lengthy litigation, arduous motion practice, and expensive, expansive discovery battles.

This practical reality has led to inappropriate efforts by defendants to expand the two doctrines. These efforts are distinct from the other inappropriate misuses of the doctrines already identified. Nowadays, it seems more and more common to come across Rule 12(b)(6) motions to dismiss filed with hundreds of pages of attachments, authenticated through attorney declarations. These declarations will be coupled with a request for judicial notice. That judicial notice will often conflate judicial notice and incorporation by reference. Too often, these mountainous motions make arguments more appropriate for a motion for summary judgment or some other later stage of the case. Nonetheless, with little to lose, too many defense attorneys are tempted by the puncher's chance offered by such a motion. At worst, they lose a generally inexpensive motion. But at best, they can knock their opponent out cold, right at the beginning of round one. In this way, efforts to expand courts' consideration of extrinsic evidence at the motion to dismiss stage are consistent with other developments in the law that diminish the ability of wronged plaintiffs to get their constitutionally-protected day in court. *See Iqbal*, 556 U.S. 662; *Twombly*, 550 U.S. 544. Such trends are particularly troubling in the common situation of asymmetry, where a defendant starts off with sole possession of the information about the alleged wrongdoing.

3.4 The Doctrines Applied Here

So how do these two doctrines apply here? Puma filed two supporting requests for judicial notice—one with its Motion to Dismiss, and one with its reply. Norfolk County Council opposed the request for judicial notice filed with the Motion to Dismiss, and tried unsuccessfully to get permission to file a surreply opposing the request for judicial notice filed with the reply. There are also incorporation by reference arguments in some of the

requests for judicial notice, reflecting the common conflation of the two doctrines by counsel (and sometimes courts). The parties largely seem to agree that any documents the Court considers under either doctrine should only be considered for their existence, and not for the truth of their contents. *See Gammel*, 905 F. Supp. 2d at 1061.

There are fourteen or fifteen disputed exhibits. Puma asks the Court to consider (one way or another) twenty-eight exhibits as part of its analysis of the Motion to Dismiss. These exhibits consist of SEC filings, transcripts of conference calls, a press release, and a set of slides from a presentation. To its credit, Norfolk County Council only disputes some of the exhibits—specifically, exhibits 14 and 16 through 28. Norfolk County Council also objects to the incompleteness of exhibit 15, but not in any meaningful way. Accordingly, the Court will now consider documents 1 through 13 and 15, without determining whether these documents are appropriate for judicial notice or whether they fall within the doctrine of incorporation by reference.

3.4.1 Should the Court Consider Exhibit 14? Yes, Sort Of.

Exhibit 14 is a set of slides. Puma asks the Court to consider these under the incorporation by reference doctrine, and in the alternative, through judicial notice. Puma says the complaint "references certain materials available on the American Society of Clinical Oncology's ("ASCO") website," including these slides. Norfolk County Council argues that Puma included the wrong set of slides, and attaches what it sees as the right set of slides.

The Court will consider Norfolk County Council's version of Exhibit 14, as Puma asks the Court to do, without determining whether these slides fall within the doctrine of incorporation by reference or whether they are appropriate for judicial notice.

3.4.2 Should the Court Consider Exhibits 16, 17, and 19 through 26? No.

Exhibits 16, 17, and 19 through 26 are market analyst reports. Puma wants the Court to consider these documents through judicial notice "to demonstrate the information publicly available and known to the market." Norfolk County Council argues that Puma hasn't shown that these reports were publically available and that the reports reflect an inherent bias favoring Puma.

The Court agrees with Norfolk County Council that Puma hasn't adequately shown that Exhibits 16, 17, and 19 through 26 should be judicially noticed here. Puma argues that the complaint itself refers to analyst reports, but it doesn't show that the complaint refers to the same reports Puma wants the Court to consider. Puma also cites several cases supporting its proposition that "[m]arket analyst reports . . . are frequently subject to judicial notice" and that judicial notice is appropriate here. But some of these cases don't clarify the types of documents they address. *See, e.g.*, *In re Impact Mortgage Holdings, Inc. Sec. Litig.*, 554 F. Supp. 2d 1083, 1088 (C.D. Cal. 2008) ("The Court takes judicial notice of the 22 documents submitted as exhibits to Defendants' Request for Judicial Notice ('RJN').") Some of these cases discuss different sorts of documents. *See, e.g.*, *In re Nuvelo, Inc. Sec. Litig.*, 668 F. Supp. 2d 1217, 1219 (N.D. Cal. 2009) (discussing a journal article and FDA documents); *Constr. Laborers Pension Trust of Greater St. Louis v. Neurocrine Biosciences, Inc.*, No. 07-CV-1111 IEG RBB, 2008 WL 2053733, at *6 (S.D. Cal. May 13, 2008) ("[D]efendants request judicial notice of several FDA documents."). Some of these cases involve undisputed requests for judicial notice. *See, e.g.*, *Primo v. Pac. Biosciences of Cal., Inc.*, 940 F. Supp. 2d 1105, 1115 n.1 (N.D. Cal. 2013) ("Plaintiffs do not oppose Defendants' requests. Accordingly, the Court GRANTS Defendants' request for judicial notice."). Some of these cases discuss analyst reports objected to on different grounds. *See, e.g.*, *In re Century Aluminum Co. Sec. Litig.*, 749 F. Supp. 2d 964, 980 (N.D. Cal. 2010) ("Plaintiffs object that the . . . analyst reports . . . are hearsay.") All of these cases are meaningfully distinguishable.

3.4.3 Should the Court Consider Exhibit 18? Yes, Sort Of.

Exhibit 18 is a transcript of a conference call. Like the market analyst reports, Puma wants the Court to consider this transcript through judicial notice. Puma offers the transcript "to demonstrate the information publicly available and known to the market." Perhaps conflating judicial notice with the doctrine of incorporation by reference, Norfolk County Council argues that the transcript wasn't referenced in the complaint. And perhaps questioning the accuracy of the transcript, Norfolk County Council argues that the transcript lacks authentication. It compares the transcript to other transcripts that it didn't object to. Puma responded by providing a more properly authenticated transcript.

The Court will consider the more properly authenticated version of Exhibit 18 only because the parties appear to agree that the Court should consider this version of the transcript. This is not a determination that this transcript is appropriate for judicial notice. Puma appears to have addressed most, and maybe all, of Norfolk County Council's concerns. It is unclear why Puma couldn't have done this from the get-go.

3.4.4 Should the Court Consider Exhibit 27? No.

Exhibit 27 is a printout from the website of Herceptin, the name-brand version of another drug called trastuzumab that's used to treat HER2-positive cancer in the first year after the initial treatment. Puma again asks the Court to consider this document through judicial notice. Puma argues that Norfolk County Council "relies on data from four clinical trials for the breast cancer treatment Herceptin, but does not provide full context for those data." Accordingly, Puma argues, the Court should take judicial notice of some "publicly available figures" from the Herceptin website. Norfolk County Council argues (and Puma doesn't seem to dispute) that the webpages Puma provided were captured in November 2015, while the relevant time period for the claims here is from roughly July 2014 through

May 2015. Norfolk County Council also argues that being publicly available online doesn't mean a document is a "source . . . whose accuracy cannot be reasonably questioned," as Puma argues this document is.

The Court agrees with Norfolk County Council that Puma hasn't adequately shown that Exhibit 27 should be judicially noticed here. There are a few problems with Puma's arguments to the contrary. First, Puma appears to improperly push the burden on a request for judicial notice onto the party opposing the request. Specifically, Puma notes that "Plaintiff cites no authority for the argument that the accuracy of the Herceptin website is questionable just because Genentech uses the website to sell Herceptin." Second, Puma argues that the Herceptin website has a link to FDA archives, and that those FDA archives have been up since at least 2010 and can't be reasonably questioned. Maybe. But Puma isn't asking the Court to take judicial notice of the FDA archives.

Or is it? Puma says, "[s]hould Plaintiff continue to dispute the accuracy of Exhibit 27 because its source (the Herceptin website) is questionable, Defendants submit the identical information reflected in the FDA archive as Exhibit 29 to this Reply." This raises a fundamental question of fairness. Moving parties typically get the last written word on motions, through a reply brief. To make things fair then, moving parties can't save arguments or requests to spring on an opponent for the first time in a reply brief, where the opponent has no chance to reply in writing (and given the frequency with which courts allow oral argument these days, often no chance period). Puma's request for the Court to take judicial notice of the FDA archives, presented for the first time in its reply brief, is inappropriate, and accordingly the Court won't address the merits of the issue. That's particularly true because, again, it's not clear why Puma couldn't have included this request in its initial motion. *See* Fed. R. Evid. 201(c)(2) (emphasis added) ("The court . . . must take judicial notice if a party requests it *and the court is supplied with the necessary information*.")

3.4.5 Should the Court Consider Exhibit 28? No.

Exhibit 28 is the "Policies and Exceptions" page from a website maintained by ASCO. Puma again asks the Court to consider this document through judicial notice. But Puma seems to conflate that legal principle with the doctrine of incorporation by reference. Puma says Norfolk County Council "relies on materials submitted to ASCO, but omits the policies governing the submission of such documents." So, Puma says, the Court should take judicial notice of the ASCO Confidentiality Policy, which it pulled in November 2015. As with the Herceptin webpage, Norfolk County Council argues (and Puma doesn't seem to dispute) that the webpages Puma provided were captured in November 2015, while the relevant time period for the claims here is from roughly July 2014 through May 2015. Norfolk County Council also has some objections about how Puma uses this document in its Motion to Dismiss.

The Court agrees with Norfolk County Council that Puma hasn't adequately shown that Exhibit 28 should be judicially noticed here. Puma responds to Norfolk County Council's arguments by providing information from the Internet Archive's Wayback Machine, an online internet page archive, showing the November 2015 page and the relevant page are "substantively identical." But even if the Court accepted this as a sufficient showing to take judicial notice, Puma is again providing this extrinsic evidence to support its extrinsic evidence for the first time in a reply brief.

3.4.6 The Requests for Judicial Notice Generally

Applying the law and the Court's best judgment, the Court has tried to justly resolve the disputes over the requests for judicial notice. But the Court can't help but note that the disputes largely reflect lots of effort with little effect. The Court's ultimate ruling on the Motion to Dismiss wouldn't change if its rulings on these requests for judicial notice were

different, given that it generally had to take all well-plead factual allegations in the complaint as true.

The requests to consider extrinsic evidence weren't inherently inappropriate, as extrinsic evidence does sometimes come in on securities fraud cases like this one. But a dispute over fourteen or fifteen of twenty-eight exhibits may have been unnecessary. A reply brief supporting a request for judicial notice may be unnecessary. An emergency application to file a surreply to that reply brief may be unnecessary. And it's not clear what happened during the meet-and-confer process required under Local Rule 7-3. Puma should have been able to avoid filing a reply laden with new material, and Norfolk County Council should have been able to avoid filing an emergency application to file a surreply responding to that reply, if the parties had meaningfully discussed these requests. It's not clear who's at fault—it's possible Puma didn't adequately describe its planned requests, it's possible Norfolk County Council held back its objections, and it's possible neither side wanted to focus on requests for judicial notice instead of the Motion to Dismiss itself. It's also not particularly important now. The inefficiencies created by whatever happened here are small in the scope of civil litigation. But the Court notes them to encourage counsel to try to avoid them moving forward.

4. ANALYSIS

Finally, at last, to the merits of the Motion to Dismiss. Norfolk County Council asserts two claims: (1) violation of § 10(b) of the Exchange Act and Rule 10b-5 and (2) violation of § 20(a) of the Exchange Act. Both parties appear to agree that the second claim's fate at this point in the case is tied to the fate of the first claim. Accordingly, the Court only discusses the first claim.

1 To adequately plead a violation of Rule 10b-5 based on misstatements, a plaintiff
2 must adequately allege: "1) a material misrepresentation or omission by the defendant; 2)
3 scienter; 3) a connection between the misrepresentation or omission and the purchase or sale
4 of a security; 4) reliance upon the misrepresentation or omission; 5) economic loss; and 6)
5 loss causation." *In re Rigel Pharm., Inc. Sec. Litig.*, 697 F.3d at 876.
6
7 Puma points to three reasons why the Court should shut the courthouse doors on
8 Norfolk County Council's complaint. First, Puma says Norfolk County Council hasn't
9 adequately pled falsity, which is part of the first element. Second, Puma says Norfolk County
10 Council hasn't adequately pled scienter. Third, Puma says Norfolk County Council hasn't
11 adequately tailored its allegations so that each Defendant knows what it supposedly did
12 wrong. Rule 9(b), Rule 12(b)(6), the PSLRA, and the cases interpreting each of these laws
13 provide the relevant pleading standards. For example, there are particular pleading standards
14 applicable to the falsity and scienter elements.
15
16 **4.1 More Pleading Standards**
17
18 The PSLRA has exacting requirements for pleading "falsity." *Metzler Inv. GMBH v.*
19 *Corinthian Colleges, Inc.*, 540 F.3d 1049, 1070 (9th Cir. 2008). A complaint has to "specify each
20 statement alleged to have been misleading, the reason or reasons why the statement is
21 misleading, and, if an allegation regarding the statement or omission is made on information
22 and belief, the complaint shall state with particularity all facts on which that belief is
23 formed." 15 U.S.C.A. § 78u-4.
24
25 Similarly, to adequately plead scienter under the PSLRA, the complaint must "state
26 with particularity facts giving rise to a strong inference that the defendant acted with the
27 required state of mind." 15 U.S.C. § 78u-4(b)(2)(a). Courts have described the required state
28 of mind as one that intends to deceive, manipulate, or defraud. *See Metzler*, 540 F.3d at 1070.

Courts have also said a complaint "must allege that the defendants made false or misleading statements either intentionally or with deliberate recklessness." *Siracusano v. Matrixx Initiatives, Inc.*, 585 F.3d 1167, 1180 (9th Cir. 2009) (quoting *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 991 (9th Cir. 2009), *aff'd sub nom. Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27 (2011) (quotation marks omitted)). But in any case, "[t]he inferences that the defendant acted with scienter need not be . . . of the 'smoking-gun' genre." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 324 (2007).

"[F]alsity and scienter in private securities fraud cases are generally strongly inferred from the same set of facts, and the two requirements may be combined into a unitary inquiry under the PSLRA." *In re Daou Sys., Inc.*, 411 F.3d 1006, 1015 (9th Cir. 2005) (quotation marks omitted) (quoting *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1091 (9th Cir. 2002)). The Court does just that here.

4.2 Falsity, Scienter, and the Adequacy of the Allegations

Norfolk County Council has pled both falsity and scienter well enough to allow this case to get out of the starting gate. Many of Puma's arguments to the contrary are really a better measure of whether Norfolk County Council's case will be victorious past the eighth pole and down to the finish line. The Court has considered all of those arguments, and summarizes and addresses some of them here.

Puma argues that the alleged DFS misrepresentations don't satisfy the falsity pleading requirement because Norfolk County Council is confusing the absolute difference between two DFS rates with another way DFS rates can be evaluated, the hazard ratio. Using the hazard ratio, Puma argues, the disputed representations are true.

1 But there's enough here to force Puma to pony up and present that theory another
2 day. For example, Puma issued a press release and held a conference call with analysts in July
3 2014. The press release stated that the ExteNET trial had "demonstrated that treatment with
4 neratinib resulted in a 33% improvement in disease free survival versus placebo." On the
5 call, an analyst asked Defendant Auerbach if the DFS for the placebo group is "probably
6 around mid to high 80s, around 86% or so?" Auerbach says he's "comfortable with that
7 number." The DFS rate for the placebo group was 91.6%. On the call, the analyst then asked
8 Auerbach if he and Puma "probably had to show around 90% or 91% [in the neratinib
9 group]? Is that reasonable?" Auerbach said "yes" and then stated "I think you can do a 33%
10 improvement in DFS and come up with that calculation, given the numbers we gave." The
11 DFS rate for the neratinib group was 93.9%. Norfolk County Council has adequately and
12 specifically alleged why each of these statements and several others could be false or at least
13 misleading. Puma's hazard ratio explanation doesn't so obviously control here as to stop
14 Norfolk County Council's complaint in its tracks.
15
16 This is true for Puma's arguments about the Kaplan-Meier curves too. During the
17 same conference call, another analyst said to Auerbach, "I assume you have seen the curves
18 for the two arms," and then asked whether the curves separated over time. Auerbach replied
19 with a "yes," describes some of the data, and then states "it looks like the curves are
20 continuing to separate." He went on. Puma noted that in several of these statements, the
21 analyst, and not Auerbach, offered the DFS rate or other applicable measure. But Auerbach
22 didn't appear to correct or disagree with the analysts. In any case, Puma's innocuous
23 explanations for these statements might be right, but they're not right for right now. Puma
24 underscores that with its repeated reference to statements taken "out of context." Perhaps
25 Norfolk County Council is taking statements out of context. But a motion to dismiss isn't
26 typically where that context is fully fleshed out.
27
28

Puma places great weight on *Kleinman v. Elan Corp.*, a case from the Second Circuit. *See Kleinman v. Elan Corp.*, 706 F.3d 145 (2d Cir. 2013). It's understandable why, but *Kleinman* is meaningfully distinguishable. The facts there and here are different enough to merit different outcomes. In *Kleinman*, "[m]ost if not all of [the plaintiff's] argument centers on omissions—statements he believe[d] were necessary to make [a press release] not misleading." *Id.* at 152. In *Kleinman*, the complaint "does not allege that anything in the [press release] was literally false." *Id.* at 153. In *Kleinman*, the disputed representations involve relatively clear-cut, inactionable puffery—for example, a statement that some preliminary findings were "encouraging." *Id.* These and other facts distinguish that case from this one.

Like Puma's arguments about falsity, Puma's arguments about scienter aren't persuasive at this point. Norfolk County Council points to another part of the conference call to show that Auerbach knew about the allegedly real trial results when he made the alleged misrepresentations. That and the other allegations in the complaint are enough to adequately plead the required state of mind. After all, "[t]he most direct way to show both that a statement was false when made and that the party making the statement knew it was false is via contemporaneous reports or data, available to the party, which contradict the statement." *Nursing Home Pension Fund v. Oracle Corp.*, 380 F.3d 1226, 1230 (9th Cir. 2004). That seems to be exactly what Norfolk County Council's alleged here.

It's a close call deciding whether there's enough in the complaint to support a strong inference as to motive to commit the fraud, particularly under the heightened pleading standard. But taken together and examined alongside the other allegations in this case, Norfolk County Council's allegations about the timing of Puma's alleged misrepresentations and the public offering, as well as the allegations about Auerbach and Eyler's individual performance-based compensation, are enough, even if barely so. "[A] reasonable person would deem the inference of scienter cogent and at least as compelling as" Puma's arguments to the contrary. *Tellabs*, 551 U.S. at 324.

Puma makes other arguments—for example, about whether allegations are sufficiently specific as to each Defendant. As noted, the Court has considered and rejected these arguments.

For all of these reasons and others, the Court DENIES the Motion to Dismiss. So, we're out of the starting gate, off and running. Looming ahead, just around the turn, may be a summary judgment motion.

5. DISPOSITION

The Court DENIES the Motion to Dismiss.

DATED: September 30, 2016

Andrew J. Guilford
United States District Judge

United States District Court
EASTERN DISTRICT OF TEXAS
SHERMAN DIVISION

SECURITIES AND EXCHANGE COMMISSION	§ §	
	§	CIVIL ACTION NO. 4:16-CV-246
v.	§	JUDGE MAZZANT
	§	
WILLIAM E. MAPP, III, WARREN K. PAXTON, JR., CALEB J. WHITE, and SERVERGY, INC.	§ § § §	

MEMORANDUM OPINION AND ORDER

Pending before the Court is Warren K. Paxton, Jr.'s Motion to Dismiss Under Federal Rules of Civil Procedure 12(b)(6) and 9(b) (Dkt. #16). Having considered the relevant pleadings and oral arguments of the parties, the Court finds that the motion should be conditionally granted.

I. BACKGROUND

Servergy, Inc. ("Servergy") is a computer hardware company that develops secure, cloud-based data storage servers. From November 2009 to September 2013, Servergy raised approximately $26 million in private securities offerings to develop what it claimed was a revolutionary new server. William E. Mapp, III ("Mapp"), Servergy's co-founder and then-CEO, was responsible for the fundraising campaign and had signatory authority over Servergy's bank accounts. As Servergy's primary fundraiser, Mapp identified prospective investors through word-of-mouth referrals and offered compensation to individuals for introducing new investors to the company.

Warren K. Paxton, Jr. ("Paxton") became involved in Servergy's fundraising campaign in the summer of 2011. Paxton currently serves as the Attorney General of Texas. Prior to serving

as Texas's Attorney General, Paxton was a Texas state senator from January 2013 to December 2014 and a Texas state representative from January 2003 to December 2012. Paxton was also registered as an investment advisor representative from July 2003 to December 2004 and from December 2013 to November 2014.

On July 12, 2011, Mapp met Paxton—then a member of the Texas House of Representatives—at Paxton's law office in McKinney, Texas, to discuss Servergy. During their meeting, Mapp offered to pay Paxton a 10% commission for any investors Paxton recruited to invest with Servergy. Following the meeting, Mapp emailed Paxton and reiterated his offer to pay Paxton either with Servergy common stock or a combination of cash and stock. Paxton responded to Mapp's offer via email, stating, "I will get to work."

Paxton actively recruited investors for Servergy between July 11, 2011, and July 31, 2011. Throughout Paxton's recruiting efforts, Paxton told prospective investors that he had met with Servergy's management and determined it was a great company and the investment presented an interesting opportunity. Paxton did not conduct any due diligence into Servergy or reveal to potential investors that he was being compensated to promote Servergy's stock.

On July 22, 2011, Paxton organized and invited at least seven prospective investors to an investment pitch at Servergy's office. Paxton attended that meeting and also introduced Mapp to at least five additional prospective investors by telephone and email the same day. Among the people Paxton recruited were his friends, business associates, law firm clients, and members of an investment group to which he belonged.[1] Based on prior dealings in the investment group, members trusted each other to consider the interest of the group as a whole and not exploit one another for a member's personal benefit. Typically, the member who recommended the

[1] At oral argument, the Commission clarified that Paxton was *not* recruiting current law firm clients in his capacity as their attorney.

investment would monitor the investment going forward and represent the group's interest. Paxton did not inform the investment group of his compensation arrangement with Servergy.

Following the initial pitch to his investment group, Paxton followed up with one of its members ("Investor 1"), a fellow state representative, to further encourage his investment in Servergy. In early 2013, Paxton organized and attended a meeting with Investor 1 and Mapp, at which Mapp falsely claimed Servergy was flush with purchase orders.

Paxton also followed up with another member of his investment group ("Investor 2") who had initially decided not to invest with Servergy and missed the investment deadline. Paxton placed an unsolicited late night phone call to Investor 2 to change his mind, stating that the offering price would double if he did not invest within the next week. Following the phone call, Investor 2 invested $150,000 with Servergy. Both Investor 1 and Investor 2 would not have invested in Servergy had they known Paxton was being paid to promote the company.

On July 23, 2011, Paxton forwarded one of Mapp's solicitation emails directly to a prospective investor and offered to answer any of the individual's questions. By July 28, 2011, five of the twelve prospective investors Paxton recruited had invested a total of $840,000 in Servergy. On August 5, 2011, Servergy issued a stock certificate to Paxton for 100,000 shares as payment for "services." Servergy issued Paxton a Form-1099 in the amount of $100,000 for the 2011 tax year.

On April 11, 2016, the Securities and Exchange Commission ("Commission") filed a complaint ("Complaint") (Dkt. #1) in this Court against Mapp, Paxton, Servergy, and an additional promoter, Caleb J. White, asserting various violations of federal securities laws. The Commission specifically claims that Paxton violated Sections 17(a) and 17(b) of the Securities Act and Sections 10(b) and 15(a) of the Exchange Act. On June 9, 2016, Paxton filed this Motion

to Dismiss Under Federal Rules of Civil Procedure 12(b)(6) and 9(b) (Dkt. #16). On July 5, 2016, the Commission filed its Response in Opposition (Dkt. #25). On July 15, 2016, Paxton filed a Reply (Dkt. #26). On September 9, 2016, the Court held oral argument at the request of the parties.

II. LEGAL STANDARD

Paxton moves for dismissal under Rule 12(b)(6) of the Federal Rules of Civil Procedure, which authorizes certain defenses to be presented via pretrial motions. A Rule 12(b)(6) motion to dismiss argues that, irrespective of jurisdiction, the complaint fails to assert facts that give rise to legal liability of the defendant. The Federal Rules of Civil Procedure require that each claim in a complaint include "a short and plain statement . . . showing that the pleader is entitled to relief." FED. R. CIV. P. 8(a)(2). The claim must include enough factual allegations "to raise a right to relief above the speculative level." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 555 (2007). Thus, "[t]o survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'" *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Twombly*, 550 U.S. at 570).

Rule 12(b)(6) provides that a party may move for dismissal of an action for failure to state a claim upon which relief can be granted. FED. R. CIV. P. 12(b)(6). The court must accept as true all well-pleaded facts contained in the plaintiff's complaint and view them in the light most favorable to the plaintiff. *Baker v. Putnal*, 75 F.3d 190, 196 (5th Cir. 1996). In deciding a Rule 12(b)(6) motion, "[f]actual allegations must be enough to raise a right to relief above the speculative level." *Twombly*, 550 U.S. at 555; *Gonzalez v. Kay*, 577 F.3d 600, 603 (5th Cir. 2009). "The Supreme Court recently expounded upon the *Twombly* standard, explaining that '[t]o survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as

true, to state a claim to relief that is plausible on its face.'" *Gonzalez*, 577 F.3d at 603 (quoting *Iqbal*, 556 U.S. at 678 (2009)). "A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Id.* "It follows, that 'where the well-pleaded facts do not permit the court to infer more than a mere possibility of misconduct, the complaint has alleged – but it has not 'shown' – 'that the pleader is entitled to relief.'" *Id.*

In *Iqbal*, the Supreme Court established a two-step approach for assessing the sufficiency of a complaint in the context of a Rule 12(b)(6) motion. First, the court should identify and disregard conclusory allegations, for they are "not entitled to the assumption of truth." *Iqbal*, 556 U.S. at 664. Second, the Court "consider[s] the factual allegations in [the complaint] to determine if they plausibly suggest an entitlement to relief." *Id.* "This standard 'simply calls for enough facts to raise a reasonable expectation that discovery will reveal evidence of the necessary claims or elements." *Morgan v. Hubert*, 335 F. App'x 466, 470 (5th Cir. 2009). This evaluation will "be a context-specific task that requires the reviewing court to draw on its judicial experience and common sense." *Iqbal*, 556 U.S. at 679.

In determining whether to grant a motion to dismiss, a district court may generally not "go outside the complaint." *Scanlan v. Tex. A&M Univ.*, 343 F.3d 533, 536 (5th Cir. 2003). However, a district court may consider documents attached to a motion to dismiss if they are referred to in the plaintiff's complaint and are central to the plaintiff's claim. *Id.*

Paxton also moves to dismiss the Commission's claims under Federal Rule of Civil Procedure 9(b). Rule 9(b) "prevents nuisance suits and the filing of baseless claims as a pretext to gain access to a 'fishing expedition.'" *United States ex rel. Grubbs v. Kanneganti*, 565 F.3d 180, 191 (5th Cir. 2009). Rule 9(b) states, "In alleging fraud or mistake, a party must state with

particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally." FED. R. CIV. P. 9(b).

Rule 9(b)'s particularity requirement generally means that the pleader must set forth the "who, what, when, where, and how" of the fraud alleged. *United States ex rel. Williams v. Bell Helicopter Textron, Inc.*, 417 F.3d 450, 453 (5th Cir. 2005). A plaintiff pleading fraud must "specify the statements contended to be fraudulent, identify the speaker, state when and where the statements were made, and explain why the statements were fraudulent." *Herrmann Holdings Ltd. v. Lucent Techs. Inc.*, 302 F.3d 552, 564–65 (5th Cir. 2002). The goals of Rule 9(b) are to "provide[] defendants with fair notice of the plaintiffs' claims, protect[] defendants from harm to their reputation and goodwill, reduce[] the number of strike suits, and prevent[] plaintiffs from filing baseless claims." *Grubbs*, 565 F.3d at 190 (citing *Melder v. Morris*, 27 F.3d 1097, 1100 (5th Cir. 1994)). Courts are to read Rule 9(b)'s heightened pleading requirement in conjunction with Rule 8(a)'s insistence on simple, concise, and direct allegations. *Williams v. WMX Techs., Inc.*, 112 F.3d 175, 178 (5th Cir. 1997).However, this requirement "does not 'reflect a subscription to fact pleading.'" *Grubbs*, 565 F.3d at 186. "Claims alleging violations of the Texas Insurance Code and the DTPA and those asserting fraud, fraudulent inducement, fraudulent concealment, and negligent misrepresentation are subject to the requirements of Rule 9(b)." *Frith v. Guardian Life Ins. Co. of Am.*, 9 F. Supp. 2d 734, 742 (S.D. Tex. 1998); *see Berry v. Indianapolis Life Ins. Co.*, No. 3:08-CV-0248-B, 2010 WL 3422873, at *14 (N.D. Tex. Aug. 26, 2010) ("'[W]hen the parties have not urged a separate focus on the negligent misrepresentation claims,' the Fifth Circuit has found negligent misrepresentation claims subject to Rule 9(b) in the same manner as fraud claims."). Failure to comply with Rule 9(b)'s requirements authorizes the Court to dismiss the pleadings as it would for failure to state a claim

under Rule 12(b)(6). *United States ex rel. Williams v. McKesson Corp.*, No. 3:12-CV-0371-B, 2014 WL 3353247, at *3 (N.D. Tex. July 9, 2014) (citing *Lovelace v. Software Spectrum, Inc.*, 78 F.3d 1015, 1017 (5th Cir. 1996)).

III. DISCUSSION AND ANALYSIS

The Commission alleges that Paxton engaged in fraudulent conduct by promoting Servergy's stock without disclosing to potential investors that he was being paid to do so. The central issue in this case is whether Paxton had a duty to disclose his compensation under federal securities laws. The Court must determine whether the Commission has pleaded sufficient facts to support a plausible claim against Paxton under federal securities laws.

A. Fraud Under Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act

The Commission alleges that Paxton engaged in fraud in violation of Section 10(b) of the Securities Act and Rule 10b-5 thereunder because he did not disclose to potential investors that he was being paid to promote Servergy stock. To survive a motion to dismiss a securities fraud claim under Rule 10b-5 of the Exchange Act, the Commission must allege facts that, if true, establish (1) a misstatement or omission (2) of material fact (3) in connection with the purchase of a sale or security (4) made with scienter. *SEC v. Gann*, 565 F.3d 932, 936 (5th Cir. 2009). Scienter is defined as "a mental state embracing intent to deceive, manipulate, or defraud." *Id*. The elements required to establish a claim under Section 17(a) are essentially the same except scienter is not required. *See SEC v. Evolution Capital*, 866 F. Supp. 2d 661, 667 (S.D. Tex. 2011). Since the Commission must essentially prove the same elements for Section 17(a) and Rule 10b-5 violations, the Court will consider these allegations together. *See SEC v. Arcturus Corp.*, No. 3:13-cv-4861-k, 2016 WL 1109255, at *14 (N.D. Tex. Mar. 21, 2016).

1. Liability Based upon a Misstatement

A defendant may be liable under Rule 10b-5 and Section 17(a) for either a misstatement or an omission. The Commission first alleges that Paxton made actionable representations. Paxton argues, and the Court agrees, that this is purely an omissions case.[2] But the Court will nonetheless address the Commission's position because they assert that Paxton made several material misstatements. One of these alleged material misstatements includes Paxton's assertion that Servergy was a "great company" that presented an interesting investment opportunity. The Commission also bases its material misrepresentation claim on the fact that Paxton claimed to have personally met with Servergy's management. Finally, the Commission alleges that Paxton created a sense of urgency in informing a potential investor that the share price would double before the potential investor returned from vacation. The Court will address these statements in turn.

a. Puffing Statements

The first "misrepresentation" offered by the Commission is Paxton's assertion that Servergy was a "great company" that offered an interesting investment opportunity. The Commission offers *Brody v. Transitional Hospitals Corp.* to show that these statements "affirmatively create[d] an impression of a state of affairs that differ[ed] in a material way from the one that actually exist[ed]." 280 F.3d 997, 1006 (9th Cir. 2002). But calling something a "great investment" is mere puffery. *See Southland Sec. Corp. v. INSpire Ins. Sols., Inc.*, 365 F.3d 353, 372 (5th Cir. 2004) (defining puffery as statement of "the vague and optimistic type that cannot support a securities fraud action… and contain no concrete factual or material misrepresentation"); *Carlucci v. Han*, 886 F. Supp. 2d 497, 524 (E.D. Va. 2012) (calling something a "great investment" is "non-actionable" puffery and "the sort of opinion and

[2] At oral argument, the Commission would not concede that this was purely an omissions case.

exaggeration that is immaterial as a matter of law"); *In re Fleming Cos. Inc. Sec. & Derivative Litig.*, No. MDL-1530, 2004 WL 5278716, at *9 (E.D. Tex. June 16, 2004) ("Vague, loose optimistic allegations that amount to little more than corporate cheerleading are puffery . . . and are not actionable under federal securities law." (internal quotation marks omitted)).

The Commission offers *SEC v. Curshen* to assert that Paxton's statements amounted to more than mere puffery. 372 F. App'x 872 (10th Cir. 2010). In *Curshen*, the complaint identified several statements made by the defendant regarding the short-, medium-, and long-term plan for the company, relaying information from management concerning the impending growth of the stock and providing information regarding powerful investor relations people becoming involved in the company. *Id.* at 880. But the Commission has failed to allege any statement made by Paxton that "extends beyond mere corporate optimism." *Id.* The Court finds these puffing statements are immaterial as a matter of law and cannot support a securities fraud action under Rule 10b-5 and Section 17(a). *See Southland Sec. Corp.*, 365 F.3d at 372.

b. Other Alleged Misstatements

The other two communications that the Commission bases its misrepresentation claim upon fail because the Complaint does not allege that these representations were false or misleading. The Commission alleges that Paxton told potential investors that he had met with Servergy's management but does not allege facts to show that this truthful statement was misleading. The last alleged "misstatement" is similarly flawed. The Commission claims Paxton told an investor that the offering price would double before the individual returned from vacation, but the Complaint did not allege that the statement was false or misleading. The Court finds that the Commission has not sufficiently pleaded facts that could plausibly support a fraud claim based on a material misstatement.

2. Liability Based upon an Omission

The Court has determined that under the facts alleged, Paxton has made no material misrepresentations to support a plausible claim under Rule 10b-5 and Section 17(a). But Paxton could also be liable under a fraudulent omissions theory. The Commission alleges that Paxton violated Rule 10b-5 and Section 17(a) because Paxton had a duty to disclose his compensation yet failed to do so. In a securities fraud omissions case, the defendant must have a duty to speak to be found liable. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 174 (1994) ("When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." (quoting *Chiarella v. United States*, 445 U.S. 222, 235 (1980))). Paxton argues that the fraud claims under Rule 10b-5 and Section 17(a) should be dismissed because the Commission has failed to adequately allege Paxton had a duty to disclose his compensation to potential investors.

a. A Duty to Speak

The Commission alleges generally that Paxton had a duty to inform the potential investors that he was being paid by Servergy to promote its stock. The Commission focuses the majority of its argument on the materiality of Paxton's omission. But the issue in this case is determining whether a duty existed, not whether the omission was material.[3] "As the Supreme Court explained in *Matrixx*, whether a defendant owes a duty to disclose turns on whether the omission renders his statement false or misleading, not whether the omitted information was material." *In re BP P.L.C. Sec. Litig.*, 852 F. Supp. 2d 767, 802 (S.D. Tex. 2012) (citing *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27 (2011)). While Paxton's compensastion may be

[3] The Commission has pleaded facts that show the omission was material because the Complaint alleges the investors would not have invested had they known Paxton was being paid to promote Servergy's stock. *See TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (explaining that a fact is material if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision).

material, "[Section] 10(b) and Rule 10b-5(b) do not create an affirmative duty to disclose any and all material information." *Matrixx*, 562 U.S. at 44; *see also*, *Kunzweiler v. Zero.Net, Inc.*, Civ. A. No. 3:00-CV-2553-P, 2002 WL 1461732, at *9 (N.D. Tex. July 3, 2002) ("the materiality of the information claimed not to have been disclosed . . . is not enough to make out a sustainable claim of securities fraud. Even if the information is material, there is no liability under Rule 10b-5 unless there was a duty to disclose it."). Thus, to survive this motion to dismiss, the Commission must have pleaded with particularity facts sufficient to show that Paxton had a duty to speak.

b. The Investment Club

The Commission alleges that Paxton owed a duty to reveal his compensation to his investment club because he was in a relationship of trust. There is a circuit split regarding whether a fiduciary-like relationship can trigger a duty to speak. *Compare United States v. Schiff*, 602 F.3d 152, 162–63 (3d Cir. 2010) (rejecting argument that omissions theory of fraud can be premised on a fiduciary duty to disclose and holding that "[t]his argument reaches too far," "is not supported by the language of § 10(b) and Rule 10b-5," and the "legal support for [the] fiduciary duty theory is also weak"), *with SEC v. Dorozhko*, 574 F.3d 42, 49 (2d Cir. 2009) (alterations in original) (holding that "nondisclosure in breach of a fiduciary duty satisfies § 10(b)'s requirement … [of] a deceptive device or contrivance"). The Fifth Circuit has not addressed this specific issue, but the Court agrees with other courts in this circuit that are of the opinion that a fiduciary relationship triggers a duty to speak. *See, e.g.*, *Kadlec Med. Ctr. v. Lakeview Anesthesia Assocs.*, No. CIV.A. 04-0997, 2005 WL 1309153, at *4 (E.D. La. May 19, 2005) ("Generally, a duty to disclose information will not exist absent some confidential,

fiduciary, or other special relationship which, under the circumstances of the case, justifies the imposition of a duty to disclose information.”).

The Commission cites a Ninth Circuit case that states a duty of disclosure arises when parties have “a fiduciary or agency relationship, prior dealings or circumstances such that one party has placed trust and confidence in the other.” *Paracor Fin., Inc. v. Gen. Elec. Capital Corp.*, 96 F.3d 1151, 1157 (9th Cir. 1996). The Commission also offers *SEC v. Kirch* to assert that Paxton owed a duty to his investment club to disclose his Servergy compensation. 263 F. Supp. 3d 1144, 1150 (N.D. Ill. 2003). In *Kirch*, the defendant used information gained at a business group meeting to conduct insider trading in violation of “an express policy and understanding that such matters were to indeed be kept confidential.” *Id.* at 1147. Unlike *Kirch*, the Complaint does not allege any express policy in Paxton’s investment club regarding disclosing compensation when promoting stocks.

Paxton relies on a number of cases to show that he did not have a fiduciary relationship with his investment group. In *Skelly*, the court recognized that the jury charge wrongly “omitted the elements of ‘reliance and de facto control and dominance,’ which are required to establish a fiduciary relationship.” *U.S. v. Skelly*, 442 F.3d 94, 99 (2d Cir. 2006); *see also United States v. Chestman*, 947 F.2d 551, 568 (2d Cir. 1991) (“[A]t the heart of a fiduciary relationship lies reliance, and de facto control and dominance . . . The relation exists when confidence is reposed on one side and there is resulting superiority and influence on the other . . . A fiduciary relationship involves discretionary authority and dependency: One person depends on another—the fiduciary—to serve his interests.” (internal quotations omitted)). The Commission does not allege that Paxton had any sort of control or dominance over his investment club members. There are cases from the Fifth Circuit, in a different context, supporting Paxton’s position. In *Welk v.*

Simpkins, the Fifth Circuit held, "Mere subjective trust alone is not enough to transform arms-length dealing into a fiduciary relationship. Businessmen generally do trust one another." 402 F. App'x 15, 20 (5th Cir. 2010). Another court in this circuit found that allegations of "subjective trust" and "personal relationships" are insufficient to establish a fiduciary duty that creates a duty to disclose. *Town N. Bank, N.A. v. Shay Fin. Servs., Inc.*, No. 3:11-CV-2135-L, 2014 WL 4851558, at *18, *27 (N.D. Tex. Sept. 30, 2014).

The Court finds that under the facts alleged, Paxton did not form a fiduciary relationship with his investment group. Even if the Commission had pleaded facts sufficient to allege a plausible fiduciary relationship, the Complaint is insufficient to survive this motion to dismiss because it does not plead with particularly the nature of the fiduciary-like duty as required by the Fifth Circuit. *See Carroll v. Fort James Corp.*, 470 F.3d 1171, 1174 (5th Cir. 2006) ("At most, [plaintiffs] have offered conclusory allegations that such a duty existed, and that [defendant] breached it. Even if this were enough to satisfy Rule 12(b)(6), it is certainly not sufficient to satisfy the heightened particularity requirements of Rule 9(b)."). The Complaint alleges prior dealings regarding monitoring various investments *going forward* but fails to explain what these prior dealings were or whether there were any fiduciary-like duties regarding investment *recommendations*. The Commission makes only conclusory allegations regarding Paxton's duty to tell his investment club members that he was being paid when he recommended Servergy's stock. Since the Complaint has neither pleaded facts sufficient to support a fiduciary relationship, nor a specific duty under the alleged relationship, the Court finds that a securities fraud claim based on a fiduciary duty theory is not plausible.

c. A General Duty to Disclose Compensation

The Commission argues more generally that Paxton had a duty to disclose his compensation because not doing so would be misleading. At oral argument, the Court asked the Commission to identify a case that stood for the proposition that a non-broker has a duty to reveal his compensation. The Commission was unable to do so, but offered *U.S. v. Nouri* for analysis. 711 F.3d 129 (2d Cir. 2013). In *Nouri*, a registered broker was bribed by the issuer of a security to get his customers to buy that security. *Id.* The court found that the broker had a duty to reveal the fact that he was bribed because not doing so would be misleading to the investors. *Id.* at 142. *Nouri* is distinguishable in that the underlying omitted information—the existence of a bribe—was in itself illegal. Here, the omitted information—the receipt of a sales commission—is not in itself illegal. *Nouri* cannot be read to require disclosure of the receipt of an alleged sales commission.

The Commission also pointed to an administrative opinion to support the assertion that Paxton should have disclosed his compensation. *See In re Scholander*, Exchange Act Release No. 34-77492, 2016 WL 1255596 (Mar. 31, 2016). In *Scholander*, a registered broker entered into an agreement with a Chinese issuer that completed reverse mergers into U.S.-listed public shell companies in violation of federal securities laws. *Id.* at *2. The defendant broker recommended the issuer's securities without informing their registered brokerage firm or any customers of a $350,000 arrangement with the issuer. *Id.* at *3. The Commission's review board found that the broker should have disclosed this arrangement, stating, "When a broker-dealer has a self-interest (other than the regular expectation of a commission) . . . it should be disclosed." *Id.* at *5. The situation in *Scholander* is distinguishable because Paxton did not defraud his employer, have a self-interest "other than the regular expectation of commission," or actually

effect securities transactions for the account of others. *Id.* As in *Nouri*, *Scholander* cannot be read to require a non-broker to disclose an alleged sales commission.

At oral argument, the Commission offered *SEC v. Torr*, which held that when "free-lance brokers" take initiative in recommending a stock, they become "volunteer fiduciaries." 22 F. Supp. 602, 606 (S.D.N.Y. 1938). This opinion, released in 1938, is contrary to Second Circuit precedent and insufficient to base a Section 17(b) claim upon. *See United States v. Skelly*, 442 F.3d 94, 98 (2d Cir. 2006) ("There is no general fiduciary duty inherent in an ordinary broker/customer relationship . . . ."). Further, no court since the *Torr* decision has held a stock promoter liable as a volunteer fiduciary. Thus the Court finds that the Commission has failed to plead facts sufficient to show Paxton had a duty to reveal his compensation.

3. Liability Based upon a Half-Truth

The Commission has not sufficiently pleaded facts alleging that Paxton had a duty to disclose his compensation from Servergy. But the analysis does not end there. Absent an independent duty to disclose, omissions are actionable when the defendant elects to disclose some material facts, but fails to speak the whole truth. *See First Va. Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977). In *First Virginia Bankshares*, the Fifth Circuit recognized that certain statements made will be materially misleading if the defendant has concealed the fact that he has been compensated for promoting securities. *Id.* The Commission uses the holding in *First Virginia Bankshares* to take the position that every statement Paxton made encouraging others to invest was a materially misleading half-truth. But the rule of disclosure is "not as absolute as one might gather after reading *First Virginia Bankshares*. The Fifth Circuit most likely would agree that a more precise statement of the rule is that a duty to speak the full truth *on a particular subject* arises when a defendant undertakes to say anything *on that particular subject*."

McNamara v. Bre-X Minerals Ltd., 57 F. Supp. 2d 396, 416 (E.D. Tex. 1999) (emphasis in original).

To survive a motion to dismiss under this theory, the Commission would have to identify a statement made by Paxton *regarding his compensation* that was materially misleading. *See id.*; *SEC v. Curshen*, 372 F. App'x 872, 880 (10th Cir. 2010) ("Where a party without a duty elects to disclose material facts, he must speak fully and truthfully, and provide complete and non-misleading information *with respect to the subjects on which he undertakes to speak*." (emphasis added)); *Kunzweiler*, 2002 WL 1461732, at *11 ("[T]he Court must determine whether the alleged material omissions could have rendered any *identified* affirmative statement or statements made by the defendants misleading under any set of facts." (emphasis added)).

The Commission offers *SEC v. Huttoe*, where the defendant was found liable under Rule 10b-5 in connection with publishing a stocks newsletter. No. Civ.A. 96-2543, 1998 WL 34078092 (D.D.C. Sept. 14, 1998). The newsletter read that the defendant "may own shares" and "may act as" a paid consultant but in reality was being paid directly with stock for his promotional efforts. *Id.* at *5. The court found the statement a misleading half-truth because the statements were not equivalent to a full disclosure. *Id*. This is a prototypical half-truth scenario. Once a defendant makes a statement regarding their compensation, the defendant triggers a duty to speak the whole truth. To survive a motion to dismiss, the Commission would need to "identify which specific statements made by [Paxton] would qualify as misleading half-truths such that the bonus commissions would constitute a material omission under subsection (b)." *U.S. v. Laurienti*, 611 F.3d 530 (9th Cir. 2010); *see McNamara*, 57 F. Supp. 2d at 416. Since the Commission has not alleged that Paxton made a representation regarding his compensation from

Servergy, the half-truth argument may not serve as a basis for liability under Rule 10b-5 or Section 17(a).[4]

B. Fraud Under Section 17(b) of the Securities Act

The Commission alleges that Paxton defrauded investors under Section 17(b) of the Securities Act by circulating communications describing securities without disclosing his compensation arrangement. Section 17(b) provides:

> It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

15 U.S.C. § 77(q). Paxton argues that the Commission's Section 17(b) claim fails because Paxton did not receive consideration for publishing, publicizing, or circulating any communications describing securities. The Complaint identifies two communications that require analysis under Section 17(b).[5] The Court will analyze these communications in turn.

1. The Promotional Email

The Commission first alleges that Paxton violated Section 17(b) by forwarding one of Mapp's promotional emails to a potential investor on July 23, 2011.

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[4] The Commission broadly alleges that Paxton's conduct constituted a fraudulent scheme under Sections 17(a)(1), (3) and Rules 10b-5(a), (c). This theory fails because under a scheme liability omissions case, there still must be a duty to disclose. *See In re Enron Corp. Sec., Derivative & ERISA Litig.*, 586 F. Supp. 2d 732, 793 (S.D. Tex. 2008) (rejecting scheme liability theory because the Fifth Circuit "limited the reach of § 10(b) and Rule 10b-5 to a material representation or omission where there is a recognized duty to disclose").

[5] The Commission argues that a third communication, a face to face meeting with Investor 1, could serve as a basis for liability under Section 17(b). The plain language of the statute does not support this theory. 15 U.S.C. §77(q) ("[B]y the use of any means . . . of interstate commerce").

a. *Quid Pro Quo*

Paxton argues the claim fails as to the email because the potential investor did not invest, and therefore Paxton did not earn a sales commission for that communication. Section 17(b) requires disclosure of compensation from an issuer only if that compensation is received (i) as a *quid pro quo* (ii) for a communication describing a security (iii) that is published or circulated by the means of interstate commerce. *United States v. Amick*, 439 F.2d 351, 365 (7th Cir. 1971). The Commission argues that the *quid pro quo* was the 100,000 shares Paxton received for his recruiting efforts. But the Complaint only alleges that Paxton was paid for his successful recruiting efforts.[6] Thus there was no *quid pro quo* for the communication identified, as the email recipient never invested with Servergy. *See Amick*, 439 F.2d at 365 (finding violation where defendant "published the article *in return for* the promise of payment" (emphasis added)).

The Commission offers *SEC v. Gagnon* to assert that the Commission is not required to prove that Paxton successfully secured investments for Servergy; rather, that Paxton needed only to have an agreement to receive consideration to be liable under Section 17(b). No. 10-cv-11891, 2012 WL 994892 (E.D. Mich. Mar. 22, 2012). The Commission's briefing purports that the court based its holding solely on the fact that the defendant had a compensation agreement with an issuer. Yet the court found the defendant liable for not fully disclosing the nature of his agreement after electing to disclose on his website that he would "earn commissions on the money that I bring in, but I will hardly get rich." *Id.* at *11. In reality, he received over $3 million for his promotional efforts and the court held the defendant liable for not "*fully disclos[ing]*" the nature of his arrangement. *Id.* (emphasis in original). The Complaint does not

[6] At oral argument, the Commission argued that the statute calls for consideration "received or to be received," but the Complaint does not allege that Paxton received or would ever receive any compensation for his unsuccessful attempt to recruit the email recipient.

allege that Paxton elected to publicly disclose his compensation agreement, so *Gagnon* is inapplicable. The July 23, 2011, email cannot serve as a basis for a fraud claim because the Commission did not allege Paxton was ever paid—or ever would be paid—for sending the email.

b. Due Diligence

The Complaint alleges that Paxton failed to conduct due diligence on Servergy's claims before forwarding the promotional email, but does not allege that Paxton had a duty to do so. Even if the Commission had alleged such a duty, courts have held that failure to conduct due diligence on a promoted stock does not give rise to liability. *See SEC v. Tambone*, 597 F.3d 436, 488 (1st Cir. 2010) (en banc) ("[W]e reject the SEC's notion that a breach of a duty to investigate, without more, is a breach of a duty to disclose."); *United States v. Schiff*, 602 F.3d 152, 167 (3d. Cir. 2010) ("[T]he plain language of § 10(b) and Rule 10b-5 do not contemplate the general failure to rectify misstatements of others"); *Brown v. J.P. Turner & Co.*, No. 1:09-CV-2649-JEC, 2011 WL 1882522, at *4 (N.D. Ga. May 17, 2011) (dismissing Section 10(b) claim, observing that "Plaintiffs do not cite any authority to suggest that a broker has the duty . . . to ensure the accuracy of investment materials"). The Court finds that the Commission has not sufficiently pleaded facts to support that Paxton had a duty to conduct due diligence with respect to the veracity of the promotional email. More importantly, the Court has determined that the email may not serve as a plausible basis for liability under Section 17(b) because the Complaint does not allege facts indicating that Paxton was paid or will be paid for his unsuccessful attempt to solicit the email recipient. [7]

[7] The Commission offers *SEC v. Liberty Capital Group, Inc.* to assert that Paxton did not have to be *directly* compensated for the email to be found liable under Section 17(b). 75 F. Supp. 2d 1160 (1999). But the Complaint does not allege facts to show that Paxton received or ever would receive compensation for his unsuccessful attempt, so the method in which he would receive payment is irrelevant to the analysis.

2. The Phone Call with Investor 2

The other communication upon which the Commission bases its Section 17(b) allegation is Paxton's phone call with Investor 2. Paxton argues that the Complaint fails because there was no broad dissemination of the communication and the communication was not recorded. Paxton supports his position by pointing out that there are no cases holding a defendant liable under Section 17(b) for placing phone calls to potential investors, but this fact is not dispositive. The Commission argues that any oral communication is sufficient to allege a Section 17(b) violation and that broad dissemination is not required.

a. Recorded Communication

Because there are no cases under Section 17(b) regarding phone calls, the Court must look to the text of the statute. Paxton's position is that Section 17(b) is limited to the publication or circulation of recorded communications because "communication" is found at the end of a list of recorded communications. Paxton cites the Supreme Court's reliance upon the *noscitur a sociis* canon of statutory interpretation as a basis for his argument. *See Yates v. United States*, 135 S. Ct. 1074, 1085 (2015) (stating courts must rely on the "principle of *noscitur a sociis*—a word is known by the company it keeps—to avoid ascribing to one word a meaning so broad that it is inconsistent with its accompanying words, thus giving unintended breadth to the Acts of Congress" (internal quotation marks omitted)). Paxton argues that under this canon, "communication" should be interpreted narrowly because it accompanies a list of recorded communications.[8]

[8] Paxton also points to the legislative history of the Securities Act to show that Section 17(b) was not drafted to prohibit oral communications. Committee on Interstate & Foreign Commerce, H.R. Rep. No. 73–85, at 24 (1933) (explaining that Section 17(b) was "particularly designed to meet the evils of the 'tipster sheet' as well as articles in newspapers or periodicals that purport to give an unbiased opinion."). However, this approach is unnecessary and inappropriate for the Court because "[o]nly after we apply principles of statutory construction, including the canons of

The Commission does not offer any canons of statutory interpretation but argues that "communication" should be interpreted broadly to include any oral communications. *See Communication*, BLACK'S LAW DICTIONARY (7th ed. 1999) (defining communication as "the expression or exchange of information by speech, writing, or gestures."). But words in statutes should not be interpreted in isolation, ignoring important contextual information. *Deal v. United States,* 508 U.S. 129, 132 (1993) (recognizing the "fundamental principle of statutory construction (and, indeed, of language itself) that the meaning of a word cannot be determined in isolation, but must be drawn from the context in which it is used").

The Commission bolsters its position by pointing to a case in which the court found liability under Section 17(b) for communications that included an oral statement. The Commission cites *United States v. Wenger*, where the Tenth Circuit held the defendant liable for publicizing a stock by newsletter and orally through a radio program. 427 F.3d 840, 850 (10th Cir. 2005). The court found the defendant liable because "investors—such as the listeners to [defendant's] radio program and readers of his newsletter who testified in this case—base their decisions whether to buy a stock in part on whether various opinions about the product are self-serving or not." *Id.* Because the court did not indicate whether the radio program alone was sufficient for liability, the Commission cannot use this case to demonstrate that an unrecorded single phone call is sufficient to trigger liability under Section 17(b).

The Court agrees with Paxton's interpretation of Section 17(b) but utilizes an additional, more specific contextual canon—*ejusdem generis*. The Supreme Court has recognized the utility of the principle of *ejusdem generis* and explained, "When a general term follows a specific one,

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construction, and conclude that the statute is ambiguous, may we consult legislative history." *In re Amy Unknown*, 701 F.3d 749, 759–60 (5th Cir. 2012) (citing *Carrieri v. Jobs.com, Inc.*, 393 F.3d 508, 518–19 (5th Cir. 2004)). The statute is not ambiguous after applying principles of statutory construction.

the general term should be understood as a reference to subjects akin to the one with specific enumeration." *Norfolk & W. Ry. Co. v. Am. Train Dispatchers Ass'n*, 499 U.S. 117, 129 (1991). Here, the term "communication" follows a list of tangible media, including circulars, advertisements, newspapers, articles, and letters. Thus, the term "communication" should not be interpreted so broadly as to include all unrecorded forms of communication. To hold otherwise would be contrary to longstanding Supreme Court and Fifth Circuit precedent regarding this established canon of statutory interpretation. *See McBoyle v. United States*, 283 U.S. 25, 25–27 (1931) (utilizing the *ejusdem generis* principle in determining that "automobile, automobile truck, automobile wagon, motor cycle, or any other self-propelled vehicle not designed for running on rails" did not apply to an airplane); *United States v. Kaluza*, 780 F.3d 647, 657 (5th Cir. 2015) (utilizing the *ejusdem generis* principle in determining that "[e]very captain, engineer, pilot, or *other person* employed on any steamboat or vessel" only applied to other persons conducting "marine" employment functions). Finally, had the legislature intended the statute to cover all unrecorded communications, it could have drafted the statute more broadly. *See* 15 U.S.C. § 77(w) (providing it is unlawful "to make…*any representation*"); 15 U.S.C. § 77(x) (providing it is unlawful if a person "makes *any untrue statement*"); 15 U.S.C. § 77l(a)(2) (providing it is unlawful to offer or sell securities "by means of a[n]…*oral* communication, which includes an untrue statement") (emphasis added). The Court finds that the phone call was not a recorded communication as required under the federal securities laws. Thus, the Commission has failed to allege facts that could plausibly support a violation of Section 17(b) based on the phone call to Investor 1.

b. Broad Dissemination

The Court has found that Commission has failed to allege facts that could plausibly support a violation of Section 17(b) based on either the promotional email or the phone call to Investor 1. But the parties spent a considerable portion of their briefings on arguing whether a communication must be broadly disseminated to serve as a basis for liability under Section 17(b). It is clear that the phone call to Investor 2 was not broadly disseminated—Paxton called a single potential investor. Since the Fifth Circuit has not expressly ruled on whether broad dissemination is required, the Court must look to the text of the statute. The statute provides that it shall be unlawful for any person, "by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication" describing a security without disclosing compensation. 15 U.S.C. §77(q). The ordinary, contemporary, common meanings of the words "publish," "give publicity to," and "circulate" do not connote a private, singular communication with one intended recipient. *See Buzek v. Pepsi Bottling Grp., Inc.*, 501 F. Supp. 2d 876, 880 (quoting *Williams v. Taylor,* 529 U.S. 420, 432 (2000)) ("It is of course a truism that statutory construction begins with the 'ordinary, contemporary, common meaning' of the words of the statute."). "Publish" is defined, "To distribute copies (or a work) to the public." *Publish*, BLACK'S LAW DICTIONARY (9th ed. 2009). Similarly, "publicity" is defined as "public attention; notoriety." *Publicity*, BLACK'S LAW DICTIONARY (9th ed. 2009). The plain language of the statute does not lend itself to application to a single phone call because the publicity element is absent.[9] Black's does not define

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[9] At oral argument, the Commission argued that the Court would have to draw a line regarding how broadly a communication must be disseminated to trigger liability under Section 17(b). But the Court does not have to draw such a line because the communications alleged—a single phone call and a single email—are clearly not broadly disseminated.

"circulate" but Webster's defines it as "to pass from person to person" or "to come into the hands of readers." WEBSTER'S NEW COLLEGIATE DICTIONARY (1st ed. 1977). No one in common parlance refers to a single, person-to-person telephone call as "circulating" a communication. *See Bond v. United States*, 134 S. Ct. 2077, 2090 (2014) (rejecting government's statutory interpretation, reasoning that "no speaker in natural parlance" would use the statutory term at issue to describe the defendant's conduct).

Importantly, all of the cases in other circuits holding a defendant liable under Section 17(b) have involved broadly disseminated and recurring publications. *See Amick*, 439 F.2d at 365 (finding violation where a defendant published a weekly article, Indiana Investor and Business News, that was frequented by numerous Indiana investors); *SEC v. Liberty Capital Grp., Inc.*, 75 F. Supp. 2d 1160, 1161–62 (W.D. Wash. 1999) (finding SEC adequately pleaded violation where it claimed that defendant violated Section 17(b) "by publishing favorable accounts of publicly-traded companies in a newsletter and on the Internet" over a period of two years); *Ginsburg v. Agora, Inc.*, 915 F. Supp. 733, 736-37 (D. Md. 1995) (noting that Defendants, as authors and publishers of an investment newsletter "marketed to the general public and, in May of 1993, was sent to between 6,800 and 7,200 subscribers" are "certainly within the class of persons potentially liable" under Section 17(b)). While the Court need not determine how broadly a communication must be disseminated to trigger liability under Section 17(b), the Court finds that it is too far a stretch to apply Section 17(b) to a single phone call to one investor. The same reasoning may be applied to the single-recipient promotional email.

The Commission has failed to allege that Paxton published, gave publicity or circulated any recorded communication describing a security. The promotional email allegation is deficient because the Complaint did not allege that Paxton was paid or would be paid for his unsuccessful

recruiting effort, and the phone call allegation is deficient because the call was not a recorded communication.[10] Thus the Court finds the Complaint does not allege facts to support a plausible claim under Section 17(b).

C. Failing to Register Under Section 15(a) of the Exchange Act

The Complaint's final allegation against Paxton is that he was required to register as a broker but failed to do so. Section 15(a)(1) provides that it shall be unlawful to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security unless such broker is registered. 15 U.S.C. § 78(o). The Exchange Act defines a broker as a person "engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4). Paxton claims that he was not acting as a broker as defined under the Exchange Act and thus did not have to register with the Commission.

Paxton argues that the Section 15(a) claim should be dismissed because the Commission fails to allege that Paxton effected transactions in securities for the account of others. Specifically, Paxton argues that he did not actually handle securities, enter trades, or otherwise exert any authority over anyone's account. The Commission claims it does not have to allege that Paxton had actual authority or control over his clients' accounts or assets. The Commission believes that control over accounts is merely a factor in determining whether a person is acting as a broker.[11] Paxton argues that control is an essential element under the statutory definition of "broker."

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[10] Neither communication was broadly disseminated, but this is not the basis for the Court's holding.

[11] The Commission offers *SEC v. Benger* to assert that control over clients' accounts is a non-dispositive factor rather than an element for determining broker status. 697 F. Supp. 2d 932, 945 (N.D. Ill. 2010). But the court did not reach this holding or state that control over a client's

The Exchange Act does not define what is required to "engage in the business of effecting transactions" in securities "for the account of others." The Fifth Circuit has not interpreted the specific language either, but the language of the statute indicates that more activity is required than simply recommending a stock or introducing a potential investor to company's fundraiser. Paxton provides several cases to support his interpretation of the statute. In *SEC v. Kramer*, the Commission alleged that the defendant acted as an unregistered broker in violation of Section 15(a) where he received transaction-based commissions for actively soliciting "intimate friends and family" over a period of two years. 778 F. Supp. 2d 1320 (M.D. Fla. 2011). The court determined that the defendant had acted as a facilitator rather than a broker because his conduct "consisted of nothing more than bringing together the parties to a transaction" and the Commission presented no evidence of the defendant possessing "authority over the accounts of others." *Id.* at 1339.

Similarly, in *SEC v. M&A West, Inc.*, the court was unwilling to classify the defendant as an unregistered broker where he was paid to facilitate securities transactions without actually controlling the accounts of others. No. C-01-3376 VRW, 2005 WL 1514101, at *9 (N.D. Cal. June 20, 2005). The court concluded, "In particular, no assets were entrusted to [defendant], and the Commission identifies no evidence that he was authorized to transact 'for the account of others'…Although [defendant] was in the business of *facilitating* securities transactions *among other persons*, the Commission cites no authority for the proposition that this equates to '*effecting* transactions in securities *for the account of others*.'" *Id.* at *9.

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account is not required. The court found that the SEC sufficiently alleged that the defendant was "effecting transactions in securities for the account of others" because he received transaction-based compensation, *collected the investors' funds*, and processed securities documents. *Id.* (emphasis added).

The *Kramer* and *M&A West* cases suggest that control over the account of others is an element rather than a factor. The Commission offers a case that does not rely on control of accounts as dispositive; rather, it utilizes a fact-intensive broker versus finder distinction to determine whether an individual must register with the Commission. *See SEC v. Offill*, No. 3:07-cv-1643-D, 2012 WL 246061 (N.D. Tex. Jan. 26, 2012). In *Offil,* the court noted the "distinction drawn between the broker and finder or middleman is that the latter bring[s] the parties together with no involvement on [his] part in negotiating the price or any other terms of the transaction . . . A finder, however, will be performing the functions of the broker-dealer, triggering registration requirements, if activities include: analyzing the financial needs of an issuer, recommending or designing financial methods, involvement in negotiations, discussion of details of securities transactions, making investment recommendations, and prior involvement in the sale of securities." *Id.* at *7.

The Commission also offers *SEC v. Helms*, in which the court found the defendant did more than simply introduce the investor to sellers, triggering a registration requirement. No. A-13-CV-01036, 2015 WL 6438872 (W.D. Tex. Oct. 20, 2015). In *Helms*, the "[investor] and [defendant] exchanged multiple email communications concerning the [] investment" and "[the defendant] conveyed [the investor's] questions about the investment to Sellers." *Id.* The Commission offers a similar case in which the defendant was involved in negotiations, made investment recommendations, and gave advice in connection with securities investments. *See Apex Global Partners, Inc. v. Kaye/Bassman Intern. Corp.*, No. 3:09-cv-637-M, 2009 WL 2777869, at *3 (N.D. Tex. Aug. 31, 2009). During oral argument, the Court asked the Commission if Paxton had performed any of the functions identified in these cases, such as answering any investors' questions or otherwise doing more than introducing the investors to

Mapp. The Commission stated that Paxton had not, but asserted that *offering* to answer potential investors' questions was sufficient to trigger a registration requirement under *Helms* and *Apex Global Partners, Inc*.

The Court adopts the reasoning in *Kramer* and *M&A West* and finds that Paxton was merely *facilitating* securities transactions rather than performing the functions of a broker. *See M&A West*, 2005 WL 1514101, at *9. Paxton's conduct did not amount to effecting transactions for the account of others. Here, as in *Kramer*, the Commission presented no evidence of Paxton's possessing "authority over the accounts of others." *See Kramer*, 778 F. Supp. 2d at 1339. The Commission failed to allege that assets were entrusted to Paxton or that he was authorized to transact for the account of others. *See M&A West*, 2005 WL 1514101, at *9. Further, Paxton did not transcend his role as a finder because he did not perform the functions identified in *Offill*. 2012 WL 246061, at *8. Paxton was neither involved in negotiating the price or terms of the transaction, nor was he performing any of the other functions of the broker-dealer. *See id*. Although Paxton had prior involvement in the sale of securities during his tenure as a registered broker, this factor alone is not enough to classify Paxton as a broker-dealer rather than a finder. *See id*. The Court finds that the Complaint has not pleaded facts sufficient to support a plausible claim under Section 15(a) of the Exchange Act.

IV. CONCLUSION

This case is not about whether Paxton had a moral obligation to disclose his financial arrangement with Servergy to potential investors. This case is also not about whether Paxton had some general obligation to disclose his financial arrangement to his investor group. The only issue before the Court is to determine whether the facts as pleaded give rise to a plausible claim under federal securities laws. With that limitation in mind, the Court has determined that under

the facts pleaded by the Commission, Paxton did not have a legal obligation to disclose his financial arrangement.

The Court finds that the Complaint has not alleged facts sufficient to support a plausible claim under Sections 17(a) and 17(b) of the Securities Act or Sections 10(b) and 15(a) of the Exchange Act.

In its Response (Dkt. #25), the Commission requests that the Court grant it leave to amend its Complaint. While this request does not satisfy the requirements of Federal Rule of Civil Procedure 15, the Court is inclined to allow the Commission to plead additional facts, if any, before it grants the motion and dismisses the Commission's claims against Paxton.

It is therefore **ORDERED** that: (1) Respondent Warren K. Paxton, Jr.'s Motion to Dismiss (Dkt. #16) is **CONDITIONALLY GRANTED** pending the Court's review of the Commission's submission of additional facts and (2) the Commission is **GRANTED** leave to amend its allegations against Paxton to the extent that it has additional facts that might support a claim under the statutes alleged in the Complaint.

It is further **ORDERED** that: (1) any such amendment must be filed within fourteen (14) days of the issuance of this order and (2) the Commission must place any new facts not previously alleged in the original Complaint in bold typeface.

SIGNED this 7th day of October, 2016.

AMOS L. MAZZANT
UNITED STATES DISTRICT JUDGE

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

No. 15 Civ. 6034 (RJS)

NORTH COLLIER FIRE CONTROL AND RESCUE DISTRICT FIREFIGHTER PENSION PLAN AND PLYMOUTH COUNTY RETIREMENT ASSOCIATION, INDIVIDUALLY AND ON BEHALF OF ALL OTHERS SIMILARLY SITUATED,

Plaintiffs,

VERSUS

MDC PARTNERS, INC., MILES S. NADAL, DAVID B. DOFT, MICHAEL C. SABATINO, MITCHELL GENDEL, AND MICHAEL J. L. KIRBY,

Defendants.

OPINION AND ORDER
September 30, 2016

RICHARD J. SULLIVAN, District Judge:

Lead Plaintiffs North Collier Fire Control and Rescue District Firefighter Pension Plan ("North Collier Fire") and Plymouth County Retirement Association ("Plymouth County" and, collectively with North Collier Fire, "Plaintiffs") bring this putative class action lawsuit against MDC Partners, Inc. ("MDC") and four of MDC's current and former officers and directors. Plaintiffs allege that, throughout the period from October 28, 2013 through April 27, 2015 (the "Class Period"), MDC overstated goodwill associated with certain poorly performing or defunct subsidiaries; reported earnings using a misleading version of EBITDA (earnings before interest, taxes, depreciation, and amortization); failed to disclose all of the compensation paid to MDC's then-CEO, president, and chairman; and falsely reported that its internal controls over financial reporting were adequate. Plaintiffs assert that their reliance on these four categories of false or misleading statements caused injury to them and to all other persons who acquired MDC's Class A subordinate voting shares during the Class Period, in violation of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b); Securities and Exchange Commission ("SEC") Rule 10b-5, 17 C.F.R. § 240.10b-5; and Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a).

Now before the Court is Defendants' motion to dismiss Plaintiffs' amended complaint pursuant to Federal Rule of Civil Procedure 12(b)(6). (Doc. No. 54.) For the reasons set forth below, Defendants' motion is granted.

I. BACKGROUND[1]

A. The Parties

Plaintiffs North Collier Fire and Plymouth County are a public sector pension plan and a retirement association, respectively, that allege they purchased MDC stock during the Class Period and suffered damages as a result of false or misleading statements made by Defendants during the Class Period. (Compl. ¶¶ 23–24.)

Defendant MDC is a holding company incorporated under the laws of Canada and headquartered in New York, New York, that provides a range of marketing, activation, communications, and consulting services via its subsidiaries. (*Id.* ¶ 25.) After dropping out of college, Defendant Miles Nadal founded MDC in 1980 when he was twenty-two years old, using a $500 credit card advance. (*Id.* ¶ 3.) Though MDC began as a photography and marketing services business, it quickly became through a series of acquisitions in its first few years one of Canada's largest printing companies, specializing in secure documents such as checks, airline and event tickets, and postage stamps. (*Id.*) In October 1987, MDC became a NASDAQ-traded public company, and by the late 1990s, Nadal had divested MDC's printing businesses and pivoted the company toward marketing, advertising, and public relations, while increasing MDC's presence in the United States. (*Id.*) After acquiring several advertising and public relations firms, MDC's breakthrough came in 2001, when it acquired a 49% stake in a prominent, Miami-based advertising firm. (*Id.*) The acquisition gave MDC a firm foothold in the advertising industry and launched MDC's "partnership" model, through which it typically purchases a less-than-100% interest in the agencies it acquires. (*Id.*) MDC continued to expand through acquisitions, growing from a collection of nineteen small-to-midsize marketing firms in 2004 to a network of fifty-one "agency partners" in 2015. (*Id.*) By 2015, MDC was one of the ten largest advertising agency holding companies in the world. (*Id.* ¶ 4.)

The remaining defendants (the "Individual Defendants") include current and former MDC senior officers and directors. Nadal was MDC's chairman, CEO, and president during the Class Period. (*Id.* ¶ 26.) Nadal led MDC until July 20, 2015, when he resigned amid an ongoing SEC investigation into MDC's reimbursement of certain of his expenses and into MDC's accounting practices. (*Id.*) Defendant Michael Sabatino was MDC's chief accounting officer from April 2005 through April 22, 2015. (*Id.* ¶ 28.) Effective April 23, 2015, Sabatino was reassigned to work on "special projects" at MDC. (*Id.*) On July 20, 2015, Sabatino resigned from MDC amid the aforementioned SEC investigation. (*Id.*) Defendant David Doft is MDC's current

[1] The Court takes the facts below from Plaintiffs' amended complaint (Doc. No. 46 ("Compl.")), statements or documents incorporated into the amended complaint by reference, legally required public disclosure documents filed with the SEC, and documents upon which Plaintiffs relied in bringing the suit. *See ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 98 (2d Cir. 2007). In ruling on the instant motion, the Court has also considered Defendants' memorandum of law in support of their motion to dismiss (Doc. No. 55 ("Def. Mem.")), Plaintiffs' opposition (Doc. No. 57 ("Pl. Opp'n")), Defendants' reply (Doc. No. 59 ("Def. Reply")), and the declarations and exhibits submitted with those briefs.

chief financial officer and has held that position since August 2007. (*Id.* ¶ 27.) On April 23, 2015, following Sabatino's reassignment, Doft assumed the additional role of MDC's principal accounting officer. (*Id.*) Defendant Mitchell Gendel has served as MDC's general counsel and corporate secretary since November 2004. (*Id.* ¶ 29.) Defendant Michael Kirby joined MDC's board of directors on April 22, 2004 and, at all relevant times, served as chairman of the board's audit committee and as a member of the board's human resources and compensation committee and the board's nominating and corporate governance committee. (*Id.* ¶ 30.) On June 9, 2015, MDC announced that Kirby would retire from the MDC board on or before the expiration of his then-current term in June 2016. (*Id.*)

B. The Alleged Fraud

Plaintiffs allege that, beginning on October 28, 2013 with the release of MDC's third quarter 2013 earnings and continuing throughout the Class Period, MDC (1) overstated goodwill associated with certain poorly performing or now-defunct subsidiaries, (2) reported earnings using a misleading version of EBITDA, (3) failed to report all compensation paid to Nadal, and (4) falsely reported that it maintained adequate internal controls over financial reporting. (*Id.* ¶¶ 2, 10–14.)

1. Confidential Witness's SEC Whistleblower Complaint Against MDC

Plaintiffs largely base their amended complaint on assertions from a confidential Dodd-Frank whistleblower submission made to the SEC by a "confidential witness" ("CW 1") not named in Plaintiffs' pleading. (*See id.* ¶¶ 32–36 (describing CW 1); *id.* ¶¶ 40–56 (describing the whistleblower submission).) Plaintiffs allege that MDC retained CW 1, a "former business associate[]" of Nadal's, in mid-2009 to perform consulting services in connection with certain underperforming MDC subsidiaries. (*Id.* ¶¶ 32–33.) In the summer of 2009, CW 1 reviewed nonpublic financial information from eight MDC subsidiaries, six of which had, between June 2008 and June 2009, accounted for combined losses of over $7 million on revenues of less than $30 million. (*Id.* ¶¶ 33–34.) Because these past losses were to serve as a baseline for determining CW 1's compensation, CW 1 discussed the losses with MDC management, including Nadal, Doft, Sabatino, and Gendel. (*Id.* ¶ 34.)

In July 2012, after his business relationship with MDC had ended, CW 1 filed a lawsuit against MDC regarding a dispute as to CW 1's compensation. *See KJ Roberts & Co. Inc. v. MDC Partners Inc.*, No. 12-cv-5779 (LGS), 2014 WL 1013828 (S.D.N.Y. Mar. 14, 2014), *aff'd*, 605 F. App'x 6 (2d Cir. 2015). The lawsuit was dismissed on summary judgment. *Id.* Nevertheless, on or about February 26, 2014, shortly before the summary judgment decision was issued, CW 1 made his whistleblower submission to the SEC, attaching certain discovery from the litigation such as excerpts of deposition testimony from Nadal, Kirby, and the chief financial officer of one of MDC's subsidiaries. (Compl. ¶¶ 35, 51.) After the SEC contacted CW 1 for more information, CW 1 provided supplemental submissions on April 9, May 30, and July 1, 2014, and on June 3 and August 24, 2015. (*Id.* ¶ 35.) In general, CW 1's whistleblower submissions described MDC's alleged failure to properly account for goodwill (*id.* ¶¶ 47–53) and its alleged use of nonstandard metrics to report earnings to investors (*id.* ¶¶ 42–46).

2. MDC's Growing Goodwill

The primary focus of Plaintiffs' amended complaint is MDC's accounting for "goodwill," which is an intangible asset generated by the acquisition of a business for a price greater than the value of the business's net identifiable assets (e.g., cash, investments, buildings, equipment, inventory, accounts receivable, and certain identifiable intangible assets). (*Id.* ¶ 5.) As it grew through acquisitions, MDC recorded an increasingly large amount of goodwill, which rose steadily in the years leading up to the Class Period. For the years relevant here – 2010, 2011, 2012, and 2013 – MDC reported goodwill of $514.5 million, $605.2 million, $720.1 million, and $744.3 million, respectively. (*Id.*) During the Class Period, goodwill was MDC's single largest asset, constituting more than half of MDC's total assets. (*Id.*) In its annual report for 2014, MDC reported goodwill of nearly $851.4 million – approximately 52% of MDC's total assets of $1.649 billion (*id.*) – and for the first quarter of 2015, the last reporting period within the Class Period, MDC reported goodwill of $838.9 million (*id.* ¶ 63).

MDC's growing goodwill was the subject of comment letters from the SEC to MDC's chief financial officer, Doft, dated December 11, 2008, January 30, 2009, December 15, 2010, and November 27, 2012. (*Id.* ¶¶ 6–8.) Generally speaking, the SEC's letters sought, and Doft's responses provided, explanations of MDC's reasoning for its goodwill accounting in light of falling stock prices, worsening economic conditions, and (at least in the SEC's view) MDC's declining financial performance. (*Id.*) Plaintiffs assert that, because of this publicly filed correspondence between the SEC and MDC, "investors understood that proper accounting for goodwill was an especially significant and sensitive issue that had material significance to [MDC's] financial condition and periodic financial results." (*Id.* ¶ 9.) Plaintiffs also assert that "Doft's responses and the apparent acceptance of MDC's representations by . . . the SEC led investors to believe that MDC was properly accounting for goodwill and related items and making proper and complete disclosures regarding the value of goodwill and any necessary impairment charges." (*Id.*)

Plaintiffs allege that, despite increased scrutiny from the SEC, MDC failed to record required goodwill impairments for "certain subsidiaries" reviewed by CW 1 that had performed poorly or ceased operations after MDC acquired them. (*Id.* ¶¶ 11, 33–34.) While the amended complaint refers broadly to accounting problems with "MDC's poor-performing subsidiaries" (*id.* ¶ 97), the only subsidiary it discusses with specificity is Zyman Group, a marketing and strategy consulting firm that MDC acquired in 2005 (*id.* ¶¶ 33, 68–76).[2] MDC acquired 61.6% of Zyman Group on April 1, 2005, for a total acquisition cost of $64.6 million, and agreed to pay an additional $12 million if Zyman Group achieved specific financial targets in 2006 and 2007. (*Id.* ¶ 68.) In connection with the transaction, for the second quarter of 2005, MDC recorded $45.4 million in goodwill related to Zyman Group. (*Id.*) Furthermore, MDC agreed to provide the sellers of Zyman Group with certain "earn-out" payments based on Zyman Group's financial performance over the first five years after the transaction. (*Id.* ¶ 69.) From these facts, Plaintiffs infer that, "for at least five years," MDC needed to "create stand-alone financials for Zyman [Group] to calculate the amount of earn-out payments," which in

[2] Plaintiffs' opposition brief similarly focuses on Zyman Group. (*See* Pl. Opp'n at 24–27.)

turn required MDC, under Generally Accepted Accounting Principles ("GAAP"), to conduct goodwill impairment testing at the Zyman Group level. (*Id.* ¶¶ 69–71.)

Plaintiffs allege that a number of factors arising in the years following MDC's acquisition of Zyman Group should have triggered a write-down of goodwill. First and foremost, Plaintiffs assert that, based on internal MDC documents reviewed by CW 1, Zyman Group's revenues dropped continuously following its acquisition by MDC, from $40 million in 2005 to approximately $300,000 as of 2014. (*Id.* ¶ 49.) Plaintiffs further allege that, as disclosed in MDC's annual reports for the years 2006 through 2009, Zyman Group never reached the revenue levels at which MDC would have made earn-out payments under the acquisition agreement. (*Id.* ¶¶ 72–73; *see also id.* ¶¶ 47–48 (CW 1's whistleblower complaint cited declining revenues as "a major reason for MDC's overstatement of goodwill").) Second, Plaintiffs allege that Zyman Group's founder and namesake, Sergio Zyman, whom Plaintiffs call "a legend in the advertising community," left the firm in 2008. (*Id.* ¶ 49.)[3] Third, Plaintiffs contend that at some point not specified in the amended complaint, a significant client terminated its relationship with Zyman Group. (*Id.* ¶ 51(a).) Fourth and finally, Plaintiffs allege that Zyman Group effectively ceased operations in late 2010. (*Id.* ¶¶ 50–51, 73.) The events culminating in the end of Zyman Group began in 2008 when, following Sergio Zyman's departure, MDC hired two executives from a company called Core Strategy to become the CEO and vice chairman of Zyman Group. (*Id.* ¶ 50.) Around September 2009, MDC changed Zyman Group's name to "Core Strategy" and merged Core Strategy into another MDC subsidiary called KBS+. (*Id.*; *see also id.* ¶ 73 (noting that MDC's annual reports did not mention Zyman Group after 2009).) In late 2010, MDC terminated the Core Strategy executives, gave them the rights to use the "Core Strategy" name and any of Core Strategy's remaining clients, and wound down Core Strategy's operations, leaving the company formerly known as Zyman Group as "a husk without operations." (*Id.* ¶¶ 49–50.)

Nevertheless, "according to CW 1, Zyman Group's goodwill was 'still on the books in 2015.'" (*Id.* ¶ 73.) And according to Plaintiffs, $48.0 million in goodwill related to Zyman Group (comprising $45.4 million from the original acquisition and an additional $2.6 million from Zyman Group's acquisition of two other companies) "appears to remain on MDC's books" – an assumption Plaintiffs base on the fact that, although MDC recorded impairment charges in 2012, 2013, and 2014, it did not attribute any of those charges to a write-down of Zyman Group's goodwill. (*See id.* ¶¶ 73–76.)

3. Nadal's Growing Compensation

Plaintiffs also allege that, although MDC's revenue in the years leading up to the Class Period was lower than that of MDC's largest competitors, Nadal's compensation as CEO rivaled or exceeded CEO compensation at those companies. (*Id.* ¶ 4.) For 2011, MDC reported nearly $24 million of compensation for Nadal, as a result of which *Business Insider* ranked Nadal number two on a list of the "33 Richest People in Advertising, Ranked by Income." (*Id.*) In 2012, that total dropped

[3] Those outside of the advertising community may know Mr. Zyman best as the marketing executive behind New Coke. *See* Keith McArthur, *Man Who Authored New Coke Debacle Has No Regrets*, Globe & Mail, Apr. 18, 2005, http://fw.to/yTTpKgT (last visited Sept. 30, 2016).

to just over $9 million, but rose again in 2013 to over $20 million. *See* MDC Partners Inc., Definitive Proxy Statement at 25 (Sched. 14A) (Apr. 25, 2014) ("2014 Proxy"). Finally, for 2014, MDC reported $16.8 million in compensation for Nadal, which, according to a *New York Times* article, made Nadal the 109th highest-paid CEO in America across all industries. (Compl. ¶ 4.)

Notwithstanding the media's coverage of the significant compensation disclosed for Nadal, Plaintiffs assert that MDC failed to disclose "the true amount of compensation paid" to Nadal because its filings "omit[ted] amounts for Nadal's use of MDC's corporate aircraft and corporate apartment in New York City." (*Id.* ¶¶ 10, 120.) As in previous years, Nadal's $20,679,263 in disclosed compensation for 2013 included a category of compensation called "All Other Compensation," in the amount of $500,000. (*Id.* ¶ 118–19.) A footnote to the 2014 Proxy's "Summary Compensation Table" defined "All Other Compensation" to include "a $500,000 perquisite allowance in respect of retirement benefits and employee health benefits" and further provided that,

> *[i]n addition to the amounts set forth in the table*, on limited occasions, while Mr. Nadal is traveling on business, a member of his family has accompanied him on the corporate aircraft. There is no incremental cost to [MDC] for this use of the aircraft by Mr. Nadal's family member. For business purposes during travel from outside of New York City, Mr. Nadal and certain of [MDC]'s executive officers have the use of a corporate apartment located near [MDC]'s offices in New York City. Mr. Nadal personally paid for all furnishings in this corporate apartment, and also pays for 50% of the leasehold cost. [MDC] believes that such arrangement is more cost effective than the alternative costs of a hotel in New York City.

(*Id.* ¶ 119 (emphasis altered).) As the italicized language above indicates, Nadal received some compensation or benefit beyond the reported $500,000, but the 2014 Proxy did not specify the amount of that compensation or benefit. MDC's definitive proxy statement the following year would disclose the specific amount: $54,172. (*Id.* ¶ 124.)

Plaintiffs also generally allege that MDC failed to disclose "the fact that Nadal received millions of dollars in inappropriately reimbursed personal expenses, above and beyond" his reported compensation. (*Id.* ¶ 10.) As discussed further below, Plaintiffs base this allegation on MDC's disclosures at the end of the Class Period and in the ensuing months that Nadal had agreed to repay approximately $10.5 million of expense reimbursements that MDC had paid to him improperly over the period from 2009 through 2014. (*Id.* ¶¶ 13, 17, 121(a)–(b), 129, 138.)

C. MDC Discloses SEC Investigation and Formation of Special Committee

At the end of the Class Period, after the markets had closed on April 27, 2015, MDC issued its first quarter 2015 earnings release, which disclosed, among other things, that since October 2014, MDC had been cooperating with an SEC investigation into Nadal's expense reimbursements and MDC's accounting practices. (*Id.* ¶ 121.) Plaintiffs allege that the following statements from that earnings release "stunned the market" and "reveal[ed] the truth" about MDC's alleged fraudulent scheme (*id.* ¶ 13):

- "[S]ince October 5, 2014, [MDC] has been actively cooperating with the production of documents for review by the [SEC] pursuant to a [s]ubpoena. In connection with this production of documents, [MDC] formed a [s]pecial [c]ommittee of independent directors to review certain matters relating to the reimbursement of expenses incurred by the CEO [Nadal]."

- "The [s]pecial [c]ommittee completed an extensive review of perquisites and payments made by [MDC] to or on behalf of Miles Nadal and Nadal Management Limited [a company wholly owned by Nadal] during the six-year period from 2009 through 2014. The review included a detailed analysis of the available back-up documentation supporting such payments, as well as consideration of [a] [m]anagement [s]ervices [a]greement among Mr. Nadal, Nadal Management Limited and [MDC] and certain historical practices. These payments included, among other things, travel and commutation expenses, charitable donations, medical expenses, and certain expenses for which the information was incomplete."

- "Following the review, Mr. Nadal agreed to reimburse [MDC] for perquisites and payments for which [MDC] sought reimbursement, in the aggregate amount of $8.6 million."

- "In addition to this reimbursement, the [s]pecial [c]ommittee recommended, the [a]udit [c]ommittee has adopted, and [MDC] has adopted and implemented, a series of remedial steps to improve and strengthen [MDC]'s internal controls and procedures regarding travel, entertainment and related expenses."

- "The [s]ubpoena received from the SEC also requested production of documents relating to [MDC]'s goodwill and certain other accounting practices, as well as information relating to trading in [MDC]'s securities by third parties. [MDC] has been fully cooperating with the SEC and believes that the inquiries are at an early stage."

- "Effective as of April 23, 2015, [MDC]'s prior [c]hief [a]ccounting [o]fficer, Michael Sabatino, transitioned to a new role in [MDC], in which he will work on special projects."

(*Id.* ¶ 121 (emphasis removed).)

The next day, on April 28, 2015, MDC filed its definitive proxy statement for 2015, which disclosed $16,832,355 of compensation for Nadal in 2014. Definitive Proxy Statement at 27 (Sched. 14A) (Apr. 28, 2015) ("2015 Proxy"). In addition, like the 2014 Proxy, the 2015 Proxy included a category of compensation for Nadal called "All Other Compensation," this time in the amount of $926,005. *See id.* at 28. Unlike the 2014 Proxy, however, the 2015 Proxy included a table breaking down "All Other Compensation," which included a sub-category of compensation called "Other Perquisites." *Id.* And while the 2015 Proxy, like the 2014 Proxy, disclosed that MDC had paid for "50% of the lease and 100% of the utilities, local phone charges, cable and internet charges" of the New York City apartment, *id.* at 28; (*cf.* Compl. ¶ 119 ("Mr. Nadal personally paid for . . . 50% of the leasehold cost" of the apartment)), the 2015

Proxy departed from the 2014 Proxy and disclosed the specific amount of these expenses – $71,967, 2015 Proxy at 28. The 2015 Proxy further disclosed the specific amounts of the New York City apartment expenses for 2013 and 2012: $54,172 and $50,160, respectively. *Id.* MDC had not previously disclosed these amounts (Compl. ¶ 124) – it had only generally disclosed MDC's splitting of the New York City apartment leasehold cost with Nadal. These newly disclosed amounts raised Nadal's "All Other Compensation" from $500,000 to $554,172 for 2013 and from $558,343 to $608,503 for 2012. (*Id.* ¶ 14.)

Following these disclosures at the end of the Class Period, MDC's stock price fell from $27.98 per share on April 27, 2015 to a closing price of $20.20 per share on April 28, 2015 – a drop of $7.78 per share or 27.8%. (*Id.* ¶ 127.)

D. Post–Class Period Resignations and Additional Repayment of Reimbursements

Plaintiffs also rely on certain post–Class Period disclosures as "evidenc[e] [of] Defendants' fraud." (*Id.* at 61 (capitalization removed).) In a press release issued July 9, 2015, MDC announced that two of its management directors, Stephen Pustil and Lori Senecal, had resigned from MDC's board, and that two of MDC's outside, non-management directors – Audit Committee Chairman Michael Kirby (who is a defendant) and Clare Copeland (who is not) – would retire from the MDC board on or before the expiration of their current terms, which ended in June 2016. (*Id.* ¶ 16.)

In a press release issued two weeks later, on July 20, 2015, MDC announced that Nadal had resigned as CEO and as chairman of the board of directors. (*Id.* ¶ 129.) That press release also disclosed that, in connection with the SEC's ongoing investigation, Nadal had agreed to repay an additional $1.88 million in inappropriately reimbursed expenses (bringing the total to approximately $10.5 million). (*Id.*) Moreover, the press release explained that Nadal was "required under [MDC's] [i]ncentive/[r]etention agreements to repay $10.58 million in retention amounts received between 2012 and 2015." (*Id.*) Finally, the July 20 press release announced that Sabatino, who in April 2015 had transitioned from chief accounting officer to a "new role" at MDC working on "special projects" (*id.* ¶ 121 (emphasis removed)), had resigned and "agreed to repay [MDC] $208,535 in cash bonus payments received between 2012 and 2014" (*id.* ¶ 130).

E. Procedural History

North Collier Fire initiated this action by filing a complaint on July 31, 2015. (Doc. No. 1.) On October 6, 2015, the Court issued an order appointing North Collier Fire and Plymouth County as lead plaintiffs and the law firms Robbins Geller Rudman & Dowd LLP and Berman DeValerio as co-lead counsel. (Doc. No. 33.)

Plaintiffs filed the operative, amended complaint on December 15, 2015. (Doc. No. 46.) Like the initial complaint, the amended complaint asserts violations of Section 10(b) of the Exchange Act and SEC Rule 10b-5 against all Defendants (Count I) and a violation of Section 20(a) of the Exchange Act against the Individual Defendants (Count II). The amended complaint alleges that, in various filings with the SEC during the Class period, Defendants misled investors by (1) overstating MDC's goodwill, particularly by failing to record a goodwill impairment for Zyman Group, (2) claiming to monitor MDC's financial performance using EBITDA, when in fact they used a misleadingly modified version of EBITDA,

(3) underreporting Nadal's compensation, and (4) reporting that MDC maintained adequate internal financial controls, despite MDC's inappropriate reimbursement of $10.5 million of Nadal's expenses. Plaintiffs allege that these misrepresentations were "revealed" on April 27 and 28, 2015, when MDC disclosed, among other things, Nadal's repayment of certain expense reimbursements and an ongoing SEC investigation into that subject and MDC's goodwill accounting.

On February 9, 2016, Defendants filed a motion to dismiss Plaintiffs' amended complaint in its entirety pursuant to Federal Rule of Civil Procedure 12(b)(6) (Doc. No. 54), on the grounds that Plaintiffs have failed to plead any material misstatements or omissions, failed to plead scienter, failed to plead loss causation, and relied inappropriately on confidential witnesses and a confidential whistleblower submission to the SEC (Doc. No. 55). The motion was fully briefed as of May 9, 2016. (Doc. No. 59.)

II. Legal Standard

To survive a motion to dismiss pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, a complaint must "provide the grounds upon which [the] claim rests." *ATSI Commc'ns*, 493 F.3d at 98. Specifically, a plaintiff must allege "enough facts to state a claim to relief that is plausible on its face." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007). "A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009). In reviewing a Rule 12(b)(6) motion to dismiss, a court must accept as true all factual allegations in the complaint and draw all reasonable inferences in favor of the plaintiff. *ATSI Commc'ns*, 493 F.3d at 98. However, that tenet "is inapplicable to legal conclusions." *Iqbal*, 556 U.S. at 678. Thus, a pleading that offers only "labels and conclusions" or "a formulaic recitation of the elements of a cause of action will not do." *Twombly*, 550 U.S. at 555. If the plaintiff "ha[s] not nudged [its] claims across the line from conceivable to plausible, [its] complaint must be dismissed." *Id.* at 570.

Moreover, securities fraud claims are subject to heightened pleading standards under Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act (the "PSLRA"), 15 U.S.C. § 78u-4(b). *ATSI Commc'ns*, 493 F.3d at 99. To satisfy Rule 9(b), Plaintiffs must "state with particularity the circumstances constituting fraud." Fed. R. Civ. P. 9(b). This standard requires that the complaint "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent." *ATSI Commc'ns*, 493 F.3d at 99. And to satisfy the PSLRA, Plaintiffs must "'specify' each misleading statement," "set forth the facts 'on which [a] belief' that a statement is misleading was 'formed,'" and "'state with particularity facts giving rise to a *strong* inference that the defendant acted with the required state of mind.'" *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 345 (2005) (emphasis added) (quoting 15 U.S.C. § 78u-4(b)).

A "strong" inference is one that is "more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314 (2007). This standard thus requires courts to "consider both the inferences urged by the plaintiff and any competing inferences rationally drawn from

all the facts alleged, taken collectively." *ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 198 (2d Cir. 2009) (citing *Tellabs*). Accordingly, while courts "'normally draw reasonable inferences in the non-movant's favor on a motion to dismiss,' the PSLRA 'establishes a more stringent rule for inferences involving'" a defendant's state of mind. *Id.* at 196 (quoting *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 194 (2d Cir. 2008)).

III. Discussion

A. Alleged Violations of Exchange Act Section 10(b) and SEC Rule 10b-5

"Section 10(b) of the Exchange Act makes it unlawful '[t]o use or employ, in connection with the purchase or sale of any security[,] . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.'" *Emps.' Ret. Sys. of Gov't of the Virgin Is. v. Blanford*, 794 F.3d 297, 304–05 (2d Cir. 2015) (quoting 15 U.S.C. § 78j(b)). "SEC Rule 10b-5 implements this provision of the Exchange Act and explicitly prohibits 'mak[ing] any untrue statement of a material fact'" in connection with the purchase or sale of a security. *Id.* at 305 (quoting 17 C.F.R. § 240.10b-5(b)). "To state a claim under Rule 10b-5 for misrepresentations, a plaintiff must allege that the defendant (1) made misstatements or omissions of material fact, (2) with scienter, (3) in connection with the purchase or sale of securities, (4) upon which the plaintiff relied, and (5) that the plaintiff's reliance was the proximate cause of its injury." *ATSI Commc'ns*, 493 F.3d at 105. Defendants here argue that, in the first instance, Plaintiffs' allegations based on CW 1's whistleblower submissions must be categorically rejected, and that in any event Plaintiffs have failed to plead a material misstatement or omission, scienter, and loss causation.

With respect to CW 1's allegations, the Court rejects Defendants' argument that it cannot consider them. (Def. Mem. at 43.) While it is true that courts generally do not consider averments "taken directly from uncorroborated allegations embedded in a complaint in another action" or "parroted allegations for which counsel has not conducted independent investigation," *see In re UBS AG Sec. Litig.*, No. 07-cv-11225 (RJS), 2012 WL 4471265, at *17 n.17 (S.D.N.Y. Sept. 28, 2012), *aff'd sub nom. City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173 (2d Cir. 2014), here Plaintiffs allege that CW 1 contacted their counsel after the initial complaint was filed, and that CW 1 shared information from his whistleblower submissions and other information based on his knowledge of MDC (Compl. ¶ 36). Plaintiffs' reliance on a confidential witness with whom they personally communicated is distinguishable from a lawyer's cribbing "uncorroborated allegations" that he makes no effort to verify from a "complaint in another action." *UBS AG*, 2012 WL 4471265, at *17 n.17.

Nevertheless, even accepting the confidential witness allegations contained in the amended complaint, the Court still finds as discussed below, that Plaintiffs have failed to plead a material misstatement or omission and failed to plead scienter. Because dismissal is appropriate on either of these grounds, the Court need not address Defendants' remaining argument that Plaintiffs have failed to plead loss causation.

1. Material Misstatement or Omission

Under the PSLRA, a plaintiff "must, at the pleading stage, 'specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief,'" the plaintiff must plead "'with particularity all facts on which that belief is formed.'" *Carpenters Pension Trust Fund of St. Louis v. Barclays PLC*, 750 F.3d 227, 235–36 (2d Cir. 2014) (quoting 15 U.S.C. § 78u-4(b)(1)). "Thus, plaintiffs asserting claims under Rule 10b-5 'must do more than say that the statements . . . were false and misleading; they must demonstrate with specificity why and how that is so.'" *Id.* at 236 (quoting *Rombach v. Chang*, 355 F.3d 164, 174 (2d Cir. 2004)). Moreover, a misstatement is not actionable unless it was false at the time it was made. *See In re Int'l Bus. Machs. Corp. Sec. Litig.*, 163 F.3d 102, 107 (2d Cir. 1998) ("[A]t the time these statements were made they were neither false nor misleading."); *San Leandro Emergency Med. Grp. Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 812 (2d Cir. 1996) ("Plaintiffs allege no circumstances to support their allegation that the allegedly false statements . . . were false at the time made.").

With respect to omissions, they are only actionable under Section 10(b) if "the defendant [is] . . . subject to an underlying duty to disclose." *Levitt v. J.P. Morgan Sec., Inc.*, 710 F.3d 454, 465 (2d Cir. 2013) (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988)); *see also Kleinman v. Elan Corp., plc*, 706 F.3d 145, 152 (2d Cir. 2013) ("'[Section] 10(b) and Rule 10b-5(b) do not create an affirmative duty to disclose any and all material information.'" (quoting *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 44 (2011))). A duty to disclose "may arise when there is [1] a corporate insider trading on confidential information, [2] a statute or regulation requiring disclosure, or [3] a corporate statement that would otherwise be inaccurate, incomplete, or misleading." *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 101 (2d Cir. 2015) (brackets and internal quotation marks omitted). Accordingly, "'[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5,'" *id.* at 100–01 (quoting *Basic*, 485 U.S. at 239 n.17), and "[d]isclosure of an item of information is not required . . . simply because it may be relevant or of interest to a reasonable investor," *Kleinman*, 706 F.3d at 152–53.

Finally, any misstatement or omission must be "material," which requires the court to "engage in a fact-specific inquiry." *ECA*, 553 F.3d at 197. "The materiality of a misstatement depends on whether 'there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to [act].'" *Id.* (internal quotation marks omitted) (quoting *Basic*, 485 U.S. at 240, and *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). "In other words, in order for the misstatement to be material, 'there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.'" *Id.* (internal quotation marks omitted) (quoting *Basic* and *TSC Industries*). "Because materiality is a mixed question of law and fact, in the context of a Fed. R. Civ. P. 12(b)(6) motion, a complaint may not properly be dismissed" on materiality grounds unless the alleged misstatements or omissions "are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." *Id.* (internal quotation marks omitted).

The Court now turns to the alleged misstatements.

a. MDC's Reporting of Goodwill

Plaintiffs allege that MDC materially overstated the value of its goodwill in the quarterly earnings releases (*id.* ¶¶ 97–98), quarterly reports (*id.* ¶ 108(a)–(c)), and annual reports (*id.* ¶ 117(a)–(c)) it filed with the SEC during the Class Period. As explained above, Plaintiffs focus on MDC's alleged failure to write down the $48.0 million in goodwill associated with Zyman Group, which MDC acquired in April 2005. (*Id.* ¶¶ 33, 68–76). Plaintiffs allege that, although Zyman Group performed poorly from 2005 through 2009 before ceasing operations in 2010 (*id.* ¶¶ 49–51, 73), MDC never wrote down the $48.0 million in goodwill associated with the Zyman Group acquisition and thereby overstated its goodwill balance and earnings during its Class Period financial disclosures in violation of GAAP (Generally Accepted Accounting Principles) (*id.* ¶¶ 73, 75, 97–98, 108(a)–(c), 117(a)–(c)). Importantly, Plaintiffs challenge the *overall* goodwill balances MDC reported during the Class Period, which ranged from $711.3 million to $928.2 million (*id.* ¶ 97) – not a specific amount reported for Zyman Group.[4]

"It is well-settled that GAAP provisions are subject to interpretation and 'tolerate a range of 'reasonable' treatments, leaving the choice among alternatives to management.'" *Harris v. AmTrust Fin. Servs., Inc.*, 135 F. Supp. 3d 155, 171 (S.D.N.Y. 2015) (quoting *Thor Power Tool Co. v. C.I.R.*, 439 U.S. 522, 544 (1979)), *aff'd*, 649 F. App'x 7 (2d Cir. 2016); *see also Plumbers & Steamfitters Local 773 Pension Fund v. Can. Imperial Bank of Commerce*, 694 F. Supp. 2d 287, 302 (S.D.N.Y. 2010) ("Because . . . 'GAAP is not a lucid or encyclopedic set of pre-existing rules . . . and is far from a single-source accounting rulebook,' reasonable disagreements and deference to business judgment [are] permissible." (quoting *Shalala v. Guernsey Mem'l Hosp.*, 514 U.S. 87, 101 (1995))). Thus, the law in the Second Circuit is clear that "[a]llegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim," and "[o]nly where such allegations are coupled with evidence of corresponding fraudulent intent might they be sufficient." *ECA*, 553 F.3d at 200; *see also Stevelman v. Alias Research Inc.*, 174 F.3d 79, 85 (2d Cir. 1999) ("accounting irregularities and overly optimistic disclosures, by themselves, . . . amount to allegations of 'fraud by hindsight,' which th[e] [Second Circuit] has rejected as a basis for a securities fraud complaint" (quoting *Denny v. Barber*, 576 F.2d 465, 470 (2d Cir. 1978))).

Plaintiffs' assertion that MDC's Class Period goodwill balance reflected $48.0 million from Zyman Group is based on two allegations. The first is CW 1's assertion that "Zyman Group's goodwill was 'still on the books in 2015.'" (Compl. ¶ 73.) But

[4] Plaintiffs' opposition brief argues for the first time that MDC misrepresented how it tests its goodwill for potential impairments, since "Nadal admitted in sworn deposition testimony that MDC did not perform its goodwill impairment testing," but rather "[MDC's] outside auditor did." (Pl. Opp'n at 28 (citing Compl. ¶ 51(a)).) The Court questions what inference of fraud could possibly be drawn from a company's general statement that it tests its goodwill for impairment and its subsequent delegation of such testing to an outside, independent auditor – at least in the absence of an allegation that the company withheld information from the auditor. In any event, the theory appears nowhere in the amended complaint, and the Court accordingly disregards it. *See Kleinman*, 706 F.3d at 153 ("a party may not amend pleadings through a brief" (citing *Wright v. Ernst & Young LLP*, 152 F.3d 169, 178 (2d Cir. 1998))).

according to Plaintiffs, CW 1 worked with MDC in 2009 (*id.* ¶¶ 32–33), and though CW 1 may know how MDC accounted for Zyman Group or other subsidiaries in 2009, nothing in the amended complaint suggests that CW 1 possessed similar knowledge with respect to MDC's Class Period financials and whether Zyman Group was "still on the books in 2015," years after CW 1's relationship with MDC had terminated and ended in litigation. A securities fraud complaint may rely on information from confidential witnesses only if "'they are described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged.'" *Blanford*, 794 F.3d at 305 (quoting *Novak v. Kasaks*, 216 F.3d 300, 314 (2d Cir. 2000)). CW 1's alleged assertion regarding nonpublic information that postdates his tenure at MDC by a number of years falls well short of that requirement. *See In re Lululemon Sec. Litig.*, 14 F. Supp. 3d 553, 580–81 (S.D.N.Y. 2014) (confidential witness's allegations regarding product testing in the spring of 2012 rejected because they "sa[id] nothing about" what testing the company was conducting in March 2013), *aff'd*, 604 F. App'x 62 (2d Cir. 2015); *Malin v. XL Capital Ltd.*, 499 F. Supp. 2d 117, 142 (D. Conn. 2007) ("substantial" information from confidential witnesses who were never employed at defendant company or employed there before the start of the class period was "inadequate substantively to support an inference of scienter"), *aff'd*, 312 F. App'x 400 (2d Cir. 2009). Thus, CW 1's statement does not establish the misreporting of MDC's goodwill.

The second basis for the allegation that MDC never wrote down its Zyman-related goodwill is Plaintiffs' assertion, independent of CW 1's similar contention, that that goodwill "appears to remain on MDC's books" (Compl. ¶ 73), a conclusion Plaintiffs seemingly base on the fact that MDC never specifically disclosed an impairment related to Zyman Group, and Plaintiffs were unable to deduce whether the impairment charges that MDC *did* take in 2012, 2013, and 2014 were related to Zyman Group. (*See id.* ¶¶ 74–76.) To begin with, Plaintiffs may not simply speculate that wrongdoing occurred based on their inability to discern whether any of the impairment charges MDC took were associated with Zyman Group. *See Harris*, 135 F. Supp. 3d at 171 ("The fact that [l]ead [p]laintiff c[ould not] tick and tie the loss and loss adjustment expense reported in [defendant's] consolidated financial statement to the losses its individual subsidiaries reported to insurance regulators, without more, d[id] not plausibly allege a misstatement."). Moreover, Plaintiffs' conclusion ignores the fact that MDC merged Zyman Group into another MDC subsidiary in 2009 (*see* Compl. ¶¶ 49–50) and had not referenced Zyman Group in its financial statements for several years before the Class Period even began (*see id.* ¶ 73). And although Plaintiffs conclude that, because MDC owed earn-out payments to the previous owners of Zyman Group for "at least five years" following the 2005 acquisition (*id.* ¶ 69), MDC was therefore required to perform goodwill impairment testing at the Zyman Group level (*id.* ¶ 70–71), Plaintiffs fail to explain how that held true after Zyman Group became Core Strategy and merged with KBS+ in 2009 (*id.* ¶¶ 49–50), let alone held true through the Class Period.

In addition to these two allegations, Plaintiffs assert in a footnote in their opposition brief that, "in sworn deposition testimony, Defendants Nadal and Kirby confirmed that MDC never took a goodwill impairment on account of Zyman[Group]'s decline." (Pl. Opp'n at 25 (citing Compl.

¶ 51(a)–(b)).) Plaintiffs' assertion mischaracterizes the amended complaint, which merely alleges that Nadal and Kirby testified that they did not know whether MDC had written down the goodwill associated with Zyman Group. (*See* Compl. ¶ 51(a)–(b).) Accordingly, the amended complaint provides no basis for inferring that MDC's Class Period goodwill balance included $48.0 million from Zyman Group.

Moreover, even if the amended complaint did permit that inference, it is well-settled in the Second Circuit that goodwill estimates are opinion statements because they "depend on management's determination of the 'fair value' of the assets acquired and liabilities assumed, which are not matters of objective fact" and "will vary depending on the particular methodology and assumptions used." *Fait v. Regions Fin. Corp.*, 655 F.3d 105, 110–11 (2d Cir. 2011), *modified on other grounds*, *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318 (2015); *see also Harris*, 135 F. Supp. 3d at 173 ("[A]ctuarial or accounting assumptions . . . are, by definition, not statements of fact." (citing *Fait*)).[5] For a statement of belief or opinion to be actionable under Section 10(b), a plaintiff must allege that (1) "'the speaker did not hold the belief she professed,'" (2) "'the supporting fact[s] she supplied were untrue,'" or (3) the stated opinion, "though sincerely held and otherwise true as a matter of fact," "omit[ted] information whose omission ma[de] the [stated opinion] misleading to a reasonable investor." *Tongue v. Sanofi*, 816 F.3d 199, 209 (2d Cir. 2016) (quoting *Omnicare*, 135 S. Ct. at 1327). If a plaintiff alleges falsity on the third ground, he "'must identify particular (and material) facts going to the basis for the issuer's opinion – facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have – whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context.'" *Id.* (quoting *Omnicare*, 135 S. Ct. at 1332). "[M]eeting the standard under *Omnicare* 'is no small task for an investor,'" since reasonable investors – although they rightly do not expect opinions stated in filings with the SEC "'to reflect baseless, off-the-cuff judgments'" – "'understand that opinions sometimes rest on a weighing of competing facts,'" "'do[] not expect that *every* fact known to an issuer supports its opinion statement,'" "'read[] each statement within [an SEC filing] . . . in light of all its surrounding text, including hedges, disclaimers, and apparently conflicting information,'" and "'take[] into account the

[5] Plaintiffs cite *City of Omaha, Nebraska Civilian Employees' Retirement System v. CBS Corp.*, 679 F.3d 64 (2d Cir. 2012), and *City of Sterling Heights Police & Fire Retirement System v. Vodafone Group Public Ltd. Co.*, 655 F. Supp. 2d 262 (S.D.N.Y. 2009), for the proposition that the goodwill balances MDC reported were not opinion statements, but rather misstatements of fact because "Defendants did nothing at all to determine whether MDC's goodwill was impaired and failed to take any necessary impairment charges." (Pl. Opp'n at 28.) But those cases provide no support for Plaintiffs' assertion. Rather, *CBS* held that, "even if" plaintiffs had pled "that defendants were aware of facts that should have led them to begin" testing goodwill "earlier," plaintiffs would still have to meet the pleading standard for opinion statements. *CBS*, 679 F.3d at 68. And *Vodafone* simply observed that, "if pleaded with particularity and based on allegations that a defendant disregarded clear and unmistakable loss, the failure to take impairment charges may provide a viable basis for a securities fraud claim." *Vodafone*, 655 F. Supp. 2d at 269. *Vodafone* was decided before the Second Circuit held in *Fait* that goodwill estimates are opinion statements; regardless, the allegations *Vodafone* describes presumably would satisfy both the Second Circuit's standard for recklessness, *see Novak*, 216 F.3d at 308 (recklessness includes "fail[ing] to review or check information that [defendants] had a duty to monitor, or ignor[ing] obvious signs of fraud"), and the standard for false opinion statements set forth below.

customs and practices of the relevant industry.'" *Id.* at 210 (quoting *Omnicare*, 135 S. Ct. at 1328, 1329, 1330, 1332). Accordingly, "a statement of opinion 'is not necessarily misleading when an issuer knows, but fails to disclose, some fact cutting the other way.'" *Id.* (quoting *Omnicare*, 135 S. Ct. at 1329). "The core inquiry is whether the omitted facts would 'conflict with what a reasonable investor would take from the statement itself.'" *Id.* (quoting *Omnicare*, 135 S. Ct. at 1329).

The amended complaint does not satisfy these pleading requirements. Plaintiffs' assertion that MDC failed to record a "necessary" $48.0 million goodwill impairment for Zyman Group (Compl. ¶¶ 97, 108(a), 117(a)) after Zyman Group's revenues declined or fell below targets (*id.* ¶¶ 47, 49, 72–73) and Sergio Zyman and one of the firm's significant clients departed (*id.* ¶¶ 49, 51(a)) alleges nothing more than disagreement with MDC's accounting judgments, which cannot support a fraud claim. *See Harris*, 135 F. Supp. 3d at 172 ("In the absence of a restatement or allegations pointing to objective facts that [d]efendants' accounting methods violated GAAP, carping about [d]efendants' application of GAAP amounts . . . d[id] not permit the [c]ourt to infer that the [d]efendants committed accounting fraud."); *Kuriakose v. Fed. Home Loan Mortg. Corp.*, 897 F. Supp. 2d 168, 181 (S.D.N.Y. 2012) (declining to "intervene in a business and accounting judgment simply because . . . accountants reached different conclusions" about how defendant should have exercised its judgment), *aff'd sub nom. Cent. States, Se. & Sw. Areas Pension Fund v. Fed. Home Loan Mortg. Corp.*, 543 F. App'x 72 (2d Cir. 2013); *Can. Imperial Bank*, 694 F. Supp. 2d at 303 ("allegations regarding [a company's] write-downs amount[ed] to fundamental disagreements with [d]efendants' business judgments in a tumultuous economic downturn – claims that are not actionable under Section 10(b) and Rule 10b-5").

Plaintiffs also allege that MDC was required to write down goodwill "related to MDC's [other] poor-performing subsidiaries" (Compl. ¶¶ 97, 108(a), 117(a)), but the amended complaint offers nothing but Plaintiffs' own, generalized opinion as to why an impairment was "necessary." (*See, e.g.*, *id.* ¶ 63 (alleging that MDC experienced "persistent net losses[] from the end of 2009 through Q1 2015," yet reported growing goodwill balances over that period); *id.* ¶ 67 (arguing that, "[b]ecause MDC has operated at current and historical net losses, it is not plausible to use an honest DCF [discounted cash flow] analysis or similar method to arrive at a large enough valuation to support [MDC's] growing goodwill balance and failure to record any goodwill impairments during the Class Period").) To these assertions, Plaintiffs add those of a third confidential witness, whom Plaintiffs describe as an "accounting manager" who worked two reporting levels below Sabatino over a year before the Class Period began, and who "did not personally work on goodwill accounting because it was reserved for 'higher level' personnel," but "is aware" that Sabatino, Nadal, and Doft "worked on," "oversaw," or "confirmed and approved" MDC's goodwill calculations. (*Id.* ¶¶ 38–39.) Such allegations do not approach those necessary to plead the falsity of an opinion under *Omnicare* and *Tongue*, much less suggest securities fraud. Accordingly, Plaintiffs have failed to plead that Defendants' made any false or misleading statements in connection with MDC's goodwill reporting.

b. MDC's Use of the Term "EBITDA"

Plaintiffs next allege that MDC's Forms 10-Q filed during the Class Period

misleadingly stated that MDC's management monitored MDC's "'financial performance and financial condition'" using "*industry standard* 'EBITDA,' which the Class Period 10-Qs specifically define as 'earnings before interest, income taxes and depreciation and amortization.'" (*Id.* ¶ 107 (emphasis added).)[6] While Plaintiffs acknowledge that the 10-Qs themselves did not report any earnings results using EBITDA (*id.* ¶ 12), they argue that the 10-Qs nevertheless misled investors because the EBITDA metric reported in MDC's quarterly earnings releases "d[id] not comport with the industry standard definition referenced in the Class Period 10-Qs" (*id.* ¶ 108(e)). (*See also id.* ¶ 12 ("Investors were misled" because the "highly modified" version of EBITDA reported in MDC's earnings releases did not match "the industry standard definition . . . touted in [MDC's] Forms 10-Q.").)

Specifically, relying on CW 1's whistleblower complaint, Plaintiffs allege that the "EBITDA" reported in MDC's earnings releases "actually meant 'operating income (loss) plus depreciation and amortization, stock-based compensation, acquisition deal costs, deferred acquisition consideration adjustments and profit distributions from affiliates.'" (*Id.* ¶ 44.) This was a problem, CW 1 and Plaintiffs say, because the calculation should have started with "GAAP net income," not "operating income," and because the adjustments MDC applied were "seemingly arbitrary." (*Id.*) Since these adjustments "were so extensive," and the resulting definition of EBITDA so "heavily manipulated," "constantly changing," "nonstandard," and "tortured," Plaintiffs argue that "the common term EBITDA should not have been used in [MDC's] public filings." (*Id.* ¶¶ 12, 45, 81, 82.)

However, Plaintiffs' ambitious claims in this regard ignore what MDC actually disclosed. To begin with, the challenged statements from MDC's 10-Qs read as follows: "MDC manages the business by monitoring several financial and non-financial performance indicators. The key indicators that we review focus on the areas of revenues and operating expenses, which results in earnings before interest, income taxes and depreciation and amortization ('EBITDA') and capital expenditures." *See, e.g.*, Quarterly Report at 28 (Form 10-Q) (Nov. 5, 2013). These sentences neither "tout" (nor use) the phrase "industry standard," nor do they contain actual financial disclosures, and Plaintiffs allege no facts suggesting that MDC management did not actually monitor the company's revenues and operating expenses such that the general statements above would have been untrue.

Plaintiffs nevertheless argue that these sentences in the 10-Qs led investors to believe that MDC's Class-Period earnings releases, which actually did report "EBITDA" results, followed an "industry standard" definition of that term, when in fact the earnings releases employed a "highly modified definition of EBITDA." (Compl. ¶ 12.) But this assertion also ignores MDC's filings, since the earnings releases specifically explained how MDC had calculated the "EBITDA" amounts reported in those releases. *See* Current Report Ex. 99.1, scheds. 2–3 (Form 8-K) (Oct. 28, 2013); Current Report Ex. 99.1, scheds. 2–3 (Form 8-K) (Feb. 20, 2014); Current Report Ex. 99.1, scheds. 2–5 (Form 8-K) (July 24, 2014); Current Report Ex.

[6] These include MDC's Forms 10-Q for the third quarter of 2013, filed November 5, 2013; the first quarter of 2014, filed April 29, 2014; the second quarter of 2014, filed August 11, 2014; and the third quarter of 2014, filed November 6, 2014. (Compl. ¶¶ 99–102.)

99.1, scheds. 2–5 (Form 8-K) (Oct. 29, 2014); Current Report Ex. 99.1, scheds. 2–5 (Form 8-K) (Feb. 23, 2015). In addition, under a section titled "Non-GAAP Financial Measures," MDC explained that it "has included in this earnings release certain financial results that the [SEC] defines as 'non-GAAP financial measures,'" which "[m]anagement believes . . . can provide useful supplemental information for investors" analyzing MDC's results when the non-GAAP numbers are "read in conjunction with [MDC's] reported results." *See, e.g.*, Current Report Ex. 99.1 (Form 8-K) (Oct. 28, 2013). The releases note that the non-GAAP numbers include "EBITDA and EBITDA margin (*as defined*)." *See, e.g.*, *id.* (emphasis added). No reasonable investor would ignore these definitions, much less assume that the reported EBITDA is governed by a definition set forth in a generic statement in another document, as Plaintiffs suggest.

Plaintiffs separately argue that MDC misled investors by changing its "nonstandard" calculation of EBITDA from quarter to quarter. (Compl. ¶¶ 45, 89.) But this argument also misses the mark. EBITDA is a non-GAAP metric "for which there is no 'right' formula because, unlike GAAP metrics, they have no uniform definition." *Ironworkers Local 580 – Joint Funds v. Linn Energy, LLC*, 29 F. Supp. 3d 400, 426 (S.D.N.Y. 2014). The fact that a plaintiff may "take issue with the way [a company] ch[ooses] to calculate these metrics . . . is of no moment," because "[i]t is not fraudulent for a reporting entity to calculate metrics that," like EBITDA, "are not defined under GAAP," nor is it fraudulent for the company to "tak[e] (or not tak[e]) into account whatever factors the reporting entity thinks appropriate – as long as the public is told exactly what the company is doing." *Id.* Unless Plaintiffs can show that MDC somehow misled investors about how it actually calculated EBITDA, which they have not, there can be no claim for fraud. *See id.* (dismissing complaint where plaintiffs were "unable to identify a single instance in which [defendant's] disclosures of how it calculated" the challenged non-GAAP metrics "were incorrect"); *In re One Commc'ns Corp.*, No. 07-cv-3905 (LTS), 2009 WL 857535, at *10 (S.D.N.Y. Mar. 31, 2009) (dismissing complaint where plaintiff merely alleged that defendant's EBITDA was artificially inflated without "explain[ing] how the EBITDA was incorrectly calculated" and "how this representation might be misleading").

Plaintiffs' allegation that MDC "altered the components of its EBITDA metric to further inflate [its] financial performance" (Compl. ¶ 89) is similarly deficient. The allegation is conclusory, and in any event, "[t]here is nothing inherently improper . . . about reporting a positive EBITDA while simultaneously reporting a [GAAP] net loss" because "[t]he two are entirely different measures." *Xerion Partners I LLC v. Resurgence Asset Mgmt., LLC*, 474 F. Supp. 2d 505, 518 (S.D.N.Y. 2007), *aff'd sub nom. Bay Harbour Mgmt. LLC v. Carothers*, 282 F. App'x 71 (2d Cir. 2008). Indeed, the fact that MDC included a reconciliation of adjusted EBITDA to GAAP metrics in each of its earnings releases, *see, e.g.*, Current Report Ex. 99.1, scheds. 2–5 (Form 8-K) (Feb. 23, 2015), belies Plaintiffs' conclusory assertion that MDC used adjusted EBITDA to mask GAAP losses. Accordingly, the Court finds that Plaintiffs have failed to plead that Defendants made any false or misleading statements in connection with MDC's disclosures relating to EBITDA.

c. MDC's Disclosures of Nadal's Compensation

Plaintiffs next contend that MDC failed to disclose "the true amount of compensation paid" to Nadal, both by underreporting Nadal's perquisites and by improperly reimbursing $10.5 million of Nadal's expenses. (Compl. ¶ 10.) The Court will address each in turn.

i. Underreported Perquisites

Plaintiffs allege that although the 2014 Proxy disclosed the fact that MDC split fifty-fifty with Nadal the leasehold for a New York City corporate apartment used by Nadal and other MDC officers (*id.* ¶ 119), it nevertheless concealed the fact that the cost of MDC's share was $54,172, which included "50% of the [New York City apartment] lease and 100% of the utilities, local phone charges, cable and internet charges of the apartment" (*id.* ¶ 124). Because this amount was not included in the $500,000 disclosed as other compensation for Nadal for 2013, Plaintiffs argue that the 2014 Proxy's disclosure of $20,679,263 in total 2013 compensation for Nadal was false and misleading because the actual total, with the $54,172 included, was $20,733,435. (*Id.* ¶¶ 118–20.) Plaintiffs also allege that the 2014 Proxy "omit[ted] amounts for Nadal's use of MDC's corporate aircraft," which supposedly were also "revealed in MDC's 2015 [d]efinitive [p]roxy [s]tatement." (*Id.* ¶ 120 (citing *id.* ¶¶ 123–24).)

With respect to compensation related to Nadal's use of MDC's aircraft in 2013, the 2015 Proxy does not appear to disclose any such amounts, and Plaintiffs do not identify any such disclosure. Paragraphs 123 and 124 of the amended complaint, which Plaintiffs cite in paragraph 120 for the assertion that aircraft-related compensation was "revealed" in the 2015 Proxy, merely discuss the revelation of the amounts paid for the New York City apartment. (*See id.* ¶¶ 123, 124.) Accordingly, Plaintiffs' allegation regarding undisclosed aircraft-related compensation does not plead a false or misleading statement.

With respect to the New York City apartment, there can be no dispute that the 2013 compensation originally disclosed for Nadal was "false" in the sense that the total compensation reported for Nadal ($20,679,263) did not include the $54,172 MDC paid for Nadal's use of the apartment. (*Id.* ¶ 124.) Defendants argue, however, that the undisclosed amount is not material. (Def. Mem. at 27–28.) Materiality is a "fact-specific inquiry," and courts may not dismiss securities fraud claims on materiality grounds unless the facts at issue "are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." *ECA*, 553 F.3d at 197. However, the Second Circuit has made clear that courts may evaluate materiality at the pleading stage, and if they do so "must consider," in an "integrative matter," "both 'quantitative' and 'qualitative' factors." *Litwin v. Blackstone Grp., L.P.*, 634 F.3d 706, 717 (2d Cir. 2011); *see also Hutchison v. Deutsche Bank Sec. Inc.*, 647 F.3d 479, 485 (2d Cir. 2011); *ECA*, 553 F.3d at 198; *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162–63 (2d Cir. 2000). In aid of this analysis, the Second Circuit has held that a "five percent numerical threshold" – i.e., at least a five percent difference between an inaccurate versus accurate financial disclosure – is a "good starting place for assessing the materiality of the alleged misstatement," and that useful "qualitative factors" include "(1) concealment of an unlawful transaction, (2) significance of the misstatement in relation to the company's operations, and (3) management's expectation that the misstatement will result

in a significant market reaction." *ECA*, 553 F.3d at 198.

The parties focus here on the five percent threshold and disagree as to which item in MDC's financial statements the $54,172 should be measured against. (*See* Def. Mem. at 27–28; Pl. Opp'n at 15–18.) Perhaps not surprisingly, Plaintiffs argue that it should be measured as a percentage of Nadal's "All Other Compensation" for 2013 ($500,000) (Pl. Opp'n at 16–17), which just happens to be the smallest subcategory of expenses in which the expense could fall in the 2014 Proxy and the only way to even approach the Second Circuit's 5% threshold. But while Plaintiffs correctly note that "the items in issue should be compared to like items on the corporate financial statement," *Ganino*, 228 F.3d at 165, Plaintiffs offer no justification, and the Court can think of none, for comparing the $54,172 in undisclosed benefits to any category lower than Nadal's total compensation for 2013 ($20,679,263), and arguably the more appropriate comparison is MDC's total expenses for 2013, which exceeded $1.1 billion, *see* Current Report Ex. 99.1, sched. 1 (Form 8-K) (Feb. 20, 2014). And since $54,172 is a mere 0.26% of Nadal's total 2013 compensation, it is well below the Second Circuit's 5% threshold. Moreover, the fact that the 2014 Proxy actually identified the existence of compensation beyond the numbers reported in Nadal's compensation table – by disclosing the New York City apartment perquisite, albeit without including the precise dollar value (*see* Compl. ¶ 119) – further weighs against a conclusion that the disclosure of the dollar amount, in the mind of a reasonable investor, would have "significantly altered the total mix of information made available," *ECA*, 553 F.3d at 197 (internal quotation marks omitted). Accordingly, in light of its minuscule impact on Nadal's overall compensation and given Plaintiffs' failure to identify any qualitative factors that would otherwise support materiality, the Court finds that Nadal's 2013 compensation was not materially misstated.[7]

ii. Undisclosed Improper Reimbursements

Plaintiffs also allege that MDC inappropriately reimbursed $10.5 million of Nadal's expenses over the period 2009 through 2014. (Compl. ¶¶ 13, 17, 121(a)–(b), 129, 138.) However, the amended complaint does not identify specific statements that were false when made in light of these improper expense reimbursements; indeed, its "Materially False and Misleading Statements" section mentions the $10.5 million only to establish that MDC's internal controls were inadequate. (*See id.* ¶¶ 108(d), 117(d).) Similarly, in explaining why Nadal's compensation was understated in the 2014 Proxy, the amended complaint cites only MDC's failure to specify the amounts paid for Nadal's use of company aircraft and the New York City apartment. (*See id.* ¶ 120.) Moreover, Plaintiffs allege no facts supporting the inference that MDC's financial statements improperly characterized the reimbursements as something other than expenses, so as to "conceal[] MDC's true financial condition by understating the amount of its executive compensation expenses." (*Id.* ¶ 10.) Nevertheless, Plaintiffs' opposition brief argues, for the first time, that the improper reimbursements were not just an internal

[7] The amended complaint also alleges that the 2015 Proxy revealed, like its disclosure with respect to Nadal's 2013 compensation, the specific amount of Nadal's New York City apartment compensation for *2012*. (Compl. ¶ 124.) While the amended complaint does not specifically allege that the $9,277,422 in compensation disclosed for Nadal for 2012 was thus understated (*see id.* ¶ 118), if it had made that allegation, it would have failed on the same materiality ground as set forth above.

controls issue, but also a separate ground for the assertion that MDC underreported Nadal's compensation. (*See* Pl. Opp'n at 15 (arguing that "Defendants misled MDC's investors in two respects," including by underreporting Nadal's perquisites and failing to report improperly reimbursed expenses).) With some guesswork and speculation, the amended complaint's allegations could be read as supporting, however vaguely and inarticulately, a contention that, for each year from 2009 through 2014, MDC should have characterized about $2.10 million (one fifth of the $10.5 million for the total period) as compensation paid to Nadal, rather than some other type of expense – such that MDC underreported Nadal's compensation despite accurately reporting its overall expenses.

This is not a *pro se* action, however, and the Court is not required to construe Plaintiffs' pleading "liberally to raise the strongest arguments it suggests." *Nielsen v. Rabin*, 746 F.3d 58, 63 (2d Cir. 2014). Rather, the PSLRA imposes – "[a]s a check against abusive litigation by private parties" – "[e]xacting pleading requirements" with respect to "the facts constituting the alleged violation," *Tellabs*, 551 U.S. at 313, mandating that courts dismiss a complaint that fails to "specify each statement alleged to have been misleading" and "the reason or reasons why the statement is misleading," 15 U.S.C. § 78u-4(b)(1), (3). The general allegation that "Defendants failed to disclose the true amount of compensation paid to Defendant Nadal, including the fact that Nadal received" $10.5 million "in inappropriately reimbursed personal expenses" over the period from 2009 through 2014 (Compl. ¶¶ 10, 13, 17), does not "specify [a] statement alleged to have been misleading" or "the reason or reasons why th[at] statement is misleading." Accordingly the PSLRA compels the Court to reject the allegation.

However, even if Plaintiffs had pled the theory the Court has identified from the amended complaint's unspecific allegations, that theory would still fail to plead a material misstatement. While MDC obviously would have understated the 2013 compensation reported for Nadal during the Class Period if it had failed to report $2.10 million of additional compensation in the form of reimbursements, the question remains whether the misstatement would have been material. Arguably, as with Nadal's undisclosed perquisites, the proper comparison for materiality purposes is with MDC's total 2013 expenses ($1,180,873,000), against which another $2.10 million would amount to a paltry 0.18% – well below the Second Circuit's 5% threshold and clearly immaterial. When compared to Nadal's $20,679,263 in 2013 compensation, however, the percentage lands above the threshold at 10.2%.

But even assuming that is the correct comparison, the Court's analysis does not end there, as it must also consider "'qualitative' factors" of materiality. *Litwin*, 634 F.3d at 717. On this point, Plaintiffs argue that "'management's expectation that the misstatement will result in a significant market reaction,'" *ECA*, 553 F.3d at 198, is a factor supporting qualitative materiality, and they cite negative media coverage following MDC's disclosures at the end of the Class Period. (*See* Compl. ¶¶ 172–74.) But this media coverage actually cuts *against* qualitative materiality, since none of the cited news reports express the view that MDC's disclosures revealed Nadal's pay to be materially higher than previously thought, or revealed it to be excessive whereas before it was considered reasonable. To the contrary, the reports suggest that investors already knew Nadal

was paid like a sultan. (*See id.* ¶ 172 (*Globe and Mail* article noting Nadal's history of exorbitant pay and ranking him among the highest-paid executives in Canada despite MDC's uneven financial results and the fact that its competitors perform better and pay their CEOs less)); *see also* Nathalie Tadena, *MDC Partners' Stock Takes a Hit on SEC Investigation*, Wall St. J., Apr. 28, 2015, http://on.wsj.com/1ENtdWe (last visited Sept. 30, 2016) (noting that Nadal's $16.8 million in 2014 compensation was "down from $20.7 million a year earlier" but still exceeded that of CEOs at "much bigger" and better-performing rivals), *cited in* Compl. ¶ 173. The compensation rankings cited by Plaintiffs in the amended complaint further demonstrate that Nadal's excessive compensation was widely known, ranking Nadal as the second-highest paid advertising executive in 2011. (Compl. ¶ 4.) Similarly, the *New York Times* published an article during the Class Period listing Nadal as the 58th highest-paid CEO of any American company in 2013. Karl Russell, *The Pay at the Top*, N.Y. Times, June 7, 2014, http://nyti.ms/1kI4p6h (last visited Sept. 30, 2016). An additional $2.10 million in either of those years would not have earned Nadal the number one spot among advertising executives, *see* Jim Edwards, *The 33 Richest People in Advertising, Ranked by Income*, Bus. Insider, May 19, 2012, http://www.businessinsider.com/business-insiders-advertising-rich-list-2012-2012-5 (last visited Sept. 30, 2016), and it would have bumped him only from 58th to 45th on the list of all executives, *see* Russell, *supra*.

Thus, setting aside for the moment whether the $10.5 million in improper reimbursements shows inadequate controls, when this figure is considered solely as a misstatement of Nadal's compensation, $2.10 million per year hardly registers. In that context, it is simply not "substantial[ly] likel[y] that a reasonable shareholder would," in deciding whether to purchase MDC securities, "consider it important" to know that Nadal was marginally closer to being the highest-paid advertising CEO, instead of the second-highest-paid, or that he was not the 58th highest-paid CEO in American business, but rather the 45th. *ECA*, 553 F.3d at 197; *see also Kleinman*, 706 F.3d at 152–53 ("[d]isclosure of an item of information is not required . . . simply because it may be relevant or of interest to a reasonable investor"). Stated differently, the revelation that Nadal's notoriously excessive compensation was in fact 10.2% higher than previously disclosed would not, as a matter of law, be viewed by a reasonable investor as "*significantly alter[ing]* the 'total mix' of information made available." *ECA*, 553 F.3d at 197 (emphasis added). Accordingly, the Court concludes that MDC's failure to disclose the $10.5 million in improper expense reimbursements, even if considered as an undisclosed form of compensation and compared against Nadal's 2013 pay, was not a material misstatement.[8]

d. Management's Statement that MDC's Internal Controls Were Adequate

Plaintiffs also allege that MDC, in its quarterly and annual reports filed during the Class Period, misled investors by affirming that it maintained adequate internal controls over its financial reporting (*id.* ¶¶ 105, 106, 115–16), when in fact MDC "had substantial

[8] The Court expresses no view on whether the services Nadal provided to MDC, a seemingly underperforming advertising firm holding company, justified paying him more than the CEOs of Verizon Communications, Dow Chemical, Goldman Sachs, General Electric, Coca-Cola, Pfizer, Starbucks, Lockheed Martin, Nike, and IBM. *See* Russell, *supra*. In any event, allegations of excessive compensation (Compl. ¶¶ 4, 172–73) belong in a corporate waste complaint; they do not establish securities fraud. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977).

internal control deficiencies" that caused MDC to inappropriately reimburse $10.5 million of Nadal's expenses (*id.* ¶¶ 108(d), 117(d)). While a closer call than Plaintiffs' undisclosed compensation argument, this argument also fails as a matter of law.

First, the mere fact that MDC's internal controls failed to catch these improper reimbursements does not demonstrate the falsity of MDC's statements that its controls were adequate. *See Faulkner v. Verizon Commc'ns, Inc.*, 156 F. Supp. 2d 384, 400 (S.D.N.Y. 2001) ("'The mere disclosure of adverse information shortly after a positive statement does not support a finding that the prior statement was false at the time it was made.'" (quoting *Elliott Assocs., L.P. v. Covance, Inc.*, No. 00-cv-4115 (SAS), 2000 WL 1752848, at *7 (S.D.N.Y. Nov. 28, 2000) (citing *San Leandro*, 75 F.3d at 812))); *see also, e.g.*, *In re Royal Bank of Scot. Grp. plc Sec. Litig.*, No. 09-cv-300 (DAB), 2012 WL 3826261, at *8 (S.D.N.Y. Sept. 4, 2012) ("Pointing to the subsequent subprime market collapse and alleging that [defendant] must therefore have failed to follow its internal control procedures is not sufficient."), *aff'd sub nom. Freeman Grp. v. Royal Bank of Scot. Grp. PLC*, 540 F. App'x 33 (2d Cir. 2013). Plaintiffs must instead allege "why or how" MDC's internal controls "were materially deficient at the time" of the challenged statements. *See Janbay v. Can. Solar, Inc.*, No. 10-cv-4430 (RWS), 2012 WL 1080306, at *9 (S.D.N.Y. Mar. 30, 2012) (dismissing Section 10(b) claim where "[t]he [c]omplaint [did] not allege any facts explaining why or how [the company's] internal controls were materially deficient at the time [the company] made any of the challenged statements"); *see also In re PetroChina Co. Ltd. Sec. Litig.*, 120 F. Supp. 3d 340, 359 (S.D.N.Y. 2015) (dismissing Section 10(b) claim where the complaint "d[id] not claim that [defendant] failed to evaluate its internal controls or disclose any weaknesses to its auditors" or "make any allegation as to how or why [defendant's] internal controls were inadequate"), *aff'd sub nom. Klein v. PetroChina Co.*, 644 F. App'x 13 (2d Cir. 2016); *City of Monroe Emps.' Ret. Sys. v. Hartford Fin. Servs. Grp., Inc.*, No. 10-cv-2835 (NRB), 2011 WL 4357368, at *22 (S.D.N.Y. Sept. 19, 2011) (dismissing Section 10(b) claim because "plaintiffs have not alleged any facts pertaining to the [c]ompany's internal structure for financial reporting, much less that [the company] lacked adequate internal controls").

Here, the only specific allegations in the amended complaint regarding the controls and processes in place at MDC come from a second confidential witness ("CW 2"), who offers no information regarding the adequacy of MDC's controls. Specifically, Plaintiffs allege that CW 2, who was a vice president in MDC's treasury from 2011 through 2013 and processed Nadal's expenses as part of that job, would receive a "cover sheet" containing a total amount (but not any of the details) of Nadal's travel and entertainment expenses. (*Id.* ¶ 37.) Before CW 2 received the cover sheet, however, all of Nadal's expenses were first approved by MDC's board of directors or the board's compensation committee. (*Id.*) Moreover, CW 2 would only process Nadal's expenses after obtaining an approval signature from Sabatino or, if Sabatino was unavailable, Doft. (*Id.*) After receiving that approval, CW 2 would then arrange payment to Nadal by wire transfer, and MDC's accounting department would book the reimbursements in MDC's financial records. (*Id.*) These allegations do not identify a failure to evaluate controls, to follow procedures, to report a weakness to auditors, or any other basis from which the Court could infer that MDC's controls were inadequate during the Class Period.

Nor can Plaintiffs simply rely on the fact that, upon disclosing in 2015 that Nadal had received $10.5 million in inappropriate reimbursements, MDC announced that it would be implementing "remedial steps to improve and strengthen its internal controls and procedures regarding travel, entertainment and related expenses." (*Id.* ¶ 121(c).) In fact, the law is clear that remedial efforts are "a prudent course of action that weakens rather than strengthens an inference of scienter." *Slayton v. Am. Exp. Co.*, 604 F.3d 758, 777 (2d Cir. 2010); *see also Stevelman*, 174 F.3d at 84 (rejecting argument that a company's "subsequent revelation of its accounting policy change and retroactive announcement of lowered earnings should be probative of conscious misbehavior or recklessness"); *In re Magnum Hunter Res. Corp. Sec. Litig.*, 26 F. Supp. 3d 278, 295 (S.D.N.Y. 2014) ("The fact that defendants recognized problems, announced that they were implementing effective controls and procedures, and then recognized more problems does not indicate that their statements were false at the time that they were made."), *aff'd*, 616 F. App'x 442 (2d Cir. 2015).

* * *

For the foregoing reasons, the Court concludes that Plaintiffs have not pled a material misstatement or omission, which alone warrants dismissal of the amended complaint. The Court nevertheless turns to scienter, which provides an alternate basis for dismissal.

2. Scienter

Under the PSLRA, a securities fraud complaint must "state with particularity facts giving rise to a *strong* inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added). "The requisite state of mind . . . is an intent 'to deceive, manipulate, or defraud.'" *ECA*, 553 F.3d at 198 (quoting *Tellabs*, 551 U.S. at 313). To be "strong," an inference of scienter "must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs*, 551 U.S. at 314. In making this determination, the question is not whether "any individual allegation, scrutinized in isolation, meets th[e] standard"; rather, courts must "collectively" evaluate "all of the facts alleged." *Id.* at 323.

In the Second Circuit, the requisite strong inference of scienter "can be established by alleging facts to show either (1) that defendants had the motive and opportunity to commit fraud, or (2) strong circumstantial evidence of conscious misbehavior or recklessness." *ECA*, 553 F.3d at 198; *accord ATSI Commc'ns*, 493 F.3d at 99. It is "indisputable that key directors and officers have [the] ability to manipulate their company's stock price," *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 267 (2d Cir. 1996), and so securities fraud allegations typically focus, as they do here, on officer defendants' motives, rather than their opportunity, to commit fraud.

a. Motive to Commit Fraud

To raise a strong inference of scienter by pleading motive to defraud, a plaintiff must allege that the defendant "benefitted in some concrete and personal way from the purported fraud." *ECA*, 553 F.3d at 198. However, "it is not sufficient to allege goals that are 'possessed by virtually all corporate insiders,' such as the desire to maintain a high credit rating for the corporation or otherwise sustain the appearance of corporate profitability or the success of an investment, or the desire to maintain a high stock price in order to increase executive

compensation." *S. Cherry St., LLC v. Hennessee Grp. LLC*, 573 F.3d 98, 109 (2d Cir. 2009) (quoting *Novak*, 216 F.3d at 308); *see also Acito v. IMCERA Grp., Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) ("If scienter could be pleaded" solely on the basis that "defendants were motivated to defraud the public because an inflated stock price would increase their compensation," then "virtually every company in the United States that experiences a downturn in stock price could be forced to defend securities fraud actions."). Here, Plaintiffs allege that the Individual Defendants' insider stock sales and compensation structure during the Class Period demonstrate that they had a motive to commit fraud. The Court will address each of these allegations in turn.

i. Insider Trading

A plaintiff may plead motive by alleging facts showing that "corporate insiders misrepresent[ed] material facts to keep the price of stock high while selling their own shares at a profit." *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 74 (2d Cir. 2001); *see also ECA*, 553 F.3d at 198 ("[T]he 'motive' showing is generally met when corporate insiders allegedly make a misrepresentation in order to sell their own shares at a profit."). Here, the amended complaint alleges that the Individual Defendants collectively sold 6,475,305 shares of MDC stock during the eighteen-month Class Period, for combined gross proceeds of $163,600,046, while selling only 52,050 shares for $570,049 over the same length of time immediately prior to the Class Period. (*Id.* ¶ 135; *see also id.* ¶¶ 136–37, 147, 154, 159, 162 (discussing each of the Individual Defendants' sales).)

"'However, the mere fact that insider stock sales occurred does not suffice.'" *Glaser v. The9, Ltd.*, 772 F. Supp. 2d 573, 587 (S.D.N.Y. 2011) (quoting *In re Gildan Activewear, Inc. Sec. Litig.*, 636 F. Supp. 2d 261, 270 (S.D.N.Y. 2009)). Instead, to demonstrate motive, "'plaintiffs must establish that the sales were 'unusual' or 'suspicious'" at the time they were made. *Id.* (brackets omitted) (quoting *Gildan Activewear*, 636 F. Supp. 2d at 270). "Whether trading was unusual or suspicious turns on factors including (1) the amount of net profits realized from the sales; (2) the percentages of holdings sold; (3) the change in volume of insider defendant's sales; (4) the number of insider defendants selling; (5) whether sales occurred soon after statements defendants are alleged to know to be misleading; (6) whether sales occurred shortly before corrective disclosures or materialization of the alleged risk; and (7) whether sales were made pursuant to trading plans such as Rule 10b5-1 plans." *Glaser*, 772 F. Supp. 2d at 587 (collecting cases).

To start, the allegation that the Individual Defendants collectively sold far more shares for far greater proceeds during the Class Period than they did over the eighteen-month period preceding the Class Period (Compl. ¶ 135) fails to support a strong inference of scienter because the totals are based on a time period with no apparent connection to the alleged fraud. While Plaintiffs' reason for selecting April 27, 2015 – the date MDC disclosed the SEC investigation – as the conclusion of the Class Period is clear, Plaintiffs have not explained why October 28, 2013 – a date on which MDC simply announced its third quarter 2013 earnings – holds any significance as the opening date of the Class Period. To be sure, Plaintiffs allege that that earnings release contained fraudulent statements (*see id.* ¶¶ 90, 96–98), but the bases for that allegation are that MDC had continuously failed to write down goodwill associated with Zyman Group since 2006 (*see id.* ¶¶ 72–73), that MDC had reported

non-"industry standard" EBITDA since 2012 (*id.* ¶¶ 46, 82), and that Nadal had received improper expense reimbursements since 2009 (*id.* ¶ 138).

A more logical beginning date for assessing the Individual Defendants' trades is October 5, 2014, the date MDC received a subpoena from the SEC. (*Id.* ¶¶ 13, 56, 170.) After this date, based on Plaintiffs' allegations, the Individual Defendants presumably would have realized that the unraveling of the alleged fraud was imminent and would have had motive to dump their shares before the stock price inevitably dropped. But when the alleged stock sales are reviewed from this date through the end of the Class Period, instead of the illogical eighteen-month period alleged by Plaintiffs, a much different picture emerges. Plaintiffs allege that Nadal, Doft, Sabatino, Gendel, and Kirby each executed a trade on November 5, 2013, that Doft, Sabatino, and Gendel also executed trades on December 30, 2013, February 20, 2014, and February 23, 2015, and that Nadal alone executed an additional trade on May 16, 2014 for a combined total of 6,475,305 shares and $163,600,046 in gross proceeds. (*See id.* ¶¶ 135, 136, 147, 154, 159, 162.) However, when only the February 23, 2015 trades are considered (the only trades that were made after MDC received the SEC subpoena), two of the Individual Defendants, Nadal and Kirby, sold no shares (*see id.* ¶¶ 137, 162), and the remaining three individuals collectively sold only 8,630 shares for proceeds of $219,375 (*see id.* ¶¶ 147, 154, 159). Given these facts, the Court simply cannot infer scienter from far greater sale totals occurring over Plaintiffs' far less logical time period.

Plaintiffs offer no convincing arguments for why their eighteen-month period, or even some period other than the one described above, should be considered when analyzing the Individual Defendants' trades. To get around the October 2014 subpoena date, Plaintiffs argue that the SEC began "questioning" MDC "about the way it presented earnings and accounted for its profitability" "[n]ot long after" CW 1 submitted his whistleblower complaint and that Defendants thus "likely knew of the SEC investigation" shortly thereafter. (Pl. Opp'n at 53–54 (quoting Compl. ¶ 41 (emphasis removed)).) But this is mere conjecture; Plaintiffs allege no facts suggesting that the Individual Defendants were aware of the investigation before they received the subpoena in October 2014. Moreover, the assertion that the SEC began "questioning" MDC about its financial reporting appears to be based on a comment letter the SEC sent to MDC on May 9, 2014 (*id.* ¶ 136), which was publicly filed and included certain instructions for MDC's reporting of non-GAAP metrics in "future filings." (*See* MDC Partners Inc., SEC Comment Letter (May 9, 2014).) As Plaintiffs acknowledge, however, MDC had previously received and responded to several comment letters of this nature (*id.* ¶¶ 6–8), and the May 9, 2014 letter says nothing about GAAP violations or an ongoing or potential investigation.

The only other argument Plaintiffs offer in defense of the trading period alleged in the amended complaint is that, "when the Defendants disposed of their shares, they were aware of relevant issues that had been raised in the context of CW 1's lawsuit against [MDC], which was filed in July 2012" and touched on subjects relating to goodwill and Zyman Group. (Pl. Opp'n at 54.) But CW 1's lawsuit was filed nearly a year and a half before the alleged insider trading began, and CW 1's mere allegations – in a dispute over CW 1's own compensation – would hardly have put Defendants on notice that their alleged scheme would soon unravel. Nor, for that

matter, does the filing of CW 1's lawsuit establish that Defendants knew or foresaw that issues raised in the litigation would later be submitted in a whistleblower complaint to the SEC and become the subject of an investigation. Thus, the amended complaint fails to support an inference of scienter based on the Individual Defendants' trading during the eighteen-month Class Period.

Even accepting the Class Period as a logical period of review for the Individual Defendants' trades, however, all of the trades except for the February 23, 2015 trades occurred nearly a year or more before the end of the Class Period. Courts in this District have consistently held that stock sales occurring even a few months before the alleged revelation of the fraud do not raise a strong inference of scienter. *See, e.g.*, *In re Take-Two Interactive Sec. Litig.*, 551 F. Supp. 2d 247, 279 (S.D.N.Y. 2008) (lapse of "approximately four months" between defendant's "substantial sales and the revelation of the alleged falsity" "inescapably attenuate[d] any inference of scienter"); *In re Axis Capital Holdings Ltd. Sec. Litig.*, 456 F. Supp. 2d 576, 595–96 (S.D.N.Y. 2006) (stock sales "six months in advance of" an attorney general's complaint "d[id] not suggest a motive to commit fraud"); *In re BISYS Sec. Litig.*, 397 F. Supp. 2d 430, 444–45 (S.D.N.Y. 2005) (stock sales that were "not clustered at [the] end" of the Class Period, "when insiders theoretically would have rushed to cash out before the fraud was revealed and stock prices plummeted," did not suggest scienter). Accordingly, because the vast majority of the Individual Defendants' trades occurred a year or more before the alleged revelation of the fraud, they do not support an inference of fraudulent motive even if the Class Period were a logical measurement period.[9]

The Court also notes that information contained in the Forms 4 that reported the Individual Defendants' trades to the SEC suggests that the trades were executed for legitimate rather than fraudulent purposes.[10] The filings disclose that the Individual Defendants' November 5, 2013 trades all involved the exercise of stock appreciation rights that were set to expire in February 2014, and that the trades by Doft, Sabatino, and Gendel on December 30, 2013, February 20, 2014, and February 23, 2015 all involved the withholding of shares to satisfy tax requirements on vesting restricted stock.[11] Courts in this District have held

[9] Plaintiffs further allege that Nadal "continued to dump his MDC shares" *after* the Class Period, selling 1.842 million shares (approximately 48% of his MDC holdings) on October 29, 2015. (Compl. ¶ 137.) It is not clear what relevance this sale could have to Nadal's alleged motive to make fraudulent statements during the Class Period. If anything, the fact that Nadal waited to sell millions of shares until MDC's stock price had dropped following the revelation of the alleged fraud cuts against an inference that he sold stock illegally during the Class Period.

[10] Courts may consider "legally required public disclosure documents filed with the SEC," *ATSI Commc'ns*, 493 F.3d at 98, and they routinely look to "information from SEC filings regarding a defendant's stock sales to determine whether such sales were 'unusual' or 'suspicious,'" *In re Bear Stearns Cos., Inc. Sec., Derivative, & ERISA Litig.*, 763 F. Supp. 2d 423, 582 (S.D.N.Y. 2011) (collecting cases); *see also Glaser*, 772 F. Supp. 2d at 587 ("When a complaint alleges only 'incomplete information' concerning insider sales, the court is 'free to consider' defendants' SEC filings to fill gaps on [a] motion to dismiss." (citing *In re eSpeed, Inc. Sec. Litig.*, 457 F. Supp. 2d 266, 290 n.182 (S.D.N.Y. 2006)).

[11] See the Forms 4 filed on behalf of Nadal, Doft, Sabatino, Gendel, and Kirby on November 7, 2013, and the Forms 4 filed on behalf of Doft, Sabatino, and Gendel on January 2, 2014, February 24, 2014,

that the exercise of expiring stock appreciation rights and the disposition of shares to pay taxes do not demonstrate a defendant's motive to defraud. *See City of Taylor Gen. Emps. Ret. Sys. v. Magna Int'l Inc.*, 967 F. Supp. 2d 771, 799 (S.D.N.Y. 2013) (where "the timing of [defendant's] transactions was tied to the predetermined expiration of his employee stock options," "[t]he fact that [defendant] exercised the expiring options and sold his newly-purchased shares does not, in and of itself, demonstrate a motive to defraud"); *In re Bristol-Myers Squibb Sec. Litig.*, 312 F. Supp. 2d 549, 561 (S.D.N.Y. 2004) (rejecting motive allegations where defendants' trading "show[ed] a consistent pattern of trading undertaken primarily to make payments required for the exercise of stock options or to pay taxes"); *see also Lululemon*, 14 F. Supp. 3d at 586 (executive's "established practice of exercising stock options as they vested and selling a matching number of shares on a quarterly basis" was not "suspicious[]"). Thus, the disclosed nature of the Individual Defendants' trades also suggests the absence of fraudulent motive.

ii. Compensation Tied to Earnings Results

Plaintiffs also allege that Nadal, Doft, Sabatino, and Gendel were motivated to artificially inflate MDC's financial performance using a "highly misleading EBITDA calculation" because their compensation was "[d]irectly [t]ied" to this figure. (Compl. ¶¶ 142–43, 150–51, 157, 160 (capitalization removed).) Plaintiffs also denounce Kirby for his alleged role in the decision by MDC's compensation committee to approve this EBITDA metric "as a critical component of MDC's executive compensation." (*Id.* ¶ 168.) However, the law is clear in the Second Circuit that a plaintiff cannot plead motive to defraud simply by "alleg[ing] goals that are 'possessed by virtually all corporate insiders,' such as the desire to . . . sustain the appearance of corporate profitability." *S. Cherry*, 573 F.3d at 109; *see also Kalnit v. Eichler*, 264 F.3d 131, 139 (2d Cir. 2001) ("Insufficient motives . . . can include (1) the desire for the corporation to appear profitable and (2) the desire to keep stock prices high to increase officer compensation."). These allegations accordingly do not support motive.

b. Strong Circumstantial Evidence of Conscious Misbehavior or Recklessness

Although Plaintiffs have failed to plead that Defendants had a motive to defraud, that failure "is not fatal" to a securities fraud claim, *Tellabs*, 551 U.S. at 325, since a plaintiff may also plead scienter by alleging "strong circumstantial evidence of defendants' conscious misbehavior or recklessness," *Kalnit*, 264 F.3d at 142 (internal quotation marks omitted). However, in the absence of motive, "the strength of th[ose] circumstantial allegations must be correspondingly greater." *Id.* Conscious misbehavior "encompasses deliberate illegal behavior, such as securities trading by insiders privy to undisclosed and material information, or knowing sale of a company's stock at an unwarranted discount," *Novak*, 216 F.3d at 308 (citations omitted), while recklessness is defined as "a state of mind approximating actual intent, and not merely a heightened form of negligence," and "an extreme departure from the standards of ordinary care to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it," *S.*

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and February 25, 2015, available on the SEC's EDGAR website, samples of which are attached as Exhibits 14–17 to the Declaration of Craig S. Waldman in Support of Defendants' Motion to Dismiss the Amended Complaint. (Doc. No. 56.)

Cherry, 573 F.3d at 109 (emphasis removed). A plaintiff may plead recklessness by "specifically alleg[ing] defendants' knowledge of facts or access to information contradicting their public statements," or by "alleg[ing] facts demonstrating that defendants failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud." *Novak*, 216 F.3d at 308. "[W]here plaintiffs contend defendants had access to contrary facts, they must specifically identify the reports or statements containing this information." *Dynex*, 531 F.3d at 196.

i. Approval of Nadal's Expense Reimbursements

Plaintiffs argue that Nadal's receipt of expense reimbursements that were later deemed improper, coupled with the fact that Doft, Sabatino, and Kirby signed off on those reimbursements, demonstrates that these defendants knew MDC was underreporting Nadal's compensation. (Compl. ¶¶ 138, 149, 155, 168.) But these allegations, without more, do not suggest that Nadal, Doft, Sabatino, or Kirby knew the expenses were not appropriate for reimbursement at the time of MDC's filings. The mere fact that a defendant held a supervisory position or a position of authority – including, here, Nadal's role as chairman of the board and CEO, which entitled him to "influence appointments" to MDC's compensation committee (*id.* ¶ 144), and Doft's and Sabatino's roles in the expense reimbursement approval process (*id.* ¶¶ 149, 155) – has been repeatedly rejected by courts in this District as supportive of an inference of scienter. *See, e.g.*, *Bd. of Trustees of City of Ft. Lauderdale Gen. Emps.' Ret. Sys. v. Mechel OAO*, 811 F. Supp. 2d 853, 873 (S.D.N.Y. 2011) ("[C]ourts in this District have long held that accusations founded on nothing more than a defendant's corporate position are entitled to no weight." (internal quotation marks omitted) (collecting cases)), *aff'd sub nom. Frederick v. Mechel OAO*, 475 F. App'x 353 (2d Cir. 2012). Plaintiffs' allegation that MDC announced "remedial steps to improve and strengthen its internal controls and procedures regarding travel, entertainment and related expenses" (Compl. ¶ 170; *see also id.* ¶ 13) is likewise insufficient. *See Slayton*, 604 F.3d at 777; *Stevelman*, 174 F.3d at 84; *Magnum Hunter*, 26 F. Supp. 3d at 295.

Plaintiffs' only specific allegations regarding MDC's expense reimbursement process come from CW 2, whose assertions add little to Plaintiffs' claims. As noted above, Plaintiffs do not allege that CW 2 had any role in the actual approval of Nadal's expenses; rather, CW 2's job was to process reimbursements after they had already been approved. (Compl. ¶ 37.) And although CW 2 purports to have received a "cover sheet" containing the total amount (but not any of the details) of Nadal's travel and entertainment expenses, CW 2 does not assert that this was the only information that anyone reviewed in connection with approving expenses. (*Id.*) To the contrary, it is clear that CW 2 lacks personal knowledge of the review and approval of Nadal's expenses, given Plaintiffs' allegation that, "[a]s far as CW 2 understood, all of Nadal's expenses were approved by MDC's [b]oard of [d]irectors or the [c]ompensation [c]ommittee before CW 2 received the cover sheet." (*Id.*) Thus, the Court can infer no fraud from CW 2's allegations. *See In re BioScrip, Inc. Sec. Litig.*, 95 F. Supp. 3d 711, 739 (S.D.N.Y. 2015) ("Allegations premised on the testimony of confidential sources 'must show that individual defendants actually possessed the knowledge highlighting the falsity of public statements . . . .'"); *In re Optionable Sec. Litig.*, 577 F. Supp. 2d 681, 691 (S.D.N.Y. 2008) (rejecting confidential

witness allegation that "lack[ed] detail that might suggest that th[e] [witness] had personal knowledge").

Nothing in the amended complaint, moreover, comes close to explaining why Doft, Sabatino, and Kirby would have knowingly approved the payment of reimbursements to Nadal that he was not entitled to or why these defendants would have sat idly by while MDC failed to report these payments as compensation for Nadal. Indeed, with respect to Kirby, who sat on the board's compensation committee and "ma[de] recommendations to the [b]oard" on "the compensation of senior executives" (Compl. ¶ 168), Plaintiffs cannot logically explain why a board member who had no problem approving tens of millions of dollars of *disclosed* compensation to Nadal would feel the need to secretly approve, and fraudulently omit from MDC's disclosures, an additional one or two million dollars per year. Plaintiffs simply allege that because these individuals were involved in the approval process and because MDC ultimately disclosed that Nadal had received improper reimbursements, the individuals who approved the reimbursements must have known that they were improper and that MDC was misrepresenting its expenses – a plainly insufficient "fraud by hindsight" theory.

ii. Resignations of Nadal and Sabatino

Plaintiffs also ask the Court to draw an inference of fraud from the facts that (1) Sabatino moved from chief accounting officer to "work on special projects" toward the end of the Class Period, during MDC's internal investigation, and that (2) both Sabatino and Nadal resigned "abruptly" several months after the Class Period ended, during the SEC's investigation, and returned certain bonus payments or forwent certain severance packages. (*Id.* ¶¶ 139, 156.) However, courts "have consistently held that an officer's resignation, without more, is insufficient to support a strong inference of scienter." *See Gillis v. QRX Pharma Ltd.*, No. 15-cv-4868 (PAE), — F. Supp. 3d. —, 2016 WL 3685095, at *35 (S.D.N.Y. July 6, 2016) (collecting cases); *see also Glaser*, 772 F. Supp. 2d at 598 (resignations support an inference of fraud only if they are "highly unusual and suspicious"). The fact that, as part of these resignations, Nadal and Sabatino forfeited or agreed to repay certain bonuses or severance packages does not connect a resignation to fraud any more than does the resignation itself. The amended complaint simply contains no allegations supporting an inference of fraud that is at least as compelling as an inference of mismanagement or one of the myriad other reasons an executive might resign.

iii. Involvement in Financial Reporting

Plaintiffs also attempt to plead scienter based on allegations that Nadal, Doft, Sabatino, Gendel, and Kirby were involved in MDC's financial accounting and reporting by reason of their positions at the company or their signing of SEC filings. (Compl. ¶¶ 145–46, 148, 152–53, 158, 161, 164–65.) But, as explained above, the argument that defendants must have known that alleged misstatements were false because they were high-ranking officers or board committee members has been repeatedly rejected by courts in this District. *See Mechel OAO*, 811 F. Supp. 2d at 873. Similarly insufficient are Plaintiffs' bare allegations that certain defendants signed SEC filings. *See Int'l Ass'n of Heat v. Int'l Bus. Machs. Corp.*, No. 15-cv-2492 (WHP), — F. Supp. 3d —, 2016 WL 4688862, at *7 (S.D.N.Y. Sept. 7, 2016) ("'required certifications under Sarbanes-Oxley . . . add nothing substantial to the scienter calculus' because 'allowing Sarbanes-Oxley certifications to create an inference of

scienter in every case where there was an accounting error or auditing mistake made by a publicly traded company would eviscerate the pleading requirements for scienter set forth in the PSLRA'" (quoting *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 1003–04 (9th Cir. 2009))); *In re MBIA, Inc. Sec. Litig.*, 700 F. Supp. 2d 566, 590 (S.D.N.Y. 2010) (dismissing defendants who merely "signed [the company's] SEC disclosures"). The Court thus accords these arguments no weight in its comparison of fraudulent and non-fraudulent inferences.

iv. Kirby's Performance and Qualifications as Chairman of the Audit Committee

Finally, Plaintiffs assert that, at least with respect to Kirby, scienter can be inferred from his "reckless[] abdicat[ion] [of] his duties as chairman of MDC's audit committee" and his "lack[] [of] the requisite expertise to execute those duties." (Compl. at 77 (capitalization removed).) Plaintiffs base this contention on the fact that, in a deposition taken in connection with CW 1's dismissed lawsuit against MDC, Kirby testified that he (1) was not aware whether MDC's outside auditors "reviewed and tested" Zyman Group's goodwill or "propose[d] any adjustment" based on an impairment, and (2) "would rely totally on the outside auditors . . . on the audit questions," under "the assumption that [they were] treated appropriately because the accounting firm is a good accounting firm." (*Id.* ¶ 166.) In the first instance, Plaintiffs offer no authority for the striking proposition that it is improper or a "reckless[] abdicat[ion]" of duty for the chairman of a public company's audit committee to rely on the work of an outside auditor. Even if that were true, it would describe mismanagement and poor governance, not securities fraud. *See AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 228 (2d Cir. 2000) ("[A] section 10(b) plaintiff cannot transform a fiduciary-duty claim or a mismanagement claim into a claim of non-disclosure."); *Magnum Hunter*, 26 F. Supp. 3d at 295 ("inference . . . of an oversight failure of management" did not support securities fraud claim). As for Plaintiffs' assertion that Kirby lacked "the requisite financial expertise to serve on MDC's [a]udit [c]ommittee, much less serve as its Chairman" (Compl. ¶ 167), this too alleges at most mismanagement, not securities fraud. The securities laws are not concerned with an individual's "reckless[] lack[] [of] the requisite . . . expertise" (*id.*) – only his "reckless disregard for the truth" of his public statements. *S. Cherry*, 573 F.3d at 109. This Plaintiffs have failed to plead.

c. Holistic Assessment of Scienter Allegations

Even though the Court has rejected all of Plaintiffs' scienter arguments individually, it must also consider whether the allegations and other proper sources of facts "give rise to a strong inference of scienter" when "taken collectively." *Tellabs*, 551 U.S. at 322–23. In sum, the amended complaint alleges that MDC's senior-most executives and the chair of MDC's audit committee orchestrated a scheme to defraud investors by (1) marginally inflating MDC's total assets by maintaining goodwill for a small, defunct subsidiary, (2) boosting MDC's earnings by reporting a "nonstandard" version of "Adjusted EBITDA" that Defendants also defined in every earnings release, (3) concealing immaterial amounts of Nadal's widely reported eight-figure compensation, and (4) generally attesting to the adequacy of MDC's controls despite approving $10.5 million in expense reimbursements to Nadal that ultimately had to be repaid, with no alleged benefit to MDC or the other defendants. The Court finds that the implausibility of this theory of fraud

speaks for itself and is far less compelling than an inference of, at most, non-actionable mismanagement and negligence.

B. Alleged Violations of Exchange Act Section 20(a)

"Section 20(a) of the Exchange Act provides that individual executives, as 'controlling person[s]' of a company, are secondarily liable for their company's violations of the Exchange Act." *Blanford*, 794 F.3d at 305 (quoting 15 U.S.C. § 78t(a)). Because Plaintiffs' Section 20(a) claim "is necessarily predicated on a primary violation of securities law," and the Court has determined that Plaintiffs have failed to plead a primary violation, Plaintiffs' Section 20(a) claim "must also be dismissed." *Rombach v. Chang*, 355 F.3d 164, 177–78 (2d Cir. 2004).

C. Required Findings as to the Parties' Compliance with Rule 11

The PSLRA mandates that, at the end of any private securities action, the district court must "include in the record specific findings regarding compliance by each party and each attorney representing any party with each requirement of" Federal Rule of Civil Procedure 11(b). 15 U.S.C. § 78u-4(c)(1); *see also Rombach*, 355 F.3d at 178 (remanding for findings under Rule 11 because the PSLRA "mandates" such findings and "the imposition of sanctions" if "the court finds that any party or lawyer violated Rule 11(b)"). Having carefully considered the amended complaint and the briefing on Defendants' motion to dismiss, the Court concludes that no party has violated Rule 11(b).

D. Leave to Amend

In their brief opposing Defendants' motion to dismiss, Plaintiffs request leave to amend the complaint a second time in the event that the Court grants Defendants' motion. (Pl. Opp'n at 66.) Plaintiffs' brief identifies a number of "newly discovered facts" that they propose to incorporate into a new complaint to "cure any deficiencies" identified by the Court's dismissal of their first amended complaint. (*Id.* at 10–11, 66.) These facts include MDC's disclosures in its most recent annual report and its fiscal year 2015 earnings call that (1) Nadal has agreed to repay additional reimbursements, (2) MDC incurred expenses for "business use of an airplane and helicopter that are owned by entities controlled by Nadal," (3) the SEC's investigation is ongoing and MDC cannot predict how much the company will need to spend before it concludes, (4) MDC has "engaged an outside accounting firm to review and assess the company's historical goodwill accounting," (5) MDC's cooperation with the SEC's investigation has been expensive, (6) following the resignation of Kirby and another audit committee member, MDC has been "actively looking to revamp [its] [b]oard of [d]irectors with expanded strategic vision, financial and operational expertise[,] and stronger independence," (7) two new board members will include a former executive vice president of Scotiabank and a "long-time partner" at Ernst & Young, (8) the Scotiabank executive will bring "over 30 years of experience in financial services, governance[,] and risk management" to MDC's audit committee, and (9) MDC had been looking for a new director with the Scotiabank executive's qualifications and expects that she will "step into the audit committee in a very pronounced way." (*Id.* at 10–11.)

The Court finds that these proposed new allegations would add nothing to cure the deficiencies identified in this Opinion. Rather, they are more of the same: irrelevant facts or mischaracterizations of

remedial efforts as evidence of prior misleading disclosures that amount, at best, to a claim of corporate mismanagement and breach of fiduciary duty, which are not actionable under the federal securities laws. *See Santa Fe Indus.*, 430 U.S. at 476 (rejecting the proposition that "a breach of fiduciary duty . . . , without any deception, misrepresentation, or nondisclosure, violates" Section 10(b) or Rule 10b-5). Since Plaintiffs have offered no facts to suggest that another amendment would be fruitful at this time, Plaintiffs' request for leave to amend is denied as futile. *See Loreley Fin. (Jersey) No. 3 Ltd. v. Wells Fargo Sec., LLC*, 797 F.3d 160, 190 (2d Cir. 2015) (courts may deny leave to amend where amendment would be futile).

IV. CONCLUSION

For the foregoing reasons, IT IS HEREBY ORDERED THAT Defendants' motion to dismiss the amended complaint is GRANTED, and this case is dismissed with prejudice. The Clerk of the Court is respectfully directed to terminate the motion pending at docket number 54, enter judgment in favor of Defendants, and close this case.

SO ORDERED.

RICHARD J. SULLIVAN
United States District Judge

Dated: September 30, 2016
New York, New York

* * *

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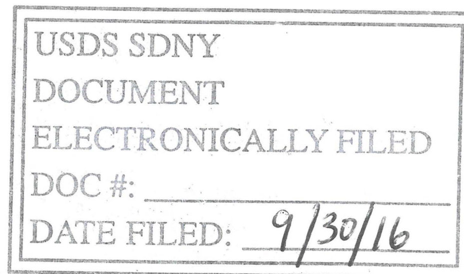
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IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE: APPRAISAL OF DELL INC.) Consol. C.A. No. 9322-VCL

MEMORANDUM OPINION

Date Submitted: September 2, 2016
Date Decided: October 17, 2016

Stuart Grant, Michael J. Barry, Christine Mackintosh, GRANT & EISENHOFER P.A., Wilmington, Delaware; *Lead Counsel for the Appraisal Class and Counsel for Petitioner Morgan Stanley Defined Contribution Trust*.

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LASTER, V.C.

In 2013, Dell Inc. completed a going-private merger in which each publicly held share of Dell common stock was converted into the right to receive $13.75 per share in cash, subject to the owner's right to seek appraisal. Holders of 38,765,130 shares demanded appraisal. Holders of 36,704,337 of those shares filed a total of thirteen different appraisal petitions.

The law firm of Grant & Eisenhofer P.A. ("G&E") represented the claimants in ten of the petitions. G&E's clients included a group of entities affiliated with T. Rowe Price & Associates, Inc. (collectively, "T. Rowe"), which together sought appraisal for the largest single block of shares. G&E represented its clients pursuant to a written contingency fee agreement. Under its terms, G&E advanced the expenses necessary to litigate the case, and its clients agreed that G&E would be reimbursed for its expenses and receive an attorneys' fee equal to the amount by which the client's recovery exceeded the merger consideration, with the percentage depending on the magnitude of the recovery and how far the litigation progressed.

G&E moved to consolidate the thirteen appraisal proceedings and to be appointed lead counsel. After the court granted the motion, G&E litigated the case through trial. In a post-trial decision, the court held that the fair value of Dell common stock at the effective time of the merger was $3.87 per share more than the merger price. In a separate post-trial decision, the court held that T. Rowe lacked standing to seek appraisal.

The appraisal statute authorizes a party that has incurred expenses litigating an appraisal to have its expenses, including reasonable attorneys' fees, allocated *pro rata* among the shares comprising the appraisal class. Morgan Stanley Defined Contribution

Trust, a G&E client whose shares remain part of the appraisal class, has moved to have G&E's expenses reimbursed from the aggregate appraisal award. Morgan Stanley also seeks an award of attorneys' fees for G&E equal to the percentage of the aggregate appraisal award that G&E would receive under the terms of its contingency fee agreement. G&E is the real party in interest, so this decision treats G&E as the movant.

Two groups of appraisal claimants oppose the motion. They argue that G&E must have incurred significant expenses defending T. Rowe's entitlement to seek appraisal, and they believe those amounts should be excluded from any award. They also argue T. Rowe was a member of the appraisal class until after trial, so T. Rowe should bear a portion of the expenses incurred litigating the valuation issues. They further contend that G&E's fees should be reduced because, after T. Rowe was dismissed from the case, G&E secured a settlement for T. Rowe and earned a fee for its efforts. Finally, they assert that any award is premature because a final order has not yet been entered.

This decision awards the requested amount of fees and expenses. The amounts are reasonable and will be allocated *pro rata* among the appraisal class. That result will be achieved by deducting the fees and expenses from the aggregate amount received by the appraisal class before the remaining amount is distributed *pro rata* to the class members.

I. FACTUAL BACKGROUND

This is a post-trial application. The facts are drawn from the trial record and the parties' submissions, which include discovery conducted in connection with the motion.

A. Thirteen Appraisal Cases

On February 5, 2013, Dell announced that it had entered into a merger agreement with entities affiliated with its eponymous founder, Michael Dell, and Silver Lake, a private equity firm. As subsequently amended, the merger agreement provided for each publicly traded share of Dell common stock to be converted into the right to receive $13.75 per share in cash, subject to the holder's right to seek appraisal. The merger closed on October 29, 2013.

Holders of 38,765,130 shares of Dell common stock initially demanded appraisal. Dkt. 5, Ex. A. After the merger closed, former holders of 36,704,337 of those shares filed a total of thirteen different appraisal petitions.

G&E represented the claimants who filed ten of the petitions. Those claimants collectively held 32,012,405 shares, representing 83% of the shares for which appraisal was sought and 87% of the shares held by claimants who filed petitions. G&E's clients included T. Rowe, which alone sought appraisal for 26,732,930 shares. *Id.*

Three of the thirteen petitions were filed by claimants that G&E did not represent. Entities affiliated with Magnetar Capital Master Fund Ltd. (collectively, "Magnetar") sought appraisal for 3,865,820 shares. They are currently represented by Lowenstein Sandler LLP and Proctor Heyman LLP. Global Continuum Fund, Ltd. and Wakefield Partners, L.P. (jointly, "Global") sought appraisal for 826,012 shares. They retained

Proctor Heyman. Cavaan Partners, L.P. sought for appraisal for 100 shares. Cavaan retained Fish & Richardson, P.C.

B. The Consolidation Order

In April 2014, the petitioners represented by G&E moved to consolidate the appraisal proceedings and to have G&E appointed as lead counsel. G&E proposed a form of order that would have granted G&E broad authority to litigate on behalf of the appraisal class, but which would not have required G&E to advocate for any appraisal claimant whose right to seek appraisal was challenged other than its own clients.

Magnetar and Global did not oppose having G&E serve as lead counsel, but they objected to the proposed terms. *See* C.A. No. 9254, Dkt. 13. They wanted the consolidation order to include provisions stating that:

- All petitioners and their counsel would have access to the discovery record.
- All petitioners and their counsel could participate meaningfully in the preparation of any expert reports and review drafts of any documents submitted to the court.
- All petitioners could participate in any settlement discussions.
- All petitioners could participate in any settlement negotiated by G&E.
- Any petitioners that did not participate in a settlement negotiated by G&E could continue to pursue appraisal and would have option to use any experts retained by G&E.
- No petitioner would be "double billed" for fees.

Magnetar's opposition explained that the concept of "no double-billing" meant that "[e]ach Petitioner solely is responsible for the fees payable to such Petitioner's counsel, and G&E's current clients solely are responsible for the fees payable to G&E, which

includes the fees payable to G&E as lead counsel." Dkt. 76, at 6. Alternatively, Magnetar asked for its lawyers to be appointed as co-lead counsel. *Id.* at 6–7.

After holding a hearing on G&E's motion, the court consolidated the action and appointed G&E as lead counsel. The court rejected the "no double-billing" concept and ruled as follows:

> To take another easy one, I am not going to adopt [Magnetar and Global's] fee proposal. [Section] 262(j) actually addresses this issue, and it says that you can tax and allocate costs and expenses pro rata across the entire appraisal class. That's in the statute. That makes sense. If Mr. Grant does a lot of work that benefits everybody, including not only people who have filed but even people who haven't filed—because, remember, part of what you do when you are an appraisal claimant is you take on a fiduciary role . . . to the people who didn't file because there are members of the appraisal class who haven't filed petitions, and they're entitled to rely on the actions of those who did file.
>
> The fees and expenses at the end under 262(j) can be taxed against the entire appraisal class pro rata because that's what's fair. It's a classic application of common-fund principles . . . .

Dkt. 88, at 7-8. The court entered a modified consolidation order that addressed many of Magnetar and Global's other concerns:

- Paragraph 7: "Other Counsel shall remain counsel of record for the Other Claimants and shall receive copies of all court filings."
- Paragraph 8: "Subject to the terms of a customary confidentiality order, the Other Counsel and Other Claimants shall have access to document discovery, may attend and participate in depositions, and may ask non-duplicative questions."
- Paragraph 9: "To the extent reasonably practicable, G&E shall circulate near-final drafts of briefs and other significant submissions to Other Counsel for review and comment before filing with the court. Other Counsel may file non-duplicative submissions . . . . Other Counsel may make non-duplicative arguments at hearings."

- Paragraph 10: "As contemplated by 8 *Del. C.* § 262(k), no appraisal claimant may settle its appraisal claim except with court approval, which may be conditioned upon such terms as the court deems just. If the G&E Claimants settle or dismiss their claims, then the remaining appraisal claimants shall be 'given notice . . . and an opportunity to intervene' to continue the appraisal suit. *Edgerly v. Hechinger*, 1998 WL 671241, at *4 (Del. Ch. Aug. 27, 1998)."

- Paragraph 11: "As contemplated by 8 *Del. C.* § 262(j), at an appropriate stage of the proceeding, G&E may seek to have its fees and expenses charged *pro rata* against the value of all the shares entitled to an appraisal."

In defining G&E's authority and obligations, the consolidation order distinguished between G&E's role as lead counsel for the appraisal class and the firm's role as counsel for its clients. Paragraph 6 stated:

> G&E is hereby appointed Lead Counsel in the Consolidated Action for the purpose of prosecuting the appraisal on behalf of the Appraisal Class. In connection with the Entitlement Hearing, G&E only shall be responsible for (i) asserting the entitlement to appraisal rights of the G&E Claimants, (ii) addressing any arguments common to all appraisal claimants, and (iii) addressing any defenses raised by Respondent that would affect all appraisal claimants. G&E shall not otherwise have responsibility for asserting the entitlement to appraisal rights of the Other Claimants and the Non-Petitioning Claimants, who are otherwise responsible for establishing their own entitlement to appraisal rights in connection with the Entitlement Hearing. If one of the Other Claimants or a Non-Petitioning Claimant is determined not to be entitled to appraisal rights, then that claimant shall not be a member of the Appraisal Class and G&E shall have no further obligation or responsibility to pursue appraisal on behalf of that claimant. If a G&E Claimant is determined not to be entitled to appraisal rights, then that claimant shall not be a member of the Appraisal Class, and G&E's continuing obligation (if any) to that claimant shall be determined by the terms of its engagement of G&E.

Dkt. 77, ¶ 6. This provision required that G&E act as lead counsel wherever an issue arose that was common to the entire appraisal class. Otherwise, G&E was not obligated to represent any particular appraisal claimants other than its clients. Any appraisal

claimants who faced unique objections or defenses would have to retain their own counsel or proceed *pro se*.

C. The Litigation Effort

The consolidated litigation proceeded along two tracks. One track involved disputes over entitlement issues. The other involved the ultimate dispute over fair value.

On the entitlement track, the court issued a series of rulings holding that various claimants were not entitled to seek appraisal. Most were relatively small holders who were not clients of G&E and who did not retain their own counsel. On June 27, 2014, the court granted an order dismissing nine claimants who had withdrawn their appraisal demands with Dell's consent. They held a total of 25,954 shares. *See* Dkt. 110. On September 10, the court granted a similar order for a claimant who held 50 shares. *See* Dkt. 119. On May 11, 2015, the court held a hearing on the remaining entitlement issues. On May 13, the court issued orders holding that the following claimants were not entitled to appraisal: (i) twenty-two claimants whose demands were not signed by the stockholder of record, Dkts. 254 & 258; (ii) eleven claimants who had sold or re-titled their shares after demanding appraisal, Dkt. 255; (iii) 104 claimants who had tendered their shares and accepted the merger consideration, Dkt. 256; and (iv) three claimants who had made untimely or duplicative demands, Dkt. 257. Collectively, these orders removed an additional 828,652 shares from the appraisal class.

G&E represented five large appraisal claimants who re-titled their shares after demanding appraisal. On July 13, 2015, the court issued an opinion holding that the five claimants lost their appraisal rights. *In re Appraisal of Dell Inc.*, 2015 WL 4313206 (Del.

Ch. July 13, 2015). That ruling eliminated another 1,675,666 shares from the appraisal class.

Dell separately challenged T. Rowe's entitlement to seek appraisal on the grounds that T. Rowe had voted in favor of the merger. Although Dell moved for summary judgment on this issue, the parties agreed to defer disposition of the issue until after trial because of factual disputes.

On the valuation track, G&E pursued written discovery, including both document requests and interrogatories, and obtained, processed, and hosted a total of 478.4 gigabytes of documents on its e-discovery platform. After completing written discovery, G&E took or defended seventeen depositions. During the expert phase of the case, G&E retained three experts, pursued expert discovery from Dell's two experts, and defended its own experts. These efforts led up to a four-day trial in October 2015. During that proceeding, the parties introduced over 1,200 exhibits and presented seven fact witnesses and five experts. The pre-trial order contained 542 paragraphs, and the pre- and post-trial briefing totaled 369 pages. In March 2016, G&E presented post-trial argument.

D. The Post-Trial Rulings

On May 11, 2016, this court held that T. Rowe was not entitled to an appraisal because T. Rowe voted in favor of the merger. *In re Appraisal of Dell Inc.*, 143 A.3d 20 (Del. Ch. 2016) (the "T. Rowe Ruling"). The T. Rowe Ruling eliminated 30,730,930 shares from the appraisal class. In total, the entitlement rulings had eliminated 33,261,252

shares from the appraisal class, reducing it from 38,765,130 shares to 5,505,730 shares.[1] Magnetar became the largest appraisal claimant, with just over 70% of the remaining shares. Morgan Stanley was the only remaining G&E client, with 357,500 shares.

Three weeks later, on May 31, 2016, this court held that the fair value of Dell at the effective time was $17.62 per share, or $3.87 per share more than the merger consideration. *In re Appraisal of Dell Inc.*, 2016 WL 3186538 (Del. Ch. May 31, 2016) (the "Fair Value Opinion"). The court awarded interest on the award at the default rate provided by the appraisal statute, which states that the "interest from the effective date of the merger through the date of payment of the judgment shall be compounded quarterly and shall accrue at 5% over the Federal Reserve discount rate (including any surcharge) as established from time to time during the period between the effective date of the merger and the date of payment of the judgment." 8 *Del. C.* § 262(h).

E. The Fee Application

On June 2, 2016, G&E sought an award of $3,964,125.60 in attorneys' fees and reimbursement of expenses in the amount of $4,035,787.18. G&E based its fee request on its written contingency fee agreement with T. Rowe. G&E had agreed to the same terms with its other appraisal clients, including Morgan Stanley.

G&E's fee agreement contemplated that G&E would receive as its fee an increasing percentage of the client's recovery according to the following chart:

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[1] The court later held that *pro se* petitioner William Martin was entitled to seek appraisal for 4,943 shares, increasing his share count by 1,852. Dkt. 447. This was the only instance of shares being added to the appraisal class.

RECOVERY RANGE	PRIOR TO FILING PETITION	AFTER PETITION AND BEFORE TRIAL	ONCE TRIAL HAS BEGUN
$13.75 - $15.75	10%	13%	15%
$15.76 - $17.75	12%	15%	17%
$17.76 - $19.75	14%	17%	19%
$19.76 and above	15%	18%	20%

Dkt. 444, Ex. A, at 1. The fee percentage thus increased with the size of the award and the stage of the case. The fee agreement provided an example of the resulting calculation: "If the appraisal award was $19.00 after petition and before trial, the fee would be 13% of the first $2 over $13.75, 15% of the next $2 over $15.75, and 17% of the next $1.25 over $17.75." *Id.* The agreement provided that an "award of interest will follow principle [sic]," meaning G&E would receive a similar percentage of the interest accruing on the amount exceeding $13.75. *Id.* at 2.

The difference between the court's fair value determination and the merger price was $3.87 per share. The difference generated a total benefit of $21,307,175.10 for the 5,505,730 shares in the appraisal class, and it was obtained in a post-trial adjudication. The terms of the contingent fee agreement therefore called for a fee of $3,401,990.57 before interest, comprising (i) 15% of first $2 recovery up to $15.75, or $1,651,719, plus (ii) 17% of the next $1.87, or $1,750,271.57. For purposes of its fee application, G&E calculated the amount of interest through May 31, 2016, as being $3,423,961.99. G&E's fee from the interest component, derived using the same formula, was $562.135.03. As of May 31, G&E's total fee award under the contingent fee agreement was $3,964,125.60. G&E sought this amount from the appraisal class.

G&E also sought reimbursement of $4,035,787.18 in expenses. G&E broke the expenses down into fourteen categories:

Expert witness fees	$3,393,353.02
Filing fees	$21,267.78
Meeting Expenses	$1,884.70
Outside Counsel Expenses	$787.34
Travel	$37,880.53
Case-Related Publication	$32.00
Duplication Services	$265,864.33
Postage and Delivery	$3,351.32
Service Fees	$39.99
Telephone	$1,269.45
Transcription Services	$42,807.45
Case-Related Services	$20,729.37
E-Discovery Related Processing Services	$55,954.95
E-Discovery Data Hosting Services	$190,564.95

G&E only sought to have its fees and expenses allocated *pro rata* across the appraisal class. G&E did not contemplate that T. Rowe would bear any of the fees or expenses.

F. The T. Rowe Settlement

On June 24, 2016, T. Rowe and Dell reached a settlement. Dell agreed to pay T. Rowe the merger consideration plus $28 million in interest (the "T. Rowe Settlement"). G&E received a fee equal to 15% of the $28 million, or $4.2 million.

This court approved the T. Rowe Settlement on June 29, 2016. The court determined that "there was no risk that T. Rowe was 'abandoning the prosecution of the [action] to the detriment of the [appraisal class].'" Dkt. 423, ¶ 2 (quoting *Ala. By-Prods. Corp. v. Cede & Co.*, 657 A.2d 254, 260 (Del. 1995)). Because it would have been irrational for members of the appraisal class to accept the terms of the T. Rowe

Settlement, the court held that Dell was not obligated to extend the same offer to the remaining members of the appraisal class. *Id.* (citing *Lutz v. A.L. Garber Co.*, 357 A.2d 746, 751 (Del. Ch. 1976)).

G. Magnetar And Global Oppose G&E's Application.

Magnetar and Global have opposed G&E's fee application. They raised several objections, which stem primarily from T. Rowe's late exit from the case and subsequent settlement with Dell.

According to Magnetar and Global, the appraisal class should not have to pay for any fees or expenses that G&E incurred litigating its clients' entitlement issues. Magnetar and Global argue that T. Rowe instead should bear some of the fees and expenses that G&E incurred litigating the valuation issues. According to Magnetar and Global, T. Rowe leveraged the Fair Value Opinion and the prospect of an appeal from the T. Rowe Ruling when negotiating the T. Rowe Settlement. Magnetar and Global also contend that their own share of the fees and expenses allocated to the appraisal class should be reduced by the attorneys' fees and expenses that they spent for lawyers to represent their own interests, and that they cannot be held to the contingency fee structure that was negotiated between T. Rowe and G&E. Finally, Magnetar and Global argue that any award of fees and expenses is premature because a final judgment has not yet been entered and an appeal is likely.

G&E responded to Magnetar and Global's oppositions by deducting from its application any expenses reasonably relating to G&E's litigation of its clients' entitlement issues. G&E now seeks expenses in the amount of $4,007,462.08.

II. LEGAL ANALYSIS

"An appraisal proceeding is a limited legislative remedy intended to provide shareholders dissenting from a merger on grounds of inadequacy of the offering price with a judicial determination of the intrinsic worth (fair value) of their shareholdings." *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182, 1186 (Del. 1988). Section 262(j) of the Delaware General Corporation Law provides in pertinent part as follows:

> Upon application of a stockholder, the Court may order all or a portion of the expenses incurred by any stockholder in connection with the appraisal proceeding, including, without limitation, reasonable attorney's fees and the fees and expenses of experts, to be charged pro rata against the value of all the shares entitled to an appraisal.[2]

Under this provision, G&E seeks to have the expenses it incurred in the appraisal proceeding, including reasonable attorneys' fees, charged "pro rata against the value of the shares entitled to appraisal."

In the *Shell* decision, this court addressed the principles to be used when awarding fees and expenses under the second sentence of Section 262(j). *In re Appraisal of Shell Oil Co.*, 1992 WL 321250 (Del. Ch. Oct. 30, 1992). After reviewing the origins of

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[2] 8 *Del. C.* § 262(j). The prior sentence in Section 262(j) states, "The costs of the proceeding may be determined by the Court and taxed upon the parties as the Court deems equitable in the circumstances. *Id.* This language does not govern G&E's application; it deals with the taxing of "costs . . . upon the parties." It thus addresses the allocation of costs in an appraisal proceeding between the petitioners and the respondent. *See* Jesse A. Finkelstein & John D. Hendershot, *Appraisal Rights in Mergers & Consolidations*, 38–5th C.P.S. § IV(G)(2), at A-25 & n.131 (BNA) [hereinafter Appraisal Rights]); *id.* § VI(P), at A-92a to A-94. "Court costs . . . ordinarily are taxed against the respondent corporation in the absence of a showing of bad faith on the part of the dissenting stockholders." *Id.* § VI(P), at A-93 (collecting authorities).

Section 262(j) and related case law, the court held that "[t]he standards governing the award of attorneys' fees in an appraisal class action . . . are identical to those in other types of shareholder benefit litigation." *Id.* at *3.

> The underlying principle that allows a successful litigant in a shareholder action to recover his expenses from other shareholders, as one of the exceptions to the general rule that each litigant must defray the costs of his own counsel, is the equitable fund doctrine. Under the equitable fund doctrine, when a litigant creates or preserves a common fund for the benefit of a class, equity demands that those who share in the benefit share in the burden of the prosecution.

Id. (citations omitted). The court concluded that Section 262(j) makes the equitable fund doctrine applicable to appraisal actions. *Id.*

The *Shell* decision explained that "[a] prerequisite for the applicability of the equitable fund doctrine is the creation of a benefit for a class." *Id.* Under Section 262(j), this means that the appraisal proceeding must generate a fair value determination that exceeds the merger price. *Id.* at *5. If an appraisal petitioner does not obtain a fair value determination that exceeds the merger price, then Section 262(j) does not "authorize any *pro rata* assessment of attorneys fees among the appraisal class." *Id.* If the appraisal proceeding has generated a fair value determination that exceeds the merger price, then "the value of the benefit produced by the litigation can best be ascertained by measuring the difference between the amount of the appraisal award and the amount that a shareholder would have received had he accepted the merger and not sought an appraisal." *Id.* at *6.

The *Shell* court wrestled with the degree to which it should include interest when determining the size of the benefit. *Id.* at *7. At the time *Shell* was decided, the appraisal

statute did not provide for a default rate of interest, and the appropriate rate of interest was the subject of intense litigation activity. The *Shell* court recognized that under that system, "[t]he success of counsel in an appraisal action in obtaining the best possible rate of interest for the client is obviously of critical importance in determining the benefit achieved given the protracted nature of appraisal proceedings," and hence "[t]he Court therefore must, on a case by case basis, attempt to ascribe an estimated value of the benefit, if any, that accrues from the award of interest." *Id.* When sizing the benefit, the *Shell* court included both interest awarded on the base amount of the merger consideration and interest awarded on the fair value award in excess of the merger consideration. The court declined to exclude interest on the base amount "because the award of interest in an appraisal action represents damages for the delay in payment and compensation for the use of [the] petitioners' money." *Id.* After considering various factors, the court incorporated 25% of the total amount of interest into its benefit calculation.

The appraisal statute currently provides for a default rate of interest:

> Unless the Court in its discretion determines otherwise for good cause shown, . . . interest from the effective date of the merger through the date of payment of the judgment shall be compounded quarterly and shall accrue at 5% over the Federal Reserve discount rate (including any surcharge) as established from time to time during the period between the effective date of the merger and the date of payment of the judgment.

8 *Del. C.* § 262(h). The default rate represents a legislative determination by the General Assembly as to an interest rate that both sufficiently compensates the petitioners for their loss of an equity investment and compels the respondent corporation to disgorge a

sufficient portion of the benefit it obtained by using the petitioners' capital.[3] Under our current interest rate regime, I approach the inclusion of interest in the amount of the benefit differently than the *Shell* court.

"In essence, an interest award is the Court's attempt to put both parties in the position most closely approximating their respective positions had the fair value of the dissenting shareholder's stock been paid on the date of the merger." *Gonsalves v. Straight Arrow Publ'rs, Inc.*, 2002 WL 31057465, at *9 (Del. Ch. Sept. 10, 2002). The statutory default rate embodies a legislative determination as to the presumptively correct rate to accomplish this purpose. Given this principle, the interest that accrues on the original merger consideration should not be treated as part of the benefit conferred, because that amount of interest is necessary to keep the petitioners in the same position as if they had received fair value on the date of the merger. Conversely, the interest that accrues on the incremental amount awarded over the merger consideration should be treated as part of the benefit conferred, because that amount is necessary to bring the value of the incremental benefit forward to the present date. A fee award pays counsel in current dollars based on the amount the petitioners receive today. The benefit for purposes of the fee award therefore should include the interest component on the incremental amount;

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[3] For insightful and refreshingly balanced commentary on the statutory rate of interest in appraisal proceedings, *see* Charles Korsmo & Minor Myers, *Interest in Appraisal*, 42 J. CORP. L. (forthcoming 2016), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2748363.

otherwise, a fee award would pay counsel using historical dollars (in this case 2013 dollars). G&E's engagement letter with T. Rowe followed this approach.[4]

In this case, G&E's litigation efforts generated a benefit for the appraisal class. This court determined that the fair value of Dell's common stock at the time of the merger was $3.87 per share more than the merger consideration. Multiplied by the 5,505,730 shares remaining in the appraisal class, the litigation conferred an initial benefit of $21,307,175.10. There has been no application to depart from the statutory default rate, and having presided over this proceeding from the outset, I am unaware of any grounds for doing so. As of September 30, 2016, interest on that amount, compounded quarterly from the effective date of the merger, totals $3,917,969.98. The aggregate benefit as of September 30 is therefore $25,225,145.08. This decision uses this amount when analyzing the application for an award of fees and expenses.

A. Expense Reimbursement

G&E's request has two components: fees and expenses. This decision addresses the expenses first because, on the facts presented, I believe it is appropriate to deduct them from the total amount of the benefit conferred before determining an amount that

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[4] This decision need not consider whether different considerations would apply if a court were to depart from the default rate. Under *Shell*, parties might argue that if the court departed from the statutory default rate, then the interest on the underlying merger consideration should be factored into the benefit, whether for better or for worse. The answer might depend on why the court departed from the statutory rate. If the court determined that a case-specific rate was necessary to achieve the same goals served by the default rate, then that would favor the approach taken in this case. *See* Korsmo and Myers, *supra*, at 20–21.

would constitute a reasonable attorneys' fee. The expenses-first approach is not an absolute rule, but in my view it makes sense when a party has litigated a case through trial and incurred significant out-of-pocket expenses.

Court of Chancery decisions have taken a case-by-case approach to the treatment of expenses. When a case settles early and the expenses are limited, as happened routinely during the era of ritualized disclosure-only and *Cox Communications* settlements, this court has expressed a preference for an all-in award. *See, e.g.*, *Brinckerhoff v. Texas E. Prods. Pipeline Co., LLC*, 986 A.2d 370, 395 (Del. Ch. 2010). An all-in award is more straightforward for the court, facilitates comparisons across cases, and incentivizes counsel to be efficient. *See In re Celera Corp. S'holder Litig.*, 2012 WL 1020471, at *33 & n.248 (Del. Ch. Mar. 23, 2012), *aff'd in part, rev'd in part on other grounds*, 59 A.3d 418 (Del. 2012); *In re Telecorp PCS, Inc. S'holders Litig.*, C.A. No. 19260, at 101 (Del. Ch. Nov. 19, 2003) (TRANSCRIPT) (Strine, V.C.).

When a case goes to trial or settles late in the litigation process, particularly after the parties have incurred fees for experts, the all-in approach can have the deleterious effect of significantly reducing the net percentage of the award that counsel receives. For example, in the *Rural Metro* litigation, counsel settled with all but one defendant on the eve of trial, achieving a gross settlement fund of $11.6 million. *See In re Rural/Metro Corp. S'holders Litig.*, 102 A.3d 205, 215–18 (Del. Ch. 2014), *aff'd sub nom RBC Capital Mkts., LLC v. Jervis*, 129 A.2d 816 (Del. 2015). The out-of-pocket costs required to create that settlement fund were approximately $1.29 million, or over 11% of the total fund. If plaintiff's counsel absorbed the out-of-pocket costs, then an all-in award of 30%

of the gross settlement fund ($3.48 million) would equate after subtracting expenses to an effective fee award of only 18.9%. Although counsel might be able to absorb the expenses in a large case, the all-in approach creates a disincentive for counsel to invest significantly in smaller to medium-sized cases.

Recognizing this problem, some decisions have awarded a fee to counsel based on the total benefit conferred, then awarded expenses on top of the fee award.[5] This approach creates a problem of its own, in that it forces the class to internalize all of the expenses out of its share of the recovery. This increases the total percentage received by counsel, reduces the share of the recovery received by the class, and in an extreme case could wipe out the class recovery altogether. Just as it seems unfair to force counsel to internalize all of the expenses, so too it is unfair to impose all of the expenses on the class.

In resolving this dilemma, some federal courts have deducted expenses first, then awarded a percentage-based fee using the "net award to the class." *In re Immunex Sec. Litig.*, 864 F. Supp. 142, 145 (W.D. Wash. 1994) (quoting *Morganstein v. Esber*, 768 F.

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[5] *See, e.g.*, *In re TD Banknorth S'holders Litig.*, Cons. C.A. No. 2557, at 5 (Del. Ch. June 25, 2009) (ORDER) (awarding 27.5% of common fund in fees plus $964,086.61 in expenses); *Ryan v. Gifford*, 2009 WL 18143, at *13–14 (Del. Ch. Jan. 2, 2009) (awarding one-third of the monetary portion of the settlement in fees plus $398,100.79 in expenses); *In re Chaparral Res., Inc. S'holders Litig.*, Cons. C.A. No. 2001, at 4 (Del. Ch. Mar. 13, 2008) (ORDER) (awarding one-third of common fund in fees plus expenses of $1,089,298.10); *In re TeleCommunications, Inc. S'holders Litig.*, Cons. C.A. No. 16470, at 9, 13 (Del. Ch. Feb. 1, 2007) (TRANSCRIPT) (awarding 30% of the common fund in fees plus $827,658.91 in expenses); *In re Berkshire Realty Co., Inc. S'holder Litig.*, 2004 WL 5174889 (Del. Ch. Aug. 10, 2004) (ORDER) (awarding 30% of the common fund in fees plus $577,787.61 in expenses).

Supp. 725, 727–28 (C.D. Cal. 1991)); *see also Lachance v. Harrington*, 965 F. Supp. 630, 648 (E.D. Pa. 1997). This approach treats counsel's fee percentage as a carried interest in the net recovery, with counsel participating *pari passu* with the class. It treats the expenses as a higher priority debt claim, representing out-of-pocket costs necessary to generate the residual return. The approach "encourages diligence in controlling expenses" because "the lawyer and the client share the goal of maximizing the net recovery." *Immunex*, 864 F. Supp. at 145.

In my view, in a case where counsel have incurred significant out-of-pocket expenses, the approach that best balances the interests of the attorneys and the class is to deduct reimbursable expenses first, then award a fee based on the net benefit achieved. I therefore use that method here.

1. The Reasonableness Of The Expenses

G&E originally requested $4,035,787.18 in expenses. In response, Magnetar and Global raised the valid objection that the appraisal class should not have to reimburse G&E for amounts incurred litigating entitlement issues that were unique to its clients and not common to the appraisal class. G&E conceded the point and reviewed its expenses to identify those amounts. G&E identified and excluded from its request an invoice for $20,475.00 from an expert who was retained solely in connection with the entitlement issues. The fees of $3,372,878.02 for the remaining experts were incurred solely in connection with valuation issues.

For the remaining $642,434.25 in expenses, G&E identified the following categories and amounts as involving valuation issues rather than entitlement issues:

- Travel expenses of $37,880.53: There were no depositions or out-of-town meetings devoted solely to entitlement issues. The only deposition involving entitlement issues was a one-day deposition of a T. Rowe representative, which took place in Baltimore, involved *de minimis* travel costs, and was noticed before the entitlement issue arose. The bulk of the questioning related to T. Rowe's analysis of the value of Dell.

- Transcription services of $42,807.45: These expenses were for deposition transcripts, so the reasoning for the allocation parallels the explanation for travel expenses.

- Meeting expenses of $1,884.70: These charges were for refreshments provided to counsel at the depositions of Dell board member Alex Mandl and at the depositions of petitioners' experts.

- A case-related publication that cost $32.00: This charge was incurred to purchase an article entitled "Management Buyouts and Earnings Management" published in the *Journal of Accounting, Auditing & Finance*.

- Outside counsel fees in the amount of $787.34: This amount was paid to Clark, Hunt, Ahern, & Embry to serve a subpoena on Bain & Company in Massachusetts. This subpoena sought information relating to work Bain did to assist Dell in implementing its transformational strategy; it thus was a valuation-related expense.

Dkt. 449, at 9 & nn.9–13.

For the other categories of expenses, G&E conceded that some small amount likely related to entitlement issues. G&E incurred $246,519.90 in expenses for e-Discovery Data Processing and e-Discovery Hosting Services. A total of 478.4 gigabytes of documents were processed and hosted on G&E's e-Discovery platform throughout the duration of the appraisal action. Of these documents, only 4.9 gigabytes (1% of the total) comprised the small productions made in June 2015, July 2015, October 2015, and November 2015 to address the entitlement issues involving T. Rowe. G&E therefore deducted 1% of its e-discovery expenses.

G&E spent $21,267.78 on filing fees. Of these fees, $531.60 related to the entitlement issues, comprising $495.25 for a summary judgment brief in January 2016 and $36.35 for a summary judgment brief in April 2016. G&E deducted these amounts.

G&E incurred other miscellaneous expenses consisting of (i) $265,864.33 in duplication services, (ii) $20,729.37 in case-related research, (iii) $3,351.32 in postage and delivery, (iv) $1,269.45 in telephone expenses, and (v) $39.99 in service fees. The entitlement issues arose in October 27, 2014, so G&E concluded that expenses in these categories incurred before that date were legitimate. For later expenses, G&E could not make a precise allocation. G&E therefore deducted 2% of the post-October 27, 2014, expenses in these categories, noting that a 2% rate was comparable to the expense rate that G&E used for categories where a specific allocation was possible (*i.e.*, 0% of the travel expenses, 0% of the transcription expenses, 0% of the meeting expenses, 0% of the outside counsel expenses, 1% of the e-Discovery Charges, and 2.5% of the filing fees). This resulted in a deduction of $5,617.09 from the miscellaneous expenses.

Having considered the parties' submissions, I find that G&E's approach to the entitlement expenses is reasonable. Magnetar and Global were given the opportunity to conduct discovery into the expenses that G&E incurred. After discovery disputes arose, the court directed G&E to provide additional information about its expenses. G&E produced 537 pages of backup documentation detailing its expenses. Magnetar and Global did not identify any problems with G&E's expenses. Accordingly, G&E has established the legitimacy of the following $4,007,462.08 in out-of-pocket expenses incurred in litigating the fair value of Dell:

Expenses Category	Total Amount	Valuation Allocation	Entitlement Allocation
Experts	$3,372,878.02	$3,372,878.02	$0
Filing Fees	$21,267.78	$20,736.18	$531.60
Meeting Expense	$1,884.70	$1,884.70	$0
Outside Counsel	$787.43	$787.43	$0
Travel	$37,880.53	$37,880.53	$0
Case-Related Publication	$32.00	$32.00	$0
Duplication Services	$265,864.33	$260,595.22	$5,269.11
Postage & Delivery	$3,351.32	$3,293.75	$57.57
Service Fees	$39.99	$39.99	$0
Telephone	$1,269.45	$1,257.09	$12.36
Transcription Services	$42,807.45	$42,807.45	$0
Case-Related Research	$20,729.37	$20,451.32	$278.05
E-Discovery Data Processing Services	$55,954.95	$55,753.45	$201.50
E-Discovery Data Hosting Services	$190,564.95	$189,064.95	$1,500
Total Expenses		**$4,007,462.08**	

Dkt. 449, at 14–15.

Magnetar and Global's only remaining objection to the expense amount is generic discomfort with the size of the bill. But "[w]ith their often complex valuation methodologies and the necessary utilization of financial experts, appraisal proceedings tend to be expensive." Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery* § 8.10[e], at 8-234 (2012). The

vast majority of G&E's expenses were for experts. G&E took the (to date) relatively unusual step of retaining a highly qualified expert to address Dell's sale process and respond to the respondent's position that the merger price should be regarded as the most persuasive evidence of fair value. The expert's testimony was helpful to the court, but it added an extra layer of expense beyond the typical cost of a valuation expert. G&E also retained a tax expert, apparently at Magnetar's suggestion. That expert's testimony was also helpful, but it too added an extra layer of expense.

In support of their size-based objection, Magnetar and Global point out that the appraisal class ended up containing 5,505,730 shares, a reduction of approximately 86% from the 38,765,130 shares that appeared originally on the verified list. Magnetar and Global suggest that a smaller appraisal class warranted a lesser investment in expenses. But the expenses of appraisal litigation do not scale proportionately with the size of the appraisal class. Dismissing some of the claimants did not, for example, lessen the need to retain experts on valuation, tax, and sale-process issues. Nor did it reduce the need to conduct discovery, file documents with the court, and try the case.

At best one might posit that expenses would rise or fall along a step function, with counsel spending somewhat less in a small appraisal case, pursuing additional discovery and perhaps hiring a more expensive expert in a larger case, and committing the most resources in the largest of cases. In my view, even with the reduced number of shares, this was a case that required the highest level of investment. Facing skilled defense counsel who retained eminent experts of their own, G&E had to hire similarly high caliber experts and expend the resources necessary to achieve a successful outcome.

Ultimately, the amount of expenses that G&E incurred is proportionate to the benefit achieved. The total amount of reimbursable expenses was $4,007,462.08, which represents 15.89% of the aggregate benefit of $25,225,145.08. In my judgment, that is a reasonable level of investment in reimbursable expenses.

2. Shifting A Portion Of The Expenses To T. Rowe

Magnetar and Global contend that T. Rowe should share in any expenses incurred by G&E. According to Magnetar and Global, "the value of the [T. Rowe Settlement] was the elimination of the risk that the [T. Rowe Ruling] would be reversed and the [Fair Value Opinion] would apply to the T. Rowe Petitioners' shares, with interest continuing to run during such an appeal." Dkt. 444, at 6. Magnetar and Global argue that G&E's work in the appraisal action gave T. Rowe the leverage reach a settlement, so T. Rowe should share in the costs of the litigation.

As a threshold matter, the appraisal statute does not permit the court to allocate expenses to former stockholders that were not entitled to seek appraisal and are not part of the appraisal class. Section 262(j) permits the court to "order all or a portion of the expenses incurred by any stockholder in connection with the appraisal proceeding . . . to be charged pro rata *against the value of all the shares entitled to an appraisal*." 8 *Del. C.* § 262(j) (emphasis added). T. Rowe's shares were not "entitled to an appraisal" and hence fall outside the scope of Section 262(j).

That said, in this case, the court could achieve the same functional result simply by reducing the total amount of expenses that it awards to G&E, because a reduced award would force G&E to bear those expenses in the first instance and likely seek

reimbursement from T. Rowe. Magnetar and Global's proposed expense calculations make it clear that their allocation argument is really an effort to reduce their share of the expenses. They propose to allocate to T. Rowe so many expenses that Magnetar's share would fall eight-fold and Global's ten-fold. *See* Dkt. 444, at 9; Dkt. 430, at 15. This decision already has held that the amount of G&E's expenses is reasonable and proportionate to the outcome achieved for the appraisal class. On the facts presented, a further reduction is not warranted.

B. The Fee Award

As the *Shell* court held, "[t]he standards governing the award of attorneys' fees in an appraisal class action . . . are identical to those in other types of shareholder benefit litigation." 1992 WL 321250, at *3. G&E seeks an award of $3,964.125.60 in attorneys' fees, plus interest accruing at the legal rate on this amount since May 31, 2016. This amount is reasonable.

The controlling authority governing fee awards in common fund or benefit situations is *Sugarland Industries, Inc. v. Thomas*, 420 A.2d 142 (Del. 1980). The *Sugarland* decision identifies factors for this court to consider when awarding fees for the creation of a common fund or benefit, but the factors appear diffusely throughout the opinion. *See id.* at 149–50. More recently, the Delaware Supreme Court has summarized the relevant factors concisely as follows: "1) the results achieved; 2) the time and effort of counsel; 3) the relative complexities of the litigation; 4) any contingency factor; and 5) the standing and ability of counsel involved." *Ams. Mining Corp. v. Theriault*, 51 A.3d 1213, 1254 (Del. 2012). "In determining the size of an award of attorney's fees, courts

assign the greatest weight to the benefit achieved," taking into account the nature of the claims and the likelihood of success on the merits. *Franklin Balance Sheet Inv. Fund v. Crowley*, 2007 WL 2495018, at *8 (Del. Ch. Aug.30, 2007). "Secondary factors include the complexity of the litigation, the standing and skill of counsel, and the contingent nature of the fee arrangement together with the level of contingency risk actually involved in the case." *Olson v. EV3, Inc.*, 2011 WL 704409, at *8 (Del. Ch. Feb. 21, 2011). "Hours worked are considered as a crosscheck to guard against windfall awards, particularly in therapeutic benefit cases." *Id.* "Precedent awards from similar cases may be considered for the obvious reason that like cases should be treated alike." *Id.*

If the benefit achieved is quantifiable, then "*Sugarland* calls for an award of attorneys' fees based upon a percentage of the benefit." *Ams. Mining*, 51 A.3d at 1259. In *Americas Mining*, after surveying a range of precedent, the Delaware Supreme Court observed that "Delaware case law supports a wide range of reasonable percentages for attorneys' fees, but 33% is the very top of the range of percentages." *Id.* (internal quotation marks and citation omitted). The Delaware Supreme Court then provided guidance on how this court should approach the percentage-of-benefit analysis by noting with approval that this court "has a history of awarding lower percentages of the benefit where cases have settled before trial." *Id.* The high court grouped the percentages into categories based on the stage at which the litigation settled.

> When a case settles early, the Court of Chancery tends to award 10–15% of the monetary benefit conferred. When a case settles after the plaintiffs have engaged in meaningful litigation efforts, typically including multiple depositions and some level of motion practice, fee awards in the Court of Chancery range from 15–25% of the monetary benefits conferred. . . .

> Higher percentages are warranted when cases progress to a post-trial adjudication.

Id. at 1259–60 (internal quotation marks and citations omitted). Selecting an appropriate percentage requires an exercise of judicial discretion. *Id.* at 1261. The test is not a mechanical one, but the use of guideline ranges helps promote consistent awards so that similar cases are treated similarly.

1. The Results Achieved

In this case, G&E generated an obvious and self-pricing benefit in the form of a gross monetary recovery of $25,225,145.08, calculated as of September 30, 2016. Net of expenses, the recovery is $21,217,683. G&E litigated the case through trial and obtained a post-trial adjudication, which would support an award of 33% of this benefit. The first and most important factor under the *Sugarland* analysis therefore would support a fee award of up to $7,072,561.

G&E is not seeking an award equal to this amount, but rather has sought an award of $3,964,125.60, plus interest. As of September 30, 2016, that proposed award is worth $4,043,705.42, representing 19.06% of the net benefit. Compared to the fee award that the net benefit could support, G&E's requested amount is facially reasonable.

Strangely, Magnetar and Global take issue with G&E's willingness to live by the contingency fee agreement it signed with its clients. Magnetar and Global contend that they rejected G&E's fee structure when G&E offered to represent them and that they should not be forced to bear that fee structure now. Dkt. 430, at 16–17. This objection

misses the point. The court is not imposing a contractual fee arrangement on Magnetar and Global. It is determining whether the fee that G&E has requested is reasonable.

This court can consider G&E's contingency fee agreement with T. Rowe when determining a reasonable fee.

> [A]lthough not specifically listed as [a] factor in our [*Sugarland*] analysis, the terms of a fee arrangement between the law firm and its client are appropriate for the Court to consider. Fee arrangements cannot absolve the Court of its duty to determine a reasonable fee; on the other hand, an arm's-length agreement, particularly with a sophisticated client, as in this instance, can provide an initial "rough cut" of a commercially reasonable fee.

Wisconsin Inv. Bd. v. Bartlett, 2002 WL 568417, at *6 (Del. Ch. Aprt. 9, 2002), *aff'd*, 808 A.2d 1205 (Del. 2002); *see Danenberg v. Fitracks, Inc.*, 58 A.3d 991, 997 (Del. Ch. 2012). A series of federal decisions have approved using private fee agreements as a basis for determining an appropriate fee award in a common fund case.[6]

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[6] The United States Court of Appeals for the Seventh Circuit has held that lead counsel in a class action should receive a fee award consistent with "the contingent fee that the class would have negotiated with the class counsel at the outset had negotiations with clients having a real stake been feasible." *In re Trans Union Corp. Privacy Litig.*, 629 F.3d 741, 744 (7th Cir. 2011); *accord In re Synthroid Mktg. Litig.*, 264 F.3d 712, 718 (7th Cir. 2001) ("We have held repeatedly that, when deciding on appropriate fee levels in common-fund cases, courts must do their best to award counsel the market price for legal services, in light of the risk of nonpayment and the normal rate of compensation in the market at the time."). Several district courts outside that circuit have used a similar methodology. *E.g.*, *Allapattah Servs., Inc. v. Exxon Corp.*, 454 F. Supp. 2d 1185, 1211 (S.D. Fla. 2006) ("[T]he more appropriate measure of a reasonable percentage is the market rate for a contingent fee in commercial cases."); *Nilsen v. York Cty.*, 400 F. Supp. 2d 266, 277-78 (D. Maine 2005) (examining various methods for measuring the reasonableness of a common fund attorneys' fee and concluding that "the methodology of the Seventh Circuit" is the most attractive). The United States Court of Appeals for the Third Circuit has held that for purposes of fee awards under the PLSRA, "courts should accord a presumption of reasonableness to any fee request submitted pursuant to a

These authorities provide strong support for the reasonableness of the fee that G&E has requested. The alternative would be to discard the contingent fee arrangement entirely and allow G&E to seek a much higher fee. The agreed-upon fee percentage is below the level that precedent would support, giving Magnetar and Global no grounds to object.

2. The Time And Effort Of Counsel

"The time and effort expended by counsel serves a cross-check on the reasonableness of a fee award. This factor has two separate but related components: (i) time and (ii) effort." *In re Sauer-Danfoss Inc. S'holders Litig.*, 65 A.3d 1116, 1138 (Del. Ch. 2011) (citation omitted). G&E attorneys spent 17,138.70 hours litigating this case. According to G&E, the value of the time incurred at customary rates would be $7,776,899. The amount that G&E seeks is just over half its lodestar. The hourly cross-check supports the reasonableness of the award.

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retainer agreement that was entered into between a properly-selected lead plaintiff and a properly-selected lead counsel." *In re Cendant Corp. Litig.*, 264 F.3d 201, 282-84 (3d Cir. 2001; *see also In re AT&T Corp.*, 455 F.3d 160, 163 (3d Cir. 2006). *See generally* Charles Silver, *Unloading the Lodestar: Toward a New Fee Award Procedure*, 70 TEX. L. REV. 865, 869 (1992) (advocating the replacement of "the lodestar method in all fee-shifting cases, regardless of the kind of relief sought," with an award system "base[d] . . . on fee agreements plaintiffs enter into with their lawyers"); Charles Silver, *A Restitutionary Theory of Attorneys' Fees in Class Actions*, 76 CORNELL L. REV. 656, 700–01, 702–03 (1991) ("Unjust enrichment occurs in class actions because absent plaintiffs enjoy the fruits of an attorney's labor without purchasing the right to do so. The remedy should therefore require absent plaintiffs to pay an amount which, if offered in advance, an attorney would willingly accept. The best guess at that amount is an attorney's usual and customary rate. . . . In cases waged by contingent fee practitioners, it is inappropriate to focus on effective hourly rates *ex post*; . . . What is important . . . is to pay attorneys on terms they would probably accept in an *ex ante* bargain . . . .").

“The more important aspect is effort, as in what plaintiffs’ counsel actually did.” *Id.* at 1139. “When an entrepreneurial plaintiffs’ firm engages in adversarial discovery, obtains documents from third parties, pursues motions to compel, and litigates merits-oriented issues, they are likely representing the interests of the class.” *Id.* The outcome here resulted from significant effort. G&E litigated the case over a three year period. G&E pursued fact discovery, including document production requests, interrogatories, and depositions. G&E obtained, processed, and hosted a total of 473.5 gigabytes of valuation-related documents and took or defended seventeen depositions. G&E also retained three experts and pursued expert discovery from Dell’s two experts. The litigation culminated in a four-day trial during which the parties introduced over 1,200 exhibits and presented live testimony from seven fact witnesses and five experts. This level of effort supports the award that G&E seeks.

Under this factor, Magnetar and Global contend that any award to G&E should be reduced because G&E performed work litigating T. Rowe’s entitlement issues. When counsel has created a common fund, “[t]he common fund is itself the measure of success.” *Ams. Mining*, 51 A.3d at 1259. If the court were awarding fees based on G&E’s lodestar, then it would examine G&E’s time records and deduct amounts devoted to the entitlement issues. But when a fee award is based on the benefit conferred, and particularly where the benefit takes the form of a common fund, it does not matter that G&E devoted some portion of its efforts to the entitlement issues. G&E is being paid for the benefit it generated, not for the other work that it did.

In a related argument, Magnetar and Global contend that any fee award to G&E should be reduced because G&E already received $4.2 million in fees for the T. Rowe Settlement:

> [N]ow that the T. Rowe Petitioners have enjoyed a substantial recovery by virtue of their $28 million settlement – resulting in a 15% fee to G&E of $4.2 million according to their discovery responses – the T. Rowe Petitioners should naturally be included among those petitioners who are required to contribute toward lead counsel's fees. Indeed, the $4.2 million fee to G&E is greater than the fee being sought in their Fee & Expense Petition, raising the question as to whether any additional fees should even be due to G&E.

Id. at 10–11. Once T. Rowe's shares were no longer part of the appraisal class, any compensation that T. Rowe paid to G&E became a private matter. G&E's fee award in this case is not based on any benefits that G&E obtained for T. Rowe. It is based on the common fund that G&E generated for the appraisal class.

G&E generated a monetary benefit for the appraisal class. Magnetar and Global must bear their full *pro rata* share of that benefit. Otherwise they would be "unjustly enriched at the successful litigant's expense." *Goodrich v. E.F. Hutton Gp., Inc.*, 681 A.2d 1039, 1044 (Del. 1996) (quoting *Boeing Co. v. Van Gemert*, 44 U.S. 472, 478 (1980)).

3. The Complexity Of The Litigation

"One of the secondary Sugarland factors is the complexity of the litigation. All else equal, litigation that is challenging and complex supports a higher fee award." *In re Activision Blizzard, Inc. S'holder Litig.*, 124 A.3d 1025, 1072 (Del. Ch. 2015).

This litigation was relatively complex. Although appraisal actions nominally have a "narrow focus" on the question of fair value, that issue itself involves "complex valuation methodologies and the necessary utilization of financial experts." Wolfe & Pittenger, *supra*, at 8-227, 8-234. In this case, the parties fought over the proper valuation inputs, such the appropriate tax rates, adjustments for overseas cash, the weighted average cost of capital, and the terminal growth rate. G&E consulted two different experts to sort through the valuation factors.

In recent years, appraisal actions have become more complex as respondents have relied on the deal price and the process that generated the underlying transaction as evidence of fair value. In five decisions before this one, the Court of Chancery found the deal price to be the most reliable indicator of the company's fair value, particularly when other evidence of fair value was weak.[7] In this case, Dell relied heavily on its sale process and the resulting merger price. To respond to Dell's arguments, G&E had to conduct discovery into the sale process and develop well-supported arguments as to why the process fell short for purposes of price discovery. That complex task added significantly to the challenging nature of the case.

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[7] *See Merion Capital LP v. BMC Software, Inc.*, 2015 WL 6164771 (Del. Ch. Oct. 21, 2015); *LongPath Capital, LLC v. Ramtron Int'l Corp.*, 2015 WL 4540443 (Del. Ch. June 30, 2015); *Merlin P'rs LP v. AutoInfo, Inc.*, 2015 WL 2069417 (Del. Ch. Apr. 30, 2015); *In re Appraisal of Ancestry.com, Inc.*, 2015 WL 399726 (Del. Ch. Jan. 30, 2015); *Huff Fund Inv. P'ship v. CKx, Inc.*, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013).

The complicated factual issues and the need for extensive discovery made this case more complex than most. This factor would support an award at the higher end of the range. It validates the reasonableness of the percentage award that G&E is seeking.

4. Any Contingency Factor

"Another secondary *Sugarland* factor is the contingent nature of the representation." *Activision*, 124 A.3d at 1073. It is the "public policy of Delaware to reward risk-taking in the interests of shareholders." *In re Plains Res. Inc.*, 2005 WL 332811, at *6 (Del. Ch. Feb. 4, 2005). "Not all contingent cases involve the same level of contingency risk." *Activision*, 124 A.3d at 1073.

G&E faced legitimate contingency risk in pursuing this action. G&E did not enter the case with a ready-made exit or obvious settlement opportunity. There was some possibility of a fair value award below the deal price. There was a serious possibility that the fair value award would equal the deal price. Although G&E prevailed at trial, the case could have turned out differently, and G&E could have ended up with nothing. It remains possible that as the result of an appeal, which seems likely, the Delaware Supreme Court could disagree with this court's rulings and G&E still could receive zero.

This case involved true contingency risk. This factor would support an award at the higher end of the range. It also validates the reasonableness of the percentage award that G&E is seeking.

5. The Standing And Ability Of Counsel

"Law firms establish a track record over time, and they 'build (and sometimes burn) reputational capital.'" *In re Del Monte Foods Co. S'holders Litig.*, 2010 WL

5550677, at *9 (quoting *In re Revlon, Inc. S'holders Litig.*, 990 A.2d 940, 956 (Del. Ch. 2010)). Six years ago, this court wrote that "G&E's track record stands out." *Id.* That comment remains true today. In my view, few litigation teams could have achieved the same result against the well-represented adversary that G&E faced. This factor supports the reasonableness of the percentage award that G&E is seeking.

6. The Overall Conclusion

The Delaware Supreme Court has held that "the Court of Chancery must make an independent determination of reasonableness on behalf of the common fund's beneficiaries, before making or approving an attorney's fee award." *Goodrich v. E.F. Hutton Gp., Inc.*, 681 A.2d 1039, 1044 (Del. 1996). As this court has observed, *E.F. Hutton* "unequivocally" requires that "where plaintiffs and defendants agree upon fees in settlement of a class action lawsuit, a trial court must make an independent determination of reasonableness of the agreed to fees." *In re Nat'l City Corp. S'holders Litig.*, 2009 WL 2425389, at *5 (Del. Ch. July 31, 2009) (internal quotation marks omitted), *aff'd*, 998 A.2d 851 (Del. 2010). Having considered the *Sugarland* factors, the fee award that G&E has requested is materially below what this court might award independently as a reasonable fee. It easily satisfies the test of reasonableness.

C. The Proposed Dollar-For-Dollar Reduction

Magnetar and Global argue that their share of any fees awarded to G&E should be reduced dollar-for-dollar by what Magnetar and Global paid for their own lawyers. Dkt. 430, at 18. According to Magnetar and Global, they "needed their own counsel to protect their interests." Dkt. 431, at 7; *accord* Dkt. 430, at 19.

> The T. Rowe Petitioners had the benefit of their own counsel, who also happened to be lead counsel, which was looking out for their unique interests – including entitlement related issues – throughout this proceeding. The Magnetar Funds did not enjoy the same such protection from lead counsel. Rather, they were required to engage their own counsel, in large part to address the same unique entitlement issue that threatened the viability of the T. Rowe Petitioners' appraisal claim.

Dkt. 444, at 9–10. Additionally, Magnetar asserts that "the Magnetar Funds provided meaningful assistance and advice in respect of the tax issues that ultimately proved to be a substantial component of the valuation uplift" by "actively push[ing] Lead Counsel to engage a tax expert, comment[ing] substantially on [Dell's] tax expert report and also participat[ing] in the deposition of [Dell's] tax expert . . . ." Dkt. 431, at 8.

This court held when it issued the consolidation order that it would follow Section 262(j) and not permit departures for particular claimants. *See* Dkt. 77. "[T]he doctrine of law of the case normally requires that matters previously ruled upon by the same court be put to rest." *Frank G.W. v. Carol M.W.*, 457 A.2d 715, 718 (Del. 1983). *See also Zirn v. VLI Corp.*, 1994 WL 548938, at *2 (Del. Ch. Sept. 23, 1994) (Allen, C.) ("Once a matter has been addressed in a procedurally appropriate way by a court, it is generally held to be the law of that case and will not be disturbed by that court unless compelling reason to do so appears."). The consolidation order distinguished between individual issues, such as a particular claimant's entitlement to appraisal, and issues that were common to the appraisal class, such as the fair value of Dell's common stock. Dkt. 77, ¶ 6. The consolidation order held that G&E could recover fees and expenses for work on common issues but not individual issues. The same principles apply to other counsel. Magnetar

and Global have not advanced any compelling reason to depart from the distinction drawn in the consolidation order.

Magnetar and Global's request fails for another reason as well. If they could offset their individual fees expenses against what the appraisal class owes G&E, then the resulting award under Section 262(j) would not be *pro rata.* Instead, the award would burden other class members disproportionately by forcing them to bear the additional portion of G&E's fees and expenses that Magnetar and Global would avoid.[8] That is inconsistent with both the equitable fund doctrine and the appraisal statute.

Most importantly, Magnetar and Global did not hire separate counsel for the purposes of providing a benefit for the appraisal class as a whole. Rather, they hired "their own counsel to protect their interests." Dkt. 431, at 7; Dkt. 430, at 19. They are

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[8] Magnetar currently holds 3,865,820 eligible shares, or about 70% of the 5,505,730 shares remaining in the appraisal class. Magnetar is currently on the hook for 70% of G&E's fee, or $2,783,390.40 of the $3,964,125.60 in attorneys' fees that G&E has requested. This amounts to 16% of the $17,363,996.15 that Magnetar gained from G&E's efforts. The non-Magnetar class members who own 30% of the shares are on the hook for 30% of the fee, which at $1,180,735.20 represents about 16% of the $7,365,938.12 benefit that they gained.

Suppose this court were to hold that Magnetar could offset its portion of the fee award by what it has paid its private counsel—say, $1,000,000. At that point, Magnetar would be on the hook for $1,783,390.40, or 45% of G&E's fee. That amount would represent only 10% of the $17,363,996.15 that Magnetar gained. Meanwhile, the remaining 30% of the class would become responsible for the balance of $2,180,735.20, or 55% of G&E's proposed fee, which would represent 30% of the $7,365,938.12 that they gained. Requiring 30% of the shares in the appraisal class to bear 55% of the expenses is not a *pro rata* allocation. Nor is it proportionate to allow one set of claimants to keep 90% of their recovery, while permitting another set of claimants to keep only 70%.

therefore not entitled to recover their fees and expenses, whether from the appraisal class or as an offset.

Magnetar and Global have suggested that their private counsel may have contributed to the success of the litigation by consulting on tax issues and other matters. Were that so, then Magnetar and Global could have filed a fee petition of their own. Section 262(j) permits "any stockholder" who incurred expenses "in connection with the appraisal proceeding" for the benefit of the appraisal class to apply for reimbursement from the appraisal class. At this point, it is too late for that type of request, and particularly so when Magnetar and Global have emphasized that they hired their own counsel to "protect their interests." Dkt. 431, at 7; *accord* Dkt. 430, at 19.

D. An Award Of Fees And Expenses Is Not Premature.

Magnetar and Global raise a final objection: They argue that an award of fees and expenses is premature because neither the valuation nor the entitlement issues have been adjudicated through a final judgment and potential appeal.

Magnetar and Global have it backwards. The Delaware Supreme Court "consistently has held that a judgment on the merits is not final until an outstanding related application for an award of attorneys fees has been decided."[9] If this court were to

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[9] *Del. Bay Surgical Servs., P.A. v. Swier*, 869 A.2d 327 (Del. 2005) (TABLE); *see also Scion Breckenridge Managing Member, LLC v. ASB Allegiance Real Estate Fund*, 68 A.3d 665, 686 (Del. 2013) ("[W]e draw a distinction between attorneys' fees and costs when determining a judgment's finality: we have consistently held that a judgment is not final until attorneys' fees are awarded, but a judgment is final where only costs remain to be awarded.").

decline to rule on G&E's fee application, then a final order could not be entered and the case would be stuck in limbo. The fee application is ripe and its adjudication is necessary to achieve a final order. *Lipson v. Lipson*, 799 A.2d 345, 348 (Del. 2001).

The court anticipated entering final judgment after issuing its valuation opinion. In letters dated June 14, 2016, counsel for the parties identified four issues that remained to be decided: (i) a determination as to the number of shares held by one claimant, (ii) a motion to modify the Fair Value Opinion, (iii) G&E's fee application, and (iv) Magnetar's renewed motion for appointment as co-lead petitioner. Dkts. 411, 412. The fee application is all that remains.[10] This decision has addressed it.

III. CONCLUSION

G&E's fee application is granted. G&E's efforts benefitted the appraisal class to the tune of $25,225,145.08, plus any additional interest accruing at the legal rate of interest since September 30, 2016.

G&E is entitled to be reimbursed for up to $4,007,462.08 in expenses. The appraisal class will be entitled to costs because the petitioners were the prevailing parties. "Except when express provision therefor is made either in a statute or in these Rules, costs shall be allowed as of course to the prevailing party unless the Court directs otherwise." Ct. Ch. R. 54(d). Section 262(j) of the appraisal statute permits "[t]he costs of

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[10] *See* Dkt. 414 (Order Denying Motion to Amend or Alter the Judgment and Motion for Reargument); Dkt. 447 (Order Granting Motion for Reconsideration (determining claimant Martin's share count)); Dkt. 452 (Order Denying Renewed Motion for Appointment as Co-Lead Petitioners and for Appointment of Co-Lead Counsel).

the proceeding [to] be determined by the Court and taxed upon the parties as the Court deems equitable in the circumstances." 8 *Del. C.* § 262(j). "Customarily, it is the rule of this Court to assess all costs not specifically allocated by the statute against the surviving corporation, unless there is a showing of bad faith on the part of the dissenting shareholders." *Charlip v. Lear Siegler, Inc.*, 1985 WL 11565, at *5 (Del. Ch. July 2, 1985). *See, e.g.*, *Owen v. Cannon*, 2015 WL 3819204, at *33 (Del. Ch. June 17, 2015) (awarding costs as a matter of course); *Taylor v. Am. Specialty Retailing Gp., Inc.*, 2003 WL 21753752, at *14 (Del. Ch. July 25, 2003) (same).

Petitioners obtained an award of fair value that was higher than the merger consideration. This case was not brought in bad faith. Nor is there any indication that petitioners racked up excessive costs. Therefore, any costs to which the petitioners are entitled as the prevailing parties will be paid by Dell. The parties shall confer on the amount. If they cannot agree, the court will address the issue in due course. Dell's obligation to pay costs may reduce to some degree the expenses for which G&E is entitled to reimbursement from the appraisal class.

After the deduction of G&E's net expenses, up to a maximum of $4,007,462.08, G&E is entitled to an award of attorneys' fees equal to 19.06% of the remaining amount that otherwise would go to the appraisal class. The final award shall provide for the balance to be distributed *pro rata* to the appraisal class, less reasonable administrative expenses necessary to accomplish the distribution.

The parties shall submit a form of final order implementing these rulings.

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE OM GROUP, INC.	:	**CONSOLIDATED**
STOCKHOLDERS LITIGATION	:	**C.A. No. 11216-VCS**

MEMORANDUM OPINION

Date Submitted: July 14, 2016
Date Decided: October 12, 2016

Michael J. Barry, Esquire and David M. Haendler, Esquire of GRANT & EISENHOFER P.A., Wilmington, Delaware; Joel Friedlander, Esquire, Jeffrey M. Gorris, Esquire, and Benjamin P. Chapple, Esquire of FRIEDLANDER & GORRIS, P.A., Wilmington, Delaware; Mark Lebovitch, Esquire, Jeroen van Kwawegen, Esquire, and Alla Zayenchik, Esquire of BERNSTEIN LITOWITZ BERGER & GROSSMANN LLP, New York, New York; and Randall J. Baron, Esquire, David T. Wissbroecker, Esquire, Edward M. Gergosian, Esquire of ROBBINS GELLER RUDMAN & DOWD LLP, San Diego, California, Attorneys for Plaintiffs.

S. Mark Hurd, Esquire and Thomas P. Will, Esquire of MORRIS, NICHOLS, ARSHT & TUNNELL LLP, Wilmington, Delaware, and Robert S. Faxon, Esquire and Adrienne Ferraro Mueller, Esquire of JONES DAY LLP, Cleveland, Ohio, Attorneys for Defendants Joseph Scaminace, Richard W. Blackburn, Steven J. Demetriou, Katharine L. Plourde, Patrick S. Mullin, Hans-Georg Betz, Carl R. Christenson, and John A. McFarland.

SLIGHTS, Vice Chancellor

With the benefit of discovery taken in support of an ultimately-abandoned motion to enjoin an arms-length merger, Plaintiffs, former stockholders of non-party, OM Group, Inc. ("OM" or "the Company"), filed their Consolidated Amended Verified Class Action Complaint ("the Complaint") against the former members of the OM board of directors (the "OM Board") seeking declarations that the individual defendants breached their fiduciary duties by entering into the merger and an award of post-closing "recissionary damages." Claims of aiding and abetting a breach of fiduciary duty against the other party to the merger, Apollo Global Management, LLC ("Apollo"), and its affiliates have been voluntarily dismissed.

The Complaint sets forth a disquieting narrative. In the face of a threat of shareholder activism, it is alleged that the OM Board rushed to sell OM on the cheap in order to avoid the embarrassment and aggravation of a prolonged proxy fight. According to Plaintiffs, OM's financial advisors had opined that separate sales of OM's many diverse business units would yield maximum value for OM shareholders. Ignoring this guidance, the OM Board decided to wrap the units for sale in one package to ensure there was nothing left for them to manage, and then hurried the pre-signing sale process and post-signing market check in a manner that ensured strategic buyers would have no time or desire to pursue piecemeal transactions. The OM Board's rush to the closing table, according to Plaintiffs,

was unreasonable and in violation of the OM Board's fiduciary duties when reviewed under enhanced *Revlon* scrutiny.

The Complaint alleges that the process undertaken by the OM Board leading up to the transaction with Apollo fell beneath any measure of reasonableness in three particular respects. First, the OM Board deliberately shut out strategic acquirors from the process in favor of a quick deal with a financial sponsor because it knew that strategic acquirors would be more interested in acquiring individual OM business units rather than the entire company. This tunnel vision was fueled by a desire to avoid a public confrontation with a vocal dissident shareholder by selling OM before the dissident could mount a proxy fight. Second, the OM Board failed to manage conflicts among its contingently compensated investment bankers, especially with respect to Deutsche Bank which had received significant fees from Apollo over the three years leading up to the merger. Finally, the OM Board relied upon, and allowed the bankers to rely upon, manipulated projections that understated OM's prospects in order to drive the bankers to conclude that a less-than-reasonable merger price was fair.

OM's stockholders voted overwhelmingly to approve the merger. Nevertheless, Plaintiffs allege that the vote should be disregarded because it was the product of OM's incomplete and misleading public disclosures to stockholders regarding a director conflict, the extent to which the OM Board appreciated and

managed the banker conflicts and material details of an indication of interest received by the OM Board during the post-signing go-shop.

Defendants have moved to dismiss the Complaint under Court of Chancery Rule 12(b)(6) on three grounds. First, they contend the Complaint fails to plead facts that would allow a reasonable inference that the OM Board acted unreasonably under *Revlon*. Second, they contend that the fully informed, uncoerced vote of a majority of disinterested stockholders in favor of the merger triggers the irrebuttable business judgment rule. In this regard, they argue that Plaintiffs have failed to identify any material omissions or misleading disclosures in any of the public filings related to the merger. Finally, Defendants argue that even if the stockholder vote did not effectively cleanse any breaches of fiduciary of duty, Plaintiffs have failed to plead either a breach of the duty of loyalty or bad faith such that they can overcome the exculpation clause within OM's certificate of incorporation.

For reasons explained more fully below, even accepting all of its allegations as true, I conclude that the Complaint must be dismissed because a majority of the fully informed, uncoerced, disinterested stockholders voted to approve the merger and Plaintiffs have not alleged that the transaction amounted to waste. Having reached this conclusion, I need not and have not considered whether Plaintiffs have

pled a viable breach of fiduciary duty claim under *Revlon* or whether any such claim would be subject to dismissal under 8 *Del. C.* § 102(b)(7).

I. BACKGROUND

The facts are drawn from allegations in the Complaint, documents integral to the Complaint and matters of which the Court may take judicial notice.[1]

A. The Parties

Lead Plaintiffs City of Plantation Police Officers' Retirement System, City of Sarasota Firefighters' Pension Fund, Cruiser Capital Advisors, LLC, Laborers' Local #231 Pension Fund and Northern California Pipe Trades Pension Plan were stockholders of OM at the time of the merger. OM was a Delaware corporation operating as a global chemical and technology conglomerate comprised of five distinct business units: electronic chemicals, photomasks, magnetic technologies, battery technologies and advanced organics.

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[1] *In re Crimson Exploration Inc. S'holder Litig.*, 2014 WL 5449419, at *8 (Del. Ch. Oct. 24, 2014) ("'A judge may consider documents outside of the pleadings only when: (1) the document is integral to a plaintiff's claim and incorporated in the complaint or (2) the document is not being relied upon to prove the truth of its contents.' Under at least the first exception, [the court finds] that consideration of the Proxy Statement is appropriate in resolving this dispute.") (citation omitted); *In re Gardner Denver, Inc.*, 2014 WL 715705, at *2 (Del. Ch. Feb. 21, 2014) (on a motion to dismiss, the Court may rely on documents extraneous to a complaint "when the document, or a portion thereof, is an adjudicative fact subject to judicial notice.") (footnotes and internal quotation marks omitted); *Narrowstep, Inc. v. Onstream Media Corp.*, 2010 WL 5422405, at *5 (Del. Ch. Dec. 22, 2010) (same).

Defendants Joseph Scaminace, Steven J. Demetriou, Hans-Georg Betz, Richard W. Blackburn, Carl R. Christenson, John A. McFarland, Patrick S. Mullin and Katharine L. Plourde comprised the OM Board. Scaminace served as OM's CEO starting in June 2005 and as Chairman of the OM Board starting in August 2005. Demetriou served as CEO and Chairman of the board of directors of Aleris Corp. ("Aleris"), a company majority-owned by an investment group that includes affiliates of Apollo. The Complaint named several additional defendants that Plaintiffs have now voluntarily dismissed without prejudice: Joseph M. Gingo, Allen A. Spizzo, Apollo, Platform Specialty Products Corporation ("Platform") and certain Apollo and Platform affiliates.[2]

Apollo, a Delaware limited liability company, along with its subsidiaries, owns and manages the funds and entities that own OM's merger partners, Duke Acquisition Holdings, LLC and Duke Acquisition, Inc. Platform, a Delaware corporation headquartered in Florida, is a diversified producer of high technology specialty chemical products. Platform joined with Apollo to acquire OM.

[2] Spizzo and Gingo were to be included in OM's 2015 slate of OM Board nominees pursuant to a Settlement Agreement (defined below) between OM and activist investor, FrontFour Capital Group LLC ("FrontFour"). On March 9, 2016, the Court entered a stipulated dismissal without prejudice as to all claims against Spizzo and Gingo. Plaintiffs initially alleged aiding and abetting claims against Apollo, Platform and their respective affiliates, but filed a notice of voluntary dismissal without prejudice as to those parties and claims on April 27, 2016.

B. OM's Financial Struggles Prior to the Merger

From 2005 to 2015, OM engaged in a growth strategy favoring acquisitions. OM spent over $1.5 billion in pursuit of this strategy but, by January 2015, the Company's enterprise value was only $750 million. As a result, OM's return on investment severely lagged behind its self-identified peer group. OM's stock traded at $36.76 per share in January 2014; by June 2015, it had fallen to $26.54.

Analyst reports indicated that OM's underperformance was due in large part to operational mishandling attributable to management, including failure to optimize costs and manage working capital. For example, KeyBank Capital Markets reported that OM's Selling, General & Administrative Expense ratio to sales was 21%, as compared to the average peer group ratio of 14%, and that OM's "working capital as a percentage of sales far exceeded that of the Company's peer group."[3]

C. FrontFour Seeks Operational and Managerial Improvements

In 2013, FrontFour, an activist investor holding approximately 5.8% of OM's outstanding stock, began to communicate with OM's management regarding the Company's lackluster performance. On January 9, 2015, FrontFour issued a public letter to the OM Board and Scaminace "expressing serious concerns with the Company's performance and destruction of stockholder value," and proposing

[3] Consolidated Am. Verified Class Action Compl. ("Compl.") ¶ 35.

an operational overhaul that would double OM's stock price by the end of 2016.[4] A feature of FrontFour's campaign to provide a "fresh perspective"[5] for OM was to highlight the disconnect between executive compensation and company performance.[6] According to FrontFour, even in the midst of OM's value-destructive acquisition strategy and failure to meet compensation targets, the OM Board continued to pay OM's executives at twice the levels of OM's peers.[7]

In its January 9, 2015 letter, FrontFour identified a specific "path to value creation . . . through (i) . . . cost-cutting opportunities of at least $50 million, (ii) the release of $30 million in working capital and (iii) a $250 million stock buyback."[8] On January 28, 2015, following the OM Board's refusal to entertain FrontFour's proposals, FrontFour announced its delivery of formal nominations of three director candidates for election to the OM Board at OM's June 1, 2015

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[4] Compl. ¶ 36.

[5] *Id.*

[6] Though FrontFour directed its criticisms at management, they also implicated Demetriou's interests by targeting him for replacement on the OM Board as part of their proxy campaign.

[7] Indeed, the OM Board's willingness to pay relatively excessive compensation to OM's executives led to "corporate governance monitor Glass Lewis . . . consistently assign[ing] OM's compensation practices[] a grade of 'D' . . . or worse." Compl. ¶ 37.

[8] Compl. ¶ 38. By FrontFour's calculations, "successful implementation of these initiatives should result in OM Group's shares trading at approximately $60 per share, which represents upside of nearly 120%." Compl. ¶ 39 (emphasis removed) (quoting a statement made by David A. Lorber, managing member and principal owner of FrontFour).

annual stockholder meeting.[9] Analysts reacted favorably to FrontFour's proposals, raising price estimates for OM's stock to $35–$40 per share.

In response to FrontFour's January 9 letter, OM issued a press release on January 30, 2015, announcing that it was in the process of implementing most of FrontFour's proposals. Soon after, OM announced a series of additional improvements to its operations and cost structure that would result in substantial cost savings by year end 2017. On March 4, 2015, FrontFour filed a presentation with the SEC expressing concerns regarding certain aspects of OM's performance similar to those expressed in its January 9 letter including, *inter alia*, OM's value-destructive acquisition strategy, excessive executive compensation and low margins. The March 4 presentation contained a financial analysis that assumed effective implementation of FrontFour's recommendations and calculated a resulting implied share price of $55.51—more than double the company's January 8, 2015 share price.

D. The OM Board Engages BNP Paribas to Asses Strategic Options

As early as 2005, OM's various business lines began attracting interest from potential strategic purchasers. On August 12, 2014, a financial advisor acting on behalf of Platform contacted OM to express Platform's interest in purchasing OM's electronic chemicals business. OM refused Platform's overture and

[9] Due to the OM Board's classified structure, only three of the eight OM Board members stood for reelection in 2015.

indicated that it was not interested in pursuing a sale of only one segment of its business. In September and October 2014, three financial sponsors expressed to OM an interest in acquiring or investing in the company, including a written indication of interest submitted by Advent International Corporation ("Advent") to purchase all of OM's outstanding common stock at $27.00 to $32.00 per share.[10] On October 31, 2014, the OM Board held a special meeting at which management detailed its concern that "activists could derail the execution of [OM's] strategy" by calling for "change[s] in capital priorities" and an "externally driven change of board members."[11] According to Plaintiffs, these concerns prompted the OM Board to engage BNP Paribas to assess potential value creation options.[12]

During the October 31, 2014 meeting, BNP Paribas presented to the OM Board preliminary financial analyses of OM and its strategic alternatives. Included in the presentation was BNP Paribas's opinion that OM's "'[a]bility to maximize value [through a sale] may be limited due to few, if any strategic buyers for the whole company,' since OM's '[d]iverse portfolio of assets limits merger candidates,' and that a lack of operational synergies could limit the premium in any

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[10] Plaintiffs allege that at this point in time, while FrontFour had not yet initiated a proxy contest, OM management and the OM Board were acutely aware of pressure from activist investors. Compl. ¶ 48.

[11] Compl. ¶ 48. During this September–October 2014 timeframe, FrontFour attempted to meet with OM management "and OM management cancelled at least twice." *Id.*

[12] *Id.*

transaction with a financial buyer."[13] The OM Board authorized management to engage BNP Paribas to conduct a confidential market test and negotiated a fee structure under which BNP Paribas would be paid approximately $10 million, $7 million of which was contingent on OM consummating a merger.

E. The OM Board Focuses on Financial Sponsors

On November 10, 2014, Apollo and Platform submitted a joint indication of interest to acquire all of OM's common stock at a range of $27.00 to $32.00 per share (Apollo and Platform joint bids are hereafter referred to as Apollo bids). The following day, the OM Board met and authorized management to engage with both Advent and Apollo regarding their respective proposals, and to request that BNP Paribas contact additional potential suitors. The OM Board indicated that the outreach efforts should remain limited to financial buyers reasonably likely to consider a transaction involving a sale of the entire company. This outreach

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[13] Compl. ¶ 49 (quoting BNP Paribas Oct. 31 Presentation at OMG00013, Suppl. Transmittal Aff. of Thomas P. Will in Supp. of the Director Defs. Reply Br. in Supp. of Their Mot. to Dismiss Pls. Consolidated Am. Verified Class Action Compl. Ex. A ("BNP Paribas Oct. 31 Presentation"). Defendants point out that in that same presentation BNP Paribas discussed other strategic options including doing nothing and remaining standalone, engaging in a LBO, pursuing acquisitions or realigning the Company's portfolio through divestitures which would involve the "sale of certain assets that may be more synergistic for another party." The presentation of the divestiture approach included a discussion of sales of OM divisions to "strategic acquirors" in "multiple transactions" and noted that such a strategy carried certain identified "risks and complexities." *Id.* at OMG00013, OMG00031. *See Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752, 797 (Del. Ch. 2016) (the "incorporation-by-reference doctrine permits a court to review the actual document to ensure that the plaintiff has not misrepresented its contents and that any inference the plaintiff seeks to have drawn is a reasonable one.").

strategy was in apparent conflict with BNP Paribas's presentation suggesting that a transaction with a financial sponsor would forfeit synergistic value that might be obtained by selling OM's specific business units to strategic buyers.

Beginning in mid-November, BNP Paribas contacted five additional financial sponsors, none of which expressed interest in acquiring OM at a price competitive with Advent's or Apollo's proposals. Also in mid-November, Advent and Apollo executed confidentiality agreements after which OM released additional due diligence materials.[14] "On December 1, 2014, shortly after Apollo began its due diligence, Demetriou had a lunch meeting with Matthew Michelini, a key employee in Apollo's metals group."[15]

F. The OM Board Engages a Second Financial Advisor

Plaintiffs allege that the OM Board desired an opinion from a second financial advisor because it recognized that BNP Paribas was conflicted.[16] To that end, the OM Board (with assistance from OM management) hired Deutsche Bank to act as the OM Board's third-party advisor independent of management. The

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[14] Plaintiffs allege on information and belief that the confidentiality agreements "contained standstill provisions prohibiting Advent and Apollo/Platform from acquiring OM for one year or more unless OM released them from the standstill." Compl. ¶ 55.

[15] Compl. ¶ 109. The Complaint says nothing of what occurred at this meeting.

[16] Plaintiffs' only allegations regarding BNP Paribas's purported conflict are that BNP Paribas had experience working with management and therefore may favor a transaction with a private equity buyer content with retaining management, and that $7 million of BNP's $10 million compensation became payable only upon consummation of a deal. Compl. ¶¶ 57–60.

OM Board initially discussed a two-stage engagement of Deutsche Bank, consisting of a flat fee for independent advice and, if the sale process progressed, the possibility that the engagement would continue through consummation. Contrary to its initial plan, however, the OM Board ultimately engaged Deutsche Bank on a fully contingent basis, conditioning a payment of $5.32 million on the delivery of a fairness opinion and the closing of a transaction. Prior to its engagement, Deutsche Bank disclosed to OM that it had received "significant" fees from Apollo since January 1, 2013, but omitted the precise amount of those fees.[17]

By the end of December 2014, Apollo had proposed to acquire OM for between $33.00 and $35.00 per share, and Advent had submitted a non-binding proposal to acquire OM for $34.00 per share. During a meeting of the OM Board on January 15, 2015, Deutsche Bank reported that no strategic buyer had expressed interest in acquiring the entire company. It also provided its opinion that OM's implied share price for the Company as a whole was $36.80.

On January 21, 2015, OM rejected Advent's request for exclusivity causing Advent, on March 15, 2015, formally to withdraw its indication of interest. In the

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[17] The Proxy (defined below), after disclosing that OM knew that Apollo had paid "significant fees" to Deutsche Bank at the inception of Deutsche Bank's engagement, also disclosed that the actual amount of the fees paid by Apollo to Deutsche Bank amounted to over €140 million since 2013. Deutsche Bank had also received more than €2 million from Platform over the same time period. Transmittal Aff. Of Thomas P. Will in Supp. of the Director Defs. Br. in Supp. of Their Mot. to Dismiss Pls. Consolidated Am. Verified Class Action Compl. Ex. A (OM Group, Inc. DEFM14A Proxy Statement("Proxy")) at 25, 47–48.

meantime, the OM Board's negotiations with Apollo, which had begun in 2014, continued into 2015. OM provided Apollo access to its electronic data room and additional due diligence.[18] On April 26, 2015, Apollo submitted a bid of $34.00 per share. Three days later, during a telephonic OM Board meeting, Deutsche Bank presented the OM Board with a DCF analysis valuing OM's stock at $35.27 per share.

G. The OM Board Settles with FrontFour

As the OM Board continued to negotiate with Apollo, it also was negotiating with FrontFour in an effort to head off a proxy fight. According to the Complaint, the OM Board never revealed to FrontFour during the course of these negotiations that it was actively pursuing a sale of the Company.

On March 23, 2015, OM announced that it reached an agreement with FrontFour regarding OM Board composition (the "Settlement Agreement"). The Settlement Agreement contemplated that OM would submit two FrontFour nominees, David A. Lorber and Joseph M. Gingo, in its 2015 proxy statement for approval at the annual stockholder meeting. In addition, OM would expand the OM Board by one seat to be filled by Allen A. Spizzo, one of FrontFour's original nominees.[19]

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[18] Compl. ¶ 55; Proxy at 26.

[19] Plaintiffs allege that OM was motivated to enter the Settlement Agreement as a means to silence FrontFour's criticism of OM's executive compensation. They also allege that

In return for OM's agreement to seat FrontFour's designees on the OM Board, FrontFour agreed to vote its shares in favor of the OM Board's nominees and to abide by standstill provisions in the Settlement Agreement that prohibited FrontFour from taking any public action regarding OM for nearly a year. The prohibited public actions included, *inter alia*, proxy solicitation activity, participation in group voting or voting trusts with respect to OM securities, encouragement of contests to the OM Board's nominations, participation in merger proposals or communications in opposition to any merger, pursuit of additional OM Board representation and any requests to amend the terms of the Settlement Agreement.[20]

H. The OM Board Approves a Transaction with Apollo

The OM Board terminated negotiations with Apollo on two separate occasions in May 2015 when negotiations over deal terms stalled. On both occasions, Apollo capitulated and negotiations resumed.

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silencing FrontFour contributed to Scaminace's interest in closing the Apollo transaction. Specifically, the Apollo transaction would allow Scaminace (and other executives) to continue with OM without the "oversight by new Board members who were profoundly critical of their performance and sought to . . . sharply reduce their compensation," or would at least ensure that if Apollo ultimately dismissed Scaminace following a change of control event, he "would be eligible for [a] generous golden parachute package[] . . . valued at approximately $15 million." Compl. ¶¶ 105, 107.

[20] Plaintiffs argue that the standstill provisions, in combination with OM's announcement of the transaction the same day the stockholders were to seat FrontFour's directors Compl. ¶ 81, "indicates that OM negotiated the Settlement Agreement specifically with an eye towards ensuring that the Transaction (with Apollo) could be completed without interference." Compl. ¶ 119.

On May 31, 2015, the OM Board approved Apollo's offer to acquire all outstanding OM shares for $34.00 per share cash, resulting in a total transaction value of approximately $1 billion.[21] Following the transaction, it was understood that Apollo would retain OM's magnetic technologies, battery technologies and advanced organics businesses, and would sell OM's electronic chemicals and photomasks businesses to Platform for total cash consideration of $365 million.[22]

While BNP Paribas and Deutsche Bank both provided fairness opinions endorsing the transaction, the Complaint contains several allegations that question the *bona fides* of the bankers' views. According to Plaintiffs, alone or together these concerns raise a reasonable inference that the OM Board acted unreasonably in approving the transaction.[23]

First, the $34.00 deal price fell within the lower half of BNP Paribas's suggested fair value range of $29.42 to $41.59 per share and Deutsche Bank's suggested fair value range of $31.25 to $41.75 per share.[24] In this regard, Plaintiffs

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[21] Plaintiffs' question, in addition to the price, the timing of the transaction, citing the fact that OM's June 1, 2015 announcement of the transaction caused its stock to jump from $26.54 on May 29 to $34.04 on June 1, allowing Scaminace to exercise options with a strike price of $34.03 at a profit of approximately $480,000.

[22] Following Apollo's post-transaction spin-off, "Platform announced that the OM businesses it acquired would provide a synergy opportunity to it in excess of $20 million over two years." Compl. ¶ 81.

[23] Compl. ¶¶ 72-79.

[24] When presenting its analysis to the OM Board, one of Deutsche Bank's DCF analyses stated that the implied share price was $36.27. Compl. ¶ 72.

allege that the May 31, 2015 meeting was the first time the OM Board considered a "sum-of-the-parts" valuation, which was conducted by Deutsche Bank and resulted in a fair value range of $32.75 to $39.50 per share.[25]

Second, Plaintiffs allege that the fair value ranges provided by BNP Paribas and Deutsche Bank undervalued OM because management and the OM Board "instructed the . . . financial advisors to use revised projections that were less favorable to [OM] and contradicted statements that OM management had made to investors."[26] Specifically, in a March 6, 2015 presentation to the OM Board, management provided revised projections that reduced share price estimates by approximately $4.00 per share by lowering OM's projected EBITDA and increasing its projected working capital requirements.[27] The increase in working capital—responsible for a $3.21 per share reduction in the revised projections—was "inappropriate, given that OM management had been stressing to investors that they expected [OM's] working capital to decline."[28]

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[25] *Id.*

[26] Compl. ¶ 73.

[27] The revised projections reduced the cumulative EBITDA projections for 2015–2019 from $796 million to $767 million, reducing OM's valuation by $2.12 per share. At the same time, the revised projections increased the cumulative working capital over the same period to $74 million from $53 million, reducing OM's valuation by $3.21 per share. The total reduction of $5.33 per share was partially offset by a decrease in capital expenditures from $238 million to $216 million, increasing the fair value per share by $1.34. Compl. ¶¶ 73–77.

[28] Compl. ¶ 78 (emphasis removed) (citing March 2 and April 30, 2015 analyst calls with OM's CFO discussing expectations regarding working capital requirements).

Third and finally, although the $34.00 per share deal price represents an approximate 28% premium to OM's unaffected stock price, it also reflects "only an 18.3% premium over the average closing price for the 30 trading days prior to the transaction . . ., [and is] an approximate 10% discount to OM's 2014 high, an approximate 17% discount to OM's five-year high, and a greater than 50% discount to OM's all-time high."[29] According to Plaintiffs, OM's Management could have increased OM's market capitalization merely by signaling an end to its acquisition binge. Instead, by plowing forward into the transaction, OM prompted certain sophisticated investors, including a *Seeking Alpha* analyst, Cove Street Capital and an APB Financial Group analyst, to criticize the transaction and to perform their own sum-of-the-parts analyses which revealed a fair value per OM share ranging from "the low $40s" to $49 per share.[30]

In addition to the value left on the table by the OM Board, Plaintiffs point to several non-monetary flaws in the transaction they allege reflect the OM Board's rush to lock up and close the first deal that would allow them to avoid the embarrassment of a battle with FrontFour. Sections 1.6 and 7.5 of the Merger Agreement provided for the OM Board's mandatory resignation immediately before the closing date, forcing out the FrontFour nominees almost immediately

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[29] Compl. ¶ 84.

[30] Compl. ¶ 90.

after they were elected and ensuring that any improvements implemented during their short tenure would inure to the exclusive benefit of Apollo and Platform.[31] The Settlement Agreement assured that any opposition to the transaction FrontFour might have expressed was silenced.

Section 6.2 of the Merger Agreement provided for a "go-shop" period of just over one month, but allowed Apollo and Platform to scrutinize the entire process. The go-shop lasted from May 31, 2015 through July 5, 2015 (the "Go-Shop Period"). During this time, upon providing non-public information requested by any potential acquirer, OM was required to "substantially concurrently" provide to Apollo and Platform that same information unless it was previously disclosed. Section 6.2 also required OM to keep Apollo and Platform "informed on a reasonably current basis (and in any event within forty-eight hours) of the status and terms and conditions of any [competing proposal], including the price and form of consideration and all material terms and conditions (other than the identity of the party thereto) . . . and any material developments, discussions or negotiations in connection therewith."[32] If informed of a superior proposal, Section 6.2 granted Apollo and Platform corresponding "matching rights."

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[31] Sections 1.6 and 7.5 of the Merger Agreement further provide that the directors of the merger subsidiary are to replace the OM Board upon its mandatory resignation.

[32] Proxy at Annex A (Agreement and Plan of Merger ("Merger Agmt.")) § 6.2(a).

While the Merger Agreement countenanced post-go-shop negotiations with Excluded Parties,[33] it prohibited OM from soliciting third parties after 12:00 a.m. eastern time on July 5, 2015. After that time, the OM Board could negotiate with third parties only if the third party submitted an unsolicited proposal the OM Board could reasonably expect to lead to a Company Superior Proposal.[34] Notably, Section 6.2(f) of the Merger Agreement prohibited OM from altering its recommendation to the stockholders in favor of the Apollo transaction unless the OM Board determined in good faith that the third-party proposal could reasonably qualify as a Company Superior Proposal. This prohibition effectively barred the OM Board from recommending any transaction for less than 90% of OM's assets.

Finally, Sections 9.1(c) and 9.2(b) of the Merger Agreement contemplated a termination fee of $18.3 million (approximately 1.83% of the transaction price) if the agreement terminated prior to expiration of the Go-Shop Period or at any time in favor of an agreement with an Excluded Party. If terminated in any other circumstance, the Merger Agreement's termination fee would jump to $36,575,000 (approximately 3.66% of the transaction price).

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[33] The Merger Agreement defines "Excluded Party" as any party from whom OM Group has received, prior to termination of the Go-Shop Period, a Company Superior Proposal or an offer that "could reasonably be expected to lead to a Company Superior Proposal." *Id.* § 11.2.

[34] The Merger Agreement defines "Company Superior Proposal" as a "written, [bona fide inquiry, proposal or offer] . . . that if consummated would result in a third party . . . acquiring, directly or indirectly, (1) more than 50% of [OM's] Common Stock or (2) [more than 90 % of OM's] assets or businesses." *Id.*

I. The Post-Signing Go-Shop

During the Go-Shop Period, BNP Paribas and Deutsche Bank contacted forty-nine parties, including twenty-one strategic buyers, marking the first solicitation to potential strategic acquirers during the sale process. Only five parties responded, three of which entered into confidentiality agreements with OM and received due diligence materials. On July 5, 2015, the first day following the expiration of the Go-Shop Period, OM received a letter dated July 4, 2015 from Advanced Technology & Materials Co., Ltd. ("Advanced") indicating its interest to acquire OM, jointly with one or more co-investors, for between $35.00 and $36.00 per share.

The OM Board determined that Advanced was an Excluded Party. Accordingly, the OM Board could continue to negotiate with Advanced beyond the Go-Shop Period. But Advanced had a problem. It was a foreign company that was banned by federal law from acquiring certain OM assets that sold high-tech equipment to the U.S. military. Advanced asked OM to postpone the stockholder vote on the Apollo merger to allow it more time to work around the problem. The OM Board declined. According to Plaintiffs, this effectively took Advanced out the running. On August 4, 2015, OM reported that Advanced would not submit a Company Superior Proposal and reaffirmed its recommendation that OM's stockholders approve the Merger Agreement.

J. The Closing

On July 10, 2015, OM filed its Form DEFM14A Proxy Statement (the "Proxy") noticing an August 10, 2015 special stockholder meeting to approve the Merger Agreement and recommending that stockholders vote their shares in favor of the transaction. At the August 10 special meeting, the stockholders approved, by a margin of 10:1, the Merger Agreement and a precatory executive compensation scheme in line with the merger. The Merger Agreement closed on October 28, 2015. Also on October 28, Scaminace announced his decision to step down as CEO thereby triggering $15 million in golden parachute payments.

K. The Procedural History

Six complaints challenging the transaction were filed in this Court within weeks of OM's announcement of the deal. The Court consolidated the complaints and granted a motion to expedite in aid of a motion to enjoin the transaction. After conducting expedited discovery, Plaintiffs withdrew their motion for a preliminary injunction and amended their complaint to seek post-closing remedies. Defendants then moved to dismiss the amended Complaint.

II. ANALYSIS

A. Motion to Dismiss Standard

"[T]he governing pleading standard in Delaware to survive a motion to dismiss is reasonable 'conceivability.'"[35] Under this standard, the Court will deny the motion if the plaintiff has pled a reasonably conceivable cause of action.[36] All well-pled allegations in the complaint will be regarded as true, but the Court need not accept conclusory allegations that lack any factual basis.[37]

B. Standard of Review

When faced with a stockholder challenge to a board of directors' exercise of fiduciary duties in the course of negotiating and approving a corporate transaction, the prime determination for the Court is the applicable standard of review. "Delaware has three tiers of review for evaluating director decision-making: the business judgment rule, enhanced scrutiny, and entire fairness."[38] This Court generally applies the entire fairness standard "when the board labors under actual conflicts of interest."[39] While Plaintiffs allege that each member of the OM Board

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[35] *Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Hldgs. LLC*, 27 A.3d 531, 537 (Del. 2011).

[36] *Id.*

[37] *Price v. E.I. DuPont de Nemours & Co.*, 26 A.3d 162, 166 (Del. 2011); *Criden v. Steinberg*, 2000 WL 354390, at *1 (Del. Ch. Mar. 23, 2000).

[38] *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 457 (Del. Ch. 2011).

[39] *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 44 (Del. Ch. 2013); *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 747 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

acted out of an overpowering sense of self-interest (indeed, reputational self-preservation), they do not advocate for entire fairness review.[40] This likely reflects their appreciation that the Complaint alleges no facts from which one could infer that a majority of the OM Board was interested in the transaction or that the OM Board labored under the influence of a controller.

Accordingly, the question here is whether the transaction is subject to the business judgment rule or enhanced scrutiny under *Revlon*. The OM stockholders were cashed-out in the merger. At first glance, therefore, it would appear that *Revlon* governs and that the Court should review the sales process to determine whether the OM Directors acted reasonably to pursue the transaction that offered the best value reasonably available to the OM stockholders.[41]

Before the Court launches into its *Revlon* analysis, however, it must first account for the fact that another "qualified decision maker," the disinterested OM

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[40] Tr. of Oral Arg. on Defs. Mot. to Dismiss ("Oral Arg. Tr.") 74 ("Your Honor, you're correct in that I am not arguing entire fairness.").

[41] *TW Servs., Inc. v. SWT Acq. Corp*., 1989 WL 20290, at *7 (Del. Ch. March 2, 1989) (Allen, C.) ("In the settling of a sale of a company for cash, the board's duty to shareholders is inconsistent with acts not designed to maximize present share value, acts which in other circumstances might be accounted for or justified by reference to the long run interests of shareholders."); *In re Rural Metro Corp.*, 88 A.3d 54, 82–83 (Del. Ch. 2014) ("Enhanced scrutiny applies in [the context of a sale of a corporation for cash] because of the potential conflicts of interest that fiduciaries face when considering whether to sell the corporation, to whom, and on what terms.").

stockholders, overwhelmingly approved the transaction.[42] If their approval was the product of a fully informed, uncoerced vote, then, under *Corwin v. KKR Financial Holdings, LLC*,[43] the irrebuttable business judgment rule would apply and the OM Board's decision to approve the Merger would be "insulate[d] … from all attacks other than on grounds of waste."[44] Since the effect of the stockholder vote will dictate the standard of review by which the OM Board's conduct will be measured, it is appropriate to address this potentially case dispositive issue first.[45]

C. The OM Stockholders' Vote Was Fully Informed

In the wake of disinterested stockholder approval of a merger not subject to the entire fairness standard, a plaintiff seeking to hold directors individually liable

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[42] *See* J. Travis Laster, *The Effect of Stockholder Approval on Enhanced Scrutiny*, 40 Wm. Mitchell L. Rev. 1443, 1444 (2014) ("To the extent the board is compromised by the situational pressures that trigger enhanced scrutiny, the collective body of disinterested and informed stockholders should be able to act as a qualified decision maker to which the court should defer.").

[43] 125 A.3d 304 (Del. 2015).

[44] *In re KKR Fin. Hldgs. LLC S'holder Litig.*, 101 A.3d 980, 1001 (Del. Ch. 2014), *aff'd*, *Corwin v. KKR Fin. Hldgs. LLC,* 125 A.3d 304, 312-14 (Del. 2015). *See also Volcano Corp. S'holder Litig.*, 2016 WL 3626521, at *9 (Del. Ch. June 30, 2016) ("[R]ecent Supreme Court decisions confirm that the approval of a merger by a majority of a corporation's outstanding shares pursuant to a statutorily required vote of the corporation's fully informed, uncoerced, disinterested stockholders renders the business judgment rule irrebuttable.").

[45] *Corwin*, 125 A.3d at 308 ("[W]e need not delve into whether the Court of Chancery's determination that *Revlon* did not apply to the merger is correct for a single reason: it does not matter. Because the Chancellor was correct in determining that the entire fairness standard did not apply to the merger, the Chancellor's analysis of the effect of the uncoerced, informed stockholder vote is outcome-determinative, even if *Revlon* applied to the merger.").

for approving the merger must take either or both of two paths to overcome a motion to dismiss: (1) demonstrate that the transaction amounted to corporate waste; or (2) demonstrate that the stockholder vote was uninformed or coerced.[46] The path of least resistance is to challenge the soundness of the stockholder vote.[47] Indeed, "the [*Corwin*] doctrine applies only to fully informed, uncoerced stockholder votes, and if troubling facts regarding director behavior were not disclosed that would have been material to a voting stockholder, then the business judgment rule is not invoked."[48]

Plaintiffs have not attempted to plead a claim for waste but instead seek to avoid *Corwin* burden-reduction by arguing that the OM Board either failed to disclose material information or made materially misleading partial disclosures to the OM stockholders regarding the merger thereby rendering the vote uninformed. It is well-settled that directors of Delaware corporations owe to the stockholders "a fiduciary duty to disclose fully and fairly all material information within the

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[46] *Id.* at 312–14.

[47] *Singh v. Attenborough*, 137 A.3d 151, 152 (Del. 2016) (ORDER) (noting that dismissal "is typically the result" in cases where a plaintiff has challenged a transaction on grounds of waste, a concept that has "little 'real-world relevance'" in M&A transactions "because stockholders would be unlikely to approve a transaction that is wasteful."). *See also In re Zale Corp. S'holders Litig.*, 2015 WL 6551418, at *2 (Del. Ch. Oct. 29, 2015); *City of Miami General Employers' and Sanitation Employees' Retirement Trust v. Comstock, et al.*, 2016 WL 4464156, at *17 (Del. Ch. August 24, 2016) ("[I]n such cases, dismissal is typically the result because the transaction then can be attacked only on grounds of waste. . .").

[48] *Corwin*, 125 A.3d at 312.

board's control when it seeks shareholder action."[49] "The duty of directors to observe proper disclosure requirements derives from the combination of the fiduciary duties of care, loyalty and good faith."[50] A fact is material if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[51] Stated differently, material facts are those that, if disclosed, would "significantly alter the 'total mix' of information."[52]

To establish the materiality of an omitted fact, a plaintiff "must show a substantial likelihood that the omitted facts would have assumed actual significance in the deliberations of a reasonable stockholder. . . ."[53] While the determination of materiality is a case specific endeavor,[54] our courts have recognized that a board's disclosure obligation is "not boundless"[55] and that the board need not disclose information simply because it "might be helpful."[56] Thus, a board need not disclose "[c]onsistent and redundant facts" or "insignificant

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[49] *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992).

[50] *Malone v. Brincat*, 722 A.2d 5, 11 (Del. 1998).

[51] *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

[52] *Abrons v. Maree*, 911 A.2d 805, 813 (Del. Ch. 2006).

[53] *McMillan v. Intercargo Corp.*, 1999 WL 288128, at *5 (Del. Ch. May 3, 1999).

[54] *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 143 (Del. 1997).

[55] *In re CheckFree Corp. S'holders Litig.*, 2007 WL 3262188, at *2 (Del. Ch. Nov. 1, 2007).

[56] *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170, 1174 (Del. 2000).

details and reasonable assumptions" and must remain mindful of "the fallacy that increasingly detailed disclosure is always material and beneficial disclosure."[57]

Here, 89.6% of the shares voted at the stockholder meeting approved the transaction, representing 75.7% of OM's total outstanding common shares. Nevertheless, Plaintiffs urge the Court to ignore the stockholder vote because the Proxy was misleading in three material respects: (1) it omitted information regarding Advanced's competing bid through misleading partial disclosures; (2) it omitted information about Demetriou's alleged conflicts of interest; and (3) it omitted information about the evolution of Deutsche Bank's engagement and the timing of the OM Board's discovery of the extent of Deutsche Bank's conflicts.[58]

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[57] *Zirn v. VLI Corp.*, 1995 WL 362616, at *4 (Del. Ch. June 12, 1995), *aff'd*, 681 A.2d 1050 (Del. 1996)). *See also In re Answers Corp. S'holders Litig.*, 2011 WL 1366780, at *5 (Del. Ch. Apr. 11, 2011) (noting that public disclosures need not "inundate" stockholders "with an overload of information").

[58] Curiously, the Complaint does not allege that the OM Board failed to disclose facts that would allow stockholders to appreciate the factual bases of the gravamen of Plaintiffs' breach of fiduciary duty claim, including the financial advisors' views that separate sales of OM's divisions would yield more value for stockholders than a sale of OM in the aggregate, the rushed timing of the transaction to a avoid confrontation with a shareholder activist, or the flaws in the management projections used by the OM Board to value OM. The *Corwin* doctrine does not apply if "troubling facts regarding director behavior were not disclosed that would have been material to a voting stockholder. . . ." *Corwin*, 125 A.3d at 312. And while a board need not engage in "self-flagellation," *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 143 (Del. 1997), it is telling that Plaintiffs have not suggested that the OM stockholders were not told of material facts relating to FrontFour, including the FrontFour settlement, the advice received by the OM Board from financial advisors regarding the value of sum-of-the-parts transactions, management projections or the details of the alleged banker conflicts (as opposed to the timing of the OM Board's discovery of the conflicts).

Whether the Company's disclosures are adequate is a mixed question of law and fact.[59] In this case, I am satisfied that no further development of the factual record would be useful in determining the materiality of the alleged disclosure deficiencies. Whatever discovery that might be useful in evaluating the disclosures has been taken by Plaintiffs in aid of their later-abandoned motion for preliminary injunction and the fruits of that effort have been incorporated within the Complaint. Moreover, Plaintiffs have not identified any areas of factual dispute with respect to their disclosure claims and I can discern none. The identified omissions or misleading partial disclosures are either legally material or they are not. I will address them in turn.[60]

1. Advanced's Competing Bid

Plaintiffs argue that the Proxy's failure to disclose (i) that Advanced "made a written proposal in the $35.00 to $36.00 per share range during the Go-Shop [Period] . . .; and (ii) that Advanced . . . requested additional time to work out certain issues in order to submit a [Company] Superior Proposal but the Board

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[59] *Zirn v. VLI Corp.*, 681 A.2d 1050, 1055 (Del. 1996).

[60] Even though Plaintiffs elected not to press their "disclosure claims" pre-closing in connection with their ultimately-abandoned motion for preliminary injunction, *see In re Transkaryotic Ther., Inc.*954 A.2d 346, 360-62 (Del. Ch. 2008) (expressing a preference to address disclosure claims prior to the stockholder vote), it is appropriate to address them on the merits in this procedural context since Defendants have invoked the *Corwin* doctrine and thereby have called the question of whether the stockholder vote approving the merger was uncoerced and fully informed. *See City of Miami Gen. Empls. & San. Empls. Ret. Trust v. Comstock*, 2016 WL 4464156, at *9 (Del. Ch. Aug. 24, 2016).

refused to consider the request" are both material omissions that render the Proxy materially misleading.[61] According to Plaintiffs, the omissions are particularly misleading in light of the Proxy's partial disclosures that (i) an Excluded Party emerged during the Go-Shop Period; (ii) the OM Board negotiated with the Excluded Party; and (iii) the Excluded Party ultimately did not submit a Company Superior Proposal. In Plaintiffs' view, these "partial and incomplete disclosures" misleadingly suggested to OM's stockholders that Advanced's bid was below Apollo's and that Advanced walked away from negotiations when, in fact, the OM Board refused to consider Advanced's request for a time extension.[62]

Plaintiffs point to *Arnold v. Soc'y for Sav. Bancorp, Inc.*,[63] where our Supreme Court recognized that a partial and incomplete disclosure of arguably immaterial information regarding the history of negotiations leading to a merger might result in a materially misleading disclosure if not supplemented with information that would allow the stockholders to draw the complete picture.[64] Against the *Arnold* backdrop, although not conceding the point, Plaintiffs are willing to spot the Defendants their argument that the negotiations with Advanced

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[61] Pls. Opp'n to the Director Defs. Mot. to Dismiss ("Pls. Answering Br.") 46.

[62] *Id.* at 47–48. Oral Arg. Tr. 80 ("The disclosures that we just read give the distinct impression . . . that Advance[d] just walked away, that they weren't interested. And that's demonstrably not true. They were interested. They wanted to continue working, and the board said no.").

[63] 650 A.2d 1270 (Del. 1994).

[64] *Id.* at 1281.

were so tentative and the likelihood of a deal with Advanced was so speculative that any facts relating to an Advanced proposal would be deemed immaterial as a matter of Delaware law.[65] Even so, Plaintiffs argue that once the Proxy "traveled down the road of partial disclosure of the history" of discussions with Advanced, the OM Board was obliged to "provide the stockholders with an accurate, full, and fair characterization of those historic events."[66]

While Plaintiffs' statement on Delaware law regarding partial disclosures is correct as a general matter, it does not quite complete the circle. "The partial disclosure rule is implicated only where the omission of a related fact renders the partially disclosed information *materially* misleading."[67] Even in the partial disclosure context, our Supreme Court's guidance on materiality is still the benchmark. And given the Proxy's discussion of the Advanced overture, with references to defined terms within the Merger Agreement that place the potential proposal in context, I cannot reasonably infer that the absence of the information

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[65] This Court generally will deem as immaterial for disclosure purposes a board's decision to shut down negotiations with a potential acquirer that have not produced an offer worth pursuing. *Simonetti Rollover IRA v. Margolis*, 2008 WL 5048692, at *12 (Del. Ch. June 27, 2008) ("In the usual case, where a board has not received a firm offer or has declined to continue negotiations with a potential acquirer because it has not received an offer worth pursuing, disclosure is not required."). Indeed, "requiring disclosure of every material event that occurred *and* every decision not to pursue another option would make proxy statements so voluminous that they would be practically useless." *In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 736 (Del. Ch. 1999), *aff'd sub nom.*, *Walker v. Lukens, Inc.*, 757 A.2d 1278 (Del. 2000).

[66] *Arnold*, 650 A.2d at 1280.

[67] *Zirn*, 681 A.2d at 1057 (emphasis in original).

Plaintiffs have identified as omitted facts from the Proxy rendered the Proxy materially misleading.

In a section titled "Subsequent Events", which appears after the history of the merger negotiations, the Proxy discloses that "[p]rior to the expiration of the Go-Shop Period, the Board received a written company takeover proposal."[68] Based on this information, the stockholders were aware that a party had come forward during the Go-Shop Period with a proposal that potentially competed with the Apollo offer. The Proxy continues: "[a]fter consulting with its financial advisors and legal counsel, the Board determined that the party submitting the proposal is an excluded party under the Merger Agreement with which the Company may continue to negotiate following the end of the Go-Shop Period until such party ceases to be an excluded party as defined under the Merger Agreement."[69] The term "Excluded Party" is defined in the Merger Agreement as:

> any Person, or group of Persons from whom the Company or any of its Representatives has received, prior to the No-Shop Period Start Date, a Company Takeover Proposal that the Company Board or duly constituted or authorized committee thereof determines, in good faith, prior to or as of the No-Shop Period Start Date and after consultation with its financial advisors and legal counsel, constitutes or could reasonably be expected to lead to a Company Superior Proposal.[70]

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[68] Proxy at 32.

[69] *Id.*

[70] Merger Agmt. §11.2. The Proxy entreats stockholders more than once to "read the entire Merger Agreement carefully." *See, e.g.*, Proxy at 5, 23, 75.

With this information, stockholders knew that, with the help of financial and legal experts, the Board had determined that Advanced was an Excluded Party, meaning that the Board had, in good faith, determined that Advanced's proposal either constituted or could reasonably be expected to lead to a Company Superior Proposal. The term "Company Superior Proposal" is defined in the Merger Agreement as:

> a bona fide, written Company Takeover Proposal . . . (i) that if consummated would result in a third party . . . acquiring, directly or indirectly, (1) more than 50% of the Company Common Stock or (2) assets or businesses of the Company and its Subsidiaries representing more than 90% of the consolidated assets, revenues or net income of the Company and its Subsidiaries . . . that is reasonably capable of being completed as proposed on a timely basis, after taking into account (A) all financial, legal, regulatory and other aspects of such Company Takeover Proposal . . . and (B) the identity of the Person making such Company Takeover Proposal, and (ii) that the Company Board determines in good faith, after consultation with legal counsel and its financial advisor . . . is more favorable to the stockholders of the Company than the Merger.[71]

Based on this information, the stockholders knew that the Excluded Party had submitted a proposal that either was or could lead to a bona fide offer for at least 50% of the common stock or 90% of the Company's assets and that the Board, in good faith, thought the proposal could be more favorable to stockholders than the Apollo offer. The Proxy made clear, however, that

> [t]here can be no assurance that the proposal or any other alternative proposal will ultimately lead to a superior proposal, as negotiations

[71] Merger Agmt. § 11.2

> with the excluded party may not result in a superior proposal and could terminate at any time. The Company does not intend to make any public announcement regarding the negotiations with the excluded party unless such party ceases to be an excluded party or the Board makes a change of recommendation.[72]

The company later announced that the bidder would not be making a superior proposal. This, in turn, allowed stockholders to conclude that for either "financial, legal, or regulatory" reasons, the Board, in good faith, had determined that the offer would not be more favorable to stockholders than the current merger proposal or that it was not "reasonably capable of being completed on a timely basis." Indeed, given that Advanced, a Chinese company, faced unresolved and potentially unresolvable regulatory obstacles to an acquisition of certain of OM's assets that were connected to the United States military, the disclosure that Advanced could not make a "Company Superior Proposal" reflected accurately the OM Board's assessment that Advanced was not able to make a proposal on a "timely basis" that was "reasonably capable of being completed" from a "regulatory" perspective. There was no material omission and no materially misleading partial disclosure.[73]

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[72] Proxy at 32.

[73] *Globis P'rs, L.P. v. Plumtree Software, Inc.*, 2007 WL 4292024, at *12 (Del. Ch. Nov. 30, 2007) ("[A] reasonable line has to be drawn or else disclosures in proxy solicitations will become so detailed and voluminous that they will no longer serve their purpose." (alteration in original) (internal quotation marks omitted)); *Dent v. Ramtron Int'l Corp.*, 2014 WL 2931180, at *15 (Del. Ch. June 30, 2014) ("Delaware law does not require management 'to discuss the panoply of possible alternatives to the course of

Plaintiffs also suggest that the OM Board made the wrong call when it determined that the Advanced overture was not worth pursuing after designating Advanced an "Excluded Party" during the Go-Shop Period.[74] A similar argument was raised and rejected in *City of Miami General Employers' and Sanitation Employees' Retirement Trust v. Comstock*.[75] There, Chancellor Bouchard concluded that the plaintiff's disclosure claim boiled down to an argument that plaintiff disagreed with a Special Committee's decision not to pursue another acquisition proposal and that other "stockholders should have been informed about the offer in case they, too, disagreed with the Special Committee."[76] The Chancellor noted that the Board was "not obliged to [make such a disclosure] under Delaware law, which does not require disclosing details about other offers

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action it is proposing,' in part because 'stockholders have a veto power over fundamental corporate changes (such as a merger) but entrust management with evaluating the alternatives and deciding which fundamental changes to propose.'") (internal quotation marks omitted).

[74] Oral Arg. Tr. 82–83 ("[T]he mere fact of telling stockholders that this other potential superior bid is out there, 'I said no to extend the time because I thought I wasn't allowed to,' might cause them to vote down the deal and allow that extra time. That's within the discretion of the shareholders. For them to say, 'Well, I'm not going to tell you because you might get confused and vote against this transaction,' that's precisely why they should have explained it to them and let the shareholders make an informed vote.").

[75] 2016 WL 4464156 (Del. Ch. Aug. 24, 2016).

[76] *Id.* at *15.

that directors conclude are not worth pursuing."[77] The same is true for the OM Board.[78]

2. Demetriou's Conflicts of Interest

Plaintiffs next allege that the Proxy's failure to inform OM stockholders that "(i) Demetriou was Chairman and CEO of a company partially owned by Apollo; and (ii) . . . Demetriou met with Apollo during the sales process" constitute material omissions. To be sure, stockholders of Delaware corporations are "entitled to know that certain of their fiduciaries [have] a self-interest that [is] arguably in conflict with their own, and the omission of [that] fact [is] material."[79]

As in all matters of public disclosure, materiality is the touchstone of the board's disclosure duty. This is true with respect to the disclosure of director conflicts.[80] And not every fact tending remotely to suggest that a board member's interest might differ in some respect from that of the stockholders amounts to a material omission.[81] Plaintiffs must allege facts from which the Court may

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[77] *Id.*

[78] *Simonetti Rollover IRA*, 2008 WL 5048692, at *12.

[79] *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1061 (Del. Ch. 1987).

[80] *See Weinberger v. Rio Grande Indus., Inc.*, 519 A.2d 116, 122-23 (Del. Ch. 1986) (dismissing disclosure claims regarding director conflicts on summary judgment because alleged omissions not material as a matter of law).

[81] *Id*.

reasonably infer that "there is a substantial likelihood that a reasonable shareholder would consider [the omission] important in deciding how to vote."[82]

The Complaint alleges no facts from which I can reasonably infer that the omitted facts relating to Demetrious' connection to Apollo reflect an actual conflict or are otherwise material. The Complaint alleges: (1) Demetriou was the CEO of Aleris; (2) Apollo (through its affiliates) owns 18.99% of Aleris as part of an investment group; and (3) on December 1, 2014, Demetriou had lunch with "Matthew Michelini, a key employee in Apollo's metals group."[83] Other than conclusory assertions of conflict, however, the Complaint pleads no facts that would allow a reasonable inference that a single lunch meeting between an Apollo employee and an executive of a company in which Apollo and its affiliates have an ownership stake would somehow compromise Demetriou's independence or otherwise be material to a reasonable investor.[84]

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[82] *Rosenblatt*, 493 A.2d at 944 (quoting *TSC Indus., Inc.*, 426 U.S. at 449).

[83] Compl. ¶ 109.

[84] *See In re CompuCom Sys., Inc. S'holders Litig.*, 2005 WL 2481325, at *9 (Del. Ch. Sept. 29, 2005) (conclusory allegations of director conflict not sufficient). Plaintiffs do not cite a single case, and I am aware of none, in which a remote potential conflict of a single fiduciary was deemed *per se* material. In all of the cases cited by the Plaintiffs for the proposition that stockholders have the right to full disclosure of potential conflicts, the undisclosed potential conflict occurred in factual scenarios in which the directors had either an undisclosed financial interest directly adverse to stockholders or in which there were reasons to believe that a director with an undisclosed conflict had actual or potential influence over other members of the Board. Pls. Answering Br. 49–50. *See, Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051 (Del. Ch. 1987) (holding that an Offer to Purchase used for a self-tender offer contained material omissions because, among other

Notably, Plaintiffs do not allege that Apollo controlled or even influenced Demetriou or that Demetriou controlled or had undue influence over any other members of the OM Board. Plaintiffs' conclusory allegation that "Demetriou was influenced to support the Transaction" due to his "pre-existing relationship with OM's counterparty Apollo"[85] does not make it reasonably conceivable that this information should have been inserted in the Proxy or, if it was included, that it would have changed the total mix of information available to investors or would be important to a reasonable investor in deciding how to vote her shares. Thus, even if Plaintiffs' conclusory allegations regarding Demetriou's conflict were deemed factual and true, without even the slightest indication much less allegation that Demetriou could exercise undue influence over the other indisputably independent

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deficiencies, it failed to disclose that half of the directors, as holders of significant amounts of common stock, had a direct financial conflict of interest with preferred stockholders); *In re Lear Corp. S'holder Litig.*, 926 A.2d 94 (Del. Ch. 2007) (holding that a proxy statement contained material omissions because it failed to disclose a CEO, the negotiator singularly employed by the board to obtain the best price for the stockholders, had an acute liquidity need which could rationally lead him to favor a deal at a less than optimal price); *Millenco L.P. v. meVC Draper Fisher Jurvetson Fund I, Inc.*, 824 A.2d 11 (Del. Ch. 2002) (holding that it is material for stockholders to know the interconnected relationships of independent and insider directors when the insider director has *de jure* and *de facto* control over the independent directors at another entity); *In re Orchard Enterprises, Inc. S'holder Litig.*, 88 A.3d 1 (Del. Ch. 2014) (holding that genuine issue of material fact as to whether proxy statement's disclosures about negotiating committee chairman's relationship with controlling stockholder were inaccurate or misleading precluded summary judgment).

[85] Compl. ¶ 109.

members of the OM Board, I cannot accept Plaintiffs' contention that the omission of facts relating to the Demetriou "conflict" was material.[86]

3. Deutsche Bank Conflicts

Plaintiffs' final argument to challenge the cleansing effect of the stockholder vote is that the stockholders were uninformed regarding material aspects of the OM Board's engagement of Deutsche Bank. Specifically, they allege that the Proxy misled OM stockholders in two material respects: (1) the Proxy failed to disclose that the OM Board did not discover the precise amount fees paid by Apollo to Deutsche Bank until the day the OM Board approved the merger; and (2) the Proxy failed to disclose that the OM Board initially contemplated hiring Deutsche Bank on a flat fee basis but then inexplicably converted the engagement to a contingency fee arrangement.

"Because of the central role played by investment banks in the evaluation, exploration, selection, and implementation of strategic alternatives, this Court has required full disclosure of investment banker compensation and potential conflicts."[87] It is important that stockholders "understand what factors might

[86] I note that Plaintiffs deposed Demetriou in aid of their motion for preliminary injunction and cited frequently to his deposition transcript throughout their Complaint. If there was a factual basis to allege that Demetriou controlled other members of the OM Board, Plaintiffs certainly would have pled those facts.

[87] *Del Monte*, 25 A.3d at 832.

influence the financial advisor's analytical efforts."[88] Here, the Proxy thoroughly and accurately disclosed the terms under which Deutsche Bank was engaged by the Board to provide investment banking advice and the extent to which Deutsche Bank had previously provided services to Apollo and Platform.

With respect to the terms and circumstances of Deutsche Bank's engagement, the Proxy disclosed that Deutsche Bank would be paid $1.5 million upon delivery of a fairness opinion and that payment of the balance of the fee was contingent upon consummation of the merger.[89] The Proxy also disclosed that "more than €140 million in fees [had been paid to Deutsche Bank] from Apollo" since January 1, 2013.[90] In this regard, stockholders were advised that the OM Board knew upon Deutsche Bank's engagement that it "had an ongoing relationship with Apollo and its affiliated funds and had received *significant fees*

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[88] *David P. Simonetti Rollover IRA*, 2008 WL 5048692, at *8.

[89] Specifically, the Proxy states that

> [p]ursuant to an engagement letter between OM Group and Deutsche Bank, dated February 4, 2015, OM Group has agreed to pay Deutsche Bank a fee estimated to be approximately $5.32 million for its services as financial advisor to the non-executive members of the Board in connection with the merger, of which $1,500,000 became payable upon delivery of its opinion (or would have become payable if Deutsche Bank had advised the Board that it was unable to render its opinion) and the remainder of which is contingent upon consummation of the merger.

Proxy at 47.

[90] *Id.* at 47–48.

from Apollo and its affiliates for a variety of investment and commercial banking services over the prior three years."[91]

With these disclosures in hand, OM stockholders knew precisely the amount and circumstances under which Deutsche Bank would be paid for its services. And they knew that the OM Board was aware that Deutsche Bank had received "significant fees" from Apollo at the time the OM Board agreed to the engagement. It is not reasonably conceivable that stockholders would have found the timing of the OM Board's discovery that "significant fees" means "€140 million" to be important in deciding whether to vote to approve the merger.[92]

Plaintiffs' argument that the Proxy materially omitted that the OM Board altered the compensation arrangement with Deutsche Bank from fixed fee to contingency fee fares no better. While Plaintiffs have correctly recited that our law "require[s] full disclosure of investment banker compensation and potential conflicts"[93] so that "stockholders [can] understand what factors might influence the

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[91] *Id.* at 25 (emphasis added).

[92] Such a disclosure would add little, if anything, to the total mix of information available to stockholders and, at best, might tend to expose the OM Board to a potential claim for breach of the duty of care. Yet it is well settled that "a board is not required to engage in 'self-flagellation' and draw legal conclusions implicating itself in a breach of fiduciary duty from surrounding facts and circumstances prior to a formal adjudication of the matter." *Stroud*, 606 A.2d 75, 84 n.1 (Del. 1992).

[93] *Del Monte*, 25 A.3d at 832.

financial advisor's analytical efforts,"[94] they have failed to articulate in what manner the Proxy materially missed this mark. The OM stockholders were fully apprised of Deutsche Bank's past work with Apollo and of the contingent nature of its engagement by the OM Board. They were not misled as to Deutsche Bank's incentives. To the extent Plaintiffs are arguing that the evolution of the OM Board's thinking regarding the terms by which Deutsche Bank would be engaged should have been disclosed, this is precisely the sort of "'play-by-play' information that this Court repeatedly has eschewed requiring companies to disclose."[95]

Plaintiffs have not well-pled facts that allow me to conclude it is reasonably conceivable that any of the omissions regarding Deutsche Bank would have significantly altered the total mix of information available to OM's stockholders or that a reasonable investor would have considered this information important in deciding how to vote on the proposed merger.[96] Consequently, Plaintiffs' allegations regarding Deutsche Bank fail to state a disclosure claim and fail to undermine the cleansing effect of stockholder approval.

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[94] *David P. Simonetti Rollover IRA*, 2008 WL 5048692, at *8.

[95] *Dent v. Ramtron Int'l Corp.*, 2014 WL 2931180, at *15 (Del. Ch. June 30, 2014). *See also In re Sauer-Danfoss Inc. S'holders Litig.*, 65 A.3d 1116, 1130 (Del. Ch. 2011) (holding that the board's "underlying reasons for acting" generally not deemed material); *Newman v. Warren*, 684 A.2d 1239, 1246 (Del. Ch. 1996) ("asking why a fiduciary took a certain action does not state a meritorious disclosure claim.").

[96] *Abrons*, 911 A.2d at 813.

D. The Business Judgment Rule Applies

Having determined that a majority of the disinterested, uncoerced and fully informed OM stockholders approved the merger, it follows that the standard of review will shift from enhanced scrutiny to the business judgment rule.[97] And, '[w]hen the business judgment rule standard of review is invoked because of a vote, dismissal typically is the result."[98] As Plaintiffs have not alleged or argued that the merger amounted to waste, they cannot overcome the presumption of the business judgment rule.[99]

III. CONCLUSION

The OM stockholders' fully informed, disinterested and uncoerced approval of the Merger Agreement cleansed any failure of the OM Board to act reasonably to seek the transaction offering the best value reasonably available. Consequently, the motion to dismiss the Complaint must be GRANTED.

IT IS SO ORDERED.

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[97] *Corwin,* 125 A.3d at 308–312; *Volcano*, 2016 WL 3626521, at *11 (a transaction approved by a fully informed vote of the majority of a company's disinterested, uncoerced stockholders irrebuttably invokes the business judgment rule and "can [only] be challenged on the basis that it constituted waste.").

[98] *Singh v. Attenborough*, 137 A.3d 151, 152 (Del. 2016) (ORDER).

[99] *Id.*

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

CHESTER COUNTY EMPLOYEES' RETIREMENT FUND,	)	
Plaintiff,	)	
v.	)	C.A. No. 11058-VCMR
NEW RESIDENTIAL INVESTMENT CORP., WESLEY R. EDENS, MICHAEL NIERENBERG, ALAN L. TYSON, DAVID SALTZMAN, KEVIN J. FINNERTY, DOUGLAS L. JACOBS, FIG LLC, FORTRESS INVESTMENT GROUP LLC and FORTRESS OPERATING ENTITY I LP,	)	
Defendants.	)	

MEMORANDUM OPINION

Date Submitted: July 14, 2016
Date Decided: October 7, 2016

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Robert S. Saunders, Ronald N. Brown, III, and Sarah R. Martin, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, Wilmington, Delaware; Scott D. Musoff, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, New York, New York; *Attorneys for Defendants.*

MONTGOMERY-REEVES, Vice Chancellor.

In this action, a stockholder of New Residential Corp. ("New Residential") asserts direct and derivative breach of fiduciary duty claims against the members of the New Residential board of directors, New Residential's manager FIG LLC ("FIG"), FIG's owner Fortress Operating Entity I LP ("FOE I"), and Fortress Investment Group LLC ("Fortress"), which allegedly controls New Residential, FIG, and FOE I. Plaintiff alleges that the Defendants caused New Residential to overpay for the assets of Home Loan Servicing Solutions, Ltd. ("HLSS") in order to advantage other real estate assets of Fortress and to maximize management fees, incentive compensation, and stock option awards to Fortress and its affiliates.

Plaintiff also seeks a declaratory judgment that certain limitations on the fiduciary duties of Fortress affiliates in the New Residential certificate of incorporation and limitations on FIG's liability in the New Residential management agreement are not valid defenses in this case. Similarly, Plaintiff seeks a declaratory judgment that a termination agreement between HLSS and New Residential purporting to release all New Residential stockholder claims against HLSS is not a valid defense in this action.

Defendants move to dismiss this complaint under Court of Chancery Rules 23.1 and 12(b)(6). Defendants argue that all of Plaintiff's claims are derivative because they amount to claims for corporate overpayment. Defendants contend that a majority of the New Residential board is disinterested and independent, and

that even if a majority of the board is beholden to Fortress, Fortress is not interested in the underlying transactions. Defendants also argue that the complaint should be dismissed as to Fortress, FOE I, and FIG because they do not owe fiduciary duties to New Residential. As to the declaratory judgment claims, Defendants contend that Plaintiff's claims are not ripe because Defendants have not raised the certificate of incorporation, management agreement, or termination agreement as defenses.

In this Memorandum Opinion, I hold that the facts alleged give rise to a derivative claim. Plaintiff, however, has not pled particularized facts sufficient to infer that Fortress has a material interest in the challenged transactions. As a result, demand is not excused for the HLSS asset purchase and the ancillary transactions challenged in the complaint. Further, I hold that only the facial challenge to the New Residential certificate of incorporation is ripe for judicial review.

I. BACKGROUND

The facts outlined in this opinion derive from Plaintiff's Amended and Supplemented Verified Class Action and Derivative Complaint (the "Complaint" or "Amended Complaint") and the documents it incorporates by reference.[1]

[1] *In re Morton's Rest. Gp., Inc. S'holders Litig.*, 74 A.3d 656, 659 n.3 (Del. Ch. 2013) ("To be incorporated by reference, the complaint must make a clear, definite

A. Parties and Relevant Non-Parties

Plaintiff Chester County Employees' Retirement Fund is a stockholder of New Residential.

Nominal defendant New Residential is a publically traded Real Estate Investment Trust ("REIT") that primarily invests in and manages residential real estate, including excess mortgage servicing rights and residential mortgage-backed securities. Newcastle Investment Corp. ("Newcastle") formed New Residential as a wholly owned subsidiary and spun it off to Newcastle stockholders on May 15, 2013. New Residential is a "permanent capital vehicle" in the Fortress web of companies.[2] New Residential stock trades on the New York Stock Exchange under the symbol NRZ.

Defendant FIG managed New Residential pursuant to the Second Amended and Restated Management and Advisory Agreement, dated August 5, 2014, (the "Management Agreement") at the time of the challenged transactions.[3] All New Residential officers and employees are FIG employees. Defendant FOE I is the

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and substantial reference to the documents." (quoting *DeLuca v. AccessIT Gp., Inc.*, 695 F. Supp. 2d 54, 60 (S.D.N.Y. 2010)) (internal quotation marks omitted)).

[2] Compl. ¶ 13.

[3] After the HLSS transactions, FIG and New Residential executed the Third Amended and Restated Management and Advisory Agreement.

sole managing member of FIG. FIG Corp., is the general partner of FOE I. Defendant Fortress allegedly owns 100% of the stock of FIG Corp.[4]

Fortress managed $67.5 billion in assets as of December 31, 2014. As of that date, Fortress and its affiliates and principals together owned 2.4 million New Residential shares and 8.9 million options for New Residential shares, amounting to 7.4% of the common shares on a fully diluted basis.[5]

Nationstar Mortgage Holdings, Inc. ("Nationstar") and Springleaf Holdings, Inc. ("Springleaf") are companies in which Fortress indirectly owns majority equity stakes. Fortress affiliates own 74.7% of Nationstar and 85.3% of Springleaf Financial Holdings LLC. Springleaf Financial Holdings LLC owns 74.8% of the equity of Springleaf.[6]

HLSS is a publicly traded company that owns mortgage-servicing rights ("MSRs"), which are rights to fees from servicing mortgage loans, and Excess MSRs, which are rights to fees on mortgages serviced by another party. Plaintiff alleges that Ocwen Financial Corp. ("Ocwen") is the servicer on the underlying

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[4] Compl. ¶¶ 40, 42.

[5] *Id.* ¶ 52.

[6] *Id.* ¶¶ 87, 94.

loans for many HLSS Excess MSRs, and if Ocwen were terminated as the servicer, HLSS has the potential to lose the value of its Excess MSRs.[7]

Defendants Wesley R. Edens, Kevin J. Finnerty, Douglas L. Jacobs, Michael Nierenberg, David Saltzman, and Alan L. Tyson are New Residential directors. Edens is a founder, principal, and co-chairman of Fortress. He is responsible for the private equity and publically traded alternative investment business of Fortress. Edens owns about 23.2% of the Fortress Class A shares and about 27.9% of the Fortress Class B shares. In 2014, Edens received $4,022,668 in compensation from Fortress, and he received distributions of $48,518,051 from Fortress private equity funds. Edens is a beneficial owner of FOE I. Edens also is a director of FIG and numerous other Fortress entities.[8]

Finnerty serves as both a New Residential director and a Newcastle director. Finnerty received $125,009 in compensation from New Residential and $125,000 in compensation from Newcastle in 2014. In 2009, Finnerty received a $500,000 personal loan from Edens and a $500,000 personal loan from Randal A. Nardone, another Fortress principal. Plaintiff alleges that the loans have been listed in every

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[7] *Id.* ¶¶ 97, 103.

[8] *Id.* ¶¶ 15, 17, 18. The Complaint does not identify other beneficial owners of FOE I.

Newcastle proxy statement from 2010 through 2015, indicating that they have not been repaid.[9]

Jacobs is a New Residential director and has been a Fortress director since 2007. He also has been a director of Springleaf since 2010. Before becoming a Fortress director in 2007, Jacobs was the CEO and chairman of the board of Global Signal, Inc. (another Fortress affiliate) from 2004 to 2007. In 2014, from his directorships, Jacobs received $135,004 from New Residential, $239,999 from Fortress, and $80,000 from Springleaf.[10]

Nierenberg has been both a director and the CEO of New Residential since November 2013. Because FIG manages New Residential, FIG employs Nierenberg as the New Residential CEO. Nierenberg also is a Managing Director at Fortress and is paid as a Fortress employee. Part of his compensation includes "tandem awards" of options for New Residential stock under the New Residential Nonqualified Stock Option and Incentive Award Plan, adopted April 29, 2013 (the "Stock Options Plan").[11]

Saltzman is a New Residential director. He also is the Executive Director of the Robin Hood Foundation, a charitable organization. The Complaint alleges that

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[9] *Id.* ¶¶ 19-20, 23.

[10] *Id.* ¶¶ 25-28.

[11] *Id.* ¶¶ 35-36; Stock Options Plan § 5.5(c).

Michael Novogratz, one of the four Fortress principals, is a significant donor to the foundation. For his services as a New Residential director, Saltzman received $125,004 in 2014.[12]

Tyson is a New Residential director and a Newcastle director. In 2014, Tyson received $125,009 for his services as a New Residential director and $135,000 for his services as a Newcastle director.[13]

B. Facts

1. FIG Management Agreement

Before New Residential's acquisition of the HLSS assets, FIG managed the New Residential business pursuant to the Management Agreement. FIG or its assignees received two types of compensation from New Residential under the Management Agreement: a management fee and incentive compensation. Every year, FIG was entitled to a management fee of 1.5% of New Residential's paid-in capital (adjusted to include equity capital of any New Residential subsidiaries), paid in monthly installments (the "Management Fee").[14] In addition to the

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[12] Compl. ¶ 32-33.

[13] *Id.* ¶ 37-38.

[14] Management Agreement § 8(a) ("During the term of this Agreement . . . the Manager will receive an annual management fee (the 'Management Fee') equal to 1.50% of the Company's 'Gross Equity.' The Management Fee shall be calculated and paid monthly in arrears . . . ." Gross Equity means "(A) the sum of (i) the 'Total Equity,' plus (ii) the value of contributions made by partners other

Management Fee, FIG or its assignees were entitled to incentive compensation under the Management Agreement. The incentive compensation was essentially 25% of New Residential income above a 10% annual return.[15] Plaintiff argues that many mortgage REITs pay no incentive compensation or much lower incentive compensation than New Residential. The Complaint alleges that the original negotiation of the Management Agreement was a self-dealing transaction not conducted at arm's length.[16]

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than the Company, from time to time, to the capital of any Subsidiary . . . , less (B) any capital dividends or capital distributions made by the Company to its stockholders or, without duplication, by any Subsidiary to its stockholders, partners or other equity holders. As used herein, the term 'Total Equity' shall mean (i) the equity transferred by Newcastle Investment Corp. on the Distribution Date, plus (ii) the total net proceeds to the Company from any common or preferred equity capital heretofore or hereafter raised by the Company or any Subsidiary of the Company . . . .").

[15] *Id.* § 8(e) (granting FIG a right to incentive compensation in "an amount equal to the product of (A) 25% of the dollar amount by which (1)(a) the Funds from Operations . . . of the Company, excluding Funds from Operations from Investments in . . . Consumer Loan Companies and any unrealized gains or losses from mark-to-market valuation changes on investments and debt . . . , per REIT Share . . . , plus (b) earnings (or losses) from [certain asset classes, including Consumer Loan Companies, calculated with special accounting treatment] . . . per REIT Share . . . , exceed (2) an amount equal to (a) the weighted average of the book value per REIT Share . . . multiplied by (b) a simple interest rate of ten percent (10%) per annum multiplied by (B) the weighted average number of REIT Shares outstanding during such period.").

[16] Compl. ¶¶ 40, 86.

2. New Residential Stock Options Plan

The New Residential Stock Options Plan allows the New Residential board or a committee of the board to grant stock option awards.[17] The plan states that the committee responsible for administering the plan may grant FIG—or its assignees under the Management Agreement—New Residential stock options as compensation for raising New Residential equity. Section 5.5(a) of the plan states as follows:

> As consideration for the Manager's role in raising capital for the Company, the Manager may be awarded Stock Options in connection with any equity issuance by the Company, to acquire that number of shares of Stock up to ten percent (10%) of the equity securities issued by the Company in such equity issuance . . . .[18]

The committee also may grant FIG additional options outside the context of an equity issuance in its discretion.[19] FOE I allegedly holds the options for New Residential stock that have been granted to FIG under the Stock Options Plan.[20]

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17 Stock Options Plan § 3.1 ("The maximum number of shares of Stock reserved and available for issuance under the Plan shall be 30,000,000, as increased during the term of the Plan on the first day of each fiscal year beginning in and after calendar year 2014 by the number of shares of Stock equal to 10% of the number of shares of Stock newly issued by the Company during the immediately preceding fiscal year . . . .").

18 *Id.* § 5.5(a).

19 *Id.* § 5.5(f) ("The Committee may, from time to time, grant such Awards to the Manager as the Committee deems advisable in order to provide additional incentive to the Manager to enhance the value of the Company's Stock; provided, however, that no Award shall be awarded to the Manager (or its designee) in

3. The Initial HLSS Merger

On February 22, 2015, New Residential entered into an Agreement and Plan of Merger (the "Initial Merger Agreement") to acquire all 71 million outstanding HLSS shares for $18.25 per share in cash, or a total of approximately $1.3 billion.[21] The Initial Merger Agreement contained a representation that HLSS had made all required SEC filings as of the date of the closing, and New Residential retained the right to terminate the Initial Merger Agreement if HLSS breached that representation. On March 17, 2015, HLSS filed a form 8-K stating that it could not file a form 10-K because it needed to prepare information related to its ability to operate as a going concern. On March 18, 2015, NASDAQ notified HLSS that it was not compliant with the NASDAQ listing requirements due to HLSS's failure to file a form 10-K. On March 23, 2015, HLSS received a subpoena from the SEC regarding communications with certain investment advisors and hedge funds. In mid-March 2015, HLSS and New Residential began negotiating an alternative

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connection with any equity issuance by the Company which provides for the acquisition of a number of equity securities in excess of ten percent (10%) of the maximum number of equity securities then being proposed to be issued by the Company.").

[20] Compl. ¶ 42.

[21] *Id.* ¶ 114; Agreement and Plan of Merger among Home Loan Servicing Solutions, Ltd., New Residential Investment Corp., and Hexagon Merger Sub, Ltd. § 2.01(c) (Feb. 22, 2015).

agreement, and on April 6, 2015, the two parties entered into a Termination Agreement releasing all claims under the Initial Merger Agreement, including New Residential stockholder claims (the "Termination Agreement").[22]

4. The HLSS Acquisition and Related Transactions

On April 6, 2015, New Residential agreed to purchase substantially all of the HLSS assets and assume all HLSS liabilities except a term loan, which was paid off, and approximately $50 million in post-closing liabilities. Under the asset purchase agreement, New Residential paid approximately $1.007 billion in cash and 28,286,980 shares of New Residential common stock as consideration. The total purchase price for the HLSS assets equaled approximately $1,441,200,000. The asset acquisition closed simultaneously with the signing of the asset purchase agreement. HLSS planned to sell the New Residential stock received as consideration in a public offering "as soon as practicable" after the asset purchase. HLSS would then merge into a New Residential subsidiary, and New Residential would pay an additional $50 million in cash to HLSS stockholders in the merger.[23]

In order to help fund the HLSS acquisition, New Residential conducted two public offerings in April and June of 2015. In an offering that closed on April 13,

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[22] Compl. ¶¶ 115-16.

[23] *Id.* ¶¶ 117-21 (citing New Residential 10-Q for the Quarter Ended June 30, 2015 (Aug. 10, 2015)).

2015, HLSS sold the 28,286,980 New Residential shares it had received as consideration. New Residential sold an additional 29,213,020 shares to the public for $15.25 per share. In a June offering, New Residential sold $444 million worth shares at $15.88 per share. FOE I and certain FIG employees sold New Residential shares worth $56 million at the same time.[24]

The stock issued to fund the HLSS acquisition increased the New Residential paid-in equity capital account. As a result, the Stock Options Plan authorized New Residential to issue options awards to FOE I (presumably through FIG) in an amount equal to 10% of the shares New Residential issued. FIG also became entitled to a greater Management Fee equal to 1.5% of any new equity raised. FOE I received 2,828,698 options in connection with New Residential's stock issuance to HLSS as consideration for its assets, 2,921,302 options in connection with the April offering, and 2,793,593 options in connection with the June offering, totaling approximately 8.54 million options for New Residential stock. As to the Management Fee, the Complaint alleges that FIG's annual Management Fee increased from $19.7 million to $26.1 million, a $6.5 million

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[24] *Id.* ¶¶ 123-25 (citing New Residential Prospectus Supplement (April 10, 2015)). The Complaint alleges that the $15.25 price per share was below market because on April 6, 2015, New Residential stock traded between $15.29 per share and $15.43 per share. The stock price closed at $15.95 on April 10, 2015, and closed at $16.07 on April 13, 2015, the next trading day.

increase, as a direct result of the stock issued to HLSS in the asset purchase. The Complaint does not enumerate the increase in fees, if any, that resulted from the public offerings.[25]

Plaintiff alleges that certain New Residential actions made the HLSS acquisition even more favorable for Fortress. On April 8, 2015, New Residential recharacterized certain income from HLSS servicer advances from an increase in fair market value to interest income. The change increased New Residential's pro forma interest income from $524.2 million to $695.1 million. As a result of the recharacterization, FIG's incentive compensation increased from $34.5 million to $78.3 million.[26]

Plaintiff also alleges that after the HLSS acquisition, on May 7, 2015, New Residential and FIG renegotiated the Management Agreement and agreed to the Third Amended and Restated Management and Advisory Agreement (the "Renegotiated Agreement"). The Renegotiated Agreement retroactively changed the amortization of non-routine expenses in calculating FIG's incentive

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[25] Compl. ¶¶ 123-24, 128, 131. The April options had a strike price of $15.25 per share, and the June options had a strike price of $15.88 per share.

[26] *Id.* ¶ 135.

compensation, which led to a $3.3 million increase in FIG's 2015 incentive compensation.[27]

5. The HLSS Acquisition Aftermath

Plaintiff alleges that New Residential overpaid for HLSS given the highly risky state of the HLSS business and certain HLSS liabilities that New Residential assumed. Several months before the HLSS acquisition on September 15, 2014, the SEC initiated an investigation into HLSS's restatement of its financial statements. HLSS agreed to a cease and desist order and a $1.5 million settlement payment. New Residential agreed to pay the $1.5 million payment in the HLSS acquisition. Then on September 29, 2015, Standard & Poor's Rating Services downgraded Ocwen's master service rating to Below Average. The downgrade triggered a default under the indenture for $2.525 billion of notes issued by HLSS Servicer Advance Receivables Trust. As a result, New Residential was required to repay in full the $2.525 billion of notes.[28]

6. Limitations on Fiduciary Duties Owed to New Residential

Plaintiff alleges that article twelfth of the New Residential certificate of incorporation eliminates any fiduciary duties of Fortress affiliates, directors,

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[27] *Id.* ¶ 137-38.

[28] *Id.* ¶¶ 139-41. HLSS Servicer Advance Receivables Trust is allegedly owned by New Residential. The Complaint does not specify whether it was acquired along with the other HLSS assets.

officers, or employees, including those who serve as directors of New Residential. Specifically, the article eliminates any duty that such Fortress parties may have to present corporate opportunities to New Residential or to refrain from competing with New Residential. It further provides that any transaction between New Residential and Fortress or its affiliates, "except as otherwise required by law," shall not be considered to breach any fiduciary duty that the Fortress affiliates may owe to New Residential.[29]

The Management Agreement purports to limit FIG, FOE I, and FIG employees' liability to New Residential.[30] "The Manager assumes no responsibility under this Agreement other than to render the services called for under this Agreement in good faith and shall not be responsible for any action of the Board of Directors in following or declining to follow any advice or recommendations of the Manager . . . ."[31] Additionally, "[t]he Manager, its members, managers, officers and employees will not be liable to the Company or

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29 *Id.* ¶ 78; Amended and Restated Certificate of Incorporation of New Residential Investment Corp., art. twelfth(c), (d), (e) (Apr. 29, 2013).

30 Compl. ¶ 171; Management Agreement § 7(b) ("[T]he Manager, its directors, officers, stockholders and employees shall not be liable to the Company or any Subsidiary, the Board of Directors, or the Company's or any Subsidiary's stockholders or partners for any act or omission by the Manager, its directors, officers, stockholders or employees except as provided in Section 11 of this Agreement.").

31 Management Agreement § 11(a).

any Subsidiary, to the Board of Directors, or the Company's or any Subsidiary's stockholders or partners for any acts or omissions by the Manager, its members, managers, officers or employees," except for "acts constituting bad faith, willful misconduct, gross negligence or reckless disregard of the Manager's duties under this Agreement."[32]

C. Procedural History

Plaintiff filed its original complaint in this case on May 22, 2015 and the Amended Complaint on October 30, 2015. On December 11, 2015, Defendants filed a motion to dismiss the Amended Complaint. Plaintiff responded to the motion on February 23, 2016, and Defendants filed a reply brief on April 1, 2016. The parties presented oral argument on June 14, 2016. This opinion addresses Defendants' motion to dismiss.

II. ANALYSIS

A. Count I States a Derivative Claim

In Count I, Plaintiff alleges that Defendants breached their fiduciary duties by overpaying for the HLSS assets with stock and issuing options for New Residential shares to Defendant FOE I. Plaintiff argues that this states a direct claim because the equity value and voting power of Plaintiff's shares were reduced through the transactions. Defendants respond that any dilution Plaintiff suffered

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[32] *Id.* § 11(a).

was the unavoidable accounting result of a transaction with a third party that allegedly injured New Residential, and thus, the claim must be derivative.

Stockholders of Delaware corporations can sue directly for injuries they have incurred in their individual capacities as stockholders. Stockholders of Delaware corporations also can sue derivatively on behalf of a corporation in which they own shares if the requirements of Court of Chancery Rule 23.1 have been satisfied. Because of the additional standing requirements in Rule 23.1 for derivative claims, plaintiffs and defendants often contest whether a claim is direct or derivative, and the court must make its own determination of the suit's classification.[33]

In *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, the Delaware Supreme Court held that "the law to be applied henceforth in determining whether a stockholder's claim is derivative or direct" turns "solely on the following questions: (1) who suffered the alleged harm (the corporation or the suing

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[33] *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1035 (Del. 2004) ("The Court of Chancery correctly noted that '[t]he Court will independently examine the nature of the wrong alleged and any potential relief to make its own determination of the suit's classification. . . . Plaintiffs' classification of the suit is not binding.'") (quoting *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 2003 WL 203060, at *3 (Del. Ch. Jan. 21, 2003)).

stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)."[34]

In *Gentile v. Rossette*, the Supreme Court held that "[i]n the typical corporate overpayment case, a claim against the corporation's fiduciaries for redress is regarded as exclusively derivative, irrespective of whether the currency or form of overpayment is cash or the corporation's stock."[35] Such claims normally are derivative "because any dilution in value of the corporation's stock is merely the unavoidable result (from an accounting standpoint) of the reduction in the value of the entire corporate entity . . . ."[36] But a corporate overpayment case may result in both a direct and a derivative claim when:

> (1) a stockholder having majority or effective control causes the corporation to issue 'excessive' shares of its stock in exchange for assets of the controlling stockholder that have a lesser value; and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling stockholder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders."[37]

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[34] *Id.* at 1033.

[35] 906 A.2d 91, 99 (Del. 2006) (footnote omitted).

[36] *Gentile*, 906 A.2d at 99.

[37] *Id.* at 99-100.

Public stockholders need not be reduced from a control position to a minority position to have both direct and derivative claims.[38]

There is some tension in recent cases about how far to extend *Gentile*. In *Feldman v. Cutaia*, the Court of Chancery emphasized the limited reach of *Gentile*.[39] The Court in *Feldman* stated that for a transaction between a corporation and a third party to give rise to a direct claim, the corporation must have a controlling stockholder that used its controlling position to orchestrate the transaction.[40] The Court believed that limiting the reach of *Gentile* was necessary

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38 *Id.* at 101; *see also In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 766, 774–75 (Del. 2006) (quoting *In re Paxon Commc'n Corp. S'holder Litig.*, 2001 WL 812028, at *5 (Del. Ch. July 12, 2001) ("[D]ilution claims are individual in nature only where a significant stockholder's interest is increased at the sole expense of the minority" and not "'where the entity benefiting from the allegedly diluting transaction . . . is a third party rather than an existing significant or controlling stockholder.'").

39 *Feldman v. Cutaia*, 956 A.2d 644, 657 (Del. Ch. 2007) ("*Gentile* and *Gatz* are predicated on the idea that transactions of this type result in an improper transfer of both economic value and voting power from the minority to the controlling stockholder. Thus, it is clear from those decisions that the Delaware Supreme Court intended to confine the scope of its rulings to only those situations where a controlling stockholder exists. Indeed, any other interpretation would swallow the general rule that equity dilution claims are solely derivative, and would cast great doubt on the continuing vitality of the *Tooley* framework.").

40 *Id.* Plaintiff alleges that Fortress is a controlling stockholder of New Residential. Fortress, together with its affiliates and principals, owned 7.4% of New Residential before the challenged transactions on a fully diluted basis, and Fortress is exempt from New Residential's 9.8% limitation on stock ownership. Fortress allegedly chose the directors on New Residential's initial board and controls the nominating committee. New Residential also has a staggered board, and stockholders are not permitted to call a special meeting or act by written consent.

to avoid "swallow[ing] the general rule that equity dilution claims are solely derivative."[41] The Supreme Court affirmed and stated that "[i]n the absence of a controlling stockholder, 'such equal "injury" to the [company's] shares resulting from a corporate overpayment is not viewed as, or equated with, harm to specific shareholders individually.'"[42]

Conversely, in *Carsanaro v. Bloodhound Technologies, Inc.*, the Court of Chancery held that dilution of economic value through new stock issuances to venture capitalists gave rise to a direct claim, even without a controlling stockholder, because the board was not independent from the venture capitalists.[43] The opinion held that:

> the Delaware Supreme Court's decisions preserve stockholder standing to pursue individual challenges to self-interested stock issuances when the facts alleged support an actionable claim for breach of the duty of loyalty. Standing will exist if a controlling stockholder stood on both sides of the transaction. Standing will also

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Compl. ¶¶ 50-76. I have serious doubts that Fortress exercises control over New Residential in light of *In re KKR Fin. Hldgs. LLC S'holder Litig.*, 101 A.3d 980 (Del. Ch. 2014). I need not decide that issue, however, because I agree with *In re El Paso Pipeline P'rs, L.P. Deriv. Litig.*, 132 A.3d 67 (Del. Ch. 2015) that these claims are subject to Rule 23.1.

[41] *Feldman*, 956 A.2d at 657.

[42] *Feldman v. Cutaia*, 951 A.2d 727, 732 (Del. 2008) (quoting *Gentile*, 906 A.2d at 99).

[43] 65 A.3d 618, 658–59 (Del. Ch. 2013).

> exist if the board that effectuated the transaction lacked a disinterested and independent majority.[44]

The Court recognized that prohibiting direct stockholder claims would be inequitable when strong derivative claims would be extinguished by a merger.[45]

The Court of Chancery in *In re El Paso Pipeline Partners, L.P. Derivative Litigation* reiterated a broader view of dual-natured claims but explained that different considerations apply when this question arises in the context of a Rule 23.1 motion to dismiss versus a determination of whether investors can continue to pursue claims after a merger. The Court specifically stated as follows:

> In my view, Delaware law can and should treat a dual-natured claim as derivative for purposes of Rule 23.1 and the doctrine of demand, but as direct for purposes of determining whether sell-side investors can continue to pursue the claim after a merger. Treating a dual-natured claim as derivative for purposes of claim initiation achieves the important goals of screening out weak claims and providing an efficient and centralized mechanism for conducting the litigation. Treating a dual-natured claim as direct for purposes of claim continuation preserves the ability of investors to pursue legitimate claims, promotes accountability, and provides a superior mechanism for doing so than secondary litigation challenging the transaction that eliminated the plaintiff's standing to sue derivatively.[46]

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[44] *Carsanaro*, 65 A.3d at 658.

[45] *Id.*

[46] 132 A.3d 67, 75, 105 (Del. Ch. 2015).

Even assuming that the claims here are dual-natured, as Plaintiff argues, I find that conducting a Rule 23.1 demand analysis for claims that a corporation overpaid for a third-party's assets with stock best harmonizes the case law. Therefore, I review the breach of fiduciary duty claim under a Rule 23.1 demand analysis.

B. Plaintiff Has Not Sufficiently Pled Demand Futility

Plaintiff did not demand that the board of New Residential bring this derivative suit. Thus, Plaintiff must plead particularized facts showing that demand is excused as futile to avoid dismissal under Rule 23.1.[47]

1. Rule 23.1 Standard of Review

A stockholder seeking to pursue a derivative claim in this Court must meet the burden imposed by the demand requirement. The demand requirement is embodied in Delaware Court of Chancery Rule 23.1, which provides that "[t]he complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort."[48] A stockholder plaintiff may satisfy the demand requirement by either making demand on the board to undertake corrective action or demonstrating that any such demand would have been futile and, therefore, that

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[47] Ct. Ch. R. 23.1.

[48] *Id.*

demand is excused. Where the plaintiff fails to comply with the demand requirement and fails to plead with particularity why a demand would be futile, the complaint will be dismissed.[49]

The Supreme Court in *Aronson v. Lewis* articulated a two-part test to show demand futility.[50] The court must decide whether, given the particularized facts alleged, a "reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[51]

In order to be disinterested, a director "can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."[52] Independence means that "a director's decision is based on the merits of the subject before the board rather than extraneous considerations or influences."[53] In order to show lack of independence, the plaintiff must

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[49] *See Haber v. Bell*, 465 A.2d 353, 357, 360 (Del. Ch. 1983).

[50] 473 A.2d 805, 814 (Del. 1984).

[51] *Aronson*, 473 A.2d at 814.

[52] *In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 808, 821 (Del. Ch. 2005) (quoting *Aronson*, 473 A.2d at 812) (internal quotation marks omitted).

[53] *Id.* (quoting *Aronson*, 473 A.2d at 816) (internal quotation marks omitted).

adequately allege that a director is "so 'beholden' to an interested director . . . that his or her 'discretion would be sterilized.'"[54] This requires a showing of "financial ties, familial affinity, a particularly close or intimate personal or business affinity or . . . evidence that in the past the relationship caused the director to act non-independently vis-à-vis an interested director."[55]

The court will examine all facts pled to determine whether, when taken together, they cast a reasonable doubt on the director's disinterest or independence.[56] When a director of a corporation owes fiduciary duties as a director or officer of another corporation, the director is conflicted for purposes of the first prong of *Aronson* in a transaction between the two corporations "[w]hether phrased as an interest issue (per § 144) or an independence issue (because of [the director's] duties to an interested party) . . . ."[57] "A board that is evenly divided

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[54] *Beam v. Stewart*, 845 A.2d 1040, 1050 (Del. 2004) (quoting *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993)).

[55] *Beam*, 845 A.2d at 1051.

[56] *Cal. Pub. Empl. Ret. Sys. v. Coulter,* 2002 WL 31888343, at *9 (Del. Ch. Dec. 18, 2002) ("If taken separately, none of the individual allegations would be adequate to raise a reasonable doubt as to Mandigo's disinterest or independence. . . . Taken together, they give this Court reason to doubt that Mandigo is disinterested and independent."), *cited in Del. Cty. Empl. Ret. Fund v. Sanchez*, 124 A.3d 1017, 1022 n.20 (Del. 2015).

[57] *Parfi Holdings AB v. Mirror Image Internet*, 794 A.2d 1211, 1231 (Del. Ch. 2001), *rev'd on other grounds*, 817 A.2d 149 (Del. 2002).

between conflicted and non-conflicted members is not considered independent and disinterested."[58]

Demonstrating demand futility under the second *Aronson* prong—that the challenged transaction was not the exercise of valid business judgment— requires a showing that the situation is one of the "rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability exists."[59] The second *Aronson* prong applies when the particularized facts are such that it is "difficult to conceive" that a director could have satisfied his or her fiduciary duties.[60]

2. At Least Half of the New Residential Directors are Beholden to Fortress

To determine whether Plaintiff has alleged particularized facts giving rise to an inference that the majority of the board lacks independence from Fortress, I must analyze whether each New Residential director is independent.[61]

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58 *Gentile v. Rossette*, 2010 WL 2171613, at *7 (Del. Ch. May 28, 2010).

59 *See Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984).

60 *See Ryan v. Gifford*, 918 A.2d 341, 355 (Del. Ch. 2007).

61 *See Sanchez*, 124 A.3d at 1020. I do not review the individual directors for disinterestedness because Plaintiff alleges personal interests of only one director, Edens. All other allegations of interest relate to the individual directors' relationships with the Fortress entities.

Edens is a founder, principal, and co-chairman of Fortress. He owns 23.2% of the Fortress Class A shares and 27.9% of the Fortress Class B shares. He is a director of FIG and FIG Corp., and he earned approximately $47.5 million in compensation and distributions from Fortress funds during 2014. Edens is also a beneficial owner of FOE I.

Jacobs is a director of Fortress, New Residential, and Springleaf as well as two other companies not identified in the Complaint. Plaintiff alleges that Jacobs has received $450,000 from his Fortress, New Residential, and Springleaf directorships in 2014.

Nierenberg is a director of New Residential and a Managing Director at Fortress.[62] He is the New Residential CEO, a FIG employee, and he received tandem awards of options for New Residential stock through that position.

Edens and Jacobs serve on both the Fortress board and the New Residential board, and Nierenberg is a Fortress officer and a director of New Residential; thus, they owe fiduciary duties to both companies and are considered conflicted in board decisions regarding dealings between New Residential and Fortress.[63] To the

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[62] *Kahn v. Portnoy*, 2008 WL 5197164, at *12 (Del. Ch. Dec. 11, 2008) ("As a director of TA and an officer of RMR, O'Brien owes fiduciary duties to both TA and RMR.").

[63] *See Parfi Holdings AB v. Mirror Image Internet*, 794 A.2d 1211, 1230-31 (Del. Ch. 2001), *rev'd on other grounds*, 817 A.2d 149 (Del. 2002).

extent Fortress is materially interested in the side benefits it might receive from the HLSS transactions, Plaintiff has alleged particularized facts sufficient to create a reasonable doubt as to Edens, Jacobs, and Nierenberg's disinterestedness in the HLSS transactions because of their dual fiduciary positions at Fortress and New Residential.[64]

3. Plaintiff Does Not Allege Sufficient Facts to Excuse Demand

All of the director defendants' alleged conflicts are based on their relationships with Fortress; therefore, Plaintiff must adequately allege that Fortress is materially interested in the challenged transactions.[65]

Plaintiff argues that Fortress is interested because "Fortress has already received 8,543,538 options, $6.5 million in increased management fees, $43.8 million in increased incentive fees from recharacterization of HLSS income, $57 million in stock sale proceeds and $3.3 million in increased compensation from the

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[64] *See Portnoy*, 2008 WL 5197164, at *11–12; *see also Gentile v. Rossette*, 2010 WL 2171613, at *7 (Del. Ch. May 28, 2010) ("A board that is evenly divided between conflicted and non-conflicted members is not considered independent and disinterested."). Because I hold that Plaintiff casts a reasonable doubt on at least half of the New Residential directors' disinterestedness and independence, I do not analyze the remaining directors.

[65] *In re Walt Disney Co. Deriv. Litig.*, 731 A.2d 342, 357 (Del. Ch. 1998) ("Since, as a matter of law, Plaintiffs are unable to show a reasonable doubt as to Eisner's absence of self-interest, his potential domination over these two directors is inconsequential.").

Management Agreement amendment relating to the transaction expenses."[66] The Complaint actually alleges that FOE I received the options, FIG received the increased Management Fee and incentive compensation, and FIG, FOE I, and FIG employees received the proceeds from the stock sales. The Complaint cites Fortress's form 10-K for the year December 31, 2014, which refers to New Residential as a "permanent capital vehicle" and states the following regarding Fortress's interest in its permanent capital vehicles:

> Pursuant to our management agreements, we earn management fees from each publicly traded permanent capital vehicle equal to 0.75% - 1.50% of the company's contributed capital or book equity (as defined in such agreements). In addition, we generally earn incentive income equal to 25% of operating results in excess of specified returns to the shareholders. In addition to these fees, we also receive, for services provided, options in connection with each of their common stock offerings.[67]

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[66] Pl.'s Answering Br. 35. Plaintiff also alleges that New Residential pursued the HLSS acquisition to facilitate Nationstar's acquisition of MSRs from Ocwen. That allegation, however, is conclusory and does not meet the Rule 23.1 standard for demand futility. The only facts alleged are that the two acquisitions were close in time and that New Residential agreed to retain Ocwen as a mortgage servicer for two years following the HLSS acquisition. Comp. ¶ 112. Those are not particularlized facts giving rise to the inference that Fortress had a *quid pro quo* arrangement with Ocwen to retain it as the servicer for the HLSS assets.

[67] Fortress Investment Group LLC 2014 10-K, at 5 (Feb. 25, 2016), *cited in* Compl. ¶ 57. "We" and "our" in the Fortress form 10-K "refer, collectively, to Fortress Investment Group LLC and its subsidiaries, including the Fortress Operating Group (as defined below) and all of its subsidiaries, excluding consolidated variable interest entities, unless the context requires otherwise." Fortress Operating Group "refers to the limited partnerships and their subsidiaries through

Defendants do not contest that Fortress controls FOE I and FIG, but they argue that Plaintiff does not adequately allege that Fortress is interested because the Complaint does not allege that FIG Corp. receives any economic returns from FOE I as its general partner.[68] I need not resolve this dispute because even assuming that Fortress is interested and received the benefits described above, Plaintiff fails to plead facts showing that Fortress's interest is material.

Fortress's interest in the challenged transactions must be material in order to show that the board had a disabling conflict that excuses demand in this case.[69]

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which we conduct our business and hold our investments. The public company controls the Fortress Operating Group through wholly owned subsidiaries that serve as the general partner of each FOG entity."

[68] Defs.' Opening Br. 31-32.

[69] *Khanna v. McMinn*, 2006 WL 1388744, at *17 (Del. Ch. May 9, 2006) ("Ultimately, the inquiry into independence turns in this instance on whether Covad's business relationship with BEA Systems was material to BEA or to [the director] himself as a director of BEA."); *see also Jacobs v. Yang*, 2004 WL 1728521, at *6 (Del. Ch. Aug. 2, 2004) ("Merely stating that the agreements between Yahoo! and AMG are 'crucial to AMG's continued viability' is not enough. . . . [T]he facts alleged do not give rise to the inference that the value of these contracts was material to Activision or Macromedia."). This is not a case of self-dealing where the materiality requirement does not apply. *Cf. Cambridge Ret. Sys. v. Bosnjak*, 2014 WL 2930869, at *5 (Del. Ch. June 26, 2014) ("[T]he need to demonstrate materiality to establish the interest of a director in a transaction applies only 'in the absence of self-dealing' and that 'whenever a director stands on both sides of the challenged transaction he is deemed interested and allegations of materiality have not been required.'" (quoting *Orman v. Cullman*, 794 A.2d 5, 23, 25 n.50 (Del. Ch. 2002)). Rather, the HLSS acquisition was a third-party transaction between New Residential and HLSS in which Fortress allegedly received a special side benefit. *See id.* ("[A] 'plaintiff's burden of proof of a director's self-interest in an arms-length third-party transaction should be greater

Plaintiff has not alleged that the options FOE I received and the fees FIG received were material to Fortress. For example, the Complaint does not allege anything regarding the percentage of Fortress's ownership of FOE I, through FIG Corp., or the ratio of the alleged benefits to any Fortress financial metric. Even if these specific benefits are not material to Fortress, Plaintiff has not alleged that the challenged business practices (or these types of transactions) are material to Fortress taken together. Allegations that some of the effects of the challenged transactions benefited Fortress alone are not enough. Plaintiff must allege that the benefits were material to Fortress to excuse demand under the first prong of *Aronson*. Without allegations of the materiality of the fees and options, Plaintiff has not cast a reasonable doubt on Edens, Nierenberg, or Jacobs's independence in the challenged transactions.

The Complaint also does not allege one of the "rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability exists."[70] Plaintiff does not allege that the New Residential directors were uninformed or

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than in a classic self-dealing transaction where a director or directors stand on both sides of a transaction.'" (quoting *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362-63 (Del. 1993))).

[70] *See Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984).

acted blatantly without regard to New Residential's interests. Demand thus is not excused for Plaintiff's claims.

Plaintiff also fails to adequately allege how the New Residential directors were incentivized to overpay for HLSS. Plaintiff argues that the increased Management Fee and options rendered Fortress interested. The incentive compensation under the Management Agreement, however, appears to limit any incentive to overpay because FIG's incentive compensation depends on the percent return New Residential can earn on the book value of equity. Plaintiff should allege the amount by which New Residential allegedly overpaid, and Plaintiff's allegations should deal with the overpayment incentives so the Court can analyze the effects of the challenged transactions in the aggregate.

Because Plaintiff pleads potentially viable claims, I dismiss Counts I and II with leave to replead.[71] In light of that dismissal, I decline to resolve Defendants' Rule 12(b)(6) motion to dismiss Counts I and II.

C. Count III's "As Applied" Challenges Are Unripe

In Count III Plaintiff seeks a declaratory judgment that: (1) the New Residential certificate of incorporation article twelfth does not limit the fiduciary duties of the Defendants with respect to any conduct challenged in Counts I and II;

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71 Ct. Ch. R. 15(aaa).

(2) the Management Agreement sections 7(b) and 11(a) do not limit Defendants' liability with respect to the same conduct; and (3) the Termination Agreement did not release the claims of New Residential stockholders against HLSS.[72]

Defendants argue that these claims for declaratory judgment are not ripe because Defendants have not raised these provisions as defenses.[73]

1. Standard of Review

The Delaware courts can hear declaratory judgment actions under 10 *Del. C.* § 6501 provided that an "actual controversy" exists.[74] The following four criteria must be satisfied for an "actual controversy" to exist:

> (1) It must be a controversy involving the rights or other legal relations of the party seeking declaratory relief; (2) it must be a controversy in which the claim of right or other legal interest is asserted against one who has an interest in contesting the claim; (3) the controversy must be between parties whose interests are real and adverse; (4) the issue involved in the controversy must be ripe for judicial determination.[75]

To determine whether a controversy is ripe, the court must balance the benefits to be derived from issuing a declaratory judgment against the desire to avoid advisory

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[72] Compl. ¶ 170.

[73] Defs.' Opening Br. 53.

[74] *Stroud v. Milliken Enters., Inc.*, 552 A.2d 476, 479 (Del. 1989).

[75] *Id.* at 479-80.

opinions.[76] The Supreme Court recently stated that "a dispute will be deemed ripe if 'litigation sooner or later appears to be unavoidable and where the material facts are static.'"[77] Additionally, this Court has held that stockholder challenges to the statutory validity of charter or bylaw provisions of a Delaware corporation will be considered ripe.[78] But as applied challenges cannot be brought until the bylaw or certificate provision is applied improperly.[79]

2. The Termination Agreement

Plaintiff's claim as to the Termination Agreement is not ripe because Counts I and II are dismissed without prejudice. I will not decide now whether Defendants may, at a later point in this case, have a valid defense. To construe this contract when its provisions are not implicated by the litigation in this Court would be to

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[76] *In re Allergan, Inc. S'holder Litig.*, 2014 WL 5791350, at *6 (Del. Ch. Nov. 7, 2014).

[77] *XI Specialty Ins. Co. v. WMI Liquidating Trust*, 93 A.3d 1208, 1217 (Del. 2014) (quoting *Julian v. Julian*, 2009 WL 2937121, at *3 (Del. Ch. Sept. 9, 2009)).

[78] *See Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 947 (Del. Ch. 2013) ("Facial challenges to the legality of provisions in corporate instruments are regularly resolved by this Court." (quoting *Lions Gate Entm't Corp. v. Image Entm't Inc.*, 2006 WL 1668051, at *6 (Del. Ch. June 5, 2006)) (internal quotation marks omitted)).

[79] *Allergan*, 2014 WL 5791350, at *7 ("Count I . . . does not challenge the facial validity of any provision of Allergan's Certificate or Bylaws. Plaintiffs . . . advance what is essentially a claim of contractual construction concerning the meaning of the Similar Item provision as it might apply in a hypothetical situation. . . . [T]his is a classic example of a request for an advisory opinion that is not ripe, and many never become ripe, for judicial review.").

render an advisory opinion.[80] Therefore, Count III is dismissed without prejudice as to the Termination Agreement.

3. The New Residential Certificate of Incorporation

Taking all inferences in Plaintiff's favor, it appears that Plaintiff has pled both a facial challenge to the statutory validity of article twelfth and an as applied challenge to the application of article twelfth in the context of the HLSS transactions. The statutory validity claim is ripe for judicial review,[81] but the as applied challenge is not ripe because Defendants have not invoked article twelfth in this case, and they may never invoke it.[82] Defendants' motion to dismiss the statutory validity claim is denied, but the motion to dismiss Plaintiff's as applied claim is granted without prejudice.

4. New Residential's Management Agreement

There does not exist a ripe controversy over the validity of the contractual limitation on FIG's liability under the Management Agreement because Counts I

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[80] *See KLM Royal Dutch Airlines v. Checchi*, 698 A.2d 380, 382 (Del. Ch. 1997) ("Advisory opinions ill-serve the judicial branch and the public by expending resources to decide issues that may never come to pass. More importantly, the judiciary's role in the lawmaking process is an interstitial one, carried out by the application of legislative enactments and common law principles to concrete factual circumstances that have created real and present controversies. An action seeking declaratory relief is not exempt from these requirements and must present the court with an actual controversy that is ripe for judicial decision.").

[81] *See Chevron*, 73 A.3d at 945.

[82] *See Allergan*, 2014 WL 5791350, at *7.

and II are dismissed without prejudice. Further, this Court will not opine on potential defenses that Defendants might raise if Plaintiff decides to replead. Defendants' motion to dismiss Count III as to the Management Agreement is granted without prejudice.

III. CONCLUSION

For the foregoing reasons, Defendants' motion to dismiss Count I as an improperly pled derivative claim is GRANTED with leave to replead. Defendants' motion to dismiss Count II for failure to comply with Rule 23.1 is GRANTED with leave to replead. Defendants' motion to dismiss Count III as unripe is GRANTED as to the Termination Agreement, the Management Agreement, and the as applied challenge to the New Residential certificate of incorporation, with leave to replead. The motion is DENIED as to the facial validity challenge to the certificate of incorporation.

IT IS SO ORDERED.

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE RECEPTOS, INC. : Civil Action
STOCKHOLDER LITIGATION : No. 11316-CB

- - -

Chancery Courtroom No. 12A
New Castle County Courthouse
500 North King Street
Wilmington, Delaware
Thursday, July 21, 2016
2:05 p.m.

- - -

BEFORE: HON. ANDRE G. BOUCHARD, Chancellor

- - -

ORAL ARGUMENT ON PLAINTIFFS' PETITION FOR AN AWARD OF ATTORNEYS' FEES AND EXPENSES and RULINGS OF THE COURT

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1 APPEARANCES:

2 BRIAN D. LONG, ESQ.
Rigrodsky & Long, P.A.
3 -and-
PETER B. ANDREWS, ESQ.
4 DAVID SBORZ, ESQ.
Andrews & Springer, LLC
5 -and-
DONALD J. ENRIGHT, ESQ.
6 of the District of Columbia Bar
Levi & Korsinsky, LLP
7 for Plaintiffs

8 JON E. ABRAMCZYK, ESQ.
ZI-XIANG SHEN, ESQ.
9 Morris, Nichols, Arsht & Tunnell LLP
for Defendants Celgene Corporation and Strix
10 Corporation

11 RAYMOND J. DiCAMILLO, ESQ.
Richards, Layton & Finger, P.A.
12 for Defendants Receptos, Inc., William H.
Rastetter, Kristina Burow, Mary Lynne Hedley,
13 Richard A. Heyman, Erle T. Mast, Mary Szela, S.
Edward Torres, and Faheem Hasnain

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1 THE COURT: Good afternoon, Counsel.
2 ALL COUNSEL: Good afternoon, Your
3 Honor.
4 MR. LONG: Good afternoon, Your Honor.
5 THE COURT: Mr. Long.
6 MR. LONG: May it please the Court.
7 Brian Long from Rigrodsky & Long on behalf of
8 plaintiffs. I rise to introduce my co-counsel, Donald
9 Enright of Levi & Korsinsky.
10 MR. ENRIGHT: Good afternoon.
11 THE COURT: Good afternoon.
12 MR. LONG: Your Honor admitted him pro
13 hac vice. With your permission, he'll present today.
14 THE COURT: That's fine.
15 MR. LONG: Also we have Peter Andrews
16 and David Sborz from Andrews & Springer.
17 THE COURT: Good afternoon.
18 MR. ANDREWS: Good afternoon, Your
19 Honor.
20 MR. SBORZ: Good afternoon.
21 THE COURT: All right. I think the
22 floor is yours, Mr. Enright.
23 MR. ENRIGHT: All right. Good
24 afternoon, Your Honor. May it please the Court. As

1 Mr. Long said, I'm Donald Enright with Levi &
2 Korsinsky LLP. I'm one of the co-lead counsel for the
3 plaintiffs in this matter, and we're here on the
4 hearing on plaintiffs' motion for a mootness fee in
5 this matter.
6 By way of background, on July 14th of
7 2015, Receptos and Celgene entered into a merger
8 agreement based on a purchase price of $232 per share
9 in cash, for an aggregate of $7.2 billion. So this
10 was a pretty large transaction.
11 Litigation followed. Several cases
12 were filed, and the Court consolidated them and
13 appointed lead counsel. At the same time, plaintiffs
14 filed a motion for expedited proceedings and a motion
15 for a preliminary injunction before Your Honor. In
16 response, defendants agreed and stipulated to
17 expedited proceedings.
18 Defendants produced documents, and
19 plaintiffs deposed the Receptos CEO, Faheem Hasnain,
20 and a banker from Centerview, Joshua Thornton.
21 Centerview had been the financial advisor to the
22 Receptos board.
23 Based on this discovery, the parties
24 entered into an MOU for a disclosure-based settlement.

1 However, in the wake of Your Honor's ruling in the
2 Trulia matter, the parties agreed to terminate the
3 settlement and proceed instead with a mootness
4 dismissal.
5 As such, we're not asking the Court to
6 approve a settlement today. There is no release to
7 the defendants, so the Court need not apply the
8 plainly material standard that was enunciated in the
9 Trulia decision in reviewing the corrective
10 disclosures that were obtained here today, although we
11 do believe at least some of the disclosures we
12 obtained would at least arguably rise to the level of
13 being plainly material.
14 Now, under well-established Delaware
15 law, plaintiffs' counsel are entitled to a mootness
16 fee in the context of a common benefit if the claims
17 were meritorious when filed, if the claims caused a
18 beneficial remedial action on the part of the
19 defendants prior to adjudication on the merits.
20 So the first question is were there
21 meritorious claims here. And defendants don't even
22 argue that there weren't meritorious claims here, in
23 opposing our motion.
24 THE COURT: What's the standard you

1 say should apply to that factor?
2 MR. ENRIGHT: Your Honor, I would --
3 there are decisions that clearly lay out what that is.
4 It's something akin to a colorable claims analysis
5 that the Court would reach on a motion to expedite or
6 a motion to dismiss standard. Somewhere in that
7 neighborhood. The language on it has sort of
8 vacillated a little bit in the decisions over the
9 years, but it would be something akin to a claim that
10 at least one would think has a reasonable chance of
11 success. And I think we meet that here. And I would
12 argue that by stipulating to expedited proceedings in
13 this case, the defendants arguably stipulated to that
14 as well.
15 Moreover, if you look at the actual
16 complaint here, Your Honor, there were several
17 disclosure claims asserted here that I think rise to
18 the level of being, at the very least, colorable, in
19 that we alleged that employment communications were at
20 least evident, given the fact that there was an
21 agreement to have management remain with the company,
22 but there was no disclosure in the proxy as to when
23 those communications took place that led to that.
24 There was the issue of the bankers'

1 financial analyses. There were certain things that we
2 alleged were glaring and missing in the DCF analysis.
3 The financial projections, most particularly the
4 unadjusted financial projections, as well as the basis
5 for the adjustments that were made to reach the
6 adjusted projections that were depicted in the
7 proxy -- I'm sorry, the 14D-9. If I refer to it as
8 the proxy, I apologize. It's actually a
9 recommendation statement. And also, the terms of the
10 alternative proposals that the board was considering
11 at the same time. We alleged all of these, and these
12 were pretty much what we got addressed in the
13 supplemental disclosures, plus additional things that
14 we found during discovery.
15 Excuse me just one moment, Your Honor.
16 So defendants don't even argue that
17 these claims weren't meritorious, nor do they dispute
18 that this litigation and the efforts of counsel caused
19 the supplemental disclosures. That was conceded in
20 the supplemental disclosures themselves when they were
21 filed with the SEC. So that's not really in dispute
22 either.
23 So those points are conceded, and that
24 leaves us with the question of what the disclosures

1 were worth under a Sugarland analysis. And under
2 Sugarland, the primary consideration is the value of
3 the benefit. And here, that means the value of the
4 disclosures that were obtained. And I think, looking
5 at these, at least a couple of them were -- rose to
6 the level I would say of being plainly material and
7 highly valuable. And some others were at least, I
8 think, significantly helpful and arguably material.
9 And so I'll go through those, Your
10 Honor. With regard to the additional financial
11 projections, first, there is the earnings-per-share
12 projections that were prepared by management and were
13 used by the bankers in connection with their
14 discounted future share price analysis. Now, the law
15 is pretty clear that financial projections prepared by
16 management and used by bankers in connection with
17 their financial analyses used -- prepared in
18 connection with their fairness opinion are not per se
19 material, but at least there's a -- I think a strong
20 argument that under the law, that they are likely to
21 be.
22 THE COURT: Yeah, but that set of
23 projections was disclosed in full, wasn't it? I mean,
24 long before the supplemental disclosures came along,

1 wasn't the entire risk-adjusted set of projections
2 from 2015 to 2032 already disclosed?
3 MR. ENRIGHT: But not the earnings per
4 share.
5 THE COURT: Well, okay. So let's talk
6 about the earnings per share line. Isn't that just
7 math? I mean, didn't that just take the net income
8 number that was in the risk-adjusted projection and
9 divide it by some assumption about outstanding shares?
10 MR. ENRIGHT: Well, therein is the
11 rub, Your Honor, because there are all sorts of
12 assumptions of the number of shares for a
13 developmental company like this. Because a company
14 like this was likely to have to raise additional
15 equity in the future in order to --
16 THE COURT: Well, am I right about at
17 least the method? That is, to get to the EPS,
18 somebody took some assumption about outstanding shares
19 and divided the net income line for each year between
20 2015 to 2032 by that number. Isn't that right?
21 MR. ENRIGHT: Your Honor, I don't
22 think that is -- number one, I'm not sure that's
23 right. And number two, I don't think a stockholder in
24 possession of the original projections could have

1 calculated the number, the EPS numbers that were
2 ultimately reported. If --
3 THE COURT: Well, I'm asking you just
4 sort of where the information came from for a second.
5 If you know. Because I just --
6 MR. ENRIGHT: Well, I --
7 THE COURT: Hold on.
8 MR. ENRIGHT: Oh, sorry.
9 THE COURT: Because I assume you asked
10 some people in depositions about these things. I
11 mean, I just sort of worked through the numbers.
12 Seemed to me that if you divide every net income
13 number by 33.5 million, you basically got the
14 per-share number. Am I right?
15 MR. ENRIGHT: You know, Your Honor, I
16 don't think so. I think that the --
17 THE COURT: So what is the number that
18 was used to --
19 MR. ENRIGHT: I think it was changed
20 over time.
21 THE COURT: You're sure about that?
22 MR. ENRIGHT: I'm not sure.
23 THE COURT: Did you ask anybody
24 questions in deposition about that?

1 MR. ENRIGHT: I'd have to go back and
2 look, Your Honor. I assume it was, but I don't
3 recall, as I'm standing here today.
4 THE COURT: Now, I maybe only tested
5 six or seven data points, but it would just be a wild
6 coincidence if it turns out, from your perspective,
7 that it was a static number per share? A static
8 number of shares that was used for every single year
9 in that model?
10 MR. ENRIGHT: If it was, Your Honor,
11 then it was.
12 THE COURT: All right.
13 MR. ENRIGHT: I don't know -- I didn't
14 think it was, but if I'm wrong -- I could be wrong.
15 I'd have to go back and look, and I don't know the
16 answer as I'm standing here.
17 THE COURT: So if you can't even tell
18 me sort of like where that outstanding share number
19 came from, which obviously it therefore isn't
20 reflected in the supplemental disclosure, what utility
21 is it to anybody?
22 MR. ENRIGHT: Well, Your Honor, number
23 one, earnings per share were used in the discounted
24 future share price model that the --

1 THE COURT: Which one?
2 MR. ENRIGHT: The discounted future
3 share price model, which is --
4 THE COURT: Was it used in the sum of
5 the parts?
6 MR. ENRIGHT: I don't think so.
7 THE COURT: All right. So it was used
8 in the alternative one that was provided for
9 informational purposes?
10 MR. ENRIGHT: Correct, Your Honor.
11 And in the fairness presentation that was made to the
12 board. And I would note that that was --
13 THE COURT: Whoa, whoa, whoa. When
14 you say the fairness presentation that was made to the
15 board, I mean, when I read the summary of Centerview's
16 analysis, its recommendation was based on three
17 analyses.
18 MR. ENRIGHT: Right.
19 THE COURT: And this second DCF was
20 not one of those three; right? It was an additional
21 solely-for-information-purposes analysis; is that
22 right?
23 MR. ENRIGHT: I think -- I think
24 that's fair to say, Your Honor. It was called

1 illustrative.
2 THE COURT: Right.
3 MR. ENRIGHT: And it's not a second
4 DCF per se. It's a discounted future share price
5 model.
6 THE COURT: Yeah. You're right.
7 It's --
8 MR. ENRIGHT: And I'm looking at it
9 right now. It was on page 16 of the fairness
10 presentation. Immediately after this -- the selected
11 transactions analysis chart. So it was in the midst
12 of the valuation analyses in the presentation.
13 THE COURT: Is that in my materials
14 here somewhere?
15 MR. ENRIGHT: Yes, Your Honor. It is.
16 THE COURT: Where is that in these
17 exhibits?
18 MR. ENRIGHT: Mr. Long will look for
19 that. If you need to, Your Honor, I can hand this up,
20 if we have a hard time locating it.
21 Do you want me to go on, and we'll
22 come back to that?
23 THE COURT: Yeah. Why don't you go
24 on, and if Mr. Long finds it, you can just tell me

1 where it is.
2 MR. ENRIGHT: Okay. So the -- I've
3 kind of gotten off track a little here.
4 So long story short, Your Honor, there
5 were the earnings per share, which I understand you're
6 saying may be just a function of math, but because
7 they -- I would consider that projection in tandem
8 with the disclosure of the discounted future share
9 price analysis, which had been totally undisclosed.
10 Albeit labeled as illustrative in the -- in the
11 fairness presentation, we thought it was still
12 significant. So that would be one point.
13 The second point is in terms of the
14 projections, the unadjusted revenue projections, and
15 the basis for and the actual percentages applied in
16 those risk adjustments. Now, any kind of
17 developmental pharmaceuticals company, what the
18 company's really selling to its stockholders is a
19 sense of the possibility of future profit from the
20 commercialization of a product that is on its way,
21 hopefully, to being approved by the FDA and
22 commercialized.
23 Most stockholders, at least sizable
24 stockholders, sophisticated stockholders, develop a

1 pretty well-developed sense themselves of what the
2 likelihood is of that product actually reaching
3 commercialization based on their own view of the
4 clinical results. Okay?
5 To the extent that their view of the
6 likelihood of success and commercialization of this --
7 of this product going through the FDA process differed
8 from the risk adjustments that were made by the
9 bankers here, that's something that I think is of
10 exceptional value to the stockholders. Because
11 ultimately, the risk adjustments assumed only a 34
12 percent chance that this product would actually make
13 it to market.
14 THE COURT: That was only for one
15 indication. And it was 32 percent.
16 MR. ENRIGHT: Well, right. Okay. The
17 point being that these were significantly adjusted
18 downwards based on risk. And depending on the, as you
19 said, the indications you looked at. The sense was
20 that if a stockholder thought that it was more likely
21 that this drug would reach the market than those
22 assumptions, they could know that, and they should be
23 able to sort of reassess those risk-adjusted
24 projections accordingly. Again, we think that this

1 was very helpful to any stockholder who really had a
2 well-developed sense of what they thought the clinical
3 prospects of this drug, ozanimod, was, compared to
4 what the risk adjustments were that were applied.
5 And it's worth noting that the risk
6 adjustments that were applied were based on industrial
7 data and peer-reviewed articles, and were not
8 specifically based on their assessment of this
9 particular drug, based on the specific clinical data
10 to that point. It was sort of based on an industry
11 standard, based on published --
12 THE COURT: Let me just make sure I
13 got this, though. First of all, I think I misspoke.
14 It was 35 percent, not 32, for the third indication.
15 But putting that detail aside, these probabilities,
16 two questions I have about it. Number one, just to
17 make sure I have the facts, were management's best
18 estimate of the probabilities of ozanimod, if I'm
19 pronouncing it correctly, obtaining regulatory
20 approval in three different indications of interest;
21 right?
22 MR. ENRIGHT: That is my understanding
23 as well, Your Honor.
24 THE COURT: That's what I thought.

1 And two, even though they may not have been expressed
2 in the prior disclosures as such, those assumptions
3 were built into the projection, the risk-adjusted
4 projections that were fully disclosed; correct?
5 MR. ENRIGHT: Correct.
6 THE COURT: Okay.
7 MR. ENRIGHT: But what the
8 shareholders didn't know was what the un-risk-adjusted
9 projections were, which was, you know --
10 THE COURT: Why is that useful? I
11 mean, isn't that just like, wow, if everything goes
12 perfect in a world, you can have some crazy number out
13 there, but what really matters, it would seem, is what
14 people's judgment -- the people who know -- what their
15 judgment is about what's realistically possible, not
16 just some crazy idea if everything goes perfect is.
17 MR. ENRIGHT: Well, it creates sort of
18 an upper bound on what this company could be worth.
19 In other words, if a client -- I'm sorry. If a
20 stockholder thought "I think this thing is -- has a
21 very strong political profile, I think it's going to
22 get approved for all of these indications, and I think
23 it's going to do well once it does that. I want to
24 know what the management thinks the revenues will be

1 if all three of those go through, because I think they
2 are going to go through." And they couldn't assess
3 that, because everything was, number one, risk
4 adjusted, and, number two, they didn't know to what
5 extent or by what factor or what percentage they were
6 adjusted.
7 Giving the stockholders a sense of
8 that upper bound of what this could be worth if it all
9 got approved, I think that has a real value. Because,
10 listen, stockholders don't invest in a company like
11 this if they don't think that it's going to be
12 approved.
13 So again, Your Honor, I'm not saying
14 that this in particular issue was plainly material and
15 we would have won an injunction on this point before
16 Your Honor, necessarily. I do think that it is
17 clearly of substantial benefit to the stockholders to
18 know the upper bound of what this product could be
19 expected to do if it got approved on all three of
20 those indications. And that's what was obtained here.
21 And I don't think that's crazy, Your
22 Honor. I think that that's something that a
23 stockholder really would want to know, and that it
24 would change the total mix of information to know if

1 this product got approved through all three of these
2 indications, what revenues is it expected -- what kind
3 of sales is it expected to achieve. By only telling
4 them the risk-adjusted, they only knew, basically --
5 THE COURT: Well, you would agree with
6 me, knowing the risk-adjusted estimate is material?
7 MR. ENRIGHT: Oh, absolutely.
8 THE COURT: That's really important?
9 MR. ENRIGHT: Absolutely. Absolutely.
10 Because, look, it's sort of like Schrodinger's cat.
11 Today, or on that day, they didn't know if it was
12 going to be approved or not approved, and so it was
13 sort of both. And they had to value it based on that
14 nebulous status. But for stockholders who thought it
15 was going to go through, for them to know --
16 THE COURT: So you think stockholders
17 are really out there doing that, huh? You know, just
18 some average stockholder is going to do a probability
19 analysis of this drug being used for Crohn's Disease
20 and whether it's going to get regulatory approval for
21 that indication?
22 MR. ENRIGHT: I -- Your Honor, I don't
23 think a retail stockholder with 100 shares is doing
24 that.

1 THE COURT: All right.
2 MR. ENRIGHT: I think an institutional
3 investor that has a group that specializes in
4 pharmaceuticals investment, like a mutual fund that
5 has a group that specializes in pharmaceuticals
6 investment, absolutely does that.
7 THE COURT: Uh-huh.
8 MR. ENRIGHT: Absolutely does that.
9 THE COURT: And so what do they look
10 at when they do that? Long before this deal comes
11 along, what do they look at?
12 MR. ENRIGHT: They look at the
13 clinical data as it's reported by the company. And if
14 they like it, they invest in the company. If they
15 don't, they don't. Okay.
16 The point being, Your Honor, for them
17 to be able to assess if those risk adjustments
18 comported with their own sense of the likelihood of
19 approval and eventual market access for this product
20 for these three indications, that's of real value.
21 Because if they thought -- putting aside the
22 unadjusted revenue projections for a moment. Just
23 looking at the risk adjustments that were made and the
24 percentages applied. If they thought -- T. Rowe

1 Price, if they were a pharmaceuticals group, thought
2 that ozanimod had an 85 percent chance of reaching
3 market for Crohn's Disease, to use your example, then
4 they might think, well, gee, I actually think that
5 this is worth more than is, and the actual revenue
6 stream is likely to be higher than what's being
7 projected here. And that's -- having them understand
8 how the risk adjustments were performed in that regard
9 I think provides a real value.
10 Okay. Moving on. Beyond the
11 projections, we got disclosure of two financial
12 analyses that had been included in the fairness
13 presentation but which apparently we don't have a copy
14 of for Your Honor.
15 THE COURT: I didn't see it in my
16 papers, but anyway --
17 MR. ENRIGHT: If you'd like, Your
18 Honor, I can hand you up mine if you'd like. I'd be
19 happy to do that. It's a little dog-eared and has a
20 couple of --
21 THE COURT: That's all right.
22 MR. ENRIGHT: -- highlighter circles
23 on it, but I'll hand it up to you as is, if that's all
24 right.

1 THE COURT: I'll give it back to you.
2 MR. ENRIGHT: I appreciate it, Your
3 Honor.
4 THE COURT: Just give me one second.
5 MR. ENRIGHT: The page that we were
6 just talking about a moment ago was on page 16.
7 THE COURT: Let me just see something.
8 MR. ENRIGHT: I am slightly stunned
9 that it wasn't included in our filings, Your Honor. I
10 apologize.
11 THE COURT: That's all right. Yeah, I
12 haven't seen this before.
13 Donna, could you hand that back to
14 him, please. Thank you.
15 MR. ENRIGHT: Thank you, Your Honor.
16 If you'd like, I can have a copy of
17 this e-mailed to you today, or whatever you'd like.
18 THE COURT: That's not necessary.
19 MR. ENRIGHT: At any rate, so the
20 illustrative -- discounted future share price analysis
21 which we just discussed was included in the same
22 section of the presentation as the discounted cash
23 flow analysis and the selected transactions analysis,
24 et cetera.

1 And while it does say that it's
2 illustrative, so does the summary of -- the summary of
3 financial analyses calls them all illustrative, on
4 page 14. So I'm not sure how much that matters, the
5 fact of the word "illustrative" in this context.
6 The point is that they looked at the
7 future EPS of the company, applied some multiples
8 assumptions, discounted it back to the present, and
9 came up with an implied value of it. And what this
10 showed was a potential future share price as high as
11 $356 per share, number one, based on projected 2020
12 earnings per share of $10.18 per share.
13 But none of the discounted back prices
14 rose above $232 per share. However, if you look just
15 one year further out, at 2021, and you look at the
16 earnings per share that were projected in the
17 supplemental projections here, and you do the same
18 analysis, apply those same multiples and discount it
19 back to the present, that yields values well above the
20 deal price here.
21 THE COURT: What's the basis for
22 picking that year?
23 MR. ENRIGHT: What's the basis for
24 picking any particular year?

1 THE COURT: Did Centerview do that?
2 MR. ENRIGHT: Excuse me?
3 THE COURT: Did Centerview do that?
4 MR. ENRIGHT: No, they didn't. But --
5 THE COURT: So in a summary of their
6 analysis, why would you be picking a number they
7 didn't analyze?
8 MR. ENRIGHT: This is the point that
9 I'm trying to make, Your Honor, is that by disclosing
10 the earnings per share projections as well as the
11 methodology that was applied here, the stockholders
12 could look at another year and say, well, okay, that's
13 just discounting from 2020. The year that you decide
14 to discount back from is kind of arbitrary. You can
15 pick any year and decide to say, okay, I'm going to
16 make that my benchmark year and discount back from
17 that.
18 THE COURT: Why did they pick 2020?
19 What did the records show?
20 MR. ENRIGHT: My understanding is
21 because it was five years out. Okay? So -- but --
22 THE COURT: That's what the Centerview
23 witness you deposed testified to?
24 MR. ENRIGHT: I don't believe -- I

1 don't recall if he was specifically asked that
2 question.
3 THE COURT: "It's five years out, so
4 that's why we picked it"?
5 MR. ENRIGHT: I think the -- my
6 understanding -- again, Your Honor, I don't have a
7 photographic memory. My understanding is that it was
8 because it was five years out.
9 THE COURT: All right.
10 MR. ENRIGHT: But the point being that
11 if you then -- if you just looked at one extra year
12 out, then the values exceed the 232 per share. And
13 I'm not saying --
14 THE COURT: What happens if you go one
15 year earlier?
16 MR. ENRIGHT: Much lower. Because
17 honestly, the company -- because it's developmental,
18 it wasn't expected to really start making earnings per
19 share for a couple years out anyway. Okay?
20 So that's that analysis. The other
21 analysis that we got disclosure of that was completely
22 undisclosed was the illustrative total company value
23 DCF sensitivity analysis. Now, the proxy had -- I'm
24 sorry. The recommendation statement had disclosed

1 that a DCF had been performed, and then it yielded a
2 range of values, and that range of values is reflected
3 on page 19 of the fairness presentation. And it came
4 out to, in the proxy -- I believe it was 176 to 214,
5 I'd have to go back and look, but it was well below
6 232 per share.
7 However, what they didn't tell the
8 stockholders is that Centerview had prepared this
9 sensitivity analysis for what would happen to the
10 present value if certain assumptions were changed.
11 And what that showed was a tremendous amount of
12 additional upside beyond the disclosed range of values
13 for the DCF analysis. If you increase the RMS POS to
14 85 percent, from 71 percent, it's an additional $13.40
15 per share. Increase UC POS to 80 percent, from 62
16 percent, that's $24.70 per share of additional value.
17 And then there's another one for 25.65 per share, and
18 then there's another one based on pricing that could
19 have added or subtracted 27.95 per share. And another
20 one based on peak penetration variants that would
21 increase or decrease it by $34.95 per share.
22 So there is $126.65 of potential value
23 that was calculated by Centerview and presented to the
24 board in this presentation that was completely

1 unreflected in how they described it in the proxy --
2 in the recommendation statement, the DCF analysis.
3 THE COURT: Is the bullet point, if
4 you will, of additional information concerning the
5 sensitivities that you obtained by way of a
6 supplemental disclosure, is that a complete statement
7 of all the sensitivities that Centerview performed or
8 just some subset of them?
9 MR. ENRIGHT: Let me turn to that,
10 Your Honor. It appears to be -- it appears to be
11 complete. Yes. Looking at the page here and looking
12 at those, the description of it here, Your Honor, it
13 does appear to be complete to me.
14 THE COURT: All right.
15 MR. ENRIGHT: Yes, it is. Okay. We
16 think that disclosure of all that additional potential
17 value was plainly material in and of itself,
18 particularly because the DCF was disclosed, the value
19 range of the DCF was disclosed. To disclose that, the
20 implied range of values yielded by the DCF, without
21 disclosing that these sensitivities were calculated
22 and presented to the board as well, is an incomplete
23 picture, a materially incomplete picture, and --
24 THE COURT: Well, this happens a lot.

1 So are you aware of some case that you're going to
2 point out to me where the failure to disclose
3 sensitivities to a DCF analysis that otherwise was
4 fully disclosed was deemed to be material?
5 MR. ENRIGHT: Your Honor, I'm not
6 aware --
7 THE COURT: I didn't see it in the
8 papers, so I figured you must not know about such a
9 case.
10 MR. ENRIGHT: I'm not aware of one.
11 THE COURT: Yeah.
12 MR. ENRIGHT: What I will say is I've
13 never seen a situation like this before, where you
14 have a page in the presentation, right after the
15 DCF -- you have the discounted cash flow laid out
16 here, and then the very next page has all these
17 sensitivities for all this additional upside that's
18 completely undisclosed and unreflected in that range
19 of potential values.
20 Normally when you have a sensitivity
21 analysis, the range of values yielded by that
22 sensitivity analysis -- which is usually reflected in
23 different assumptions of a terminal growth rate or the
24 discounted rate applied -- usually that full range of

1 values is disclosed. This is beyond -- this goes
2 beyond that, and then it changes the assumptions and
3 does essentially, essentially, a second DCF. Because
4 it does -- it calculates what the discounted -- what
5 the present value of the future cash flows from the
6 company will be based on all these different
7 assumptions. And that's completely undisclosed.
8 That's a lot of additional value that the stockholders
9 had no idea was being contemplated as being
10 potentially available to them. And so I think this is
11 extremely material.
12 And the difference between this and
13 any other case I've ever seen, Your Honor, is that
14 they didn't throw it out before they made the fairness
15 presentation. You'll see it sometimes in earlier
16 books during the course of a process where they're
17 fine-tuning their assumptions. They'll talk about
18 well, maybe this, maybe that, early on, and have a
19 very wide range of values as they're sort of taking in
20 the universe of potential outcomes. But it gets
21 narrowed down for the final fairness presentation, and
22 that's what's depicted.
23 Here, this is the -- the page that
24 immediately follows the DCF analysis in the fairness

1 presentation. I think that that's -- that's genuinely
2 material, Your Honor. Because it's -- and it's not a
3 couple dollars, Your Honor. It's as much as $126.95
4 per share. You're talking about something that could
5 add, you know, something like -- I'd have to do the
6 math, but I think it's something like 70 percent
7 additional value above the low end of the stated
8 implied range of values in the DCF analysis. That's
9 significant, Your Honor. At the very least, I think
10 it's extremely helpful to the stockholders.
11 Okay. And, Your Honor, you asked
12 for -- you asked for case law on this issue, and I
13 don't know of any that go directly to this sensitivity
14 analysis point, but there's the Weinberger case that
15 we cited in our brief that said, look, if an analysis
16 is performed by the bankers for the purposes of
17 informing the board's assessment of the value of the
18 enterprise, it's material and should be disclosed.
19 And I think that this falls squarely under that.
20 Next, Your Honor, we have the issue of
21 the other proposals that the board was considering
22 during the process that led up to the merger
23 agreement. Now, the other proposals that they were
24 considering were primarily in the form of

1 commercialization partnerships, where another company
2 would pay the company a bunch of money, in terms of an
3 up-front payment and milestone payments, for
4 essentially the rights to commercialize and then
5 market the product for a period of time. And these
6 included potential payments as much $2.5 billion.
7 And throughout this, the stockholders
8 would be able to maintain ownership of the company.
9 They wouldn't be selling the company, they'd just be
10 selling rights to the product for a period of time.
11 Now, the stockholders were never told the terms of
12 these other proposals. They were just told that there
13 were partnership discussions going on with these other
14 parties. They were never told the documents --
15 THE COURT: Your brief also says that
16 they were told that they would have yielded lower
17 value --
18 MR. ENRIGHT: Right.
19 THE COURT: -- that Celgene's
20 proposal; right?
21 MR. ENRIGHT: Right. Yes. But the
22 actual numbers, never disclosed. I think -- if
23 somebody's offering you -- because it's not apples to
24 apples, Your Honor. If it was just another merger

1 proposal, another acquisition proposal, and the value
2 of that acquisition proposal was much lower, perhaps
3 that's not material, because it's apples to apples,
4 and one apple is not as good as two apples, and so
5 they don't necessarily have to tell the world that the
6 value of the other offer was only one apple. They can
7 just tell them it's lower. Here, it's not apples to
8 apples. The shareholders had an opportunity to retain
9 ownership of the company and just sell rights to this
10 for a period of time.
11 THE COURT: I'm trying to understand
12 this, then. So they disclose an orange that you say
13 you can't compare to their apple. And how does that
14 help anybody?
15 MR. ENRIGHT: Because -- because if
16 the stockholders were told what the value of these
17 other proposals were, what the payments would be, they
18 could make a decision for themselves. Would I rather
19 keep control of the company and take this $2.5 billion
20 in payments that would be coming to us, or do I rather
21 sell to the company? Without -- it's sort of like --
22 it's sort of like -- I don't know if you've ever
23 watched "The Price Is Right," Your Honor, but, you
24 know, there's a showcase showdown, and there are two

1 showcases, okay? Wouldn't it be nice if you could
2 pick which one you want after having seen them both?
3 Now, in "The Price Is Right" you can't.
4 THE COURT: That would take away the
5 drama, wouldn't it?
6 MR. ENRIGHT: Right, exactly.
7 Exactly. But this isn't a game show, Your Honor.
8 This is Delaware law. And --
9 THE COURT: We have no drama here.
10 MR. ENRIGHT: Well, I try to keep it
11 to a minimum. The point being that if you're
12 asking -- or if you want to talk about "Let's Make A
13 Deal," if we want to keep with the game show theme.
14 The point being, if you know what your two options are
15 in terms of the actual dollar value, you can make an
16 informed decision.
17 Without being told what the value of
18 these other proposals were, while also keeping control
19 of the company, the stockholders really weren't able
20 to make an informed decision. "Well, gee, you know, I
21 think I'd rather keep control of the company and be
22 able to explore other business opportunities for the
23 company and keep ownership of it and take that
24 $2.5 billion, rather than sell it." That's an option

1 that they should have had an opportunity to make an
2 informed decision on. And because of the supplemental
3 disclosures, they did have that option.
4 So, Your Honor, this Court, I think
5 rightfully, takes a scrutinizing approach to looking
6 at disclosures to make sure that we're not just
7 inundating stockholders with useless blather. I get
8 that. But these are -- all the points I've raised
9 today I think were things that genuinely would affect
10 the way a reasonable stockholder who was really paying
11 attention would view this transaction.
12 The additional upside in the DCF
13 analysis, the earnings per share projections, which I
14 suppose maybe I'd have to go back -- as I said, you
15 have to go back and look. Maybe you can just do the
16 math yourself, but the point is every sophisticated
17 stockholder knows how to value an enterprise based on
18 earnings per share. It's one of the first metrics
19 that people look at in trying to value an enterprise.
20 Valuable for that purpose. The discounted future
21 share price analysis, at the very least, helpful to
22 stockholders. The adjustment rates that -- that
23 were -- percentages that were applied, clearly helpful
24 to let stockholders judge for themselves if the risk

1 that was being assumed in these projections comported
2 with their sense of the risk to the eventual
3 commercialization of this product. I think this was a
4 genuinely meaningful package of disclosures.
5 Now, we didn't proceed with a
6 settlement before Your Honor. We terminated the
7 settlement. Frankly, in the wake of the Trulia
8 decision and my discussions with Your Honor when I was
9 before you last at the Keurig motion to expedite
10 hearing, where, at the very end of the hearing, you
11 admonished us "Do not come back into this courtroom
12 with a disclosure settlement," we took that message to
13 heart, and we said we're not going to try the Court's
14 patience. We're going to terminate this, and we're
15 just going to proceed on a mootness basis. Despite
16 the fact that I thought that these were genuinely
17 meaningful, and some of them even plainly material
18 disclosures.
19 So based on all of that, and I think
20 based at least in part on the fact that there is no
21 release being given here, which I think also is a
22 value to the stockholders, plaintiffs have moved for
23 a -- would move the Court for an award of attorneys'
24 fees and expenses in the amount of $350,000.

1 Now, a year ago, I would have had very
2 little consternation about applying for a number well
3 above that in this Court. But, you know, we're trying
4 to feel our way through the new paradigm that the
5 Court has laid out for us to try to follow, and that's
6 what we're trying to do. So we're asking for $350,000
7 here, which we think is fair and reasonable under this
8 Court's precedents both before and since Trulia.
9 The $350,000 is inclusive of $25,000
10 in expenses, which were laid out mostly on experts and
11 things of that nature, court reporters. And the
12 remainder of the $325,000 represents a blended rate of
13 about $640 per hour over a course of 510 hours that
14 were expended prior to the disclosures. So I think
15 that that is a modest, and even -- or a reasonable and
16 even modest rate compared to this Court's precedents.
17 I also think it's modest when you
18 consider that the Court awarded a $325,000 fee in the
19 BTU case recently on the strength more or less of just
20 the cash flow projections, as I understand that
21 transcript.
22 THE COURT: Well, if I recall
23 correctly, they were cash flows for the back years of
24 the projection that were actually used by the banker.

1 MR. ENRIGHT: Right. Yes.
2 THE COURT: That's what made that
3 significant.
4 MR. ENRIGHT: Understood, Your Honor.
5 THE COURT: Okay.
6 MR. ENRIGHT: So compared to BTU, as
7 you said, as I've laid out, we've got two entire
8 undisclosed banker analyses, one of which showed
9 significant potential value to the company in
10 connection with the DCF analysis that had been
11 completely undisclosed, the risk-adjustment
12 percentages, as well as the basis for those risk
13 adjustments, EPS projections, and the dollar value
14 terms of the other proposals. Comparison to earlier
15 disclosure packages that have been before this Court,
16 I think would, in the past, have justified a fee in
17 the mid to high 4s. But we're only asking for
18 $350,000 today.
19 The defendants, for their part, urge a
20 fee of only $75,000, which I think, frankly, in light
21 of the quality of these disclosures, is out of line
22 with this Court's precedents, and it seems to be -- to
23 stem from the fact that the settlement was terminated.
24 I guess they feel like we haven't kept up our end of

1 the bargain, and they're not happy about that. But
2 that isn't really the standard here, Your Honor, what
3 they're happy about or what I'm happy about. It's the
4 Sugarland factors. And I think under the Sugarland
5 factors, there was real value delivered here.
6 I would also note one other thing,
7 Your Honor. With regard to the contingency factor
8 here, the risk associated with these cases in the past
9 year or so for plaintiffs counsel has gone up
10 considerably. And as a result, I think when we do
11 achieve real benefits for the stockholders, that
12 warrants a higher fee than perhaps would otherwise be
13 the case. Because as our risks have gone up, when we
14 actually do achieve meaningful benefits, we should be
15 awarded accordingly, commensurate with that risk.
16 So for all those reasons, Your Honor,
17 I ask that the Court grant the motion. If you have
18 any questions for me, I'd be happy to answer them.
19 Otherwise, I'll just reserve for a brief reply.
20 THE COURT: That's fine. Thank you.
21 MR. ENRIGHT: Thank you, Your Honor.
22 THE COURT: Mr. Abramczyk.
23 MR. ABRAMCZYK: Good afternoon. Jon
24 Abramczyk for defendants. May it please the Court.

1 Really, just a few comments, I think, should do it
2 today. The real issue here on a fee app in the
3 mootness context is whether any of these supplemental
4 disclosures remedied a material omission. I know the
5 plaintiffs trip lightly over that here, but it's
6 important.
7 It's not whether these were helpful,
8 whether they were additive and, a few, whether they
9 were meaningful, as counsel for plaintiffs says. The
10 test -- and this is set out quite plainly in
11 Sauer-Danfoss and cited in our brief -- is did they
12 fix anything material? Did they fix any material
13 omission in the disclosure? It doesn't confer a
14 benefit on the stockholders that would justify a
15 mootness fee if the supplement only satisfies some
16 additional information request or adds something,
17 unless the supplemental disclosures remedy some
18 material omission.
19 And if you listened carefully to what
20 we've heard today and what you read in your papers,
21 and if you look at the disclosures, it's clear that
22 none of their disclosures here remedied any material
23 omission. And I'm happy to go through each of them,
24 just to track --

1 THE COURT: I think no need to do
2 that. Why don't you start, for example, Mr. Enright
3 seems particularly exercised, if you will, about the
4 disclosure of the sensitivity analysis.
5 MR. ABRAMCZYK: Sure.
6 THE COURT: That's one. And then
7 probably the second to address would be the disclosure
8 of the probabilities that were factored into their
9 risk-adjusted projections, the actual probabilities
10 themselves for the three indications of interest for
11 the drug at issue.
12 MR. ABRAMCZYK: Sure, Your Honor.
13 First, the sensitivity on the DCF analysis. As I
14 think some of the colloquy indicated here, sometimes
15 sensitivity is done. What's important, however, for
16 the disclosures, and what was done here, is that the
17 DCF analysis itself was fully disclosed in the
18 original 14D-9. The additive part in the supplement
19 is the sensitivity around the -- certain inputs to the
20 DCF, as they're described in the supplement, that
21 really talked about changing the probabilities of
22 success for each of the different applications of the
23 particular star drug they had here, the leading
24 candidate that might get to market.

1 It is interesting, they bring up for
2 the first time in the reply brief about just why these
3 sensitivities should be important. And I looked,
4 before coming over here, as to just what in the
5 deposition -- how did they cover this. And it looks
6 to me that it's all about, charitably speaking, maybe
7 one page of the deposition, but most focused on seven
8 lines of the deposition. Somebody at the deposition
9 on the plaintiffs' side asked -- this is at page 93,
10 line 17:
11 "On the next page, page 20, there's
12 the DCF sensitivity analysis. I think we discussed
13 this a little bit when we looked at the prior
14 presentation, but again, is there any significance to
15 the numbers they chose to increase the percentage of
16 probability to?
17 "Answer: No.
18 "Question: For instance, from 71 to
19 85?
20 "Answer: Again, my recollection is
21 just looking at the best-case scenario."
22 There wasn't really a probing
23 discussion of these sensitivities. But for good
24 reason. These are just reflections of changing these

1 probabilities in a way that really was not material to
2 any stockholders' decision, because management's best
3 estimate of what the drug was going to do were
4 included in the DCF that was disclosed. And of course
5 it's true that if you change the assumptions in the
6 DCF model, you can directionally change them to
7 increase value.
8 What the plaintiffs' counsel omitted
9 to tell the Court earlier, or simply aggregated all
10 the changes, was that, individually, if you toggle
11 just a few of the sensitivity items around percentage
12 of success for certain applications of this ozanimod
13 drug, there weren't material changes in the DCF --
14 maybe $30 on a $232 valuation or a valuation that
15 ranged below that. But it was not that this was some
16 increase of 70 percent unless, unless, you took the
17 aggressive assumption of all the sensitivities and
18 added them together and considered that as the best
19 estimate of what the drug would do. That would be the
20 total home run.
21 Why is that wrong here? Well, it's
22 wrong because, as you look at all of the disclosures
23 in toto, it's quite clear that for a company like
24 this, a development-stage pharmaceutical company, they

1 are in the business of trying to get a drug to market,
2 and it's a very expensive business. This is a company
3 that had never, ever, made any money. It had never
4 even gotten a revenue stream from any drug that it was
5 marketing. It hadn't taken anything to market.
6 So you cannot assume -- and this
7 applies to some of the other supplemental disclosures
8 that we'll talk about in a minute -- you can't assume
9 that this is going to be a home-run company and all
10 the applications of the drug are going to sail through
11 the testing, get commercial application, and
12 successfully be marketed. That is not the way it
13 works, and that's not the way it's presented.
14 And again, in toto, the disclosures
15 make this quite clear. The disclosures are very clear
16 about the speculative nature of the business and why
17 no stockholder should assume that every one of these
18 trials was going to work out or that the drug would go
19 to market on each of these different applications.
20 And so the sensitivity around this DCF model is not
21 material, because it's not the DCF that management
22 relied on. And in fact, the assumptions -- and
23 certainly to aggregate them only on the upside would
24 be misleading here, and misleading in a very dangerous

1 way to the stockholders.
2 So that's the DCF, the sensitivity of
3 the DCF.
4 THE COURT: Do you agree with
5 Mr. Enright that the bullet of supplemental disclosure
6 that discloses the sensitivity is all the
7 sensitivities that were in Centerview's presentation,
8 or were there others that were not included? If you
9 know.
10 MR. ABRAMCZYK: I do. I think the
11 best way to put it is it's complete only as far as it
12 goes. So I think I understand what he meant by that,
13 is when you read the supplemental disclosures, it does
14 address each of the sensitivities as to each of the
15 applications for ozanimod and when they toggled those.
16 Certainly other sensitivity analysis was done as part
17 of the overall banker work, but that was not included
18 in the supplemental disclosure, if that answers your
19 question.
20 THE COURT: Right. But he was pulling
21 out a book and saying -- I think he was essentially
22 saying all the sensitivities in this book, we got
23 included in the supplemental disclosures.
24 MR. ABRAMCZYK: No. That's certainly

1 not the case.
2 THE COURT: That's what I was
3 wondering what you --
4 MR. ABRAMCZYK: Your Honor, the
5 disclosure, at least the way I'm framing the response
6 to the question, the disclosure in the supplement is
7 this paragraph that appears -- I'm getting the page,
8 if you'll just bear with me one second -- that
9 appears --
10 THE COURT: I don't think any of these
11 pages are numbered, actually.
12 MR. ABRAMCZYK: These pages are not
13 numbered, but it's in Exhibit C, Your Honor, and it's
14 just about three pages from the back.
15 THE COURT: Yeah. I've got it.
16 MR. ABRAMCZYK: The sensitivity of the
17 sum-of-the-parts DCF analysis.
18 THE COURT: Right.
19 MR. ABRAMCZYK: And then it goes into
20 how -- if you change the probability of success here.
21 THE COURT: Right. You're telling me
22 the book, the bankers' book, had other sensitivities
23 that weren't included in the supplemental disclosure?
24 MR. ENRIGHT: Your Honor, would you

1 like me to hand this up so you can look at them side
2 by side?
3 THE COURT: Well, I'm asking
4 Mr. Abramczyk's position on it. You told me yours.
5 MR. ENRIGHT: I just figured you'd
6 rather look at them -- I'm sorry.
7 MR. ABRAMCZYK: The short answer is
8 there is sensitivity analysis, but not around this
9 disclosure.
10 THE COURT: Okay.
11 MR. ABRAMCZYK: Anyway, so on the
12 sensitivity DCF analysis, Your Honor, that's our
13 response to Mr. Enright's points.
14 Now, turning to what appears to be the
15 other favorite here this afternoon, which is the
16 non-risk-adjusted forecast. This, I must say, seems
17 like more than a small stretch to explain why giving
18 stockholders non-risk-adjusted forecasts would be
19 meaningful here and, more to the point, would actually
20 satisfy material omission here.
21 They simply don't, and here's why.
22 First of all, as the Court has already pointed out,
23 Centerview, the banker, probably used the
24 risk-adjusted forecast in its analysis. Those were,

1 without dispute, fully disclosed to the stockholders,
2 and that's really what matters. It is not the case
3 that some sophisticated holder here objected to the
4 disclosure because they were sharpening their pencil
5 coming up with different risk assessments.
6 No institutional stockholder
7 complained here about the quality of the disclosures
8 or the necessity for any supplement. And it strains
9 credulity to believe that some stockholder is going to
10 be assessing here, in a way that's, frankly, helpful
11 to the stockholder, his or her own assessment. And if
12 they do, they were free to either not tender, and
13 demand appraisal -- which no one did -- or make some
14 other assessment of this price. But the critical
15 disclosure was made here. That is, the risk-adjusted
16 revenue projections were in the original schedule 14D.
17 Again, a lot of this -- and the
18 importance of this around the risk-adjusted revenue
19 projection focuses on the speculative nature of the
20 business and why the industry standard is to present
21 the numbers this way. Because everybody needs to know
22 how, on a relative basis, the products may or may not
23 do. It's not just left to some investor to determine
24 what the probabilities are, because they're so

1 different and so fact-specific.
2 So what was disclosed was the critical
3 information. And this is not like some of the cases
4 they mentioned both here at argument today or the
5 Plato case that's in the papers, in which financial
6 projections weren't disclosed at all. That's not the
7 case here. The right projections were disclosed.
8 Management's best estimates are the risk-adjusted
9 projections, not the non-risk-adjusted projections.
10 And the disclosures make it quite clear in the 14D-9
11 that neither Centerview nor the board relied on
12 non-risk-adjusted forecasts.
13 THE COURT: So let me ask you this
14 question, then. Well, first of all, let me verify
15 something. As I understand it, before the
16 supplemental disclosures, a stockholder would not know
17 that baked into the risk-adjusted projections were the
18 assumptions of a 71, 62, and 35 percent probability of
19 obtaining regulatory approval for three indications
20 for this drug; is that right?
21 MR. ABRAMCZYK: Correct. The
22 specific -- the specific quantification --
23 THE COURT: Right.
24 MR. ABRAMCZYK: -- was not, no. It

1 was all over the disclosures that this is a very
2 speculative decision.
3 THE COURT: Right. Right.
4 MR. ABRAMCZYK: We don't know if the
5 applications will work. You know, it's at this stage,
6 it's at that stage.
7 THE COURT: Right.
8 MR. ABRAMCZYK: So all of that
9 qualitatively was presented, but the numbers were not.
10 THE COURT: All right. And I get it's
11 baked into projections. That's not lost on me. But
12 here is my question, which is, you debate how much
13 value, but is there, like, some value to the idea of,
14 you know, it's one thing to know that some projection
15 assumed a drug has a 5 percent chance versus a 95
16 percent chance. I mean, is there something to the
17 idea of some sense of order of magnitude? Wouldn't
18 that be somewhat useful?
19 MR. ABRAMCZYK: It is useful, and it
20 is disclosed here, Your Honor. They --
21 THE COURT: Well, by virtue of the
22 supplemental disclosure; right?
23 MR. ABRAMCZYK: No. No.
24 THE COURT: That's what I'm getting

1 at.
2 MR. ABRAMCZYK: Importantly, no, Your
3 Honor. The qualitative assessment that you're talking
4 about -- let me put it this way: As to a qualitative
5 assessment of the issue you're talking about, that is
6 disclosed, because the disclosures, including the
7 disclosures incorporated by the D&I and the prior Q's
8 and K's, for example, all talk with a great deal of
9 specificity about what is going on with the
10 development of ozanimod for this company at various
11 stages. And at various stages, there are assessments
12 of, you know, we think it's five years out, we think
13 this is going to happen, we think that's going to
14 happen.
15 It is true that there is no "It's a 5
16 percent, not a 95 percent," but the -- at least as you
17 read the disclosure, it becomes immediately apparent
18 that it would be very difficult for management to get
19 tighter into any sort of meaningful range on those,
20 because there are so many variables around whether the
21 drug gets over the hurdle. So they talk about it in
22 terms of what the stages of development are, and where
23 the drug is in those stages, rather than long-term
24 projections of future success numerically. That's

1 just not the way it's presented.
2 So what was done here is what the
3 stockholders -- what was disclosed here is what the
4 stockholders needed to make their assessment as to
5 whether to tender. And I would add that it's
6 important to note that even when the non-risk-adjusted
7 revenue projections were put in, they don't uncover
8 some suspicious adjustment here, or some -- raise
9 anything that's contrary to what Receptos was saying
10 about the development of its drug. In fact, they
11 really confirm that the risk adjustments seem well
12 grounded and adequate, including to the point of
13 talking about where they come from and that this is
14 what the industry does.
15 So this is, importantly, as the Chief
16 Justice, then the Chancellor, recognized, this is not
17 the kind of disclosure as to this
18 risk-adjusted/non-risk-adjusted point that comes in
19 that was contrary to what was already disclosed. This
20 is consistent with what's already in the total mix,
21 which, after all, is where the test funnels down to.
22 Does it make a difference in the total mix? The
23 non-risk-adjusted revenue forecasts do not change the
24 total mix here.

1 And just briefly to touch on some of
2 the others, I think the Court has already covered
3 quite well with the plaintiffs' counsel the relevant
4 points on the earnings-per-share analysis.
5 THE COURT: Well, do you know, can you
6 just tell me how it works? Is it the same number
7 that's being used in the denominator, I guess, to
8 calculate the EPS?
9 MR. ABRAMCZYK: I believe it is, Your
10 Honor. But one of the reasons why, and probably the
11 principal reason why the adding information about
12 earnings per share out to 2032, when you're talking
13 about 2015, is that they are so inherently
14 speculative. Number one, on the earnings side, this
15 is a company that never made any money on anything.
16 So in one sense, every projection is more speculative
17 than it would be in a company that has a steady stream
18 of cash flows from earnings.
19 Secondly, per share -- and plaintiffs'
20 counsel already covered this -- is also something
21 that's at issue in a developmental and pharmaceutical
22 company like this, because what they do is they go out
23 into the capital markets to raise more money. And
24 part of what they do is if they have access, they get

1 the equity markets, into the equity markets, and they
2 add a lot of shares, including this company. And
3 that's described in detail in the 14D-9 and the prior
4 K's and Q's. And as recently as, I think, November of
5 2014, they added 4 million shares.
6 So, you know, you have these very
7 speculative projections about both earnings and the
8 per-share denominator for that calculation, which
9 means any further refinement on that could not be, by
10 definition, satisfying some material omission. It is
11 just too speculative to make a difference here. And
12 what is important, of course, is that the company's
13 best estimate of future performance was already in the
14 14D-9. And this was not, importantly, additive.
15 So what's left? I suppose what's left
16 is what I think is probably one of the easiest
17 questions, and that is, what about these lower offers
18 from other bidders? Well, I think there is certainly
19 authority we cited in our brief that you don't, when
20 there is a lower offer from other bidders, lower than
21 the consideration ultimately offered by Celgene, under
22 Ramtron and other cases, you don't find that to
23 satisfy a material omission.
24 So this idea that "should have said

1 more about what Party A and Party C were doing on
2 collaborative efforts" really doesn't hit the mark
3 here for the plaintiffs here or create any basis on
4 which they can claim that they created a benefit or
5 deserve a fee. And again, the additional disclosures
6 here just confirmed that the deal price was the best
7 out there for the stockholders. And that's clear
8 under the analysis in the Medicis transcript ruling
9 that we included with our papers.
10 It is also important to note, I think,
11 that the disclosures around what was done with Party A
12 and Party C are extensive in the original 14D-9, and
13 all that's laid out, including a statement that the
14 company believed that Party A and Party C going away
15 on these collaborative proposals was beneficial,
16 because it allowed the company to pursue a sale of the
17 entire company, which is ultimately what happened
18 here.
19 We didn't hear anything, and I don't
20 know whether it's worth mentioning, about promise of
21 employment to -- at least I don't think we heard it.
22 Maybe we did --
23 THE COURT: There was a vague
24 reference to it.

1 MR. ABRAMCZYK: Yeah. And fortunately
2 so, Your Honor. There's just no "there" there. We go
3 over this in our papers, and I won't spend time on
4 this this afternoon. There was no promise of
5 employment. They had a supplemental sentence that was
6 from an early indication of interest from us that we
7 said we'd welcome the Receptos employees into the
8 Celgene family, or something like that. And there was
9 very affirmative not only -- not only disclosure, but
10 in the deposition testimony that the plaintiffs did
11 not include here, where the chief executive said, "We
12 did not have arrangements going forward." So there's
13 nothing -- there's nothing there.
14 I think that, again, it really comes
15 back to, you know, the Court's task today is to
16 evaluate the qualitative importance of the disclosures
17 that were obtained in the supplement. And it's only
18 compensable if the supplemental disclosures remedied a
19 material omission. Here, these disclosures don't rise
20 to the level of filling some and remedying some
21 material omission, and there really is nothing here on
22 which plaintiffs can claim they created a benefit for
23 the stockholders.
24 I don't think it's really a case that

1 the Court compares this to what would have happened in
2 other cases. It really is, as the Sauer-Danfoss case
3 describes, an inquiry into the materiality of these
4 disclosures, in the sense of did they satisfy some
5 material omission. And here, when you take them one
6 by one, you can't find a basis on which a benefit was
7 created. And therefore, there really is no
8 entitlement to a fee here. And there's nothing else
9 in the Sugarland factors here that would justify a
10 higher fee.
11 I heard plaintiffs' counsel saying
12 before he sat down that, well, the cases are now more
13 risky than they were. Well, this was filed before
14 Trulia. And so I'm not sure exactly when the period
15 he was talking about was, but this doesn't appear to
16 involve any more contingency risk than there used to
17 be, given when it was filed. And there was no
18 protracted litigation here.
19 So again, there is no disclosure here
20 that remedies some material omission here. And simply
21 by making a supplement that remedies some immaterial
22 omission through a supplemental disclosure does not
23 create a benefit for the stockholders and does not
24 provide the basis for a fee award.

1 THE COURT: All right. Thank you.
2 Mr. DiCamillo, did you have anything
3 you wanted to add?
4 MR. DiCAMILLO: I have nothing to add,
5 Your Honor. Thank you.
6 THE COURT: Thank you.
7 Mr. Enright.
8 MR. ENRIGHT: Thank you, Your Honor.
9 I will try to be brief. Brevity is not a strength of
10 mine, I apologize, but I will attempt to do my best.
11 Counsel said that the question for
12 Your Honor today is did the supplemental disclosures
13 cure a material omission. That's not the standard,
14 really. The standard is did they change the total mix
15 of information before the stockholders. And I think
16 on at least a couple of these, they did.
17 With regard to the sensitivity
18 analysis, the first thing I would say, Your Honor, is,
19 just to try to put a -- you know, nail down the --
20 THE COURT: Right.
21 MR. ENRIGHT: -- the issue. If you
22 look at the disclosure of the sensitivity analysis in
23 that bullet point in the supplemental disclosures and
24 you look at it side by side, at the -- the discussion

1 of the sensitivity analysis on page 20 of the fairness
2 presentation, each of these that are listed, and the
3 impact of them, each of them that are listed here are
4 in the proxy -- or are in the supplemental
5 disclosures. So to the extent you're asking is what
6 is on this page completely disclosed in this bullet
7 point in the supplemental disclosures, the answer is
8 yes.
9 THE COURT: And that page in the
10 fairness presentation is the only sensitivity
11 analysis; is that right?
12 MR. ENRIGHT: Yes, Your Honor.
13 Correct. Yes. The only one that was presented to the
14 board in connection with the DCF analysis. Yes.
15 THE COURT: Okay. And is it
16 correct -- I mean, I would think it probably would be
17 the case, but you got the discovery -- that there were
18 a number of other sensitivities that Centerview ran
19 before that?
20 MR. ENRIGHT: I don't know. I don't
21 know that that was asked, Your Honor. I apologize.
22 But what we do know is that what was actually
23 presented to the board in the fairness presentation --
24 THE COURT: Right.

1 MR. ENRIGHT: -- was disclosed here.
2 THE COURT: All right.
3 MR. ENRIGHT: Just to set that out.
4 THE COURT: And do you disagree with
5 the testimony from the CEO that Mr. Abramczyk read, in
6 terms of what he made of that information? I think he
7 was quoting from the transcript.
8 MR. ENRIGHT: Yeah. No, I don't
9 dispute any of that. The question was, you know, what
10 was the basis for the likelihood percentages that were
11 selected there. And I think the answer he basically
12 gave there was essentially "I don't know," more or
13 less. He seemed to say, well, it just seemed like
14 good numbers to pick. I don't dispute his testimony.
15 I just -- I think it was vague enough that it wasn't
16 particularly informative of what actually happened
17 here.
18 What we do know is that the bankers
19 took the time to conduct this analysis and present it
20 to the board.
21 THE COURT: Yeah, but that's not the
22 standard; right? I mean, part of me wishes people
23 would just staple the fairness presentation --
24 MR. ENRIGHT: Like a 13D filing for

1 everything.

2 THE COURT: -- and just end the misery
3 of having to go through this -- you know, this torture
4 every time. Because you can always find something in
5 a bankers' book that's not in the proxy.

6 But that's not the test. The test is
7 giving a fair summary of the analysis the banker
8 did --

9 MR. ENRIGHT: I agree, Your Honor.

10 THE COURT: -- that the board relied
11 on. Not every piece of minutia that's in a book.

12 MR. ENRIGHT: I agree, Your Honor.
13 The point here, though, is that they prepared an
14 entire sensitivity analysis. It isn't a line item.
15 It's not a footnote. It's an entire page that affects
16 the total -- the value of the DCF range of values
17 dramatically. And it was -- and it's not like it was
18 in an appendix, Your Honor. It was presented the next
19 page after it. It was right there.

20 THE COURT: So you got this disclosure
21 that says, you know, 71, 62, 35 percent probabilities.

22 MR. ENRIGHT: Uh-huh.

23 THE COURT: Wouldn't I just know by
24 logic, well, jeez, if I goose up each of those by 20

1 percent, this value is going way up? Wouldn't I just
2 know that?
3 MR. ENRIGHT: Sure. Sure.
4 THE COURT: Okay. And isn't that
5 essentially what that sensitivity says?
6 MR. ENRIGHT: What it does is it
7 actually -- well, a couple things. Number one, it
8 actually quantifies it.
9 THE COURT: Okay.
10 MR. ENRIGHT: And number two --
11 THE COURT: So I whip out my
12 calculator and I can quantify it.
13 MR. ENRIGHT: And number two, it says
14 that somebody thought that these were realistic enough
15 possibilities to be worth quantifying and presenting
16 to the board. And that's really --
17 THE COURT: Not the CEO, apparently,
18 according to that deposition testimony.
19 MR. ENRIGHT: Well, he said he --
20 well, he also testified that the reason why all of
21 these analyses were done was to inform the board of
22 the value of the company. That was at, I want to say,
23 page 90 of the CEO's deposition.
24 THE COURT: Well, at some level,

1 wouldn't that have to be true?
2 MR. ENRIGHT: Sure, exactly. Well,
3 and I think that's the case here.
4 THE COURT: Okay.
5 MR. ENRIGHT: The reality is, Your
6 Honor, somebody thought that these potential upsides
7 were realistic enough to be worth doing an analysis on
8 it and presenting it to the board. The mere fact that
9 they did that is of import to the stockholders.
10 Because again, this isn't a line item. It's not an
11 appendix. It's an entire slide right on the heels of
12 the main DCF analysis page. And by indicating -- and
13 if it was a couple bucks, it would be irrelevant.
14 This isn't a couple bucks. The total potential upside
15 here is gigantic. Talks about billions and billions
16 of dollars. It is certainly, I think, enough to
17 change the total mix of information.
18 And we're not saying that any of this
19 stuff was guaranteed to happen, as Mr. Abramczyk said.
20 All we're saying is that the stockholders, in
21 considering the total range of potential outcomes
22 here, had a right to know what the potential upside
23 was that the bankers were quantifying and presenting
24 to the board. And that's what we got here.

1 Now, with regard to the risk
2 adjustments, Your Honor, you know, putting aside the
3 unadjusted revenue projections, okay, which I think
4 are certainly helpful, but I think the real point here
5 is that the stockholders were told how they came up
6 with these percentages and then told what the actual
7 percentages were.
8 So, for example, if T. Rowe Price, you
9 know, Biotech Fund A has a view that this is a really
10 likely drug to be approved and be a primary indication
11 for treating Crohn's Disease, sees that it's being
12 treated here as only 34 percent probable, if they see
13 that and they think, well, gee, we actually think that
14 it's well over 50 percent chance of being approved,
15 knowing that it was discounted that much is of real
16 value to them, and it really changes the total mix of
17 information. I have a hard time understanding how
18 that wouldn't be relevant.
19 Now, again, we're not saying that you
20 should assume that those un-risk-adjusted revenues are
21 going to come to pass. Not at all. What they do have
22 a right to know is what risk is being assumed here, so
23 that they can -- they can compare that to their own
24 view of the clinical profile of the company. Because

1 as Mr. Abramczyk said, what companies like Receptos do
2 in their communications with stockholders and their
3 10-Qs and Ks and press releases is tell the market in
4 a very aggressive way what the status is of their
5 clinical development process, because that's the whole
6 ball of wax for how a company like this is going to be
7 valued.
8 So these stockholders, at least
9 sophisticated stockholders, have a very well-developed
10 view of what the likelihood of approval is. And to
11 the extent that their view differed from the
12 assumptions that the bankers applied, they should know
13 that. And we got that for them.
14 With regard to the -- and lastly, Your
15 Honor, with regard to the lower offers, they weren't
16 really lower offers. They were differently structured
17 proposals that weren't to acquire the company. And so
18 all the cases Mr. Abramczyk cited are really
19 distinguishable, because again, it's not an apples to
20 apples, you know, Company A says we'll buy you for $5
21 a share, Company B says we'll buy you for $10 a share.
22 Company B's offer is obviously better. They're both
23 the same kind of transaction. You don't need to know
24 all the details about what Company A did, because

1 Company B's offer is significantly better, and
2 therefore, you can just proceed on that without all
3 the minutia about what Company A did.
4 Here, because the other proposals were
5 in the form of commercialization partnerships, that is
6 a tremendous difference. And the fact that the
7 stockholders could have received these payments while
8 maintaining control of the company and maintaining
9 control of this drug and maintaining the right to --
10 at least partial rights to commercialize it in the
11 future, that's all highly important. And they had a
12 right to know what those terms were, to make an
13 informed decision as to if they wanted prize package 1
14 or prize package 2.
15 If you have any questions for me, Your
16 Honor, nothing further.
17 THE COURT: No.
18 MR. ENRIGHT: I will say, Your Honor,
19 that I do think that this was a genuinely significant
20 total package of information for the stockholders, and
21 we worked hard to get it. We are not giving up a
22 release here. A reasonable and fair fee, I think,
23 should be awarded.
24 Thank you.

1 THE COURT: Thank you.
2 Mr. Abramczyk, I'll give you the last
3 word if you had anything else. I don't know if you
4 did or not.
5 MR. ABRAMCZYK: I have nothing to add,
6 Your Honor.
7 THE COURT: Thank you, Counsel, for
8 the arguments. I've thought about this a lot in
9 preparing for today, and I had put together some
10 notes. What I heard from the arguments essentially
11 confirms where I was at to begin with, so I'm going to
12 provide you with my ruling at this time.
13 This ruling addresses the petition of
14 plaintiffs' counsel for an award of attorneys' fees
15 and expenses arising out of several stockholder class
16 actions that were filed in July 2015 challenging
17 Celgene Corporation's then-proposed acquisition of
18 Receptos, Inc. for $232 per share in cash.
19 The actions were consolidated on
20 August 4, and the parties self-expedited the case by
21 stipulation on August 13th. The very next day, on
22 August 14, the parties entered a memorandum of
23 understanding to settle the case solely for
24 supplemental disclosures. The transaction closed on

1 the terms prosed on August 27, 2015.
2 In March 2016, after Trulia was
3 issued, the parties changed course by stipulating to
4 the dismissal of the case with prejudice to the named
5 plaintiffs only and without prejudice to any other
6 putative class members. All that remains is the
7 application of plaintiffs' counsel for an award of
8 attorneys' fees. They seek $350,000.
9 Defendants oppose this application,
10 taking the position that none of the supplemental
11 disclosures were material and that plaintiffs' counsel
12 should be awarded no more than $75,000. I am in much
13 more agreement with the defendants' position, but I
14 will grant an award of $100,000 in total, for reasons
15 that I will explain.
16 Today's petition is governed by the
17 mootness fee doctrine. Under Delaware law, plaintiffs
18 are entitled to an award of attorneys' fees in a
19 mooted class or derivative action under the corporate
20 benefit doctrine where they can establish that, one,
21 their suit was meritorious when filed; two, the action
22 producing a benefit to the corporation was taken by
23 the defendants before a judicial resolution was
24 achieved; and, three, the resulting corporate benefit

1 was causally related to the lawsuit.
2 As to the first factor, I am assuming
3 for today's purposes that the action was meritorious
4 when filed, although I note I've had no occasion
5 before today to consider the merits of any of
6 plaintiffs' claims. There was no motion to expedite.
7 There was no motion to dismiss. There was no motion
8 for preliminary injunction that was actually presented
9 for decision.
10 The third factor, the causal
11 relationship, is not disputed and is plainly satisfied
12 here, since the supplemental disclosures would not
13 have been made except for the plaintiffs' litigation
14 efforts.
15 What today's motion comes down to,
16 predictably, is whether the litigation produced a
17 benefit to the corporation and, by extension, to its
18 stockholders, which dovetails with the key factor of
19 the Sugarland test; namely, the quality of the benefit
20 conferred.
21 The benefit here is totally
22 therapeutic, consisting of supplemental disclosures
23 falling into three categories related to, first, the
24 company's financial projections; second, the financial

1 analysis prepared by Receptos' financial advisor,
2 Centerview; and, third, the background of the
3 transaction. None of the supplemental disclosures
4 satisfy the standard of materiality, in my view, which
5 is the reason for my ultimate conclusion that a
6 relatively modest fee award is warranted here.
7 I'll briefly address now each category
8 of the supplemental disclosures. The first category
9 of supplemental disclosures added three pieces of data
10 to a set of projections that was included in the
11 original recommendation statement. Before turning to
12 those, it's important to emphasize that the
13 recommendation statement already contained the
14 complete set of the company's risk-adjusted
15 projections for the period from 2015 to 2032,
16 including the unlevered free cash flows.
17 Significantly, this is the set of projections that
18 Centerview relied on in preparing its sum-of-the-parts
19 DCF analysis for its fairness analysis.
20 The three data points that the
21 supplemental disclosures added were, first, a line for
22 revenue in each year of the model assuming no risk
23 adjustments; second, a line to the risk-adjusted
24 projections translating the projected net income for

1 each year of the model into an earnings-per-share
2 figure; and, third, Receptos' management's estimated
3 probability of success in obtaining regulatory
4 approval of ozanimod for three indications of
5 interest. In my opinion, the third data point
6 provided some useful, but not material, information of
7 some value, but the other two data points added
8 nothing of meaningful value.
9 Before going through these, let me
10 start with some nomenclature. When I refer to
11 "risk-adjusted projections," what I am referring to is
12 the set of projections into which management's
13 estimated probability of success in obtaining
14 regulatory approval of ozanimod for various
15 indications of interest was built in. These are the
16 projections that matter, because they reflect
17 management's best estimate of what was achievable. As
18 such, it's logical that these are the projections that
19 Centerview used in its analysis, and as I already
20 stated, these were the projections that were fully
21 disclosed in the original recommendation statement.
22 With that background, let me turn to
23 the three additional data points. The first data
24 point is the addition of a revenue line for ozanimod

1 containing no risk adjustments. This information, in
2 my view, has no real value, because it's information
3 of the "pie-in-the-sky" variety that assumes that
4 everything goes perfectly with ozanimod, which does
5 not reflect the real-world reality of the risks of
6 obtaining regulatory approval.
7 The second data point is the EPS line.
8 This information appears to be a simple mathematical
9 calculation where the already-disclosed net income is
10 divided each year by a certain outstanding share
11 assumption that remains static. I think it was 33.5
12 million. I could be wrong about that. That's not
13 terribly relevant, at the end of the day.
14 The only relevance of the added EPS
15 line, though, pertains to an illustrative analysis
16 that Centerview did for informational purposes. As
17 I'll discuss in a minute, that analysis doesn't have
18 any meaningful value, in my view, negating the
19 theoretical importance of the added earnings-per-share
20 line.
21 The third data point, which is
22 management's best estimate of the probabilities of
23 regulatory approval for three indications of interest,
24 is the most useful piece of information, in my view,

1 because it gives stockholders some feel for
2 management's estimate of the likelihood of approval.
3 The probabilities were 71, 62, and 35 percent for the
4 three different indications of interest.
5 Because these probabilities were
6 already built into the projections, I don't think
7 calling them out separately alters the total mix of
8 information in a significant way. Nevertheless,
9 seeing them has some value, in my opinion, to get some
10 sense of the order of magnitude of management's
11 confidence in obtaining regulatory approval for
12 various indications.
13 I am now turning to the second
14 category of supplemental disclosures, which concerns
15 the summary of Centerview's analysis. Again, it's
16 important to put things in context. The
17 recommendation statement originally disclosed the
18 three analyses that were the basis of Centerview's
19 recommendation to the board: the selected public
20 company analysis, the selected precedent transaction
21 analysis, and the sum-of-the-parts discounted cash
22 flow analysis. This is the kind of information that
23 is important to satisfy the requirement of Delaware
24 law to provide a fair summary of the basis for a

1 financial advisor's advice to the board. There is no
2 obligation under Delaware law to disclose every piece
3 of information that a financial advisor conveys to a
4 board, nor would such a standard make any sense.
5 The second category of supplemental
6 disclosures added two pieces of information that I
7 view as the "tell-me-more" variety that are not
8 material. The first piece of information describes an
9 illustrative discounted future share price analysis.
10 Notably, plaintiffs, who deposed a representative of
11 Centerview and the CEO of Receptos, provided no
12 evidence that either Centerview or the board relied on
13 this particular analysis.
14 In my view, this information did not
15 significantly add to the total mix of information and
16 had questionable value because it was a secondary
17 piece of information provided to the board solely for
18 informational purposes and because it merely confirmed
19 the fairness of the transaction price, in any event.
20 The range from that analysis ranged from $139 to $195
21 per share.
22 The second piece of information
23 discloses some sensitivities associated with changing
24 certain assumptions in the sum-of-the-parts DCF

1 analysis. This information did not significantly
2 alter the total mix of information, in my view,
3 because it just confirms what should be self-evident,
4 which is if you modify certain assumptions in the
5 projections up or down, the value derived from a DCF
6 based on the projections will change one way or the
7 other.
8 Finally, the third category of
9 supplemental disclosures concerned two items
10 pertaining to the background of the transaction. The
11 first item concerns the disclosure of certain payments
12 that were part of collaboration proposals from Party A
13 and Party C. The original recommendation statement
14 discussed these proposals, and as plaintiffs admit --
15 this is at page 21 of their brief -- disclosed that
16 they yielded a lower value than the Celgene proposal.
17 Thus, the additional information was confirmatory of
18 the fairness of the Celgene proposal and did not, in
19 my view, alter the total mix of information in a
20 significant way.
21 Finally, the second item consists of a
22 single sentence stating, and I'm now quoting, but I
23 substitute the word "Celgene" for "parent" -- "In its
24 preliminary indication of interest, [Celgene] also

1 referenced the importance of welcoming the Company's
2 employees to [Celgene's] organization in the event a
3 transaction were consummated."
4 Plaintiffs argue that this sentence
5 was material -- and I'm now quoting again from page 22
6 of their brief -- "because it revealed for the first
7 time that Receptos management had an expectation
8 throughout the negotiation process that they would be
9 welcomed into lucrative positions with the combined
10 company after a transaction had been consummated."
11 This is frivolous. The added sentence
12 is a vague statement that was, at most, an expression
13 of good will. Completely missing from the
14 supplemental disclosures is any hard information
15 demonstrating that management had negotiated
16 undisclosed pay packages for themselves or suffered
17 from any genuine conflict of interest.
18 To be complete, let me mention the
19 other Sugarland factors briefly. There's no question
20 this case was done on a contingent basis, that the
21 plaintiffs' lawyers have experience with this kind of
22 case, and that they expended time and effort. On the
23 other hand, the issues in this case were relatively
24 straightforward. The case settled very early, and the

1 amount of heavy lifting in the case was actually very
2 modest. But most importantly, it comes down to the
3 issue of the benefit conferred. All these other
4 factors really are secondary to the benefit conferred,
5 which is the primary consideration.
6 As I stated at the outset, none of
7 these additional pieces of information was material,
8 in my view. And I'll add that a lesson to take away
9 from this application today is that contingent cases
10 are risky. They're meant to be risky. There is no
11 right to cover one's supposed time and expenses just
12 because you sue on a deal, and plaintiffs should not
13 expect to receive a fee in the neighborhood of
14 $300,000 for supplemental disclosures in a post-Trulia
15 world unless some of the supplemental information is
16 material under the standards of Delaware law. That
17 did not happen here, although some of the supplemental
18 information was of some value, for the reasons I've
19 explained.
20 Accordingly, I am granting a fee and
21 expense award in a total amount of $100,000.
22 I think the order is on the system,
23 and I can enter it that way. Is it, Mr. Long?
24 MR. LONG: I'm not sure it is, Your

1 Honor. If I --
2 THE COURT: Do you have one?
3 MR. LONG: What I'd like to do is
4 confer with defendants, present them with a copy, and
5 maybe in a day or two we can present Your Honor with
6 an agreed form.
7 THE COURT: That's fine. If I see it
8 on the system, I'll enter it. If I don't, I'll wait
9 to get it from you.
10 MR. LONG: Okay.
11 THE COURT: All right. Thank you very
12 much, Counsel.
13 (Court adjourned at 3:36 p.m.)
14
15 - - -
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1
2 CERTIFICATE
3
4 I, JULIANNE LABADIA, Official Court
5 Reporter for the Court of Chancery of the State of
6 Delaware, Registered Diplomate Reporter, Certified
7 Realtime Reporter, and Delaware Notary Public, do
8 hereby certify that the foregoing pages numbered 3
9 through 77 contain a true and correct transcription of
10 the proceedings as stenographically reported by me at
11 the hearing in the above cause before the Chancellor
12 of the State of Delaware, on the date therein
13 indicated, except for the rulings at pages 66 through
14 76, which were revised by the Chancellor.
15 IN WITNESS WHEREOF I have hereunto set
16 my hand at Wilmington, this 27th day of July, 2016.
17
18 /s/ Julianne LaBadia
----
19 Julianne LaBadia
Official Court Reporter
20 Registered Diplomate Reporter
Certified Realtime Reporter
21 Delaware Notary Public
22
23
24

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

INTEAM ASSOCIATES, LLC, Plaintiff, v. HEARTLAND PAYMENT SYSTEMS, INC., a Delaware corporation, Defendant. ______________________________ HEARTLAND PAYMENT SYSTEMS, INC., Counterclaim Plaintiff, v. LAWRENCE GOODMAN, III, and INTEAM ASSOCIATES, LLC, Counterclaim Defendants.	)	C.A. No. 11523-VCMR

MEMORANDUM OPINION

Date Submitted: June 10, 2016
Date Decided: September 30, 2016

Thad J. Bracegirdle and Andrea S. Brooks, WILKS, LUKOFF & BRACEGIRDLE, LLC, Wilmington, Delaware; *Attorneys for Plaintiff and Counterclaim Defendants*.

Jeffrey L. Moyer, Travis S. Hunter, and Arun J. Mohan, RICHARDS LAYTON & FINGER, P.A., Wilmington, Delaware; *Attorneys for Defendant and Counterclaim Plaintiff*.

MONTGOMERY-REEVES, Vice Chancellor.

In this action, two Delaware entities, inTEAM Associates, LLC ("inTEAM") and Heartland Payment Systems, Inc. ("Heartland"), that own K-12 school meal management software each assert breach of contract claims against the other. inTEAM's predecessor, School Link Technologies, Inc. ("SL-Tech"), and Heartland entered into a transaction in which Heartland bought substantially all of SL-Tech's assets. The transaction was detailed in three agreements that were executed together and work in tandem. These agreements contain various non-competition, non-solicitation, exclusivity, and cross-marketing and support obligations.

inTEAM alleges that Heartland breached its non-competition obligations as well as its cross-marketing and support obligations. Heartland claims that inTEAM breached its reciprocal non-competition covenant, and inTEAM's chief executive officer breached his non-solicitation and non-competition obligations.

In this post-trial Memorandum Opinion, I hold that inTEAM did not breach any of its contractual obligations. Heartland, however, breached its non-competition and exclusivity obligations, and inTEAM's chief executive officer breached certain of his non-solicitation provisions. No affirmative defense excuses any of the breaches. As a result, both inTEAM and Heartland are entitled to relief.

I. BACKGROUND

These are my findings of fact based on the parties' stipulations, documentary evidence, and testimony of eight witnesses during a four-day trial. I accord the evidence the weight and credibility I find it deserves.[1]

A. Parties and Relevant Non-Parties

inTEAM is a Delaware limited liability company with its principal place of business in Santa Monica, California.[2] inTEAM operates "in the USDA-driven, funded state and local school district child nutrition programs, primarily in K through 12 schools," offering "consulting services, training services and technology at both the state and school district level."[3] Before the parties' execution of the Asset Purchase Agreement, dated September 12, 2011 (the "Asset Purchase Agreement"), inTEAM was a division of SL-Tech.

SL-Tech "develop[ed], manufacture[d], [sold], service[d] and maintain[ed] computer software and POS terminal hardware" that was "designed to facilitate (i)

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[1] Citations to testimony presented at trial are in the form "Tr. # (X)" with "X" representing the surname of the speaker, if not clear from the text. After being identified initially, individuals are referenced herein by their surnames without regard to formal titles such as "Dr." No disrespect is intended. Exhibits are cited as "JX #," and facts drawn from the parties' Joint Pre-Trial Stipulation and Order are cited as "PTO ¶ #." Unless otherwise indicated, citations to the parties' briefs are to post-trial briefs.

[2] PTO ¶ III.A.1.

[3] Tr. 11-12 (Goodman).

accounting and (ii) reporting of transactional data functions and management of food service operations of K-12 schools (including point-of-sale operations, free and reduced application processing, ordering and inventory, menu planning and entry of meal and other payments by parents via the Internet or kiosk)."[4]

Chip Goodman is the Chief Executive Officer (the "CEO") of inTEAM and, prior to the parties' execution of the Asset Purchase Agreement, was the CEO and "Major Shareholder" (as defined in the Asset Purchase Agreement) of SL-Tech.[5] Janet Luc Griffin is the Director of Business Development at inTEAM and is the contact person for state agency deals, provides consulting services for districts and state agencies, and reviews software implementation.[6] Lei Ditch is the Director of Technology at High5LA, LLC, formerly Startech Global Corporation ("Startech"), who was hired by SL-Tech to help develop their software products.[7]

Heartland is a Delaware corporation with its principal place of business in Princeton, New Jersey.[8] Heartland is a credit card payment processor for various

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[4] PTO ¶ III.A.6 (citing JX 25 at 1).

[5] *Id.* ¶ III.A.3.

[6] Tr. 361-62 (Griffin).

[7] Tr. 481-84 (Ditch).

[8] PTO ¶ III.A.2.

industries, including K-12 schools.[9] Heartland also offers computer software products designed to help customers manage school meal programs for the K-12 foodservice industry in the United States.[10] These products perform menu planning, create recipes, monitor inventory, process orders, analyze nutrients, generate production records, and facilitate USDA compliance.[11]

Michael Lawler currently serves as the President of the Strategic Markets Group for Heartland and is responsible for the School Solutions division, among others.[12] Terry Roberts is the Senior Vice President of Heartland's School Solutions division; he served as SL-Tech's Chief Operating Officer ("COO") before its acquisition by Heartland.[13] Tyson Prescott is the Director of Research and Development for Heartland and was a software development manager at SL-Tech before its acquisition by Heartland.[14]

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[9] Tr. 611-12 (Lawler).

[10] *Id.*

[11] *Id.* at 618.

[12] *Id.* at 608-11.

[13] Tr. 982-83 (Roberts).

[14] Tr. 789-90 (Prescott).

B. Facts

The federal government provides funding to schools that participate in and comply with certain meal nutrition programs for students.[15] The United States Department of Agriculture (the "USDA") issues national regulations for these meal nutrition programs, and state agencies monitor compliance with the regulations through an administrative review process.[16] As part of these programs, the federal government subsidizes meals at various rates that are set each year.[17]

Until 1977, the regulations focused on four menu "components:" meat, vegetables/fruits, grains, and milk.[18] By the 1990s, the focus shifted to certain nutrient targets, and the government introduced Nutrient Standard Menu Planning, which required schools to keep track of extensive nutrition information for various food offerings.[19] This spurred the development of software programs to assist schools in managing this information. The USDA approves software programs

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15 DOROTHY PANNELL-MARTIN & JULIE A. BOETTGER, SCHOOL FOOD & NUTRITION SERVICE MANAGEMENT FOR THE 21ST CENTURY 5 (6th ed. 2014).

16 *Id.* at 6-8.

17 *Id.* at 13 (showing base rates for SY2014 are $0.34 for paid lunch, $2.59 for a reduced-price lunch, and $2.99 for a free lunch).

18 *Id.* at 77.

19 *Id.*

that perform the required "nutrient analysis."[20] This software, Nutrient Analysis Software Approved for Nutrient Analysis Required in the School Meal Programs ("Nutrient Analysis Software"),[21] analyzes calories, saturated fat, sodium, protein, Vitamin A, total fat, dietary fiber, carbohydrates, water, and iron, among other nutrients, either by utilizing manual data entry of all menu items or by retrieval of nutrient data from an approved database.[22]

In 2010, the federal government promulgated the Healthy, Hunger-Free Kids Act of 2010 (the "HHFKA").[23] Later that year, the Institute of Medicine's Committee on Nutritional Standards for National School Lunch and Breakfast Programs, of which inTEAM consultant Mary Jo Tuckwell was a member, issued new recommendations for changes to related USDA regulations (the "IOM Report").[24] The IOM Report suggested an integration of the pre-1977 menu-component model with the 1990s nutrient-focused model, which would emphasize

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[20] JX 400.

[21] *Id.*

[22] Tr. 910 (Fox); JX 400.

[23] 42 U.S.C. § 1751 *et seq.*; PANNELL-MARTIN & BOETTGER, *supra* note 15, at 78-80.

[24] INST. OF MED. OF THE NAT'L ACADS. COMM. ON NUTRITION STANDARDS FOR NAT'L SCH. LUNCH AND BREAKFAST PROGRAMS, SCHOOL MEALS: BUILDING BLOCKS FOR HEALTHY CHILDREN v, 194-95, 235 (2010), http://www.fns.usda.gov/sites/default/files/SchoolMealsIOM.pdf; JX 248, at 1.

food-based menu planning and deemphasize nutrient analysis.[25] The USDA followed these recommendations and issued proposed rule changes on January 13, 2011 that stated, "nutrient-based menus will be eliminated and only food-based menu planning will be permitted . . . ."[26] The new regulations create five main food groups (meat/high protein foods, whole grains, vegetables, fruit, and fat-free/low-fat milk), which have specified subcategories and nutrient targets for calories, saturated fat, trans fat, and sodium.[27]

Under the HHFKA, the USDA also introduced performance-based funding to foster compliance with the new meal standards.[28] Currently, a school district may receive an additional six cents per reimbursable meal if it complies with the meal pattern requirements promulgated under the HHFKA ("six cent

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25 INST. OF MED. OF THE NAT'L ACADS. COMM. ON NUTRITION STANDARDS FOR NAT'L SCH. LUNCH AND BREAKFAST PROGRAMS, *supra* note 24, at 194-95 ("[The] USDA could consider . . . approaches [that] would move away from the current emphasis on completing nutrient analysis and documenting compliance. The initial approach might address fewer elements at a time but occur on a more frequent basis. . . . Focusing on Meal Requirements rather than the Nutrient Targets in planning and assessing school meals fits with the goals of both CRE and SMI reviews."); JX 58, at 4-5; Tr. 58 (Goodman).

26 Nutrition Standards in the National School Lunch and School Breakfast Programs, 76 Fed. Reg. 2494, 2536 (proposed January 13, 2011).

27 PANNELL-MARTIN & BOETTGER, *supra* note 15, at 78, 80-81.

28 JX 321, at 12.

certification").[29] The governing state authority must make an initial certification determination and, thereafter, monitor each school district's ongoing compliance with meal pattern requirements through administrative reviews that occur every three years.[30]

In 2012, the USDA provided three options to school districts to submit information to their state agencies for six cent certification. Option 1 involved submitting menus, a USDA worksheet, and a nutrient analysis.[31] This option allowed school districts that already owned Nutrient Analysis Software for their other needs to use it towards six cent certification as well. Option 2 allowed districts to submit menus, the USDA worksheet, and a Simplified Nutrient Assessment in lieu of nutrient analysis.[32] The Simplified Nutrient Assessment only analyzes calories, saturated fat, and sodium.[33] It does not require the data entry of all menu items or the use of a nutrient database.[34] School districts using this option could purchase another category of USDA-approved software, called Menu

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[29] *See* PANNELL-MARTIN & BOETTGER, *supra* note 15, at 43; *see also* 42 U.S.C. § 1753(b)(3)(C)(i) & (D).

[30] *See* JX 401, at 5.

[31] *Id.* at 10.

[32] *Id.* at 12.

[33] *Id.*

[34] *Id.*

Planning Tools Approved for Certification for Six Cent Reimbursement ("Menu Planning Tools"),[35] which performs the necessary functions under this option. Under Option 3, the state agency would conduct an on-site review.[36]

1. The parties prior to the transaction

Prior to the transaction, SL-Tech owned software and hardware to help K-12 schools monitor their food service operations' compliance with applicable regulations.[37] Three of these products are relevant in this dispute: WebSMARTT, mylunchmoney.com ("MLM"), and the Decision Support Toolkit ("DST"). WebSMARTT, a USDA-approved Nutrient Analysis Software, provided the end-to-end functionality to allow schools to monitor children's nutrition in school meals.[38] WebSMARTT encompassed point of sale, free and reduced meal eligibility tracking, menu planning, nutrient analysis, and production records functionalities.[39] MLM, a proprietary online payment-processing product, had approximately 10,000 schools as users.[40]

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[35] Tr. at 393-94 (Griffin); JX 400.

[36] Tr. at 393-94 (Griffin).

[37] PTO ¶ III.A.6 (citing JX 25, at 1); Tr. 20-22 (Goodman).

[38] Tr. 793-94 (Prescott).

[39] *Id.*

[40] JX 12.

In 2007, SL-Tech began building DST Phase 1 as a prototype, and in 2009, SL-Tech engaged Startech to develop and write the functional design documents for the full software product, DST Phase 2, which SL-Tech published on January 11, 2011 (the "Functional Design Documents").[41] In Phase 1, DST developed data analytics of sales and meal count data.[42] In Phase 2, DST would become cloud-based software that would allow schools and districts to menu plan and project the menus' effects on staffing, equipment, and other costs, and state administrators would be able to view this data simultaneously.[43]

SL-Tech also owned inTEAM, which was a "15-year-old management consulting company known historically for its hands-on workshops in financial management for school nutrition programs."[44] Additionally, inTEAM provided "comprehensive assessments of school nutrition programs."[45]

Heartland primarily acted as a credit card processor that provided terminals and software to enable merchants to accept credit cards.[46] In 2010, Heartland

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41 Tr. 487-90 (Ditch).

42 Tr. 30 (Goodman).

43 *Id.* at 33, 54.

44 JX 58, at 4.

45 *Id.*

46 Tr. 611-12 (Lawler).

began entering the K-12 school market because it "saw an opportunity [to] acquir[e] these companies that provided [] food management software."[47] Owning these products would allow Heartland to make money when the parents of students used their credit cards to pay for their children's lunches.[48] This strategy became the Heartland School Solutions division.[49]

2. The transaction

As part of their new School Solutions strategy, Heartland approached SL-Tech about a potential acquisition.[50] Goodman prepared an "Outline of Key Terms" in April 2011.[51] Goodman proposed that Heartland pay $17 million at closing (representing 60% of a "low-end valuation" of SL-Tech) plus earn-out payments (calculated as a percentage of a multiple of gross profit or EBITDA realized by Heartland) on each of the first five anniversaries of closing to compensate SL-Tech for the remaining 40% of the value of the company.[52] In addition, Goodman would become CEO of Heartland's School Solutions

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47 *Id.*

48 *Id.* at 613.

49 *Id.* at 612-13.

50 Tr. 738 (Lawler); Tr. 60 (Goodman).

51 Tr. 62 (Goodman).

52 JX 9, at 3.

business.[53] Heartland, however, did not want inTEAM's consulting business, including DST, which it felt was outside their strategy of "acquiring companies that provided the point-of-sale solutions to K through 12" schools.[54]

Eventually, the two companies agreed that Heartland would purchase substantially all of SL-Tech's assets, excluding the "inTEAM Business," among others.[55] Goodman would remain the owner and CEO of inTEAM as a separate legal entity, and he would serve as a consultant to Heartland.[56] The parties effectuated the transaction through the execution of three agreements: the Asset Purchase Agreement, the Co-Marketing Agreement, dated September 30, 2011 (the "Co-Marketing Agreement"), and the Consulting Agreement, dated September 30, 2011 (the "Consulting Agreement"). These agreements contain non-competition, non-solicitation, exclusivity, and cross-marketing and support obligations that form the basis of the alleged breaches here.

a. The Asset Purchase Agreement

On September 12, 2011, SL-Tech (the "Seller"), Heartland (the "Buyer"), Goodman (the "Major Shareholder"), and other shareholders (the "Seller

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53 Tr. 65-66 (Goodman).

54 Tr. 614 (Lawler).

55 JX 25 ("Asset Purchase Agreement") Exs. A-4, M.

56 JX 13, at 3-5.

Shareholders") executed the Asset Purchase Agreement.[57] Under the Asset Purchase Agreement, Heartland acquired WebSMARTT and MLM, among other assets, for $17 million.[58]

i. The non-competition provision

The Asset Purchase Agreement's covenant not to compete states in relevant part as follows:

> For a period of five (5) years from and after the Closing Date, neither Seller nor the Major Shareholder will engage directly or indirectly, on Seller's or the Major Shareholder's own behalf or as a Principal or Representative of any Person, in providing any Competitive Services or Products or any business that School-Link conducts as of the Closing Date in any of the Restricted Territory . . . .[59]

Thus, this non-competition provision prohibits SL-Tech and Goodman from engaging, directly or indirectly, on their own behalf or on behalf of any Person, in providing (1) any Competitive Services or Products, or (2) any business that School-Link conducts in the United States as of September 30, 2011.

The Asset Purchase Agreement defines "Competitive Services or Products" and "School-Link" as follows:

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[57] Asset Purchase Agreement at 1. The deal closed on September 30, 2011. *Id.* at 4.

[58] PTO ¶ III.B.4-5.

[59] Asset Purchase Agreement § 5(n), Ex. A. (defining "Restricted Territory" as the United States).

> "*Competitive Services or Products*" means a business that develops, manufactures, sells and services and maintains computer software and/or POS terminal hardware designed to facilitate (i) accounting and (ii) management and reporting of transactional data functions, of food service operations of K-12 schools (including point-of-sale operations, free and reduced application processing, ordering and inventory, and entry of meal and other payments by parents via the Internet or kiosk); *provided, however*, that for purposes of clarity, Competitive Services or Products shall not include the inTEAM Business as currently conducted.
>
> . . . .
>
> "*School-Link*" means the entirety of Seller's business, including the business of Seller known as "School-Link," but excluding the inTEAM Business.[60]

Hence, the Asset Purchase Agreement's non-competition provision excludes the "inTEAM Business" from the scope of prohibited activity (the "inTEAM Carve-Out").

The Asset Purchase Agreement defines "inTEAM Business" as follows:

> "*inTEAM Business*" means certain Excluded Assets consisting of Seller's consulting, e[L]earning and DST segments of the business known as "inTEAM" and including those products and services described in Exhibit C to the Co-Marketing Agreement.[61]

Accordingly, the non-competition obligations of SL-Tech and Goodman under the Asset Purchase Agreement are limited by and understood with reference to a

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[60] Asset Purchase Agreement Ex. A-1, A-8.

[61] Asset Purchase Agreement Ex. A-4.

carve-out defined therein and further described in Exhibit C of the Co-Marketing Agreement.[62]

ii. The non-solicitation provision

The Asset Purchase Agreement also contains a non-solicitation provision stating:

> For a period of five (5) years from and after the Closing Date, none of Seller or any Seller Shareholder will directly or indirectly, on Seller's or such Seller Shareholder's own behalf or as a Principal or Representative of any Person, solicit, divert, take away or attempt to solicit, divert or take away a Protected Customer or a Referral Source in any of the Restricted Territory for the purpose of providing Competitive Services or Products.[63]

The Asset Purchase Agreement goes on further to define "Protected Customer" as follows:

> (a) any Person to whom Seller sold, licensed or leased its products or services at any time during the twelve (12) month period ending on the Closing Date and (b) any Person that at any time during the twelve (12) month period ending on the Closing Date, Seller (i) provided a written price quote to or (ii) discussed with in writing other material terms.[64]

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[62] *See infra* Section I.B.2.b.i.

[63] Asset Purchase Agreement § 5(o).

[64] *Id.* Ex. A-7.

Thus, neither SL-Tech nor any shareholder of SL-Tech may solicit any Protected Customer or Referral Source in the United States in order to provide any Competitive Product or Service on or before September 30, 2016.[65]

b. The Co-Marketing Agreement

The Co-Marketing Agreement grants both Heartland and SL-Tech the right to market one another's products.[66] inTEAM assumed and was assigned all of SL-Tech's rights under the Co-Marketing Agreement through an Assignment and Assumption Agreement, dated October 31, 2011.[67]

i. The non-competition and exclusivity obligations

Similar to the Asset Purchase Agreement, the Co-Marketing Agreement provides that during the five years following closing, "inTEAM shall not engage, directly or indirectly, on its own behalf or as a principal or representative of any person, in providing any services or products competitive with the HPS Business."[68] In the same provision, Heartland grants a reciprocal covenant, which states,

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[65] *See supra* Section II.B.1.a.i. for further definitions of Restricted Territory and Competitive Services and Products.

[66] JX 23 ("Co-Marketing Agreement") § 2.1.

[67] PTO ¶ III.C.15.

[68] Co-Marketing Agreement § 9.1.1(B).

> [Heartland] shall not engage, directly or indirectly, on its own behalf or as a principal or representative of any person, in providing any services or products competitive with the inTEAM Business, and [Heartland] hereby grants to inTEAM the exclusive right and license under any intellectual property of [Heartland] (other than trademarks) to conduct the inTEAM Business.[69]

The Co-Marketing Agreement further defines "HPS Business" and "inTEAM Business" as follows:

> "HPS Business" means the development, manufacture, or sale of computer software and/or POS terminal hardware designed to facilitate (A) accounting and (B) reporting of transactional data functions and management of of [sic] food service operations of K-12 schools (including point-of-sale operations, free and reduced application processing, ordering and inventory, and entry of meal and other payments by parents via the Internet or kiosk).
>
> . . . .
>
> "inTEAM Business" means certain Excluded Assets consisting of inTEAM's consulting, eLearning and DST segments of the business known as "inTEAM" and including those products and services described in Exhibit A and those inTEAM products and services described in Exhibit C and Exhibit D.[70]

Thus, like the Asset Purchase Agreement, the Co-Marketing Agreement defines the inTEAM Business by reference to, among other things, products and services

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[69] *Id.* § 9.1.1.

[70] *Id.* § 1.1.2.

described in Exhibit C, which the parties attached to the Co-Marketing Agreement.[71]

Exhibit C states in its entirety:

> **Functional Specifications**
>
> Functional specifications for DST Phase 1 and add-ons and DST Phase 2 (future release); including unique state value added functionality (attached)
>
> Student Rewards functional specifications (attached)
>
> Off Campus Merchants functional specifications (attached)[72]

Attached to the Co-Marketing Agreement, and incorporated by reference, are the functional specifications for DST Phase 1 and Phase 2 in the form of the Functional Design Documents.[73]

The two DST Phase 2 Functional Design Documents discussed at trial were "Milestone A – Menu Item"[74] and "Milestone B – Menu Planning."[75] These Functional Design Documents explain how DST utilizes core menu planning

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[71] *Id.* Ex. C.

[72] *Id.*

[73] *See, e.g.*, JX 3 (DST Phase 2 Functional Design, Milestone A – Menu Item, dated January 10, 2011); JX 4 (DST Phase 2 Functional Design, Milestone B – Menu Planning, dated January 11, 2011); JX 326.

[74] JX 3.

[75] JX 4.

concepts, such as "menu items," "menu categories," "menu templates," and "menu cycles."[76] Each represents a building block that a school district or state administrator would use to create and plan a menu.[77] Menu items (servings of a specific food) are grouped into menu categories (such as fruits, etc.) and combined to form menu templates (an arrangement of items comprising a single meal).[78] A menu cycle then aggregates menu templates for each day over a specific period of time (week, month, etc.).[79] Further, the Functional Design Documents show DST Phase 2 anticipates allowing the user to create, edit, copy, and save in each phase of menu planning.[80]

ii. The termination provision

The Co-Marketing Agreement also contains a termination provision. Section 4.2.2 of the Co-Marketing Agreement states:

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76 Tr. 501-03 (Ditch); JX 3, at 7; JX 4, at 6.

77 Tr. 501-02 (Ditch).

78 *Id.*

79 *Id.* at 502-03.

80 *Id.* at 509-36; JX 3, at 8-12 (edit, save, and delete menu category, including create and input description), 20-25 (copy menu items), 29-30 (input and edit portion size and service unit for menu items); JX 4, at 19-22 (create new menu template), 23-27 (copy existing menu template), 29-35 (create, copy, and edit menu items to populate menu template), 36-39 (create new menu cycle and input menu cycle data), 40-41 (copy existing menu cycle), 47-48, 52-54 (drag and drop menu templates into menu cycles).

> In the event that a Provider does not meet a Renewal Threshold applicable to a Product of the Recipient, the Recipient may terminate this Agreement with respect to the provision of such Product upon thirty (30) days' prior written notice to the Provider, provided that the Recipient must provide notice of termination within sixty (60) days after the applicable anniversary of the Effective Date. In the event of a termination of a product . . . (A) the corresponding obligations set forth in Section 2 and Section 3 shall cease to apply and (B) if the termination is a termination by HPS of Student Rewards or Off-Campus Merchants, the obligations set forth in Section 9.1, including, without limitation, the exclusivity and non-competition obligations therein, shall cease to apply with respect to Student Rewards or Off-Campus Merchants, as applicable.[81]

In other words, if for instance, inTEAM does not meet its Renewal Thresholds, which are sales targets, for a certain Heartland product, Heartland can terminate the Co-Marketing Agreement with respect to that product with thirty days' written notice.[82] Upon termination, the obligations in Sections 2 and 3 no longer apply.

iii. The cross-marketing and support obligations

Section 2 of the Co-Marketing Agreement creates several cross-marketing and support obligations. The relevant portion of Section 2.4 provides:

> As part of HPS Services, during the Term, HPS shall prominently display the Licensed Content provided by inTEAM on the MLM website and shall work in good faith with inTEAM to determine the commercial viability

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[81] Co-Marketing Agreement § 4.2.2.

[82] *Id.*

> of incorporating such Licensed Content into other K-12 payment center websites (with functionality similar to MLM) of HPS that are developed by such parties during the Term.[83]

"Licensed Content" is defined as "website content, promotional materials or campaign-related communications . . . includ[ing] only content developed or created by or for a Party that such Party delivers to the other Party and specifically designates in writing as Licensed Content."[84] Thus, Heartland agrees to display inTEAM's Licensed Content on its MLM website, and Heartland also agrees to perhaps incorporate the content into other K-12 payment center websites.[85]

Section 2.5.2 incorporates by reference Section 4.2.2, the termination provision, and states:

> HPS shall provide inTEAM the customer lists and reseller lists pertaining solely to MLM and the Developed Websites (including updates to such lists that are made during the Term) of HPS and HPS Affiliates for the purposes of marketing and selling Student Rewards and Off-Campus Merchants to such customers and resellers.[86]

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83 *Id.* § 2.4.

84 *Id.* § 5.2.1.

85 *Id.* §§ 2.4, 5.2.1.

86 *Id.* § 2.5.2.

Under this provision, Heartland is obligated to provide inTEAM with lists of parents and schools from MLM and any other Heartland K-12 payment center websites with functionality similar to MLM in order to allow inTEAM to market Student Rewards and Off-Campus Merchants.[87]

The parties also agreed to provisions governing the support of technology. The relevant language from Section 2.6 states:

> To the extent that performance or receipt of Services hereunder requires a Party to have access to the other Party's intranet or other computer software, networks, hardware, technology or computer-based resources ("Required Technology"), such other Party shall provide (or cause to be provided) limited access to such Required Technology . . . In no event shall a Party be obligated to provide such access beyond the limited access necessary to permit the other Party to perform or receive the Services as required under this Agreement.[88]

"Services" are defined as "inTEAM Services" and "[Heartland] Services." inTEAM Services are "subject to Section 4.2.2," and give inTEAM Parties "the right to market, advertise, and promote sales of the HPS Products."[89] Heartland Services are "subject to Section 4.2.2" and give Heartland Parties "the right to

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[87] *Id.* §§ 2.4, 2.5 (incorporating the definition of Developed Websites from Section 2.4.).

[88] *Id.* § 2.6.

[89] *Id.* § 2.1.

market, advertise, and promote sales and licenses of the inTEAM Products."[90] In other words, each party must allow the other party the minimum access to whatever necessary technology is required for them to perform their marketing and sales obligations under the agreement, but no more. These obligations are expressly subject to the termination provision.

Section 2.8 adds: "[p]arties shall use commercially reasonable best efforts to develop and maintain all applicable Products, related websites and related technology assets and ensure that the Products and related websites and technology assets are all integrated and interfaced . . . such that the products may be cross-promoted."[91]

c. The Consulting Agreement

Under the Consulting Agreement, Goodman is to act as a "strategic advisor" to Heartland and as a "liaison with key industry stakeholders advancing Heartland's objectives."[92] In return, Goodman is to receive a monthly salary of $16,666.67.[93]

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[90] *Id.* § 2.1.

[91] *Id.* § 2.8.

[92] JX 22 ("Consulting Agreement") ¶ 1.

[93] *Id.* ¶ 3.

i. The non-competition provision

The relevant non-competition language binds Goodman ("Consultant") as follows:

> During the Term of this Agreement and for two (2) years thereafter, the Consultant shall not directly or indirectly, on behalf of himself or on behalf of any other person, firm or business entity: (i) become an owner of any outstanding capital stock, or a member or partner, of any company, partnership, or entity that engages in, Competitive Business within the Restricted Territory; or (ii) perform or provide any services, whether as an employee, owner, consultant or otherwise, to, for or on behalf of any company, partnership, or entity that engages in Competitive Business within the Restricted Territory, if such services are the same or similar in character to the services performed or provided by the Consultant to Heartland pursuant to this Agreement. . . . For purposes of this Agreement, "<u>Competitive Business</u>" shall be defined as follows: developing, manufacturing, selling, servicing or maintaining computer software and/or POS terminal hardware designed to facilitate (i) accounting or (ii) management and reporting of transactional data functions of food service operations of K-12 schools (including point-of-sale operations, free and reduced application processing, ordering and inventory, entry of meal or other payments by parents via the Internet or kiosk); provided, however, for purposes of clarity, Competitive Business shall not include the inTEAM Business (as defined in the Asset Purchase Agreement) as conducted as of the effective date of the Asset Purchase Agreement. For purposes of this Section 11, "Restricted Territory" shall be defined as the entire United States of America.[94]

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[94] *Id.* ¶ 11(a).

In other words, for five years[95] after the agreement's Effective Date on September 30, 2011, Goodman cannot directly or indirectly become an owner of any entity that does Competitive Business with Heartland, or perform or provide any services to an entity that engages in Competitive Business, in the entire United States of America. "Competitive Business" essentially refers to the same definition as "Competitive Services or Products" under the Asset Purchase Agreement, and it specifically carves out the inTEAM Business.[96] If Goodman provides services to a Competitive Business, he will only be in breach if such services are similar to those he is providing to Heartland.

ii. The non-solicitation provision

The Consulting Agreement contains a non-solicitation provision that also binds Goodman. It states:

> During the Term of this Agreement and for two (2) years thereafter, the Consultant shall not directly or indirectly, on behalf of himself or on behalf of any other person, firm or business entity: (i) contact, solicit or do business with, or attempt to contact, solicit, or do business with, any Customer of Heartland for purposes of conducting any Competitive Business; or (ii) encourage or attempt to encourage any Customer of Heartland to terminate, or

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95 The agreement's "Term" is three years following the effective date, Consulting Agreement ¶ 5, and the provision at issue adds "two (2) years thereafter," totaling five years. Consulting Agreement ¶ 11(b).

96 *See supra* Sections I.B.2.b.i, I.B.2.a.i.

> materially and adversely modify, its relationship with Heartland or to cease or refrain from doing business with Heartland. "Customers" means all customers, clients, vendors, and suppliers, as well as any prospective customers, clients, vendors, and suppliers, of Heartland (or any of its subsidiaries or affiliated entities), and all customers, clients, vendors, and suppliers, as well as any prospective customers, clients, vendors, and suppliers, of Seller prior to the Effective Date. The non-solicitation provision in this Section 11 shall only apply to those Customers with whom the Consultant worked, or about whose business or needs the Consultant gained information, either in his capacity as an officer with Seller, or in his capacity as Consultant under this agreement.[97]

Goodman essentially cannot contact or attempt to contact any customer or prospective customer of Heartland for purposes of conducting Competitive Business, as defined in the corresponding non-competition provision, or encourage any customer of Heartland to terminate or modify its relationship with Heartland. The customer must be someone with whom Goodman worked or on whose business he gained information through his capacity at SL-Tech or his capacity as consultant for Heartland.

3. Post-transaction occurrences

After the closing of the transaction, the parties began working together under the new arrangement. But this co-existence was short lived and unsuccessful.

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[97] Consulting Agreement ¶ 11(b).

a. The parties execute memoranda of understanding and launch KidsChoose

Shortly after executing the Asset Purchase Agreement and Co-Marketing Agreement, Heartland and inTEAM executed a Memorandum of Understanding dated November 29, 2011 (the "2011 MOU") and a supplemental Memorandum of Understanding dated February 10, 2012 (the "2012 MOU").[98] The 2011 MOU clarified inTEAM's ability to develop a state-level Meal Benefits Management System within DST to fulfill pre-existing contracts with customers without becoming competitive with Heartland.[99]

The 2012 MOU memorialized the agreement between Heartland and inTEAM regarding the new program KidsChoose, but it did not alter the Co-Marketing Agreement.[100] Under the 2012 MOU, inTEAM would develop KidsChoose to allow parents to set up spending accounts for students to buy third-party products, and inTEAM would have exclusive marketing rights.[101] Heartland would share student payment information, allow promotion by a "banner ad" in Heartland's existing MLM program, provide the payment processing functionality

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98 JX 29; JX 44.

99 JX 29, at 1; JX 34, at 1.

100 JX 44, at 1.

101 JX 42; JX 44, at 2-3.

for the KidsChoose website, and, in return, retain a portion of the revenue.[102] Over the course of the next year, Roberts and Goodman had multiple discussions regarding the pilot launch of KidsChoose.[103] Heartland selected the KidsChoose pilot schools in January 2014 and sent out the initial marketing e-mail campaign in March 2014.[104]

The KidsChoose launch failed to meet expectations.[105] Thereafter, Heartland decided not to devote additional resources to KidsChoose.[106] In August 2014, Heartland and inTEAM agreed that inTEAM would develop a version of KidsChoose that was independent of any Heartland product.[107] Heartland agreed to promote KidsChoose every six months through e-mails to parents in twenty MLM districts and to provide meal history for students who used KidsChoose.[108]

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[102] JX 44, at 2-3.

[103] JX 105; JX 112; JX 131; JX 142; JX 143.

[104] Tr. 1117-18 (Roberts).

[105] JX 212 (stating that the first marketing campaign did not yield a single sign up for KidsChoose).

[106] Tr. 1129-30 (Roberts).

[107] JX 240.

[108] *Id.*

As compensation, Heartland would receive two percent of revenue from KidsChoose transactions.[109]

b. The USDA approves DST as a Menu Planning Tool

After the HHFKA's new regulations were finalized in 2012,[110] inTEAM incorporated the Simplified Nutrient Assessment components into the existing DST functions and created the "Menu Compliance Tool+" module, which became the first USDA-approved Menu Planning Tool for six cent certification.[111] inTEAM also added administrative review software to its arsenal in 2014.[112] inTEAM's Menu Compliance Tool+ currently is not approved as Nutrient Analysis Software.[113]

c. Heartland partially terminates the Co-Marketing Agreement

In November of 2013, Heartland notified inTEAM that it was terminating the Co-Marketing Agreement as to WebSMARTT, State Compliance Software, MLM, Student Rewards, and Off-Campus Merchants because inTEAM had not

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[109] *Id.*

[110] *See supra* Section II.B.

[111] Tr. 387 (Griffin); Tr. 542 (Ditch).

[112] Tr. 142 (Goodman).

[113] JX 359; JX 360.

met sales targets for those products.[114] Michael Lawler sent an e-mail to Chip Goodman stating as follows:

> The purpose of this letter is to inform that you [sic] pursuant to the inTEAM/Heartland Co-Marketing Agreement, we would like to terminate to [sic] the CMA in relation to the following products and services identified in Exhibit B:
>
> - WebSMARTT
> - State Compliance Software
> - MLM
> - Student Rewards
> - Off Campus Merchants
>
> Pursuant to section 4.2.2 of the CMA, the sales thresholds for these products were not met as of the 2-year anniversary of the CMA's effective date.[115]

Goodman accepted this termination, but clarified that the MOU was still in place regarding KidsChoose and DST by stating as follows:

> [W]e accept [Heartland]'s notice to terminate Exhibit B of the CMA. That said, let's clarify a couple of points in areas where we have made very substantial investments: As you and I discussed at our meeting last week, the February 10, 2012 MOU (including the exclusivity rights described in the MOU) continues to govern our relationship with respect to Off-Campus Merchants/KidsChoose, and DST Phase II

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114 JX 184; Co-Marketing Agreement § 4.2.2.

115 JX 184.

> notwithstanding the termination of Exhibit B of the CMA.[116]

d. inTEAM employees e-mail potential customers

On July 24, 2014, Goodman sent an e-mail to Geri Hughes, an employee of inTEAM, with the subject line, "St Paul Window of Opportunity."[117] Goodman writes in the e-mail "Did Mary Jo recap the opportunity to you?" to which Hughes replies, "Yes. I will discuss with you when we meet this afternoon. As you know, Jean's replacement (Jim) as [sic] not been as interested in help and this is her new approach."[118] Below Hughes' reply is the tagline: "Note to Jim Hemmen regarding our menu planning tool/production record alternative to WebSMARTT."[119]

On December 15, 2014, Tuckwell e-mailed Jean Ronnei, the COO for St. Paul Public Schools, stating:

> Based on interactions I had with Jim at ANC in July I believe the department was still struggling with automating production records. In August there was discussion of me providing a demo to key central office staff of the inTEAM menu planning and production record modules as an alternative to the WebSMARTT system. That offer remains open if your team is interested . . . whether you stay with WebSMARTT or

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116 JX 187.

117 JX 234.

118 *Id.*

119 *Id.*

> are interested in an alternative, I would urge the team to prioritize this activity to achieve financial success.[120]

Tuckwell then forwarded this e-mail to Hughes, who sent it to Goodman and Michael Sawicky, a senior software engineer at inTEAM, saying that the inTEAM employees had "confirmed that Jim is leaving St Paul and he has been stopping our efforts so that is good. . . . I give MJ full credit for continuing to nurture this key relationship with Jean and for continuing to push for them to use our tools."[121]

e. Heartland collaborates with Colyar on a joint proposal and inTEAM submits a competing proposal

On May 12, 2015, the Texas Department of Agriculture issued a "REQUEST FOR OFFERS TO PROVIDE Menu Analysis & Planning System (MAPS) Software Solutions" (the "Texas Request").[122] On May 27, 2015, inTEAM contacted Heartland regarding a potential joint proposal to the Texas Request.[123] Heartland declined.[124]

On June 19, 2015, Heartland, teamed with Colyar Technology Solutions, Inc. ("Colyar"), an inTEAM competitor since 2014, and submitted a bid to provide

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[120] JX 248.

[121] *Id.*

[122] PTO ¶ III.F.31.

[123] JX 261, at 2.

[124] *Id.* at 1.

a MAPS solution.[125] Colyar's software assists state agencies in performing audits and administrative reviews for USDA compliance.[126] Texas did not select the Heartland/Colyar joint proposal.[127] After losing the bid, Heartland promised to "ramp up efforts with Colyar[]" to bid in other states.[128]

After the Heartland rejection, inTEAM submitted its competing bid to the Texas Request.[129] In its proposal, inTEAM represents that its new software, will have the capability to meet all of the requirements of the Texas Request, including point-of-sale, nutrient analysis, and menu planning.[130] inTEAM's proposal also was not selected by Texas.[131] On July 20, 2015, inTEAM notified Heartland of its wrongful competition and breach of the Co-Marketing Agreement.[132]

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[125] PTO ¶ III.F.32-34; Tr. 142 (Goodman).

[126] Tr. 141-42 (Goodman); Tr. 1161, 1165 (Roberts).

[127] PTO ¶ III.F.32-34; Tr. 1166 (Roberts).

[128] JX 295.

[129] PTO ¶ III.F.32.

[130] JX 275; Tr. 472-79 (Griffin).

[131] PTO ¶ III.F.32-34.

[132] JX 433.

f. inTEAM launches CN Central

In July 2015, inTEAM presented its "Big Reveal" of the new, rebranded successor to DST, CN Central, to the public.[133] CN Central combined all of inTEAM's modules, including the Menu Compliance Tool+, under one system.[134] This brought together the ability to analyze certain nutrients, menu plan, menu search, menu share, generate production records, and assist administrative reviews.[135]

g. An inTEAM employee gathers information regarding point of sale software

On March 22, 2016, inTEAM Senior Consultant Kim Coleman e-mailed Lisa Sims at the Kentucky School District stating:

> We are looking at adding a POS feature to our inTEAM software package to go with the Menu Planning, Production Records, Pre-cost, etc. My boss has asked me to reach out to several KY schools and see if I could get a copy of your current POS maintenance invoice for competitive research purposes. I was told that this should be public record and could help us offer the best deal possible in moving forward with this decision.[136]

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[133] JX 265; Tr. 29 (Goodman).

[134] Tr. 283-84 (Goodman); Tr. 445, 448-51 (Griffin).

[135] *Id.*

[136] JX 418, at 2.

C. Parties' Contentions

inTEAM alleges that Heartland has materially breached the non-competition, exclusivity rights, and cross marketing and support provisions of the Co-Marketing Agreement. Specifically, inTEAM avers that Heartland's partnership with Colyar breached the first two provisions, and its repeated failure to support inTEAM in various capacities or to display inTEAM's content breached the final provision. inTEAM seeks damages, costs and attorney's fees, specific performance requiring Heartland to provide certain customer and reseller lists, and injunctive relief preventing Heartland from continuing to compete with inTEAM.

Heartland denies any breach and argues that the inTEAM Business as defined at the execution of the Co-Marketing Agreement controls, which at that time did not contain anything competitive with Colyar. Furthermore, Heartland contends that it did not actually provide any service to Colyar, and inTEAM provided no evidence of Heartland's breach of cross-marketing or support obligations. Heartland also asserts the defenses of laches, prior material breach, unclean hands, and prior termination.

Against inTEAM, Heartland alleges breach of the Co-Marketing Agreement's non-competition provision because inTEAM developed a product, CN Central, which is competitive with WebSMARTT. Heartland requests

injunctive relief enforcing the Co-Marketing Agreement, as well as costs and attorney's fees.

Against Goodman, Heartland asserts breach of both the non-competition and non-solicitation provisions under both the Asset Purchase Agreement and the Consulting Agreement. Heartland alleges Goodman violated his non-solicitation obligations by serving as majority owner and CEO of a company that has developed a product that competes with WebSMARTT. Heartland further claims that Goodman breached his non-solicitation obligations through his involvement with inTEAM employees' efforts to solicit business from St. Paul Public Schools. Heartland seeks injunctive relief preventing Goodman from engaging in any further competitive activities or further participation at inTEAM, and preventing inTEAM from using any of the knowledge or services provided by Goodman. Heartland also seeks disgorgement by Goodman of any profits realized from his competitive activities.

inTEAM and Goodman contend that they are not in breach of the non-competition provisions because the three agreements create the inTEAM Carve-Out, which includes the business currently run by inTEAM. Goodman argues he is not in breach of his non-solicitation obligations under the Asset Purchase Agreement or the Consulting Agreement because there is no evidence that he made any type of contact in violation of either agreement. Goodman contends he also is

not in breach of the non-solicitation provision under the Asset Purchase Agreement because he is not a Seller Shareholder as defined under that agreement. inTEAM and Goodman also assert the defenses of laches, acquiescence, waiver/estoppel, unclean hands, prior material breach, failure to mitigate damages, and ask for reduction/set off of damages against inTEAM's own damages.

II. ANALYSIS

"Plaintiffs, as well as Counterclaim-Plaintiffs, have the burden of proving each element, including damages, of each of their causes of action against each Defendant or Counterclaim-Defendant, as the case may be, by a preponderance of the evidence."[137] Proof by a preponderance of the evidence means proof that something is more likely than not.[138] "By implication, the preponderance of the evidence standard also means that if the evidence is in equipoise, Plaintiffs lose."[139] Thus, to prevail on their respective breach of contract claims, both inTEAM as plaintiff and Heartland as counterclaim plaintiff must prove by a preponderance of the evidence (1) the existence of a contract, (2) the breach of an

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[137] *Revolution Retail Sys., LLC v. Sentinel Techs., Inc.*, 2015 WL 6611601, at *9 (Del. Ch. Oct. 30, 2015).

[138] *Agilent Techs., Inc. v. Kirkland*, 2010 WL 610725, at *13 (Del. Ch. Feb. 18, 2010).

[139] *Revolution Retail*, 2015 WL 6611601, at *9; *2009 Caiola Family Tr. v. PWA, LLC*, 2015 WL 6007596, at *12 (Del. Ch. Oct. 14, 2015).

obligation imposed by that contract, and (3) damages suffered as a result of that breach.[140]

"A contract's express terms provide the starting point in approaching a contract dispute."[141] Delaware follows an objective theory of contracts, "which requires a court to interpret a particular contractual term to mean 'what a reasonable person in the position of the parties would have thought it meant.'"[142] When a contract is clear and unambiguous, "the court's role is to effectuate the parties' intent based on the parties' words and the plain meaning of those words."[143] "'In upholding the intention of the parties, a court must construe the agreement as a whole, giving effect to all provisions therein.' The meaning inferred from a particular provision cannot control the meaning of the entire

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140 *Revolution Retail*, 2015 WL 6611601, at *9.

141 *Ostroff v. Quality Servs. Labs., Inc.*, 2007 WL 121404, at *11 (Del. Ch. Jan. 5, 2007).

142 *Charney v. Am. Apparel, Inc.*, 2015 WL 5313769, at *10 (Del. Ch. Sept. 11, 2015) (citing *Rhone-Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co.*, 616 A.2d 1192, 1196 (Del. 1992)).

143 *Zimmerman v. Crothall*, 62 A.3d 676, 690 (Del. Ch. 2013) (citing *Lorillard Tobacco Co. v. Am. Legacy Found.*, 903 A.2d 728, 739 (Del. 2006)).

agreement if such an inference conflicts with the agreement's overall scheme or plan."[144]

"The parties' steadfast disagreement over interpretation will not, alone, render the contract ambiguous."[145] Neither will "extrinsic, parol evidence . . . be used to manufacture an ambiguity in a contract that facially has only one reasonable meaning."[146] A term in a contract is ambiguous when it is "reasonably or fairly susceptible to different interpretations or may have two or more different meanings."[147] If a contract is ambiguous, a court may consider extrinsic evidence to interpret the intent of the parties.[148]

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[144] *GMG Capital Invs., LLC v. Athenian Venture P'rs I, L.P.*, 36 A.3d 776, 779 (Del. 2012) (quoting *E.I. du Pont de Nemours and Co., Inc. v. Shell Oil Co.*, 498 A.2d 1108, 1113 (Del. 1985)).

[145] *Osborn v. Kemp*, 991 A.2d 1153, 1160 (Del. 2010) (citing *Twin City Fire Ins. Co. v. Del. Racing Ass'n*, 840 A.2d 624, 628 (Del. 2003); *Rhone-Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co.*, 616 A.2d 1192, 1195 (Del. 1992)).

[146] *United Rentals, Inc. v. RAM Hldgs., Inc.*, 937 A.2d 810, 830 (Del. Ch. 2007) (citing *Eagle Indus., Inc. v. DeVilbiss Health Care, Inc.*, 702 A.2d 1228, 1232 (Del. 1997) ("If a contract is unambiguous, extrinsic evidence may not be used to interpret the intent of the parties, to vary the terms of the contract or to create an ambiguity.")).

[147] *Id.* (citing *Rhone-Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co.*, 616 A.2d 1192, 1196 (Del. 1992)).

[148] *iBio, Inc. v. Fraunhofer USA, Inc.*, 2016 WL 4059257, at *5 (Del. Ch. July 29, 2016) (citing *Eagle Indus., Inc. v. DeVilbiss Health Care, Inc.*, 702 A.2d 1228, 1232 (Del. 1997)).

None of the parties challenges the validity or enforceability of any of the provisions; as such, I do not analyze those issues. The claims, instead, hinge on this Court's interpretation of inTEAM Business as defined in the relevant agreements. Thus, I begin by analyzing the definition of inTEAM Business and determining whether the inTEAM business as currently conducted violates any of the non-competition provisions. Then, I analyze whether Heartland or Goodman breached any contractual obligations. Finally, I determine the appropriate remedy for any breaches.

A. inTEAM's Business as Currently Conducted Does Not Breach its Non-Competition Obligations Under the Asset Purchase Agreement or the Co-Marketing Agreement

Heartland contends that inTEAM breached its non-competition obligations under the Co-Marketing Agreement because the inTEAM Carve-Out only extended to functionality that existed as of the closing date.[149] Heartland argues that, because inTEAM's CN Central product now can plan menus,[150] generate production records,[151] facilitate USDA compliance,[152] and analyze nutrients,[153]

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[149] Def.'s Opening Br. 37-38.

[150] Tr. 344 (Griffin).

[151] *Id.*

[152] *Id.*

[153] *Id.* at 445.

which are capabilities developed after closing, inTEAM is in breach of the non-competition provision.[154] For all the reasons stated below, inTEAM did not breach its non-competition obligations.

The Asset Purchase Agreement and the Co-Marketing Agreement contain materially similar non-competition obligations.[155] The Asset Purchase Agreement's non-competition provision states that SL-Tech and Goodman will not provide Competitive Services or Products (or any business that SL-Tech conducts) in the United States for five years.[156] The definition of SL-Tech and the definition of Competitive Services and Products exclude the inTEAM Business.[157] Similarly, the Co-Marketing Agreement prohibits inTEAM from directly or indirectly "providing any services or products competitive with [Heartland]."[158] Both the Asset Purchase Agreement and the Co-Marketing Agreement define the inTEAM Business as the consulting, eLearning, and DST portions of the business.[159] And,

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[154] Def.'s Opening Br. 43.

[155] Although Heartland only asserts claims under the Co-Marketing Agreement against inTEAM, I also discuss the Asset Purchase Agreement for the sake of completeness.

[156] Asset Purchase Agreement § 5(n), Ex. A-8 (definition of Restricted Territory).

[157] *Id.* Exs. A-1, A-8.

[158] Co-Marketing Agreement § 9.1.1.

[159] Asset Purchase Agreement Ex. A-4; Co-Marketing Agreement § 1.1.2.

both definitions of the inTEAM Business reference those products and services described in Exhibit C to the Co-Marketing Agreement.[160] Exhibit C incorporates by reference the Functional Design Documents for "**DST Phase 2 (future release)**" (emphasis added).[161] Thus, the inTEAM Business as defined in the Asset Purchase Agreement, Co-Marketing Agreement, Exhibit C, and the Functional Design Documents, does not breach the non-competition provisions.

1. The inTEAM Business definition expressly includes the ability to plan menus, generate production records, and assist administrative reviews

Throughout 2010, SL-Tech closely followed the developments of the Committee on Nutritional Standards for National School Lunch and Breakfast Programs.[162] When the committee published the IOM Report in 2010, SL-Tech foresaw the sea change the new recommendations would bring under the HHFKA.[163] Thus, SL-Tech incorporated the IOM Report's proposed changes to de-emphasize nutrient analysis and emphasize food-based menu planning into their "2011 Business Plan," which was published at the end of 2010.[164] This plan

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160 *Id.*

161 Co-Marketing Agreement Ex. C.

162 JX 58, at 4-5.

163 Tr. 54-55 (Goodman).

164 JX 58, at 4-5.

discusses a product that will "focus on new menu planning requirements" and "may only be feasible in large districts or when offered by the state agencies."[165] SL-Tech also began to overhaul DST Phase 2 in 2010 in response to the IOM Report by incorporating the recommendations into the Functional Design Documents for DST Phase 2, which were finalized in early January 2011.[166]

The Functional Design Documents, including those titled "Milestone A — Menu Item" and "Milestone B — Menu Planning," envisioned a product that would have the new, post-HHFKA menu planning as its core concept. The menu planning functionality would allow the user to create, edit, copy, and save menu items, menu categories, and menus to be placed in menu cycles.[167] The user could manage the entire menu planning process from inputting a single serving of a specific food, to assigning it to a larger category, to arranging a collection of foods into a meal, to finally, creating a cycle of meals to rotate over weeks or months.[168] The Functional Design Documents also described a product that would allow schools or districts to project the menus' impact on other areas of food programs,

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165 *Id.* at 8.

166 JX 3; JX 4.

167 *See* JX 3, at 8-12; JX 4, at 19-22; Tr. 509-36 (Ditch).

168 Tr. 501-503 (Ditch).

such as staffing, equipment, and food/labor costs.[169] Both Heartland and inTEAM point to extrinsic evidence to support their competing interpretations of the inTEAM Business and whether menu planning is included. I need not consider any extrinsic evidence because I find that the contract unambiguously includes menu planning in the inTEAM Carve-Out.

The Functional Design Documents also envisioned that DST Phase 2 would generate production records.[170] The Functional Design Documents do not explicitly reference "production records" in the same way they mention menu planning. Both parties, however, agree on the definition of a production record.[171] Notably, Heartland's own witness, Prescott, testified that a production record is a comparison of what the school planned to serve, what the school actually prepared, and what the school actually sold.[172] He stated these components include: the menu plan to which the school is referring, the menu cycle's week, how many of each item the school planned to serve, how many the school actually produced, and how many items they actually served.[173] The DST Phase 2 Functional Design

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[169] JX 3; JX 4; JX 326; Tr. 33, 54-57 (Goodman).

[170] JX 4.

[171] *See* Tr. 794 (Prescott); Tr. 451-52 (Griffin).

[172] Tr. 794.

[173] *Id.* at 810.

Documents have inputs for all of these components.[174] Although Heartland points to extrinsic evidence to argue the agreement unambiguously supports its contention that production records are not included in the definition of inTEAM Business, I need not consider this evidence because the functionality is included, unambiguously, in the Functional Design Documents.[175]

To prove that the inTEAM Carve-Out includes administrative review software, inTEAM relies on Exhibit C, which states that DST Phase 2 will include "unique state value added functionality."[176] Goodman testified that he understood the phrase in Exhibit C to mean the ability to "allow[] [state reviewers or auditors] immediate access to records that they needed to review electronically that were created and generated generally at the school district level,"[177] causing "a breakthrough in the way audits were conducted and the value that was added for state agencies."[178] Additionally, Ditch testified that the cloud-based integration

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174 *See* JX 4, at 31 (showing an input for Name, Served as Meal %, A La Carte %, and a Week and Day label); JX 326, at 259 (showing editable columns for Served as Meal %, A La Carte %).

175 *See* Def.'s Opening Br. 37, 43 (citing Sawicky Dep. Tr. 78, 79, 87); JX 104; Sawicky Dep. Tr. 14.

176 Pl.'s Opening Br. 52.

177 Tr. 91.

178 *Id.*

would allow both state agencies and school districts to use common functions and access records in real time."[179]

Goodman also testified that the phrase meant "during an administrative review related to menu plans, in particular, the ability to have school districts within that state either to utilize the third-party systems that they already had, or allow them to utilize our menu compliance tool directly so that the data feed was always available at the state level."[180] Griffin then testified that the "additional state value" of inTEAM's Menu Compliance Tool+ was that the state agencies are able to access the districts' menu information directly and, as a result, are able to modify the menus within the system to assure the district is in compliance before the agency comes on-site to do a review.[181]

Heartland does not rebut this testimony and instead argues that because this functionality did not exist until 2014, three years after the parties signed the Co-Marketing Agreement, it could not be part of the "state value added functionality" described in the agreement.[182] This argument fails because the definition of inTEAM Business, which references Exhibit C and discusses a "future release" of

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[179] Tr. 500-01 (Ditch); JX 23, at 33.

[180] Tr. 153-54.

[181] Tr. 414-15.

[182] Def.'s Answering Br. 26-27.

DST Phase 2 as defined in the Functional Design Documents, anticipated the development of a product with functionality that did not exist at closing.

Heartland also argues "no inTEAM witness made any effort to show that the functionality of inTEAM's administrative review software module was identified in the functional design documents."[183] This argument ignores the first part of Goodman's testimony, which specifically discusses Exhibit C (and, by reference, the Functional Design Documents).[184] This argument also fails to address the language of the Functional Design Documents, which state "District Administrators [] will configure their districts within DST . . . State Agency Administrators (SAs) will . . . be able to access the new district and building setup screens."[185] Heartland offers no testimony or evidence to rebut these descriptions of the "unique state value added functionality" of the inTEAM Carve-Out, and inTEAM meets its burden to show it bargained for this functionality at the time of the transaction.

By January 2011, inTEAM was contemplating a future release of DST Phase 2 that would have greater functionalities than existed at the time of the agreement. Exhibit C and the Functional Design Documents expressly reference those

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183 *Id.* at 27.

184 Tr. 91 (Goodman).

185 JX 3-4, at 5.

functionalities, which included the ability to plan menus, generate production records, and assist administrative reviews. Heartland agreed to incorporate Exhibit C and the Functional Design Documents into the inTEAM Business definition described in the Asset Purchase Agreement and the Co-Marketing Agreement, and it cannot now simply ignore what those documents state.

2. The ability to analyze certain nutrients does not violate the non-competition obligations

Heartland also points to the Menu Compliance Tool+'s ability to analyze limited nutrients to show that inTEAM attempted to "engage in providing"[186] products and services competitive with WebSMARTT.[187] The parties seem to agree that Heartland had the exclusive ability to conduct "nutrient analysis" as the USDA regulations define that term.[188] The parties, however, dispute whether the ability to analyze a more limited subset of nutrients would violate the non-competition clause.[189] Neither the Asset Purchase Agreement nor the Co-Marketing Agreement addresses this issue or expressly defines "nutrient analysis." Therefore, I look to the USDA regulations, because the very purpose of this

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[186] Co-Marketing Agreement § 9.1.1.

[187] Def.'s Opening Br. 31.

[188] *See* Tr. 21-22, 122, 154-56 (Goodman); Def.'s Opening Br. 33.

[189] Pl.'s Answering Br. 18; Def.'s Opening Br. 33 n.10.

software is to aid districts in reporting for USDA compliance. Even if Heartland can point to some overlap in the functionalities of WebSMARTT and inTEAM's Menu Compliance Tool+ in terms of analyzing nutrients, Heartland fails to prove that inTEAM's product improperly competes with WebSMARTT.

Nutrient Analysis Software and Menu Planning Tools perform different functions under the HHFKA.[190] Nutrient Analysis Software, such as WebSMARTT, can run a full nutrient analysis, while Menu Planning Tools, such as inTEAM's Menu Compliance Tool+, can run a Simplified Nutrient Assessment of calories, saturated fat, and sodium.[191] Heartland's own expert witness admitted that this is only a subset of the nutrients WebSMARTT can analyze, and inTEAM's Menu Compliance Tool+ cannot analyze the full range of components necessary for a full nutrient analysis.[192]

Heartland tries to argue that the classification of the products is not the issue, but rather the overlapping functionality.[193] The USDA, however, classifies these various software programs according to their functionality in carrying out the

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[190] *See supra* Section I.B.

[191] *See id.*

[192] Tr. 921-22 (Fox).

[193] Def.'s Opening Br. 35, n.10.

purpose of the regulations.[194] The USDA approves certain programs as one and not the other, and some as both.[195] Heartland should be familiar with this concept, as WebSMARTT unsuccessfully attempted to obtain USDA approval as a Menu Planning Tool,[196] and another Heartland program, Mosaic Menu Planning, is an approved Menu Planning Tool and Nutrient Analysis Software.[197] Thus, Heartland has not met its burden to prove that inTEAM's Menu Compliance Tool+'s ability to analyze limited nutrients violates the Co-Marketing Agreement's non-competition provision.

B. Heartland Breached its Non-Competition and Exclusivity Obligations Under the Co-Marketing Agreement

inTEAM argues that Heartland breached its obligation not to compete with inTEAM (directly or indirectly) when Heartland collaborated with Colyar, a direct competitor of inTEAM, to create an interface between Heartland's Mosaic Menu Planning product and Colyar's administrative review software for the express

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194 JX 400 (stating that Menu Planning Tools provide an assessment of meal pattern contributions and a Simplified Nutrient Assessment that does not require data entry, while Nutrient Analysis tools provide nutrient analysis from a data source and weighted nutrient analysis).

195 *See* JX 359; JX 360 (listing different programs on each list, with only some programs on both lists); JX 400 (stating that if certain software programs consist of both assessment of meal pattern contributions and nutrient analysis functions, they need both approvals).

196 Tr. 875 (Prescott).

197 *See* JX 359; JX 360 (Mosaic appears on both lists).

purposes of "provid[ing] state auditors a consistent view of school district menu data so that they can perform audits in a more efficient manner" and offering "access to school district menu data as needed in performing an audit and providing recommendations."[198] inTEAM alleges that by enhancing the "state value added functionality" of Colyar's products through a data exchange between Mosaic Menu Planning and Colyar's administrative review software, Heartland improperly assisted a direct competitor.[199] inTEAM concedes that Heartland lost the bid and had no opportunity to provide the services, but inTEAM argues that Heartland's failure to secure the Texas bid does not excuse Heartland's "indirect[]" competition with inTEAM.[200]

Under the Co-Marketing Agreement, Heartland cannot "engage, directly or indirectly . . . in providing services or products competitive with the inTEAM Business."[201] This non-competition obligation excludes products and services defined as "[Heartland] Business." Thus, I must determine whether the products

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[198] JX 227, at 3-4; JX 255, at 5 (Heartland will "[p]rovide Mosaic menu planning in a hosted environment for access by Colyar's Customers (i.e., States) and Users (i.e., School Districts).").

[199] Pl.'s Opening Br. 55.

[200] Pl.'s Opening Br. 55; *see Kan-Di-Ki, LLC v. Suer*, 2015 WL 4503210, at *21 n.242 (Del. Ch. July 22, 2015) ("Directly engaging in the proscribed Business would entail the actual provision of mobile diagnostic services to nursing facilities by [defendant] himself.").

[201] Co-Marketing Agreement § 9.1.1.

and services at issue are reserved for inTEAM, Heartland, or both. Under the Co-Marketing Agreement, both Heartland and inTEAM can build and maintain products with menu planning functions.[202] Additionally, Heartland may own products that conduct a full nutrient analysis, as understood under the relevant regulations at the time of the transaction.[203] inTEAM's Business includes the ability to build products that assist state agencies in conducting their administrative review process as part of "unique state value added functionality."[204]

Heartland does not rebut inTEAM's purported definition of "unique state value added functionality" under the Asset Purchase Agreement and Co-Marketing Agreement.[205] Heartland also does not argue that its own business as defined in the relevant agreements contains a similar "state value added functionality" or administrative review software of any kind. Thus, the non-competition provisions allow inTEAM, but not Heartland, to provide administrative review software. Heartland cannot now obtain through this Court what it did not reserve for itself in contract negotiations.

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[202] *See supra* Section II.A.1.

[203] *See id.*

[204] *See id.*

[205] Def.'s Answering Br. 25-27.

Heartland teamed with Colyar to provide the same functionality that the Asset Purchase Agreement and the Co-Marketing Agreement reserve for inTEAM. Although offering Heartland's Mosaic Menu Planning product on its own would not have been a breach,[206] Heartland assisting a direct competitor of inTEAM's administrative review software, Colyar, indirectly breached the non-competition obligations under the Co-Marketing Agreement.[207] Based on the same facts, Heartland also breached its exclusivity obligations under the same provision.[208]

C. Heartland Did Not Breach its Cross-Marketing and Support Obligations Under the Co-Marketing Agreement

inTEAM argues that Heartland breached its cross-marketing and support obligations under various provisions of Section 2 of the Co-Marketing Agreement. Specifically, inTEAM asserts that Heartland breached its obligations with respect to its lack of support for KidsChoose and its refusal to integrate DST and

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206 Both Heartland and inTEAM have the ability to own and develop products with menu planning functionality.

207 *See, e.g.*, *Kan-Di-Ki, LLC v. Suer*, 2015 WL 4503210, at *21 n.242 (Del. Ch. July 22, 2015) (holding former CEO's involvement in assisting a direct competitor's "efforts to replace [plaintiff] as the service provider" was a breach.); Pl's Opening Br. 55.

208 *Cf.* Def.'s Answering Br. 27 (arguing "any exclusivity requirement found in Section 9.1 of the CMA does not apply because inTEAM was not 'conducting the inTEAM Business' by marketing menu planning and administrative review software to Texas.").

Nutrikids/WebSMARTT.[209] inTEAM's conclusory allegations of breaches of Section 2 of the Co-Marketing Agreement fail.

Under Section 2 of the Co-Marketing Agreement, Heartland is obligated to (1) "prominently display Licensed Content provided by inTEAM on the MLM website;"[210] (2) "work in good faith with inTEAM" to consider incorporating the Licensed Content "into other [Heartland] K-12 payment center websites;"[211] (3) provide inTEAM with customer and reseller lists of MLM and Developed Websites of Heartland in order to market and sell Student Rewards and Off-Campus Merchants;[212] (4) provide limited access (as necessary to perform obligations under the Co-Marketing Agreement) to intranet, software, networks, hardware, technology, or computer-based resources; [213] and (5) use "commercially reasonable best efforts to develop and maintain all" related described products, websites, and technology assets to ensure the integration and cross-promotion of the products.[214]

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209 Pl.'s Opening Br. 56-57.

210 Co-Marketing Agreement § 9.1.1.

211 *Id.*

212 *Id.* § 2.5.2.

213 *Id.* § 2.6.

214 *Id.* § 2.8.

1. Heartland did not breach its obligations with respect to KidsChoose under Section 2 of the Co-Marketing Agreement

In order to decide whether Heartland breached its obligations, I must first determine the true ownership of KidsChoose. The Co-Marketing Agreement designates Off-Campus Merchants and Student Rewards as Heartland products.[215] Goodman testified that KidsChoose was the "embodiment of Off-Campus Merchants and rewards program that was described in the [Co-Marketing Agreement]," which Goodman admitted were Heartland products at the time of the execution of the Co-Marketing Agreement.[216] In his deposition, Roberts testified that Off-Campus Merchants and Student Rewards were "inTEAM products."[217] At trial, Roberts clarified that each side was to focus on developing the capabilities it knew best—Heartland on MLM and inTEAM on KidsChoose—but that Heartland did not transfer ownership of Student Rewards or Off-Campus Merchants.[218] Further, the 2012 MOU explicitly states that it does not modify the Co-Marketing Agreement.[219] Thus, the Co-Marketing Agreement's language remains in full

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215 Co-Marketing Agreement Ex. B.

216 Tr. 103, 284-85 (Goodman).

217 Roberts. Dep. 39-40.

218 Tr. 1048-53.

219 JX 44, at 1.

effect, and Heartland continues to own Off-Campus Merchants and Student Rewards, which KidsChoose embodies.

a. Heartland validly terminated the Co-Marketing Agreement as to Off-Campus Merchants and Student Rewards

Heartland partially terminated the Co-Marketing Agreement in a November 26, 2013 e-mail from Lawler to Goodman.[220] Under Section 4.2.2 of the Co-Marketing Agreement, the "Recipient" (in this case, Heartland) of the cross-marketing services has the ability to terminate with respect to a specific product if the "Provider" (in this case, inTEAM) does not meet its particular goals related to that product.[221] Heartland specifically terminated the agreement as to WebSMARTT, State Compliance Software, MLM, Student Rewards, and Off-Campus Merchants.[222] inTEAM does not challenge Heartland's ability to terminate or the enforceability of the termination as to Heartland's products.[223] Instead, inTEAM argues that the 2012 MOU "continued to govern the relationship with respect to Off-Campus Merchants/KidsChoose, and DST Phase II."[224]

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220 JX 184.

221 Co-Marketing Agreement § 4.2.2.

222 JX 184.

223 Pl.'s Opening Br. 57-58.

224 JX 187.

As discussed more thoroughly above, Goodman testified that KidsChoose was a "brand of" Off-Campus Merchants and Student Rewards, which were Heartland products at the time of the execution of the Co-Marketing Agreement.[225] Thus, Heartland had the right to terminate its obligations as they related to KidsChoose. Section 4.2.2 provides that any termination of a product causes "the corresponding obligations set forth in Section 2" to cease to apply, as long as the Recipient gives the Provider "30 days' prior written notice" and the termination is within 60 days after the applicable anniversary of the Effective Date."[226] This means Heartland's obligations under the agreement ended as of December 26, 2013.[227]

b. Heartland's conduct prior to the termination did not breach its obligations under Section 2 of the Co-Marketing Agreement

inTEAM argues that even if the agreement was terminated at the end of 2013, Heartland is still liable for any breach prior to the termination.[228] The 2012 MOU gave inTEAM the "exclusive right to market and sell products and services

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225 Tr. 103, 284-85 (Goodman); *see supra* Section 2.C.1.

226 Co-Marketing Agreement § 4.2.2.

227 Heartland was validly within sixty days of the execution of the agreement (before November 26, 2013) and the beginning of the term of the agreement (before December 1, 2013). inTEAM does not argue Heartland's termination was invalid on timeliness grounds.

228 Pl.'s Opening Br. 57-58 n.24.

on the KidsChoose . . . website[]" and stated that inTEAM "shall develop the functionality described in the FDD relating to the . . . KidsChoose website[]."[229] Meanwhile, Heartland was to develop "the functionality contained within MLM and . . . web service functionality consistent with the FDD to exchange identified information with the inTEAM-developed websites."[230] inTEAM asserts that Heartland did not display any "Licensed Content" to promote KidsChoose and did not work "in good faith" with inTEAM to promote KidsChoose on its other "K-12 payment center websites" that replaced MLM in 2015.[231] inTEAM, however, does not point to any materials it "designate[d] in writing as 'Licensed Content'" under the Co-Marketing Agreement and provided to Heartland that Heartland then refused to display as required under Section 2.4.[232] Therefore, inTEAM has not met its burden to prove breach under this section of the Co-Marketing Agreement.

Similarly, with regard to Heartland's obligation to provide customer and reseller lists under Section 2.5.2 of the Co-Marketing Agreement, inTEAM asserts that Heartland never furnished the required lists of parents to inTEAM in support

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229 JX 44, at 2.

230 *Id.*

231 Pl.'s Opening Br. 56.

232 Co-Marketing Agreement §§ 5.2.1, 2.4.

of KidsChoose before the termination.[233] Heartland offers evidence that it did produce these lists prior to November 2013 for the purposes of allowing inTEAM to conduct marketing under the Co-Marketing Agreement.[234] inTEAM does nothing to rebut either the list produced by Heartland or Roberts's testimony that the list was produced for marketing purposes. At the very least, inTEAM has not met its burden of proving that it is more likely than not that Heartland did not produce these lists.

inTEAM also argues that Heartland failed to timely respond to scheduling Steering Committee meetings, did not agree to a "reasonable timeline" for development, and never agreed to a final version of the functional design document for KidsChoose.[235] All of these claims refer to obligations under the 2012 MOU and under Section 12.2.3 of the Co-Marketing Agreement, neither of which

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[233] Pl.'s Opening Br. 57.

[234] JX 97 (showing an e-mail from Erik Ramp, Vice President of Operations at inTEAM, dated Oct. 30, 2012, to Roberts at Heartland, with an attached document titled "HPS Customer List 2012"); Tr. 1080-81 (Roberts) (stating that this list was sent for the purposes of allowing inTEAM to do marketing under the Co-Marketing Agreement).

[235] Pl.'s Opening Br. 37.

inTEAM argues that Heartland breached.[236] Therefore, I need not consider inTEAM's arguments as to these issues.

inTEAM generally argues that Heartland engaged in various delay tactics that caused KidsChoose to launch much later than expected. Specifically, inTEAM argues that in 2012, Heartland assured inTEAM it would be ready to meet its June 15 deadline, but in May, Heartland told inTEAM it was "stopping development."[237] Heartland offered no justification, provided no information about what Heartland had already developed, refused to establish a new timeline for the product, and ignored inTEAM's inquiries.[238] inTEAM also asserts that Heartland delayed in (1) selecting the pilot schools, which occurred in January 2014, and (2) sending e-mails to promote KidsChoose, which occurred in March 2014.[239]

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[236] *See* JX 44, at 2 ("The Steering Committee will mutually agree on a functional design document ('FDD') to detail the functionality described in this MOU. Based on that FDD, the Steering Committee will agree to a timeline."); Co-Marketing Agreement § 12.2.3 ("The Steering Committee shall meet at such frequency as mutually agreed by the Parties, but in any event no less frequently than once per month. Steering Committee meetings shall be at a mutually acceptable location or telephonically.").

[237] Pl.'s Opening Br. 37; JX 380; JX 384; JX 385.

[238] *Id.*

[239] Pl.'s Opening Br. 38.

With respect to the June 2012 deadline, Heartland contends that it completed its development work,[240] but that inTEAM caused the delay of the pilot launch because of its own inability to secure regulatory approval until the end of January 2014.[241] Heartland also argues that the departure of Scott Fennel, an inTEAM employee responsible for securing deals for KidsChoose, caused severe internal disruption at inTEAM and further delays.[242] Moreover, Heartland alleges that as soon as inTEAM notified Heartland of the necessary approvals, Heartland immediately complied with its obligations to launch the pilot.[243] inTEAM concedes that the pilot schools were selected in January 2014, presumably the same time as inTEAM secured its regulatory approval.[244] Importantly, inTEAM

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240 JX 388; *see also* JX 137, at 2; JX 142.

241 Def.'s Answering Br. 16; JX 193 (showing a Jan. 24, 2014 e-mail from Goodman stating "it has been a tedious, expensive, and time consuming task to craft a model for state bank regulators where rules differ. . . . We believe that we have finally resolved the custodial and other mulit[sic] state issues with the ability to write and manage differential agreements.").

242 Def.'s Answering Br. 13 (quoting JX 387, an e-mail from Ditch on Jan. 29, 2013) ("[D]ue to the issues we were having with Scott that it wouldn't be wise to hunt [Heartland] down for this because we wouldn't have any Deals to pilot with anyways, and it was better to restart the conversation when we have our act together."); *id.* at 15-16 (quoting JX 148, an e-mail from Sawicky on May 7, 2013) ("[T]he project is already three weeks behind with regard to staffing and provisioning" and "I'm trying to fudge an update to the Project Plan that we can share with [Heartland] and that doesn't air too much of our dirty laundry.").

243 Def.'s Answering Br. 16.

244 Pl.'s Opening Br. 38.

does not suggest that it received the regulatory approval before January 2014, or that Fennel's departure did not cause severe issues. Therefore, inTEAM has not proven that it is more likely than not any delay in the KidsChoose launch or the integration problems were due to Heartland's behavior.

With respect to Heartland's "obligation" to send e-mails promoting KidsChoose, inTEAM suggests that Heartland sent the emails in March 2014, two months after the launch, which was too late. But, inTEAM does not argue what specific provision of the Co-Marketing Agreement this action breaches, if any. inTEAM simply asserts the fact that this occurred, which is not enough to prove a breach by Heartland.

inTEAM also points to the "integration problems" between KidsChoose and MLM as causing a negative impact on the pilot launch.[245] inTEAM states that it repeatedly tried to engage Heartland to address the issues, but Heartland ignored these requests.[246] inTEAM's evidence of its attempts to engage Heartland are dated June 2014, months after the pilot launch failure and the termination of the Co-Marketing Agreement.[247] As Heartland did not have any continuing obligations under the Co-Marketing Agreement to support the prior version of

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[245] *Id.*

[246] *Id.*

[247] JX 225.

KidsChoose in 2014, inTEAM has not met its burden of proving Heartland breached its obligations.

After the failure of the KidsChoose launch, Heartland further agreed to allow inTEAM to develop a stand-alone version of KidsChoose, independent of any Heartland products, and to send promotional e-mails to MLM users every six months and provide user data to inTEAM.[248] Concerning the e-mail obligation, Heartland agreed to send "jointly designed emails" to parents in certain districts using their payment platforms promoting KidsChoose and to provide meal information for students who performed transactions using KidsChoose.[249] inTEAM alleges that Heartland failed to comply with its new obligations. But, inTEAM produces no evidence of any "jointly designed e-mails" or even inTEAM's drafts of such e-mails. Regarding the user data, Heartland produces evidence that it provided the required user data in December 2014, including an e-mail from Goodman to Roberts thanking him for the data.[250] Although inTEAM points to certain testimony that the information Heartland produced was not in a "final usable KidsChoose launchable form,"[251] it provides no explanation for why

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[248] Pl.'s Opening Br. 40; JX 240; JX 242.

[249] JX 242.

[250] JX 414; JX 415; JX 416.

[251] Tr. 139 (Goodman).

the data was not usable or how being in a final, usable form was required per the parties' 2014 agreement.[252] Hence, inTEAM has not met its burden of proving Heartland did not comply with its obligations.

2. Heartland did not breach its obligations with respect to DST

inTEAM argues that Heartland did not cooperate with inTEAM's attempts to create an interface between Heartland's Nutrikids and WebSMARTT and inTEAM's DST, which would have allowed DST to extract data from Nutrikids and WebSMARTT.[253] inTEAM argues Heartland violated Section 2.8 of the Co-Marketing Agreement by not using "commercially reasonable best efforts" to maintain its products for the purpose of cross-promoting inTEAM's products, as well as Section 2.6 of the Co-Marketing Agreement, by not providing limited access to Heartland's technology for the purpose of allowing inTEAM to "market, advertise and promote sales and licenses" of Heartland.[254]

As an initial matter, Nutrikids is not subject to the Co-Marketing Agreement, and any claim regarding obligations towards that product fail. The "HPS

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[252] Pl.'s Opening Br. 40; JX 242 ("[Heartland] will return the meal history for breakfast and lunch or "invalid ID" or "no meal history". [sic] We will not need other information or addresses. This query will include some students eligible for free meals and possibly on other [Heartland] platforms as well.").

[253] Pl.'s Opening Br. 46.

[254] *Id.* at 46, 57.

Products" that are subject to the Co-Marketing Agreement are WebSMARTT, MLM, Student Rewards, and Off-Campus Merchants.[255] There is no mention of Nutrikids, a product Heartland acquired well after the SL-Tech transaction, in the Co-Marketing Agreement.[256] Therefore, the Co-Marketing Agreement imposes no obligations as to this product.

With regard to WebSMARTT, inTEAM fails to demonstrate adequately the basis for this alleged breach. inTEAM's sole evidence of this breach is Goodman's testimony that inTEAM "looked forward to [Heartland's] continuing support connections to WebSMARTT for our Portland contract."[257] To the extent this claim relates to Section 2.8, inTEAM does not explain how Heartland failed to use "commercially reasonable best efforts" to "develop and maintain" WebSMARTT with the specifications under Section 2.8 for the purpose of cross-promotion.[258] inTEAM merely states that Heartland "failed to continue supporting an interface" that inTEAM relied on for an "existing contract."[259] As to Section 2.6, inTEAM does not allege attempts to cross-promote WebSMARTT or that

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255 Co-Marketing Agreement at 1.

256 Pl.'s Opening Br. 41.

257 Tr. 89 (Goodman).

258 Co-Marketing Agreement § 2.8.

259 Pl.'s Opening Br. 46.

inTEAM was not able to access to Heartland's technology in order to do so. Thus, inTEAM fails to prove that Heartland breached Section 2 of the Co-Marketing Agreement.

D. No Affirmative Defenses Bar inTEAM's Claims

Heartland asserts the following affirmative defenses as a bar to inTEAM's claims: (1) laches, (2) prior material breach, (3) unclean hands, and (4) failure to mitigate damages.

First, Heartland argues that the doctrine of laches bars inTEAM's claims. The standard for a traditional laches analysis requires a defendant to prove three elements: (1) the plaintiff had knowledge of the claim; (2) the plaintiff unreasonably delayed in bringing suit on that claim; and, (3) the delay resulted in injury or prejudice to the defendant.[260] Heartland asserts that inTEAM knew of the breach by December 6, 2014,[261] but inTEAM waited nine months to file this suit on September 21, 2015.[262] Heartland ignores inTEAM's July 20, 2015 letter to

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260 *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 210 (Del. 2005).

261 JX 381 (containing an e-mail attachment to Goodman from Craig Cheslog, Prinicipal Advisor to California State Superintendent of Public Instruction, which showed the California Department of Education was using Colyar's product for administrative review, and was working with Heartland to create a menu planning interface that could be used by state administrators in Colyar's system); Tr. 147-49 (Goodman).

262 Def.'s Answering Br. 45-46.

Heartland notifying Heartland of its breach.[263] Thus, the "delay" at issue here is seven months. Heartland fails to convince me that this was an unreasonable delay under the facts and circumstances of this case. Additionally, Heartland has not argued adequately that it suffered any injury from this seven-month delay. If the alleged injury is Heartland's investment in the Colyar relationship, Heartland engaged in that behavior before inTEAM knew about the breach. To the extent that Heartland has incurred some cost by investing further in its relationship with Colyar after finding out about inTEAM's objections, it did so at its own risk, as it was on notice of its possible violation.

Second, Heartland asserts that inTEAM's development of a product that improperly competes with WebSMARTT was a prior material breach by inTEAM that bars its recovery. As discussed above, however, inTEAM is not in breach of its non-competition obligations, and this defense fails.[264]

Third, Heartland asserts the unclean hands defense. Heartland argues that inTEAM "violated conscience or good faith or other equitable principles in [its] conduct"[265] by concealing its prohibited development of the Menu Compliance

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[263] JX 433.

[264] *See infra* Section II.A.

[265] *Sutter Opportunity Fund 2 LLC v. Cede & Co.*, 838 A.2d 1123, 1131 (Del. Ch. 2003).

Tool+, and as a result, "the doors of equity should shut against [inTEAM]."[266] The Co-Marketing Agreement, however, allowed inTEAM to develop its Menu Compliance Tool+. Further, the evidence on which Heartland relies actually undercuts Heartland's argument.[267] On June 8, 2012, the same year the Menu Compliance Tool+ was approved as a Menu Planning Tool, Erik Ramp, Vice President of Operations at inTEAM, e-mailed Roberts at Heartland to "make sure [he] was clear about what [inTEAM was] doing with menu compliance."[268] Ramp informed Roberts that inTEAM was "building a menu compliance tool for use under Option #2 to certify menus submitted under the new regulations,"[269] which expressly included menu planning and analysis of certain nutrients, namely calories, saturated fat, and sodium.[270] Ramp went on to assure Roberts that inTEAM was "not building full nutrient analysis software like what you have in the POS."[271] He added that the product may be sold to both states and districts.[272]

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[266] *Id.*

[267] Tr. 1185-87 (Roberts).

[268] JX 425.

[269] *Id.*

[270] *See supra* Section I.B.

[271] JX 425.

[272] *Id.*

And he ended by stating that the new software is an add-on to DST.[273] This is exactly what inTEAM proceeded to do. Thus, Heartland fails to prove that inTEAM was not being transparent. Moreover, as explained below, Heartland has also not met its burden of proving that inTEAM is "surreptitiously developing" point of sale software.[274] Thus, the claim of unclean hands fails.[275]

Fourth, and finally, Heartland asserts the defense that inTEAM has made no effort to mitigate damages. Because I do not award damages for Heartland's breach of the Co-Marketing Agreement, I need not analyze this defense.

E. Goodman Did Not Breach His Non-Competition Obligations Under the Asset Purchase Agreement or the Consulting Agreement

Heartland argues that Goodman's ownership of CN Central and his related work at inTEAM violates the non-competition provisions in both the Asset Purchase Agreement and the Consulting Agreement because CN Central can generate the same types of data that WebSMARTT could prior to closing, namely analyzing nutrients, planning menus, and generating production records, and

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[273] *Id.*

[274] *See infra* Section II.E.2.

[275] Def.'s Answering Br. 53.

because inTEAM is developing point of sale software.[276] Heartland, however, fails to prove these allegations.

1. Work at inTEAM

The Asset Purchase Agreement provides that Goodman improperly competes with Heartland if he engages, directly or indirectly, "in providing any Competitive Services or Products" or "any business that [SL-Tech] conducts as of the Closing Date" in the United States.[277] Under the Consulting Agreement, Goodman may not "directly or indirectly . . . become an owner of any outstanding capital stock, or a member or partner of any . . . entity that engages in Competitive Business within the Restricted Territory; or perform or provide any services . . . for any . . . entity that engages in Competitive Business within the Restricted Territory."[278]

The definitions of SL-Tech and Competitive Services or Products (in the Asset Purchase Agreement) and Competitive Business (in the Consulting Agreement) exclude the inTEAM Business.[279] The inTEAM Business expressly

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276 Def.'s Opening Br. 30, 33-34.

277 Asset Purchase Agreement § 5(n).

278 Consulting Agreement ¶ 11.a.

279 The Consulting Agreement directly states "Competitive Business shall not include the inTEAM Business (as defined in the Asset Purchase Agreement)." Consulting Agreement § 11(a); *see also supra* Section I.B.2.a.i.

includes the ability to create menus and generate production records, and analyzing certain nutrients does not *per se* make a product competitive with WebSMARTT.[280] Therefore, Heartland has not proven Goodman violated his non-competition obligations by owning a competitive business under either the Asset Purchase Agreement or the Consulting Agreement.

2. Point-of-sale software

Heartland also fails to prove that inTEAM is surreptitiously developing point of sale ("POS") software and, as such, has failed to prove that Goodman breached certain non-competition obligations under the Asset Purchase Agreement or the Consulting Agreement.

Heartland cites to *Revolution Retail Sys., LLC v. Sentinel Techs., Inc.*, as support for the proposition that "broad non-compete language regarding development"[281] would prevent an entity from beginning to develop, design, or market a competitive product, i.e. a "running start."[282] Even if the provisions in the Asset Purchase Agreement or the Consulting Agreement at issue here prohibit a "running start," Heartland fails to prove that inTEAM began such a process.

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[280] *See supra* Section II.A.

[281] Def.'s Opening Br. 38.

[282] *Revolution Retail Sys., LLC v. Sentinel Techs., Inc.*, 2015 WL 6611601, at *11 (Del. Ch. Oct. 30, 2015).

Heartland relies on one e-mail to prove the "running start" allegations. That e-mail, sent by inTEAM employee Kim Coleman to the Kentucky School District, states that inTEAM is "looking at adding a POS feature" to the inTEAM software package and requests a copy of Kentucky's POS maintenance invoice for "competitive research purposes."[283] Griffin testified that inTEAM knew this type of software improperly would compete with Heartland until September 30, 2016; thus, inTEAM simply was "gathering information" and conducting research.[284]

Comparatively, in *Revolution Retail*, the defendant claimed that the non-competition provision at issue only prohibited an "actual sale" of a competitively priced product.[285] The defendant argued it was not in breach because it was conducting "market research," and it never formally agreed to sell a competitive product.[286] This Court held that the defendant was in fact engaging in actual negotiations intended to sell the competitive product, and the non-competition

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[283] JX 418, at 2.

[284] Tr. 471-72 (Griffin).

[285] *Revolution Retail*, 2015 WL 6611601, at *11-12.

[286] *Id.*

agreement prohibited such behavior, as well as other behavior occurring much earlier than the point of sale.[287]

The plaintiff in that case proved the breach through an exchange of e-mails that showed multiple employees' "desire to move towards, or beyond, the [competitive] price line,"[288] as well as a document specifying the technical plans to develop the competitive product, and various sell-side documents prepared during the non-competition period that explicitly discussed the competitive product.[289] Here, one e-mail stating that inTEAM is "looking at adding a POS feature" hardly rises to the level of proving by a preponderance of evidence that inTEAM has begun development of POS software, or is otherwise actively engaging in selling POS software while claiming to gather information and conduct research.[290] As such, Heartland has failed to show a breach of Goodman's non-competition obligations.

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[287] *Id.* (stating defendant "undertook, directly and indirectly, to assist and advise others, and to both engage in, and propose to engage in, the development, marketing, and manufacturing of the . . . R50 at per unit selling prices above the Inflation Adjusted Price Line. I find unpersuasive [defendant]'s argument that the R50 cannot be proven to 'have a selling price' above the price line because [defendant] never actually sold an R50 at any price during the Non-Competition Period.").

[288] *Id.* at *12.

[289] *Id.* at *12-13.

[290] Def.'s Opening Br. 26.

F. Goodman Did Not Breach His Non-Solicitation Obligations Under the Asset Purchase Agreement

Heartland argues that Goodman breached his non-solicitation obligations under the Asset Purchase Agreement by "working on behalf of inTEAM" to solicit business from an undisputed Protected Customer, St. Paul Public Schools.[291]

Section 5(o) of the Asset Purchase Agreement prohibits solicitations made "for the purpose of providing Competitive Services or Products."[292] The definition of "Competitive Services or Products" explicitly excludes the inTEAM Business. Therefore, any solicitation of a customer of Heartland simply for the purposes of providing the inTEAM products included in the inTEAM Carve-Out is not a violation of this provision. As such, Goodman is not in breach, and the Court need not address Goodman's argument that the Asset Purchase Agreement's non-solicitation provision does not bind him.

G. Goodman Breached His Non-Solicitation Obligations Under the Consulting Agreement

Heartland also argues that Goodman breached his non-solicitation obligations in the Consulting Agreement by encouraging St. Paul Public Schools to

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291 *Id.* at 39-40; JX 25, at 291 (showing list of customers of inTEAM for twelve months ended on June 30, 2011); Tr. 242 (Goodman) (stating that St. Paul was a WebSMARTT customer prior to the transaction between SL-Tech and Heartland and was a customer of Heartland after the transaction).

292 Asset Purchase Agreement § 5(o).

modify adversely its relationship with Heartland. Heartland points to two e-mail chains discussing St. Paul Public Schools as a possible opportunity for inTEAM as evidence that Goodman breached his non-solicitation obligations under the Consulting Agreement. In the first e-mail chain, dated July 24, 2014, Goodman emails Hughes about the "St. Paul Window of Opportunity" asking whether Tuckwell relayed the news to her about the opportunity.[293] Included in Hughes' reply is a note to Jim Hemmen, the point of contact at St. Paul, regarding inTEAM's "menu planning tool/production record alternative to WebSMARTT."[294] Hughes also plans to have a future conversation with Goodman about Tuckwell's "new approach" to get Hemmen interested in inTEAM.[295]

In the second e-mail chain, Tuckwell e-mails Ronnei, the COO at St. Paul, on December 15, 2014, reiterating her July conversation with Hemmen about St. Paul's struggles with automating production records.[296] Tuckwell goes on to say that in August she offered to provide a demonstration of inTEAM's product, once

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293 JX 234.

294 *Id.*

295 *Id.*

296 JX 248.

again, as an "alternative" to the WebSMARTT system.[297] Tuckwell then forwards this e-mail to Hughes, who forwards it to Goodman, stating that Hemmen is leaving St. Paul, and this is a positive development since Hemmen was blocking inTEAM's efforts in this regard. Further, she applauds Tuckwell to Goodman for her efforts of continuing to "push [St. Paul] to use [inTEAM's] tools."[298]

The Consulting Agreement prohibits Goodman from directly or indirectly, on behalf of himself or any other entity, "encourag[ing] or attempt[ing] to encourage any Customer of Heartland to terminate, or materially and adversely modify, its relationship with Heartland or to cease or refrain from doing business with Heartland."[299] Customer is defined as any current or prospective customers, clients, vendors, and suppliers of either SL-Tech prior to closing or Heartland.[300] The Customer must be someone "with whom the Consultant worked, or about whose business or needs the Consultant gained information, either in his capacity as an officer with [SL-Tech], or in his capacity as a Consultant [for Heartland]."[301] Thus, any direct or indirect solicitation by Goodman that attempted to affect

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297 *Id.*

298 *Id.*

299 Consulting Agreement ¶ 11(b).

300 *Id.*

301 *Id.*

adversely an existing customer's relationship with Heartland would breach the Consulting Agreement, regardless of whether Goodman sought to provide Competitive Products and Services or a Competitive Business.

Importantly, Goodman does not attempt to rebut the facts that St. Paul is a customer of Heartland, that St. Paul was a customer of SL-Tech while he was CEO, that Tuckwell or Hughes work for him, that Tuckwell was marketing inTEAM's products as an "alternative" to WebSMARTT, that Goodman was aware of an opportunity at St. Paul, or that he was proactively discussing with his employees attempts to offer inTEAM as an "alternative" to WebSMARTT.[302] Instead, Goodman argues that inTEAM was merely "help[ing] out a consulting client" and that "inTEAM had every right to market that product to the St. Paul [P]ublic [S]chools."[303] What Goodman's argument fails to consider is that by allowing his employees to market this product as an "alternative" to WebSMARTT, he indirectly is involved in attempting to encourage St. Paul to modify or alter its relationship with Heartland by replacing WebSMARTT with inTEAM's products. The language in the non-solicitation provision prohibits any attempts to get customers to materially or adversely "modify" their relationship with Heartland. Goodman encouraged, or at the very least implicitly condoned,

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302 Tr. 240-44.

303 *Id.* at 244.

inTEAM employees' efforts to persuade a Heartland customer to use inTEAM products as an alternative to WebSMARTT.

Goodman attempts to assert multiple defenses against Heartland's ability to bring these claims—namely, laches, acquiescence, waiver/estoppel, unclean hands, and prior material breach of contract. While I agree that there is "evidence establishing that [Heartland] has long been aware that inTEAM developed and sold software with the functions [Heartland] now alleges are wrongfully competitive,"[304] I need not analyze individually the affirmative defenses because each focuses on whether inTEAM's business as currently conducted violates the various non-competition provisions. Here, Goodman has breached the second clause of the non-solicitation provision, which is not dependant on and does not relate to the definition of the inTEAM Business. Instead, it precludes Goodman from encouraging any customer of Heartland to change adversely its relationship with Heartland. Thus, Goodman has not argued that any of the affirmative defenses specifically apply to this clause of the non-solicitation provision. Additionally, no facts in the record support the application of any of the affirmative defenses to the non-solicitation clause of the Consulting Agreement.

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[304] Pl.'s Answering Br. 45; *see* JX 425; Tr. 1177 (Roberts).

H. Remedies

In awarding relief, this Court "has broad flexibility and discretion."[305] The Court also must "put in place a balanced remedy that is equitable and reasonably tailored to address the precise nature of the misconduct at issue."[306] In the context of violations of restrictive covenants, this Court has awarded both injunctive and monetary relief.[307] To obtain an injunction, the plaintiff must show "(1) actual success on the merits, (2) irreparable harm, and (3) that the balance of the equities weighs in favor of issuing the injunction."[308] With respect to damages, "[t]he law does not require certainty in the award of damages where a wrong has been proven and injury established."[309] "[W]hen a contract is breached, expectation damages

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305 DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY § 12.01(a) (2014).

306 *Agilent Techs., Inc. v. Kirkland*, 2010 WL 610725, at *24 (Del. Ch. Feb. 18, 2010).

307 *See, e.g.*, *Concord Steel, Inc. v. Wilmington Steel Processing Co.,* 2009 WL 3161643, at *14-17 (Del. Ch. Sept. 30, 2009) (awarding money damages, injunctive relief, and attorney's fees for breach of a non-competition covenant).

308 *Concord Steel*, 2009 WL 3161643, at *18.

309 *Red Sail Easter Ltd. P'rs, L.P. v. Radio City Music Hall Prods., Inc.*, 1992 WL 251380, at *7 (Del. Ch. Sept. 29, 1992).

can be established as long as the plaintiff can prove the fact of damages with reasonable certainty. The amount of damages can be an estimate."[310]

1. inTEAM is entitled to an injunction

inTEAM seeks an injunction ordering Heartland "and its agents, representatives and any persons in active concert or participation with them (including Colyar) from competing directly or indirectly with the 'inTEAM Business,' which includes DST's 'unique state value added functionality' as defined in Exhibit C to the CMA."[311] As discussed above, inTEAM has proven actual success on the merits by showing that Heartland breached the non-competition agreement in Section 9.1.1 of the Co-Marketing Agreement.

Delaware law recognizes the uncertainty of what "could have been" had the non-competition agreement been honored and, thus, has consistently found a threat of irreparable injury in circumstances where a covenant not to compete is breached. Measuring the effects of breaches like this involves a costly process of educated guesswork with no real pretense of accuracy. This court has been candid

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[310] *SIGA Techs., Inc. v. PharmAthene, Inc.*, 132 A.3d 1108, 1111 (Del. 2015).

[311] Pl.'s Opening Br. 63.

to admit this reality and to use injunctive relief as the principal tool of enforcing covenants not to compete.[312]

Here, it is unknowable whether inTEAM would have gained more business, such as that from the Texas Department of Agriculture, had Heartland not improperly competed with inTEAM. Thus, the irreparable harm prong is met.

Finally, the equities favor injunctive relief as Heartland agreed not to pursue certain types of actions in the Co-Marketing Agreement, specifically, providing integrated administrative review and menu planning services to state agencies. And, inTEAM will continue to suffer the specific type of harm it sought to protect against in signing reciprocal non-competition clauses if Heartland is allowed to continue engaging in this behavior.

Heartland's breach began on March 17, 2014, when the relationship with Colyar first began, and ran until September 8, 2015, when Heartland announced Texas had not selected its proposal with Colyar.[313] This totals almost eighteen months of breach. Thus, I find the appropriate remedy is to extend the non-competition agreement from September 30, 2016 to March 21, 2018 in order to give inTEAM the full benefit of its bargain.

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[312] *Hough Assocs. Inc. v. Hill*, 2007 WL 148751, at *18 (Del. Ch. Jan. 17, 2007) (footnotes omitted).

[313] JX 295; JX 203; Tr. 1162 (Roberts).

2. inTEAM is not entitled to costs and fees

The Co-Marketing Agreement states that "if a court of competent jurisdiction . . . determines that either Party has breached this Agreement, then the breaching Party shall be liable and pay to the non-breaching Party the reasonable and verifiable legal fees and costs incurred in connection with such litigation or proceeding."[314] The Co-Marketing Agreement, however, limits the amount of any monetary payments by a breaching party to "not exceed the Fees previously paid by the other Party."[315] The provisions state further that these limitations "shall not apply with respect to (A) damages caused by the willful misconduct of the other Party; (B) damages resulting from a Party's breach of its confidentiality obligations . . . or (C) Losses that are the subject of indemnification . . ."[316] inTEAM does not rebut the fact that inTEAM has not paid Heartland any fees under the Co-Marketing Agreement, and inTEAM does not argue that any of the exceptions to the limitation under Section 11.3 apply. Therefore, inTEAM is not entitled to any costs and fees pursuant to the limitation in Section 11.2 of the Co-Marketing Agreement.

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[314] Co-Marketing Agreement § 6.5.

[315] *Id.* § 11.2.

[316] *Id.* §11.3.

3. Heartland is entitled to an injunction

Section 11(e) of the Consulting Agreement states that "any violation or threatened violation of the provisions of Section 11 by the Consultant would cause Heartland irreparable harm, and the Consultant agrees that Heartland shall be entitled, in addition to any other right or remedy it may have at law or in equity, to an injunction."[317] Heartland contends that in order to receive the full benefit if its bargain, the Court should tack on the amount of time from the beginning of Goodman's breach in July 2014, to the end date of the agreement in September 2016, equaling two years and two months.[318]

Heartland has proven that Goodman breached Section 11(b) of the Consulting Agreement from July 24, 2014 until December 15, 2014, totaling almost five months. Essentially, Heartland only received four-and-a-half years of non-solicitation, rather than the five it bargained for. The parties concede that under the Consulting Agreement, "any violation or threatened violation of the provisions of Section 11 by the Consultant would cause Heartland irreparable

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317 Consulting Agreement ¶ 11(e).

318 Def.'s Opening Br. 51; *see also* Consulting Agreement ¶ 11(f) ("Consultant agrees that the time periods referenced [in the operative provisions] shall not include any period(s) of violation or period(s) of time required for litigation to enforce the covenants set forth herein.").

harm."[319] In balancing the equities in this case, I find Heartland is entitled to an injunction against Goodman continuing the second clause of the non-solicitation provision for six months beginning September 30, 2016, and ending March 22, 2017.

4. Heartland is entitled to damages

Section 3 of the Consulting Agreement states that "[i]n the event the Consultant breaches Sections 7, 8, 9, 10, or 11 of this Agreement, Heartland shall have no obligation to pay the Consultant any compensation set forth herein."[320] Heartland argues Goodman should disgorge all compensation he received, totaling $600,000, along with pre- and post-judgment interest.[321] Heartland continued paying Goodman fees in July, August, and September 2014, all while Goodman was breaching the non-solicitation provision. Pursuant to the Consulting Agreement, Goodman lost his entitlement to those fees as soon as he began

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[319] Consulting Agreement ¶ 11(e); *see Hough Assocs. Inc. v. Hill*, 2007 WL 148751, at *18 (Del. Ch. Jan. 17, 2007) ("[T]he Non-Competition Agreement should be enforced according to its plain terms, which in this case, specify that Hill's breach would, by definition, cause irreparable harm to Hough and justify the entry of an injunction against him. No one has to sign a contract with such a provision, but when one does, he should not complain if the terms are given effect.").

[320] Consulting Agreement ¶ 3.

[321] Def.'s Opening Br. 51-52.

breaching.[322] The agreement, however, does not state that Goodman must return the fees he was entitled to before the breach occurred. Hence, I find that Goodman must disgorge any consulting fees paid in July, August, and September 2014, totaling $50,003.01.

III. CONCLUSION

For the foregoing reasons, I find in favor of inTEAM on its non-competition claims against Heartland and against Heartland on all its claims against inTEAM. Heartland shall be enjoined for a period of approximately eighteen months from "engag[ing], directly or indirectly, on its own behalf or as a principal or representative of any person, in providing any services or products competitive with the inTEAM Business."[323]

I also find in favor of Heartland and against Goodman for breach of the second clause of the non-solicitation provision in the Consulting Agreement. Goodman shall be enjoined for a period of approximately five months from "directly or indirectly, on behalf of himself or on behalf of any other person, firm or business entity . . . encourag[ing] or attempt[ing] to encourage any Customer of Heartland to terminate, or materially and adversely modify, its relationship with

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[322] Consulting Agreement ¶ 3 (stating in the event of breach, Heartland has "no obligation to pay the Consultant any compensation").

[323] Co-Marketing Agreement § 9.1.1.

Heartland or to cease or refrain from doing business with Heartland."[324] Goodman also shall disgorge $50,003.01 in consulting fees.

The parties shall submit a joint conforming final judgment within ten days.

IT IS SO ORDERED.

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[324] Consulting Agreement ¶ 11(b).

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

AN NGUYEN,	)	
	)	
Plaintiff,	)	
	)	
v.	)	C.A. No. 11511-VCG
	)	
MICHAEL G. BARRETT, THOMAS R. EVANS, ROBERT P. GOODMAN, PATRICK KERINS, ROSS B. LEVINSOHN, WENDA HARRIS MILLARD, JAMES A. THOLEN, AOL INC., and MARS ACQUISITION SUB, INC.,	)	
	)	
Defendants.	)	

MEMORANDUM OPINION

Date Submitted: June 30, 2016
Date Decided: September 28, 2016

James R. Banko and Derrick B. Farrell, of FARUQI & FARUQI, LLP, Wilmington, Delaware; OF COUNSEL: Juan E. Monteverde, of MONTEVERDE & ASSOCIATES PC, New York, New York; Michael J. Palestina, of KAHN SWICK & FOTI, LLC, Madisonville, Louisiana, *Attorneys for Plaintiff*.

Kevin R. Shannon and Jaclyn C. Levy, of POTTER ANDERSON & CORROON LLP, Wilmington, Delaware; OF COUNSEL: William Savitt, Anitha Reddy, and Nicholas Walter, of WACHTELL, LIPTON, ROSEN & KATZ, New York, New York, *Attorneys for All Defendants.*

GLASSCOCK, Vice Chancellor

This matter can now be considered twice-tested, but not in the beneficial sense made famous by Professor Berle. The action involves a challenge to a merger agreement, brought pre-close, alleging inadequate price and process, as well as some thirty disclosure violations. In his motion for preliminary injunctive relief,[1] however, the Plaintiff pursued only his "serious"[2] disclosure violation, involving lack of disclosure of purportedly material financial information. I found that a preliminary injunction was unsustainable on the merits, and the Plaintiff sought an interlocutory appeal, which our Supreme Court denied. The stockholders overwhelmingly chose to tender into the merger, which closed; the Plaintiff now seeks damages for breach of duty in regard to two alleged mal-disclosures; one, the financial disclosure claim I found not reasonably likely to succeed at the preliminary injunction stage; and a second, involving incentives of the financial advisor, which the Plaintiff pled pre-close but elected not to argue in the motion for preliminary injunctive relief—presumably, his second most serious disclosure claim. For the reasons below, I find that neither claim can withstand a motion to dismiss.

[1] The pleadings and briefing in this case have referred to the Plaintiff, An Nguyen, by both male and female pronouns. Here I use the pronoun used by Plaintiff's counsel in their most recent filing. No disrespect is meant if this is incorrect.
[2] Prelim. Inj. Hrg. Tr. 11:15–19.

I. BACKGROUND

The matter is currently before me on Defendants' Motion to Dismiss the Second Verified Amended Complaint (the "Motion").[3] On September 16, 2015, Plaintiff An Nguyen on behalf of himself, and a class of similarly situated stockholders of Millennial Media, Inc. ("Millennial" or the "Company"), filed this action, challenging the proposed acquisition of the Company by AOL, Inc. ("AOL") for $1.75 per share in cash through a tender offer and second-step short-form merger, pursuant to 8 *Del. C.* § 251(h) (the "Transaction").[4] In his initial complaint, the Plaintiff brought two counts: one for breach of the fiduciary duties of loyalty and care against the directors of Millennial (the "Director Defendants"), for their alleged failure to obtain a fair price or follow a fair process with respect to the Transaction; and the other against AOL for aiding and abetting those breaches. Because the Plaintiff has since abandoned those claims, as discussed *infra*, I need not detail the rigorous sales process conducted by the Millennial board, which culminated in the Transaction.

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[3] The facts are drawn from the well-pled allegations of Plaintiff's Second Amended Complaint (the "Complaint") and documents integral to the Complaint or incorporated by reference therein, and are presumed true for purposes of evaluating Defendants' Motion.

[4] This price represented, at the time, a 33% premium for Millennial's shares. Defs' Opening Br., Transmittal Aff. of Jaclyn C. Levy, Esq., Ex. A (the "Proxy"), at 23. This action is one of five lawsuits filed challenging the Transaction between September 10 and September 16, 2015. The other four suits, which were all voluntarily dismissed, were *Parshall v. Millennial Media, Inc.*, C.A. No. 11485-VCG (Sept. 9, 2015); *Desjardins v. Millennial Media, Inc.*, C.A. No. 11490-VCG (Sept. 10, 2015); *Chen v. Barrett*, C.A. No. 11496-VCG (Sept. 10, 2015); and *Wagner v. Barrett*, C.A. No. 11503-VCG (Sept. 15, 2015). Defs' Opening Br. 8–9.

The Millennial board unanimously approved the merger agreement on September 2, 2015.[5] It was executed, and the Transaction announced, the following day.[6] AOL commenced the tender offer on September 18, 2015.[7] That same day, the Company filed a Schedule 14D-9 Solicitation/Recommendation Statement (the "Proxy") with the SEC, in connection with the tender offer.[8] On September 24, 2015, the Plaintiff filed his first amended complaint, adding roughly thirty alleged disclosure violations concerning financial analyses prepared by the Company's financial advisor, LUMA Securities LLC ("LUMA"); Millennial's projections; board conversations with other potential bidders; and the Director Defendants' stock ownership.[9]

The Plaintiff moved for expedited proceedings and for preliminary injunctive relief on September 29, 2015. Following a telephone conference held on October 6, 2015, I determined that expedited discovery was not warranted and directed the parties to complete truncated briefing on the preliminary injunctive relief request; specifically, I directed the Plaintiff to clarify his grounds for relief sought, which to that point had constituted somewhat of a moving target. I heard oral argument on October 8, 2015, immediately following which I denied Plaintiff's request for

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[5] Proxy, at 12.
[6] Compl. ¶ 5.
[7] *Id.* at ¶ 3.
[8] *Id.* at ¶ 88.
[9] First Am. Compl. ¶¶ 88–97.

preliminary injunctive relief. The Plaintiff then moved for certification of an emergency interlocutory appeal to the Delaware Supreme Court. After taking the matter under review, I issued a letter opinion later that day denying Plaintiff's request.[10] The Supreme Court refused the appeal on October 9, 2015.[11]

In seeking preliminary injunctive relief, the Plaintiff pursued only one of the roughly thirty disclosure violations alleged in his first amended complaint: a claim concerning unlevered, after-tax free cash flow projections ("UFCF"). The Plaintiff advanced two principal—and mutually exclusive—arguments concerning this claim. First, although the Plaintiff acknowledged that our case law indicates that banker-derived financial projections need not be disclosed, he argued that here, Millennial management forecasted all of the components of the UFCF and the Company's financial advisor, LUMA, simply plugged those values into a widely used formula. As a result, the Plaintiff argued, either those inputs or the UFCF themselves should be disclosed. Second, and in the alternative, the Plaintiff contended that a corrective disclosure was required because the Proxy misleadingly created the impression that Millennial management, and not LUMA, calculated the UFCF that were used by LUMA to perform its discounted-cash-flow analysis.

[10] *Nguyen v. Barrett*, 2015 WL 5882709 (Del. Ch. Oct. 8, 2015).
[11] *Nguyen v. Barrett*, 2015 WL 5924668, *1 (Del. Oct. 9, 2015) (TABLE).

After careful review of the Proxy and applicable precedent, I determined that "a fair reading of the Proxy disclosed accurately that management did not prepare forecasts of unlevered, after-tax free cash flows,"[12] and, "[w]ith respect to the argument that all inputs provided by management on which the financial advisor relied in its [discounted cash flow] valuation must, as a matter of law, be disclosed to stockholders, I found such a *per se* rule inconsistent with our case law."[13] In sum, I concluded that "the Plaintiff had failed to demonstrate under the facts here that the Proxy was materially incomplete or misleading."[14]

The tender offer was completed on October 22, 2015, and the merger closed the following day.[15] Just over 80% of shares were tendered into the offer.[16] The Plaintiff filed a second amended complaint (the "Complaint") on January 4, 2016, which repeats the price and process claims (including aiding and abetting against AOL) of the earlier complaints, narrows down the alleged disclosure violations to only three claims, and adds a count for "quasi-appraisal."[17]

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[12] *Nguyen*, 2015 WL 5882709, at *3.
[13] *Id.* at *4.
[14] *Id.*
[15] Compl. ¶ 5.
[16] *Id.*
[17] I note, however, that quasi-appraisal is a *remedy*, not a cause of action. *See Houseman v. Sagerman*, 2015 WL 7307323, at *4 (Del. Ch. Nov. 19, 2015) ("[Q]uasi-appraisal is not itself a cause of action, but is instead a remedy that, where appropriate, awards stockholders damages based on the going-concern value of their previously owned stock upon a finding of a breach of fiduciary duty, such as the duty to disclose.") (citation omitted). The Complaint may not be sustained solely on the basis of a count for quasi-appraisal; rather, the Plaintiff must demonstrate some underlying violation, for which quasi-appraisal is the appropriate remedy. *See, e.g.*, *Chen v. Howard-Anderson*, 87 A.3d 648, 691 (Del. Ch. 2014) ("If the plaintiffs prove at trial that the

The Defendants filed their Motion to Dismiss on January 19, 2016, and the parties completed briefing. Through his briefing, the Plaintiff implicitly waived the price and process claims, by failing to defend them with any argument or authority,[18] and expressly waived one of his three remaining disclosure claims.[19] I heard oral argument on June 30, 2016, following which the Plaintiff voluntarily waived his aiding and abetting claim against AOL.[20] That leaves for my consideration here only two disclosure claims: the first, concerning the Company's UFCF which was the subject of the preliminary injunctive relief hearing; and a second, concerning LUMA's contingent-fee arrangement. For the following reasons, I find that the Plaintiff has failed to state a non-exculpated claim of breach of fiduciary duty with respect to either alleged disclosure violation; accordingly, I grant Defendants' Motion.

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defendants committed a non-exculpated breach of the fiduciary duty of disclosure, then damages can be awarded using a quasi-appraisal measure.").

[18] *See Forsythe v. ESC Fund Mgmt. Co. (U.S.)*, 2007 WL 2982247, at *11 (Del. Ch. Oct. 9, 2007) ("The plaintiffs have waived these claims by failing to brief them in their opposition to the motion to dismiss.") (citing *Emerald Partners v. Berlin*, 2003 WL 21003437, at *43 (Del. Ch. Apr. 28, 2003) (stating "[i]t is settled Delaware law that a party waives an argument by not including it in its brief")).

[19] *See* Pl's Answering Br. 13 n.7 ("However, in light of recent developments in Delaware disclosure law, *see, e.g.*, *In re Trulia, Inc. Stockholder Litigation*, 129 A.2d 884, 901 n.57 (Del. Ch. 2016), Plaintiff has elected not to raise [the third] disclosure point in this opposition.").

[20] Transcript of June 30, 2016 Oral Arg. 77:15–17.

II. ANALYSIS

The Defendants move to dismiss under Court of Chancery Rule 12(b)(6) for failure to state a claim. When considering such a motion, the Court must accept all well-pled factual allegations in the complaint as true, draw all reasonable inferences in favor of the plaintiff, and deny the motion "unless the plaintiff could not recover under any reasonably conceivable set of circumstances susceptible of proof."[21]

In order to sustain a *pre-close* disclosure claim, heard on a motion for preliminary injunctive relief, a plaintiff must demonstrate "a reasonable likelihood of proving that the alleged omission or misrepresentation is material;"[22] by contrast, when asserting a disclosure claim for damages against directors *post-close*, a plaintiff must allege facts making it reasonably conceivable that there has been *a non-exculpated breach* of fiduciary duty by the board in failing to make a material disclosure.[23] "Information is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote"; or, in other words, "if, from the perspective of a reasonable stockholder, there is a substantial likelihood that it significantly alters the 'total mix' of information made

[21] *Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Holdings LLC*, 27 A.3d 531, 536–37 (Del. 2011).
[22] *In re Trulia, Inc. S'holder Litig.*, 129 A.3d 884, 896 (Del. Ch. 2016) (internal quotation omitted).
[23] *Chen v. Howard*, 87 A.3d 648, 691 (Del. Ch. 2014) ("If the plaintiffs prove at trial that the defendants committed a non-exculpated breach of the fiduciary duty of disclosure, then damages can be awarded using a quasi-appraisal measure.").

available."[24] Where, as here, an exculpation provision under 8 *Del. C.* § 102(b)(7) shields a board from duty-of-care claims, this means a plaintiff must demonstrate that a majority of the board was not disinterested or independent, or that the board was otherwise disloyal because it failed to act in good faith, in failing to make the material disclosure.[25] A showing of bad faith requires an "extreme set of facts to establish that disinterested directors were intentionally disregarding their duties or that the decision . . . [was] so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."[26] For the following reasons, the Plaintiff has failed to clear the bar of pleading disloyalty with regard to either disclosure claim.

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[24] *Trulia*, 129 A.3d at 899 (internal quotations omitted).

[25] *In re BJ's Wholesale Club, Inc. S'holders Litig.*, 2013 WL 396202, at *6 (Del. Ch. Jan. 31, 2013). To the extent it was not waived at oral argument, I reject Plaintiff's contention, expressed in briefing, that because the existence of a 102(b)(7) exculpatory provision was not explicitly pled in Plaintiff's Complaint, it is outside the bounds of Defendants' Motion to Dismiss. Plaintiff's position, if accepted, would undermine the very purpose of a 102(b)(7) exculpation provision—that is, to spare directors from the burden and expense of litigation where the only conceivable claim is one for breach of the duty of care. Nor does Plaintiff's position comport with the Delaware Supreme Court's decision in *In re Cornerstone Therapeutics Inc, Stockholder Litigation*, 115 A.3d 1173 (Del. 2015), where the Court held that, even in the entire fairness context, a case may be dismissed at the motion-to-dismiss stage if the plaintiff has not alleged any non-exculpated claims against the director defendants. *Id.* at 1187. Rather, as the Delaware Supreme Court indicated in *Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001), the Court can take judicial notice of the existence of a 102(b)(7) exculpatory provision, which can easily be found in public filings on record with the Delaware Secretary of State's office. *See id.* at 1090 ("The trial court therefore tacitly accepted it as authentic without defendants formally asking the court to take judicial notice of [102(b)(7) provision's] existence, which could easily be found in the public files in the Secretary of State's office and could properly be noticed judicially by the court.").

[26] *In re Chelsea Therapeutics Int'l Ltd. S'holders Litig.*, 2016 WL 3044721, at *7 (Del. Ch. May 20, 2016) (internal quotations omitted).

A. The Unlevered, After-Tax Free Cash Flow Projections

I turn first to Plaintiff's claim regarding the UFCF, which was the subject of Plaintiff's application for preliminary injunctive relief.

In their briefing the Plaintiff remakes arguments similar to those previously considered in this action. The Plaintiff argues that the Defendants made selective disclosure of certain financial projections in the Proxy and "intentionally excised [what the Plaintiff describes as] Millennial's UFCF—despite the fact that LUMA's Discounted Cash Flow Analysis was specifically based on these figures."[27] They assert that the UFCF, and the components that went into it were material because Millennial "stockholders were asked to exchange their ownership stake in the Company and forego the Company's future cash flows in exchange for all-cash consideration."[28] They argue that the UFCF and its components were "even more significant than usual" here because two of LUMA's disclosed cash flow projections, which used UFCF as an input, resulted in a price per share of $0.00.[29] Additionally, they repeat their argument that these projections are not banker formulated projections but, essentially, management figures.[30] They allege LUMA took UFCF components projected by management and "using no meaningful

[27] Pl's Answering Br. 19 (citing Second Am. Compl. ¶¶ 92–93, 101).
[28] *Id.* at 21 (citing Second Am. Compl. ¶105).
[29] *Id.* (citing Second Am. Compl. ¶ 105).
[30] *Id.* at 22–24 ("[S]emantic gamesmanship aside, the UFCF figures were for all intents and purposes derived by Millennial's management.").

independent judgment of any kind, plugged them into a calculator to arrive at the UFCF figures."[31] Under these facts, they contend that the Company had a duty to disclose UFCF, or at the very least, all of the UFCF components provided to LUMA, because the Company cannot escape a duty to provide management projections by simply giving a banker numbers to plug into a formula for the banker to merely hit the "equals" button.[32] They allege that because "*some* management projections were disclosed, the Board was required to give materially complete information about *all* of the Company's projections and provide a complete summary of the key inputs relied upon by LUMA."[33]

The Defendants argue that the UFCF figures were derived by LUMA.[34] They assert that the cases cited by the Plaintiff, for the proposition that management cannot avoid its duty to disclose projections by simply handing inputs to bankers for them to perform the ministerial task of hitting enter, are distinguishable. They argue those cases involved situations where no cash flows were disclosed.[35] Here however, "all of the cash flow information that was directly prepared by management was disclosed."[36] Further, they assert that the Complaint does not allege that management directed LUMA in selecting the formula, or even knew how

[31] *Id.* at 23.
[32] *Id.*
[33] *Id.* at 27–28 (emphasis added).
[34] Transcript of June 30, 2016 Oral Arg. 56:22.
[35] *Id.* at 57:10–11.
[36] *Id.* at 57:13–15.

LUMA would treat the components management provided them, or that management had anything to do with LUMA's methodology.[37] Thus "[i]n these circumstances, it simply cannot be said that these were management's numbers."[38] Because these were banker prepared numbers and management's best projections were disclosed, the Defendants argue, the law is clear that the UFCF were not material and need not be disclosed.

Even if I were to find that the UFCF disclosures—contrary to my earlier determination on the record at the preliminary injunction hearing—constitute a material lack of disclosure, Plaintiff's UFCF claim must fail. The Plaintiff has failed to plead facts such that it is reasonably conceivable that the allegedly incomplete disclosure was made by the board disloyally or in bad faith, as is required to sustain this claim post-close. The only conflict that the Plaintiff alleges as to six of the directors—all except Millennial CEO, Michael Barrett[39]—is that they held stock options that vested in the event of a transaction, providing a lucrative payout.[40] When pressed at oral argument, the Plaintiff elaborated that the Director Defendants must have wanted to accelerate their vesting because they faced "risk."[41] The

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[37] *Id.* at 58:21–59:12.
[38] *Id.* at 59:19–21.
[39] As to Barrett, the Plaintiff alleges that he had a significant prior employment relationship with AOL, which caused the board to favor AOL, and that he stood to gain "an additional 12 months' salary of $476,000, 100% of his restricted stock units, and 100% of his stock options" in connection with the Transaction. Second Am. Compl. ¶¶ 12–14, 21, 65.
[40] *Id.* at ¶ 12.
[41] Transcript of June 30, 2016 Oral Arg. 40:23–41:12.

Plaintiff conceded that he did not know why the directors would cash out at lower price, rather than wait to maximize the value of the Company.[42] Instead, the Plaintiff argued that he need not answer that question at the motion-to-dismiss stage, without the aid of further discovery.

Under Delaware law, directors are presumed to be independent, disinterested, and faithful fiduciaries.[43] While a plaintiff need not know and articulate the exact motive of directors in order to sustain a claim, the Plaintiff does bear the burden to allege facts that rebut the presumption afforded to directors—that is, to demonstrate that it is *reasonably conceivable* that the board acted in bad faith or disloyally. Here, the single allegation as to the six directors (other than Barrett) is insufficient as a matter of law to do so. It is well-settled that where the interests of directors and stockholders are aligned, as here, the accelerated vesting of shares in a merger does not create a conflict of interest.[44] Additionally, even if an incongruency of interest had been plead, the Plaintiff has also failed to allege how the payouts that these directors stood to earn were material to them.[45] I need not address the allegations

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[42] *Id.* at 39:21–40:4.

[43] *See, e.g.*, *Beam ex rel. Martha Stewart Living Omnipedia, Inc. v. Stewart*, 845 A.2d 1040, 1048–49 (Del. 2004).

[44] *See Globis Partners, L.P. v. Plumtree Software, Inc.*, 2007 WL 4292024, at *8 (Del. Ch. Nov. 30, 2007) ("The accelerated vesting of options does not create a conflict of interest because the interests of the shareholders and directors are aligned in obtaining the highest price.") (internal quotations omitted).

[45] *See Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1167 (Del. 1995) ("[A] shareholder plaintiff [must] show the materiality of a director's self-interest to the given director's independence . . . .").

with respect to Barrett; he is only one of seven on the board, and the Plaintiff can only sustain a claim for the breach of the duty of loyalty by pleading facts showing that it is reasonably conceivable that each of a *majority* of the board is conflicted.[46] Finally, I note that Plaintiff's reliance on this Court's decision in *Chen v. Howard-Anderson*[47]—where the Court found that it was unclear at the motion-for-summary-judgment phase whether the alleged disclosure violations in the proxy statement resulted from a breach of loyalty or a breach of care, and declined the motion—is misplaced. The *Chen* court determined that, at that procedural stage, and given the "confounding evidence of the directors' knowledge and the problems that occurred in discovery," it needed further factual development to determine whether and to what extent the 102(b)(7) exculpatory provision applied.[48] That is not the case here.

Because the Plaintiff has failed to allege a reasonably conceivable breach of the duty of loyalty based on self-interest, he can only sustain his claim if he can demonstrate facts supporting an inference that the board acted in bad faith in making its allegedly incomplete disclosure—that is, facts showing an "intentional"

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[46] *See Plumtree*, 2007 WL 4292024, at *9 ("Even assuming [the plaintiff] was correct, which it is not, and such benefits were sufficient for the Court to infer [the CEO] was interested in the transaction, [the CEO] is only one member of a six person Board. The other five uninterested Individual Defendants constitute a clear majority."); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 363 (Del. 1993) ("This Court has never held that one director's colorable interest in a challenged transaction is sufficient, without more, to deprive a *board* of the protection of the business judgment presumption of loyalty.") (emphasis added).
[47] 87 A.3d 648 (Del. Ch. 2014).
[48] *Id.* at 693.

dereliction or a "conscious disregard" of duty.[49] The Plaintiff has not met that burden. Again, nothing in the pleadings, considered in the light most favorable to the Plaintiff, suggests bad faith. I note that I found at the preliminary injunction stage that the Plaintiff lacked a colorable claim of non-disclosure, and the Defendants presumably relied on that preliminary conclusion by this Court, which was undisturbed on appeal by the Supreme Court. Nothing in the record creates an inference that the Defendants *deliberately* withheld information or disregarded a manifest duty.[50]

B. LUMA's Contingent Compensation

I next turn to Plaintiff's claim regarding LUMA's contingent fee. The Plaintiff contends that the Proxy failed to disclose the amount of LUMA's fee that was contingent upon the completion of the Transaction. The Proxy discloses that

> LUMA Securities has acted as financial advisor to the Company in connection with the Merger and will receive a fee of $3.6 million for its services, a *substantial portion* of which is contingent upon the completion of the Merger (the "*Advisory Fee*"). LUMA Securities has also acted as financial advisor to the Board and received a $500,000 fee upon delivery of its opinion, which is not contingent upon the conclusion expressed or the consummation of the Merger (the "*Opinion*

[49] *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 243 (Del. 2009).
[50] The Plaintiff's reliance on this Court's decision in *Doppelt v. Windstream Holdings, Inc.*, 2016 WL 612929 (Del. Ch. Feb. 5, 2016), is unavailing. There, the plaintiff alleged specific facts that the board had knowingly withheld in its proxy: the proxy announced a $0.70 post-transaction dividend target, while the board was planning to slash that target to $0.58 following stockholder approval. Even with such facts, which do not exist here, then-Vice Chancellor Noble remarked that the complaint "test[ed] the limits of the 'reasonably conceivable' standard." *Id.* at *8 n.81.

> *Fee*"), provided that such Opinion Fee is partially creditable against any Advisory Fee.[51]

The Plaintiff argues that this "partial" disclosure was "inadequate to inform stockholders of how much of LUMA's fee was contingent upon a transaction coming to fruition," as "what constitutes a 'substantial portion' is highly subjective and open to various interpretations."[52]

As a threshold matter, the Defendants argue that this claim has been waived; it was pled in Plaintiff's first amended complaint, but was abandoned during the course of the expedited proceedings, through Plaintiff's failure to pursue the claim in briefing or argument on his motion for a preliminary injunctive relief. In my letter opinion denying certification of an emergency interlocutory appeal, I remarked that the "number of disclosure violations alleged [in the first amended complaint] is extraordinary," and found that "[b]y the time th[e] preliminary injunction request was submitted, these disclosure violations were abandoned, and are therefore waived, with a single exception" (referring to the claim concerning the unlevered, after-tax free cash flow projections).[53] The Plaintiff, on the other hand, contends that I should not consider the claim waived in this post-close context, arguing first that recent decisions have indicated a disposition toward addressing disclosure

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[51] Proxy, at 33–34 (emphasis added).
[52] Defs' Answering Br. 17.
[53] *Nguyen*, 2015 WL 5882709, at *1, 3.

claims post-close,[54] and second, that he adequately preserved his right to pursue other disclosure claims post-close during argument on the motion for preliminary injunctive relief.[55] Essentially, the Plaintiff posits that Delaware has recently established a new "regime," under which a plaintiff can elect to bring disclosure claims pre- or post-close, but creating uncertainties in the process which make leeway towards his approach appropriate here.[56]

To be clear, where a plaintiff has a claim, pre-close, that a disclosure is either misleading or incomplete in a way that is material to stockholders, that claim should be brought pre-close, not post-close. There are two aspects to such a claim: the first concerns a stockholder's right to a fully informed vote; and the second is a potential damages claim. While the latter may be remedied post-close, the former is

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[54] The Plaintiff points to *Chester Cnty. Ret. Sys. v. Collins*, C.A. No. 12072-VCL, at 21:16–23 (Del. Ch. Mar. 14, 2016) (TRANSCRIPT); *Johnson v. Driscoll*, C.A. No. 11721-VCL, at 45:19–46:5 (Del. Ch. Feb. 3, 2016) (TRANSCRIPT).

[55] *See* Prelim. Inj. Hrg. Tr. 11:15–19 ("Defendants also made this reference of frivolity. Nothing here is frivolous, Your Honor. We're moving on the serious disclosure, and whether we have other disclosures in our pleadings, we can do those post-close for quasi-appraisal.").

[56] The Plaintiff argues that recent rulings of this Court cause Plaintiffs' counsel to face a Catch-22: bring disclosure claims pre-close and risk denial of expedition on ground that damages is a sufficient remedy, or bring the claims post-close, and have them dismissed for failure to plead non-exculpated breach of duty. No such dilemma exists, in my view. This Court's jurisprudence makes clear that it is preferable to bring disclosure claims before closing. Such pleadings allow this Court to employ equitable relief to ensure an informed vote of stockholders. Those disclosure claims must, of course, be colorable—otherwise, they could not justify the expense to litigants and the Court of expedition, and in any event could not sustain equitable relief. Non-colorable claims are properly refused expedition.

Post-closing, what may remain are claims for damages. To the extent an improper disclosure was the result of an actionable breach of fiduciary duty on the part of directors, causing damages, a remedy is available post-closing, but as with any claim of breach of fiduciary duty, the plaintiff must plead facts that make it reasonably conceivable that an actionable breach of duty has occurred. That burden is not inconsequential, as the instant matter demonstrates.

irretrievably lost following a stockholder vote.[57] The preferred method for vindicating truly material disclosure claims is to bring them pre-close, at a time when the Court can insure an informed vote. Because of this interest, a salutary incentive could be provided by considering claims based on disclosure, pled but not pursued pre-close, to be waived.

However, the Defendants argue, and I agree, that regardless of whether I consider this claim waived, it fails on the merits. Here, the Proxy discloses that a "substantial portion" of LUMA's fee was contingent on the completion of the merger.[58] This Court has repeatedly held that such a disclosure regarding advisor fees, absent some indication that the fee was exorbitant or unusual, or otherwise improper, is sufficient.[59]

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[57] *In re Transkaryotic Therapies, Inc.*, 954 A.2d 346, 360–61 (Del. Ch. 2008) ([T]his Court has explicitly held that a breach of the disclosure duty leads to *irreparable harm.* On account of this, the Court grants injunctive relief to prevent a vote from taking place where there is a credible threat that shareholders will be asked to vote without such complete and accurate information. The corollary to this point, however, is that once this irreparable harm has occurred—*i.e.,* when shareholders have voted without complete and accurate information—it is, by definition, too late to remedy the harm. If the Court could redress such an informational injury after the fact, then the harm, by definition, would not be irreparable, and injunctive relief would not be available in the first place.") (citations omitted) (emphasis added).

[58] Proxy, at 33; *see also*, Second Am. Compl. ¶ 91.

[59] *See, e.g.*, *Cnty. of York Emps. Ret. Plan v. Merrill Lynch & Co.*, 2008 WL 4824053, at *11 (Del. Ch. Oct. 28, 2008) ("It is true that compensation contingent on consummation of the transaction has the potential to influence a financial advisor. However, that fact was disclosed in the proxy: 'Merrill Lynch has agreed to pay a fee to MLPFS, a *substantial portion* of which is contingent upon the merger being consummated.' And this Court has held that the precise amount of consideration need not be disclosed, and that *simply stating that an advisor's fees are partially contingent on the consummation of a transaction is appropriate*. In other words, the Plaintiff has simply not alleged a disclosure violation.") (emphasis added) (citations omitted); *Globis Partners, L.P. v. Plumtree Software, Inc.*, 2007 WL 4292024, at *13 (Del. Ch. Nov. 30, 2007) ("The Merger Proxy stated that Jefferies' fees were 'customary' and partially contingent, but did not provide

The Plaintiff points to this Court's decision in *In re Atheros Communications, Inc.*[60] for the proposition that the *level* of contingency of an advisor's fee can be material. There the Court found misleading a disclosure that the investment banker's fee was "substantially contingent" on the deal's closing, when the well-pleaded facts of the complaint showed that nearly all—98%—of the fee was contingent. The Court held that while "[c]ontingent fees are undoubtedly routine," the "percentage of the fee that is contingent exceeds both common practice and common understanding of what constitutes 'substantial,'" and "may fairly raise questions about the financial advisor's objectivity and self-interest."[61] In other words, the Court found that the plaintiff's pleadings *themselves* showed that the proxy was inaccurate, by understating the level of contingency.[62] To my mind, *Atheros* does not undermine the body of cases that hold that, generally, the disclosure that a

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further details. Without a well-pled allegation of exorbitant or otherwise improper fees, there is no basis to conclude the additional datum of Jefferies' actual compensation, per se, would significantly alter the total mix of information available to stockholders.") (citation omitted).

[60] 2011 WL 864928 (Del. Ch. Mar. 4, 2011).

[61] *Id.* at *8.

[62] *Id.* at *8; *see also In re Alloy*, 2011 WL 4863716, at *11 (Del. Ch. Oct. 13, 2011) ("Although this Court has held that stockholders may have sufficient concerns about contingent fee arrangements to warrant disclosure of such arrangements, that need to disclose does not imply that contingent fees necessarily produce specious fairness opinions. In this case, Plaintiffs provide nothing more than conclusory allegations that the presence of a contingent fee structure must have influenced [the banker], but they do not allege, for example, that the actual compensation received was excessive or extraordinary. In these circumstances, I cannot conclude that a broad salvo against such a common practice, standing alone, supports a reasonable inference that the fairness opinion rendered in this case is so flawed that the [Company's] directors could not have relied upon it in good faith.") (citations omitted).

"substantial portion" of a fee is contingent is sufficient. The Plaintiff here points to no well-pled facts indicating that the fee arraignment falls outside this general rule.[63]

Moreover, as with Plaintiff's other disclosure claim, the Plaintiff has not pled facts such that it is reasonably conceivable that this allegedly incomplete disclosure was made in bad faith. When pressed at oral argument, the Plaintiff described his theory as follows:

> Our theory is that all that information has not been disclosed intentionally to mislead shareholders in approving this transaction, and that the fact that the banker is getting paid a lot of money and that it's contingent on closing goes hand in hand, that that's why they didn't want the free cash flow disclosed.[64]

Beyond alleging, in this conclusory fashion, that the two alleged disclosure violations are related, the Plaintiff has not pled facts creating a reasonable inference that the Director Defendants acted deliberately to knowingly withhold material information regarding the contingent-banker-fee arrangement from the stockholders. The Plaintiff, in declining to pursue this claim pre-close, conceded that the claim was not its "serious" claim,[65] instead choosing only to pursue its disclosure claim regarding the UFCF; it is hard to see how the Defendants, in light of that concession,

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[63] I note that the other cases cited by Plaintiff—*In re Del Monte Foods Co. Shareholders Litigation*, 25 A.3d 813 (Del. Ch. 2011), and *In re TIBCO Software Inc. Stockholders Litigation*, 2015 WL 6155894 (Del. Ch. Oct. 20, 2015)—did not address *disclosure* claims concerning an advisor's fee.
[64] Transcript of June 30, 2016 Oral Arg. 11:3–9.
[65] Prelim. Inj. Hrg. Tr. 11:15–19.

acted in bad faith in not altering the disclosure; in any event, facts evincing bad faith are not adequately plead.

III. CONCLUSION

For the foregoing reasons, Defendants' Motion to Dismiss is granted. An appropriate Order is attached.

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

AN NGUYEN, Plaintiff, v. MICHAEL G. BARRETT, THOMAS R. EVANS, ROBERT P. GOODMAN, PATRICK KERINS, ROSS B. LEVINSOHN, WENDA HARRIS MILLARD, JAMES A. THOLEN, AOL INC., and MARS ACQUISITION SUB, INC., Defendants.	)))))))))))))))	C.A. No. 11511-VCG

ORDER

AND NOW, this 28th day of September, 2016,

The court having considered Defendants' Motion to Dismiss, and for the reasons set forth in the Memorandum Opinion dated September 28, 2016, IT IS HEREBY ORDERED that Defendants' motion is GRANTED.

SO ORDERED:

/s/ Sam Glasscock III

Vice Chancellor

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

MICHAEL D. JUDY, Plaintiff, v. PREFERRED COMMUNICATION SYSTEMS, INC., a Delaware corporation, CHARLES M. AUSTIN, and GERALD E. SETKA, Defendants.	)	Consol. C.A. No. 4662-VCL

MEMORANDUM OPINION

Date Submitted: June 29, 2016,
Date Decided: September 19, 2016

Michael W. McDermott, David B. Anthony, BERGER HARRIS LLP, Wilmington, Delaware; *Counsel for Plaintiff Michael Judy.*

Joseph B. Cicero, CHIPMAN BROWN CICERO & COLE, LLP, Wilmington, Delaware; *Counsel for the Special Committee of Defendant Preferred Communication Systems, Inc.*

Brian M. Rostocki, John C. Cordrey, REED SMITH LLP, Wilmington, Delaware; *Counsel for Intervenor Preferred Spectrum Investments, LLC.*

Evan O. Williford, Andrew Huber, THE WILLIFORD LAW FIRM LLC, Wilmington, Delaware; *Counsel for Intervenor Preferred Investors Association*.

LASTER, Vice Chancellor.

Preferred Spectrum Investments, LLC ("PSI") seeks to recover $20 million as an award of attorneys' fees and expenses from Preferred Communication Systems, Inc. (the "Company" or "PCSI"). PSI claims it is entitled to this amount because it provided the funding necessary for plaintiff Michael Judy to pursue three pieces of litigation that were filed separately and then consolidated into this action: (i) a summary proceeding to obtain books and records, (ii) a summary proceeding to compel the holding of an annual meeting, and (iii) a plenary action challenging the authority of the individual then running the Company and the validity of certain actions he took.

PSI claims that because Judy prevailed in the litigation, the Company was able to preserve its ownership of two blocks of wireless licenses that constituted the Company's primary assets. The Company subsequently sold one block of licenses for $60 million, and PSI values the other block of licenses at $40 million. PSI contends it should receive one third of the after-tax value of the aggregate $100 million benefit. PSI posits a tax rate of 40%, yielding an after-tax benefit of $60 million, and an award of $20 million.

As a fallback, PSI contends it should recover $4,059,099.12, representing expenses that PSI claims to have incurred. PSI contends it actually incurred $8,257,717.52 in expenses, but during a period when individuals affiliated with PSI also held positions with the Company, it made partial payment of the amounts due, leaving the amount PSI now seeks.

The original $8,257,717.52 appears grossly inflated. Of the total amount, PSI claims to have expended $4,198,618.40 for lawyers and other law-related expenses, but PSI admits that not all of those fees and expenses were for Judy's litigation efforts in this

action. A substantial portion of the fees went to fund lawyers for individuals who PSI encouraged to intervene and assert personal claims for equity or other securities from the Company. Another substantial portion of the fees were for lawyers who appeared in proceedings before the Federal Communications Commission (the "FCC"), where PSI took positions adverse to the interests of the Company.

The remaining $4,059,099.12 that PSI claims to have incurred is even worse. This amount includes virtually every business expense that PSI incurred to manage its operations over a period of eight years. It includes items such as the compensation that PSI paid to members of its management committee, commissions that PSI paid for its own financing transactions, and fees that PSI paid to hire an executive search firm. It includes routine corporate expenses such as accounting services, bookkeeping costs, banking fees, and office supplies. It even includes the interest PSI paid to borrow the funds that it used to pay for its other expenses.

For multiple reasons, PSI's motion is denied. First, PSI lacks standing to seek a fee award. PSI was neither the plaintiff nor plaintiff's counsel. PSI gratuitously financed litigation nominally being conducted by Judy. As a volunteer financier, PSI cannot seek an equitable fee award.

Second, PSI cannot obtain a fee award because it financed Judy's litigation as part of an attempt to take over the Company. This court has held that parties cannot obtain an equitable fee award when they use litigation in support of a takeover.

Third, PSI cannot establish the necessary causal connection between its litigation financing and the value of the licenses. There are too many intervening steps for PSI to be able to claim responsibility for $100 million in value.

Finally, PSI cannot recover a *quantum meruit* award, and in any event cannot recover all of the expenses it has claimed. Under no circumstances can PSI recover the amounts it spent to hire lawyers for individuals to pursue personal claims against the company or for lawyers to appear before the FCC and take positions adverse to the Company. Nor can PSI recover the myriad of ordinary business expenses that it has included in its petition.

I. FACTUAL BACKGROUND

PSI has made its fee application in a case that was litigated through trial to judgment. The facts are drawn from a combination of sources, including (i) the trial record and the court's earlier rulings in the case, (ii) the submissions made by the parties in connection with the application for an award of attorneys' fees and expenses, and (iii) pertinent public records that are subject to judicial notice.[1]

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[1] *See* D.R.E. 201(b); *Aequitas Sols., Inc. v. Anderson*, 2012 WL 2903324, at *3 (Del. Ch. June 25, 2012) (taking judicial notice of a pleading filed in a related action); *In re Wheelabrator Techs., Inc. S'holders Litig.*, 1992 WL 212595, at *11–12 (Del. Ch. Sept. 1, 1992) (taking judicial notice, in a motion to dismiss context, of documents of public record); *see also In re Tyson Foods, Inc. Consol. S'holder Litig.*, 919 A.2d 563, 585 (Del. Ch. 2007) (Rule 201 permits a court to take judicial notice of "documents [outside the pleadings] that are required by law to be filed, and are actually filed, with federal or state officials") (footnote omitted).

The factual background is lengthy because of the strange nature of PSI's application, which seeks in the first instance to obtain a "fee award" equal to one-third of the value of the Company's assets, and in the alternative to recover eight years worth of legal and business expenses. These broad claims make it is necessary to provide the background required to place those requests in context.

A. The Company And Its Original Buy-And-Flip Strategy

The Company is a Delaware corporation formed on January 15, 1998. It has a complex and troubled history.

The Company arose from a scheme by Pendleton C. Waugh to acquire a critical mass of specialized mobile radio licenses for sites located in the U.S. Virgin Islands and Puerto Rico, then flip them within six months to a year to Telecellular, Inc., an aspiring cellular telephone operator. At the time, Waugh was President and a director of Telecellular. Due to the various means by which the FCC historically licensed spectrum, many of the licenses that Waugh sought to acquire were held by individuals having varying degrees of financial and legal sophistication.

Waugh had a lengthy and checkered record in the cellular telephone industry. In 1990, he formed Express Communications, Inc. ("Express"), a company that also engaged in the business of acquiring wireless licenses. In 1993, federal authorities began investigating Express's activities. In 1994, Waugh was indicted in the United States District Court for the Northern District of Texas on one count of conspiracy to structure financial transactions to evade securities and banking reporting requirements and one

count of money laundering, both felonies.[2] Waugh pled guilty to the conspiracy count, and the money laundering count was dismissed.[3] In 1995, he was sentenced to twenty-one months in federal prison (later reduced to fifteen months), three years probation, and the payment of $20,000 in fines.[4] In 1997, during the same period when Waugh was developing his plan for the Company, the United States District Court for the District of Columbia granted summary judgment against Waugh in a civil action brought by the SEC for securities law violations relating to Express. Waugh was ordered to disgorge nearly $13 million in illegally acquired funds and was enjoined permanently from violating various securities laws.[5]

Waugh brought Charles M. Austin into his buy-and-flip scheme. Austin previously had worked to acquire licenses for PCC Management Corp., another of Waugh's companies. Evidencing his own regard for legal compliance, Austin never bothered to file a state or federal income tax return between 1997 and 2010.

Waugh and Austin brought in Jay Bishop, whose record in the cellular industry rivaled Waugh's. In the early 1990s, Bishop was one of three stockholder principals in Continental Wireless Cable Television, Inc. ("Continental"), another company that engaged in the business of acquiring wireless licenses. In 1994, the SEC filed an

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[2] *See* Indictment, *United States v. Waugh*, No. 3:94-CR-160-T (N.D. Tex. May 11, 1994).

[3] *See* Plea Agreement, *Waugh*, No. 3:94-CR-160-T.

[4] *See* Judgment, *Waugh*, No. 3:94-CR-160-T.

[5] *See S.E.C. v. Express Commc'ns, Inc.*, No. 95-CV-2268 (D.D.C. Mar. 7, 1997).

enforcement action against Continental for defrauding investors, obtained a restraining order against Continental, seized its assets, and froze the bank accounts of the company and its principals.[6] Bishop was eventually prosecuted by the IRS and convicted in 2001 of two felonies: conspiracy to defraud the IRS and attempted tax evasion while a principal of Continental. Bishop was sentenced to thirty months in federal prison.

Bishop added Charles Guskey to the mix. Guskey had worked for Continental as one of Bishop's accountants.

Among the four original participants, Austin's role was to serve as the front man for the Company. Earlier in this case, after trial, this court made the following finding of fact:

> [B]ecause Bishop and Waugh were convicted felons, and because the FCC looks askance at felons and fraudsters controlling (directly or indirectly) cellular communications licenses, Waugh, Bishop, Guskey, and Austin sought to conceal Waugh and Bishop's involvement. To that end, Austin always acted as the front man for the group, and Waugh and Bishop never held any official positions with PCSI. Despite foregoing any official roles, Waugh and Bishop in fact acted as principals of PCSI, participated in its operations, and made decisions on behalf of PCSI.

Dkt. 432, ¶ 4.

B. The Company's Strategy Changes

Beginning in 1998, the Company successfully assembled eighty-six licenses to operate a cellular telephone business in Puerto Rico and the U.S. Virgin Islands (the

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[6] See Press Release, Securities and Exchange Commission, Continental Wireless Cable Television, Inc. (May 21, 2002), *available at* http://sec.gov/divisions/enforce/claims/contwire.htm.

"PR/VI Licenses"). Nine of the PR/VI Licenses subsequently expired for lack of renewal. The Company assembled the PR/VI Licenses by acquiring them from individuals in return for packages of consideration that typically included securities in the Company. The Company also successfully obtained a set of thirty-eight licenses that gave the Company the right to use mobile radio frequencies in nine specified economic areas, predominantly clustered in the continental United States in Virginia and California (the "CONUS Licenses").

In 1999, the plan to flip the licenses to Telecellular foundered after Waugh encountered further legal difficulties. The FCC described them as follows:

> In 1999, Waugh was convicted of securities fraud, a felony, in a case brought by the State of Texas, arising from his failure, in 1993, to disclose to a potential investor that he was under investigation by federal authorities for activities relating to his involvement in Express. Waugh was sentenced to four years in state prison, all of which were suspended pending successful completion of probation. He also was ordered to pay $72,000 in restitution and to complete 500 hours of community service.
>
> Later in 1999, Waugh was determined to have violated the terms of his parole from federal prison and his probation on his state conviction by traveling to Puerto Rico to engage in activities relating to cellular telephone securities. As a result, Waugh was sentenced to six additional months in federal prison and four years in state prison.[7]

The reference to Waugh "traveling to Puerto Rico to engage in activities relating to cellular telephone securities" involved a trip with Austin to obtain the PR/VI Licenses for the Company.

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[7] *Pendleton C. Waugh*, 22 F.C.C.R. 13363, 13365-66 (2007); *see* Judgment for Revocation of Probation, *Waugh*, No. 3:94-CR-160-T; *Texas v. Waugh*, No. F-9703517 (Crim. Dist. Ct. Dallas, Tex., May 17, 1999).

With the assemble-and-flip strategy no longer viable, the four original founders re-oriented the Company towards the more challenging task of becoming a full service wireless telecommunications provider. Ostensibly to fund this plan, the Company raised money by issuing a variety of poorly documented securities to outside investors. When issuing these securities and engaging in related transactions, the Company did not follow corporate formalities. Earlier in this case, this court made the following finding of fact after trial:

> To use a technical corporate term, [the Company] was a mess. Its founders did not follow corporate formalities and took dramatically different positions regarding the [C]ompany's capital structure depending on whether they were dealing with regulatory authorities like the FCC, potential investors, or the Court. It is not possible to reconcile all of the conflicting evidence into a single coherent account, nor is it possible to harmonize all of the various transactions in which [the Company] engaged or the types of securities that ostensibly were issued.

Dkt. 433, ¶ 5.

This court has determined that the Company originally had two classes of stock: Common Stock, par value $.001 per share (the "Original Common Stock") and Series A Preferred Stock, par value $.001 per share (the "Series A Preferred Stock"). In 2007, the Company purported to effectuate a reorganization that would have resulted in the Company having four classes of stock: Class A Common Stock, par value $.001 per share (the "Class A Common Stock"), Class B Common Stock, par value $.001 per share (the "Class B Common Stock"), Series A Preferred Stock, and Series B Preferred Stock, par value $.001 per share (the "Series B Preferred Stock"). The reorganization had the following components: (i) a forward split of the shares of Original Common Stock on a

2:1 basis; (ii) a reclassification of the Original Common Stock into Class A Common Stock; (iii) the creation of the new Class B Common Stock; and (iv) the modification of the dividend rights of the holders of the Series A Preferred Stock by reducing their annual dividend rate from 11% to 6%. The Company sold the resulting securities to investors. This court has determined after trial that the reorganization was invalid.

The Company also raised money by issuing debt. In April 2006, the Company completed a private offering of promissory notes, due in nine months, and issued in units of $25,000. The investors were promised repayment of the principal and interest, plus warrant coverage. The notes came due at various points in 2007.

It is not clear what progress, if any, the Company made during this period to build out a cellular telephone network or become a cellular telephone provider. The Company's primary business activity appears to have been inducing individuals to buy its securities.

C. The FCC Investigation And Order To Show Cause

In July 2007, after conducting a preliminary investigation, the FCC issued an Order to Show Cause to Waugh, Austin, Bishop, the Company, and the Company's wholly-owned subsidiary, Preferred Acquisition, Inc., which was the entity that owned both the PR/VI Licenses and the CONUS Licenses (the "Licenses Sub"). Through the Order to Show Cause, the FCC initiated formal enforcement proceedings to determine whether the named individuals were qualified to be FCC licensees. The FCC summarized its reasoning for issuing the Order to Show Cause as follows:

> The record before us indicates that these individuals, two of whom are convicted felons, and the referenced entities, individually and collectively, among other things, apparently (1) failed to disclose a real-party-in-interest

> and engaged in unauthorized transfers of control of Commission licenses; (2) misrepresented material facts to the Commission; (3) lacked candor in their dealings with the Commission; (4) failed to disclose the involvement of convicted felons in ownership and control of the licenses; (5) failed to file required forms and information and respond fully to Enforcement Bureau letters of inquiry; and (6) discontinued operation of certain licenses. Evidence of such misconduct raises material and substantial questions requiring further inquiry at hearing as to whether the referenced licenses should be revoked and whether forfeitures should issue against one or more of the persons and/or entities identified above.

Pendleton C. Waugh, 22 F.C.C.R. at 13364.

The Order to Show Cause posed an existential threat to the Company. If the FCC revoked the Company's licenses, then it would no longer have any valuable assets.

By late 2007, the Order to Show Cause had driven "a wedge between Waugh and Austin." Dkt. 432, ¶ 4. Before the FCC enforcement proceeding, Waugh was "the principal decision-maker for [the Company], with Austin acting as a figurehead." *Id.* After the FCC enforcement proceeding, Austin tried to distance the Company from Waugh. Austin was able to do this because the original certificate of incorporation identified Austin as the sole director of the corporation. Shortly after the Company was formed, in his capacity as sole director, Austin had appointed himself CEO and President. The Company had never held a meeting of stockholders at any point during its existence, so Austin had continued in those roles. From a technical legal standpoint, Austin was in charge of the Company.

D. Waugh Fights Back By Forming Smartcomm, The Association, And PSI.

Waugh was not about to walk away from PCSI. He needed a way to regain control over the Company or, barring that, a means of extracting the value to which he believed

he was entitled. In furtherance of those goals, he formed a series of entities. Just as he had used Austin as his front man for the Company, Waugh nominally put others in charge of these entities as well.

In December 2007, Waugh formed Smartcomm, LLC with Carole Downs. Waugh met Downs in June 2007 through Match.com. Downs had been a successful real estate broker in Arizona, but the real estate downturn in 2007 hit her business hard, and she was ready for a new project. She had no experience in the wireless license industry and knew nothing about it. Despite her lack of experience, Downs became President of Smartcomm. Waugh served as Vice President. Smartcomm became the new vehicle through which Waugh pursued his activities in the wireless industry.

Waugh and Downs also worked to organize the various investors who had purchased securities from the Company. Their strategy was to blame Austin for the Company's lack of progress, mobilize the investors against him, and then use the investors' anger as the vector for regaining control. Notably, before the Order to Show Cause, there are no indications of any disputes between Waugh and Austin, and neither seems to have been troubled by the absence of any progress by the Company on its business plan. Both appeared content to use the Company as a vehicle for raising money from investors. Only after the FCC issued its Order to Show Cause did Waugh and his new business partner, Downs, begin attacking the Company's lack of progress.

The first investors' organization that Waugh and Downs formed was the Preferred Investors Association (the "Association"). Waugh knew that because of his criminal background and the issues pending before the FCC, he could not be the face of the

organization, so he recruited Michael Judy to serve as its public persona. In 1999, Judy became an investor in the Company after meeting with Waugh and attending a subsequent investor presentation. Waugh and his team convinced Judy about the Company's fantastic prospects, and Judy agreed to make a personally significant investment of $40,000, which he raised by maxing out his credit cards and borrowing from his father. Dkt. 385, at 13–14. Judy was not an expert in the wireless industry; his primary avocation was professional auto racing. His role was that of a passive investor until early 2007, when he became a finder for the Company and was compensated for bringing in other investors. *See id.* at 27–28.

After the Order to Show Cause created a rift between Waugh and Austin, Waugh convinced Judy that Austin was the source of the Company's problems. In November 2008, Judy, Waugh, and other investors in the Company met in San Marcos, California. They agreed to form the Association, and they elected Judy as President.

Judy's tenure as head of the Association and its role as a vehicle for Waugh were both short-lived. Disagreements quickly arose between Waugh's faction and investors associated with Edward Trujillo, who had served as a finder for the Company and brought in many of the individuals who purchased its securities. Judy resigned, and Trujillo became President. The Association eventually came to represent approximately eighty investors who collectively provided approximately $3.1 million in funding to the Company. Trujillo and the Association came to be the principal opponents of Waugh's efforts to regain control over the Company.

Having lost control of the Association, the Waugh faction needed to form a new organization. In January 2009, Judy, Waugh, and various supporters met in Solina Beach, California, where they decided to form PSI. In February 2009, Judy formally created PSI and became its President. Judy admitted at trial in this action that Waugh was instrumental in creating PSI and in developing its strategy. At the same time, he sought to downplay his own connections to Waugh. *See* Dkt. 385, at 35.

The operating agreement of PSI described the entity as having the following business purposes:

> The purpose of [PSI] is to file . . . license applications for . . . markets Sprint Nextel Corp. is vacating . . . *[PSI] also will seek to negotiate a loan transaction with holders of the shares of [PCSI's] Class A Common Stock and the contractual rights to be issued such shares representing a majority of the votes of all of [PCSI's] presently issued and outstanding shares and the shares it has committed to issue.* [PSI] may conduct any other businesses the Management Committee considers appropriate.

Dkt. 511, Ex. 2, at 1–2 (emphasis added). In other words, one of the two identified business purposes of PSI was to gain control of the Company.

E. The Judy Litigation

PSI originally approached Austin about a settlement that would involve him transferring control over the Company to PSI. When those efforts failed, PSI decided to initiate litigation. The core strategy was to obtain a court-ordered meeting of stockholders at which Waugh and his allies could replace Austin and retake control of the Company.

PSI itself was not a stockholder in the Company. Judy was, so he served as the plaintiff. PSI's initial role was to fund the litigation and, through Waugh and Downs, to control the overall strategy. PSI did not have any formal agreement with Judy or his

counsel regarding litigation funding. From a legal standpoint, PSI was paying counsels' fees gratuitously in support of its takeover effort.

In June 2009, Judy filed a statutory action for books and records. Among other materials, Judy sought information about the stockholders of the Company and a copy of the Company's stock ledger. Both were critical to PSI's purpose of taking over the Company. Waugh wanted to be able to contact other stockholders, convince them to vote against Austin, and figure out whether he had the votes to win.

In July 2009, Judy brought a statutory action to compel an annual meeting. Since its founding in 1998, the Company had never held an annual meeting. The court-ordered annual meeting was the centerpiece of PSI's strategy to take over the Company. Waugh expected that at the meeting, his faction would replace Austin with a slate consisting of Judy, Downs, and other allies of Waugh.

On the same day that he filed the annual meeting action, Judy filed a plenary action seeking declaratory and injunctive relief regarding the proper composition of the Company's board of directors and Austin's authority—or lack thereof—to take action on behalf of the Company. The plenary action also challenged various actions that Austin had taken as constituting breaches of fiduciary duty. Tactically, the plenary action initially appears to have had two near-term purposes. It would prevent Austin from taking defensive steps that might interfere with Waugh's ability to regain control at a court-ordered meeting, and it would hamper Austin's ability to deal with the FCC and address the Order to Show Cause, which Waugh feared that Austin might use to legitimize his control. In the long run, the plenary action would threaten Austin with personal liability

and potentially force a settlement. The court consolidated the three lawsuits (together, the "Judy Litigation").

F. The FCC Settlement

Meanwhile, the FCC's proceedings on the Order to Show Cause remained pending. As noted, the Order to Show Cause posed an existential threat to the Company and all of its investors because if the FCC revoked the Company's licenses, then it would have nothing. Consequently, although Austin, Waugh, Judy, Guskey, the members of the Association, the members of PSI, and myriad other Company stakeholders fought vigorously among themselves as to their rights relative to each other, they were united on one point: the FCC should not revoke the Company's licenses.

Waugh had been right to worry that Austin might use the FCC to solidify his position. Effective August 6, 2009, all of the parties to the FCC proceedings—other than Waugh—entered into a settlement agreement (the "FCC Settlement Agreement").[8] Critically for the Company, the FCC agreed that the Company could keep its licenses. For everyone other than Waugh and Bishop, the price the FCC extracted was low. As part of the settlement, the Company, the Licenses Sub, and Austin agreed "[t]o elect or appoint at least one additional member to [the Company's] Board of Directors [and] to recruit a Chief Operating Officer and Chief Financial Officer for" the Company and Licenses Sub, with the identify of those individuals subject to the approval of the FCC.

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[8] *Pendleton C. Waugh*, FCC 09M-51, EB Docket No. 07-147 (Aug. 6, 2009), *available at* https://transition.fcc.gov/eb/hearings/files/FCC-09M-51.pdf.

Id. ¶ 22. The Company and Licenses Sub also agreed to make "a voluntary contribution to the United States Treasurer in the total amount of $100,000." *Id.* ¶ 29. The Company did surrender fifty-three of its licenses, but they were not critical to its two key blocks of licenses.

For Waugh and Bishop, however, there was an additional price. The FCC Settlement Agreement strictly limited their involvement with the Company, including as investors. Paragraph 21 of the FCC Settlement Agreement stated:

> [The Company and Licenses Sub], Charles M. Austin, and Jay R. Bishop each agrees that Pendleton C. Waugh and Jay R. Bishop shall not work for, contract for, consult for, or hold any ownership interest (outright or beneficial) through stocks, warrants, voting trusts, or any other mechanism) in [the Company], [Licenses Sub], any Affiliate of [the Company], and/or any Affiliate of [Licenses Sub].

Id. ¶ 21.

Waugh was not a party to the FCC Settlement Agreement, and he immediately challenged its validity in the proceedings before the FCC. In the Judy Litigation, Judy was acting as a front man for Waugh. Consequently, despite the profound benefits of the FCC Settlement Agreement for the Company, Judy challenged it in the Judy Litigation, contending that Austin lacked authority to enter into the agreement. After trial, this court would reject that argument.

G. Judy's Early Victories

Judy moved for summary judgment in Delaware on various aspects of his claims. By order dated September 29, 2009, as amended on October 13, the court granted summary judgment in Judy's favor on his claim for books and records. The court's order

directed the Company to produce specific categories of books and records, including its "stock ledger and a list of the Company's stockholders." Dkt. 33, ¶ 2(a).

The court also granted summary judgment in favor of Judy on his request for an annual meeting. *Id.* ¶ 4. The order directed the Company hold an annual meeting of stockholders on December 9, 2009, and it appointed Richard L. Renck, Esq., to act as special master for purposes of overseeing the annual meeting. *Id.* ¶ 4(f).

The court even granted preliminary relief in favor of Judy on the claim that Austin could not take action on behalf of the Company. The order stated that "until a board of directors is properly elected in accordance with the foregoing provisions for the meeting of stockholders, Austin shall not hold himself out as constituting the board of directors of the Company." *Id.* ¶ 5.

This was a three-fold victory for Judy and the Waugh faction. The court-ordered annual meeting gave them an opportunity to take control of the Company. The injunction prevented Austin from taking defensive action that might interfere with their efforts to gain control at the meeting. At the time, the ruling on the stock ledger and related information seemed the least significant of the three, but that would soon change.

H. The PSI Loan Gambit

With his three-fold victory in hand, Judy provided investors in the Company with an update through a letter dated October 12, 2009. Dkt. 511, Ex. 5 (the "October 12 Letter"). The October 12 Letter included a description of recent events at the Company, Judy's efforts in the litigation, and what Judy expected would happen at the annual meeting. After presiding over this litigation for multiple years, during which more and

more of the full story has been revealed, I am now struck by the degree to which the October 12 Letter (i) concealed Waugh's involvement while (ii) characterizing events in a manner beneficial to Waugh's interests, particularly as to events before the FCC. For example, the October 12 letter stated that the FCC Settlement Agreement "threatens to impair the Company's [Economic Area] authorizations and cancel many of its site-based licenses." *Id.* at 3. In fact, the settlement saved the key blocks of licenses that the Company needed to have any prospect of success.

In the October 12 Letter, Judy described a plan for PSI to loan money to the Company. The money would be used to pay the legal fees incurred in the Judy Litigation and also "legal fees to be incurred with respect to several FCC regulatory matters." *Id.* at 4. The loan would be funded by a private offering of Class C Units in PSI. The letter failed to mention that the consideration sought from the Company for the loan would be shares of Company stock, such that the plan would result in PSI (and thus Waugh) regaining control of the Company. The October 12 Letter encouraged stockholders to appoint PSI as their proxy for the scheduled annual meeting on December 9, 2009.

Consistent with the October 12 Letter, PSI in fact prepared and distributed an offering memorandum to raise money from third party investors. The offering memorandum explained that PSI would use the funds it raised to (i) pay $3 million for "applications for licenses" from Smartcomm License Services, LLC, an affiliate of Smartcomm, (ii) pay $750,000 for equity in Stargate Management, LLC, an affiliate of Smartcomm, and (iii) loan the Company $2.5 million for a period of two years (the "PSI Loan"). In return for the PSI Loan, PSI expected to receive interest at a rate of 11% per

annum plus warrants to purchase 750,000 shares of common stock of the Company. The PSI Loan was an attempt by Waugh to re-establish his connection to the Company, but with the legal risk mitigated by (i) the use of a loan with warrant coverage and (ii) the channeling of the loan through PSI.

To his credit, Austin refused to negotiate with PSI over the PSI Loan. That aspect of PSI's business plan never got off the ground. The PSI Loan was consistent with Waugh's overall strategy to re-gain control over the Company and extract value from it.

I. The Judy Litigation Becomes Significantly More Complex.

After the court's rulings on September 29, 2009, Waugh and his allies thought they were on their way to a court-ordered meeting on December 9. But what seemed to have been the most straightforward of the court's rulings—the order compelling the Company to produce its list of stockholders—served as the catalyst for a far more complicated proceeding. Put simply, the Company's records were such a mess that Austin could not provide the required stockholder materials or stock ledger.

After the Company failed to meet the court-ordered deadline for producing these records, Judy sought the appointment of a receiver who would take control of the Company for the limited purpose of producing them. The motion was briefed, and on December 23, 2009, the court appointed Renck to act as receiver for the Company (the "Receiver"). Renck previously had been appointed to serve as special master for the purpose of holding the court-ordered meeting of stockholders, so this was a natural enlargement of his duties. The formal order was entered on December 23. The order

charged the Receiver with identifying the Company's stockholders, determining who could vote at the annual meeting, and then convening and conducting the meeting.

The Judy Litigation also became significantly more complex in December 2009 because the court permitted the Association to intervene. Trujillo had perceived Waugh's strategy of using a court-ordered meeting to regain control of the Company. He also perceived that Waugh was using Judy as a front man to hide his involvement.

When the Association sought to intervene, PSI moved to intervene as well. The court denied PSI's motion. Dkt. 120. The ruling noted "important differences between [the Association] and PSI," including that PSI was formed in part to pursue business opportunities that would bring it in competition with the Company. *Id.* at 2. The court concluded that PSI was "a for-profit operation that seeks to intervene in a matter in which it has no direct interest." *Id.*

J. The Receiver's Report

On March 5, 2010, the Receiver filed a thorough, lengthy, and detailed report, in which he made recommendations regarding the identity of the Company's stockholders and their holdings. The Receiver also identified serious problems with the Company's capital structure.

Several of the Receiver's recommendations displeased Waugh and his allies. One of the more significant issues that the Receiver addressed was the number of shares held by the four founders: Waugh, Austin, Bishop, and Guskey. Austin claimed to own 800,000 shares of the Company's stock, making him the Company's largest single stockholder. Waugh contended that he had been issued the same number of shares, but

that to avoid problems with the FCC, the four founders had agreed to place Waugh's shares in a trust controlled by Waugh's friend, Raymond Hebrank (the "Hebrank Trust"). The Receiver, however, recommended that the court find that the Hebrank Trust was *not* entitled to 800,000 shares. The Receiver also recommended the rejection of a claim by Alejandro Calderon, a supporter of Waugh's, to own 300,000 shares.

Waugh responded to the report by calling upon his allies to file and litigate lawsuits and objections. In an email dated March 5, 2010, to Downs, Judy, and forty other persons, he wrote:

> So now I hire an attorney and together with Raymond Hebrank file a civil lawsuit against [the Company] and the Receiver for specific performance of Mr. Austin's verbal agreement to issue the Raymond Hebrank Voting Trust 800,000 shares of Common Stock. I also will be seeking additional Common Stock Purchase Warrants and compensatory and punitive damages. I would think that Alejandro Calderon, Angel Benitez, Michael Judy and other would file similar lawsuits. I would think that Mr. Judy and other Preferred shareholders and note and warrant holders also now would pursue litigation to enforce their claims for the issuance of shares, warrants and/or notes and may seek to recover monies owed or promised.

Dkt. 511, Ex. 6.

In April 2010, just as Waugh had indicated, the Hebrank Trust filed a plenary action to obtain the shares to which Waugh believed he was entitled.[9] More importantly

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[9] *See* Complaint, *Hebrank v. Preferred Commc'ns Sys., Inc.*, C.A. No. 5434-VCL (Del. Ch. Apr. 23, 2010). This court dismissed the Hebrank Trust's claim, after which the trust appealed. *Hebrank,* C.A No. 5434-VCL *Id.* at 34–37 (June 20, 2011) (TRANSCRIPT). While the appeal was pending, Waugh passed away, and the parties dismissed the appeal by stipulation.

for present purposes, Waugh's allies filed an avalanche of objections to the Receiver's report. PSI funded the objectors' legal fees.[10]

Many of the Receiver's conclusions turned on assessments of incomplete and conflicting corporate records, and the objections made clear that a trial would be needed to resolve the persistent disputes about who owned stock and could vote at the court-ordered meeting. The parties engaged in litigation over the objections in anticipation of a hearing to take place in July 2010, but the process faltered when the Receiver's fees went unpaid. By letter dated September 7, 2010, the court confirmed that it would not hold a hearing until the Receiver's fees were paid. Trial eventually was rescheduled for February 2011, then deferred again to allow for mediation. After several additional continuances, trial ultimately took place in December 2011.

After trial, the court expanded the Receiver's authority and issued several orders and judgments. Among other things, the court's post-trial orders and rulings invalidated the attempted reorganization from 2007, adopted various settlements recommended by the Receiver, and approved a final stock list for the Company. The court directed the Receiver to "schedule a Court-ordered meeting of stockholders for the election of a new board of directors, set the record date for the meeting, give notice of the meeting,

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[10] *See, e.g.*, Dkt. 529, Ex. 5, at 5 (objective to provide PCSI's investors a fair return on their investments "at no additional cost to them."); *id.*, Ex. 7, at 2 ("offer for Legal Representation is **FREE OF COST** to you" because "PSI is actively participating in other wireless communications investment opportunities that are generating the funds to finance this legal effort on behalf of all PCSI investors") (emphasis in original); *id.*, Ex. 8, at 1 ("You will not be billed or expected to pay any portion of the attorneys' fees"); *id.*, Ex. 60, at 120–26.

convene and conduct the meeting, and determine those members of the board of directors who have been elected and qualified." Dkt. 417, ¶ 14.

K. Judy's Original Fee Petition

After obtaining the relief that this court awarded after trial, Judy sought, on behalf of PSI, an award of fees and expenses, which he asked to have granted 200,000 shares of stock. Dkt. 511, Ex. 16, at 62. The shares would represent 19.4% of the total outstanding equity. With the benefit of hindsight, it seems clear that PSI wanted the shares so it could deploy them in connection with the upcoming meeting of stockholders so as to help its faction gain control and because the shares would constitute a significant percentage of the economic value of the Company.

At the time, I rejected Judy's share-based fee petition because, as a threshold matter, I had no way to determine how much value would be conferred by 200,000 shares. The Company's future was, at that point, still contingent and highly uncertain. The Company had no operations and its only meaningful assets were the PR/VI Licenses and the CONUS Licenses. Those licenses might have turned out to have great value, or they might have turned out to be worthless. Among other reasons, there were still questions after trial as to what action the FCC would take and whether the FCC Settlement Agreement would remain in effect.

Given this uncertainty, I declined to award any shares to PSI, stating that the benefit conferred by the Judy Litigation could well be "nonexistent or entirely speculative." *Id.* at 109. Without deciding the matter, I held out the possibility that there might be some basis for a fee award in the future, stating that "[i]t may be that at some

point, things are sufficiently certain so that one could either craft a share-based award or the company would be in a position to pay an award out of real money." *Id*.

L. The 2013 Annual Meeting

After this court's rulings, a proxy contest ensued in which PSI and the Association each sought to elect candidates to the board at the court-ordered meeting. PSI put forth a slate comprising Judy, Downs, Barclay Knapp, Roman Kikta, and Michael Scott. The Association put forth its own slate. The election was hotly contested.

The annual meeting was held on January 23, 2013. Out of 172 separate stockholdings listed on the stock list, 159 holdings were voted either in person or by proxy. The vote count showed that PSI's nominees narrowly prevailed.

The Association challenged the outcome. Among other things, the Association argued that PSI and its principals had misrepresented their relationship with Bart Caso, an individual who had been charged with fraud while raising money for PSI. *See* Dkt. 452. By order dated March 18, 2013, I determined that PSI's nominees had been validly elected (the "PSI Directors"). I overruled the Association's objections, including its challenge based on PSI's relationship with Caso. Dkt. 456. In the fee application, PSI has sought to recover amounts incurred for lawyers for Caso and for the fundraising efforts in which Caso was involved.

M. The Sprint Transaction

In April 2013, the PSI Directors began taking action on behalf of the Company. They appointed Knapp as President and CEO and approved a compensation package for him that included a $450,000 salary, an incentive bonus equal to 100% of his salary, and

stock options. Shortly after becoming CEO, Knapp co-founded M2M Spectrum Networks with Downs. Dkt. 511, Ex. 59, at 25–26.

On December 20, 2013, the Company reached an agreement to sell the CONUS Licenses to Sprint for $60 million (the "Sprint Transaction"). The CONUS Licenses represented roughly 70% of the Company's fixed assets. The Company still possessed the PR/VI Licenses.

In June 2014, the Sprint Transaction closed. After receiving the $60 million in transaction proceeds, the PSI Directors authorized various payments by the Company. They included compensation payments to the directors and a special bonus to Knapp of $315,000.

N. The Next Falling Out

In 2013 and 2014, tensions began to build between Downs and Judy. One source of tension was Downs' demand that PSI pay Smartcomm for amounts due on a promissory note that PSI issued with a face amount of $3.65 million (the "Promissory Note"). PSI contends that the note memorializes funds it received from Smartcomm and used predominantly to pay legal fees for the various law firms involved in the Judy Litigation and in proceedings before the FCC. Downs has claimed that she provided the bulk of the money that Smartcomm loaned to PSI from her personal funds.

PSI's Management Committee did not immediately agree to provide the funds that Smartcomm was seeking, which infuriated Downs. The Management Committee, led by Judy, conducted an audit regarding "discrepancies, if any, in the Smartcomm loan's [sic] which may affect the remaining balance owed." Dkt. 511, Ex. 24; *see also id.*, Ex. 28.

In July 2014, Downs wrote to PSI's members and called for an election of new managers. At a meeting of members in September 2014, Judy and two other managers resigned in favor of a new group of managers that included a substantial new investor named David Mellish. *See* Dkt. 511, Ex. 36. It appears that Downs convinced Mellish and others that because PSI had helped fund the Judy Litigation, the Company owed millions of dollars to PSI, which PSI then could use to pay Smartcomm and M2M. *See* Dkt. 529, Ex. 58, at 172–73.

O. The Company Makes A Partial Payment To PSI.

In September 2014, the Company began negotiating with PSI over amounts that PSI claimed were due from the Company. In November, Downs and Knapp signed an agreement assigning the Promissory Note from Smartcomm to the Company in return for a payment to Smartcomm equal to the face value of the amount due, or $3.48 million. *See* Dkt. 511, Ex. 42. At the time, PSI was a cash-poor entity with less than $400,000 in the bank. *See id.*, Ex. 41. The assignment meant that Smartcomm and Downs replaced an effectively unrecoverable debt claim against PSI with $3.48 million in cash.

In June 2015, Knapp and Mellish signed a settlement agreement in which the Company purportedly agreed to pay the legal expenses that PSI incurred in the Judy Litigation. The consideration consisted of (i) forgiving the Promissory Note, (ii) making a payment of $658,859.36, and (iii) agreeing that PSI could file a fee application with the court (the "PSI Settlement Agreement").

P. The Fee Application

This court issued its final decision on the merits in this matter on March 26, 2013. Dkt. 460. The Delaware Supreme Court affirmed this court's post-trial ruling and issued its mandate on May 28, 2013. Dkt. 462. Two-and-a-half years later, on December 21, 2015, PSI moved to re-open the case and intervene so it could file a fee application. Dkt. 465. I granted the motion so that I could consider PSI's arguments. Dkt. 467. PSI filed its operative fee application on March 2, 2016. Dkt. 474. The Association took the lead in opposing the fee petition.

In its primary argument, PSI contends that it should receive a fee award based on the value of the Company's wireless licenses. PSI starts with the $60 million that the Company obtained in the Sprint Transaction for the CONUS License and represents that the Company paid $23,878,758.45 in taxes on that amount, for an effective tax rate of 40%.[11] PSI claims that the value of the PR/VI Licenses is between $40-$60 million. *Id.* at 1, 21. PSI contends it should receive one third of the after-tax value of the benefit. The resulting calculation yields an after-tax benefit of $60 million and an award of $20 million.

PSI attempts to bolster its claim to this amount by citing the following additional benefits:

> [T]he funding of the litigation prevented the improper dilution of PCSI's common stockholders' interest as 800,000 common shares were cancelled

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[11] *Id.* at 1, 10 n.3. PSI claims the effective tax rate is 39%. My calculation yields 39.7%, so I have rounded up rather than down.

> through the litigation. Moreover, numerous other stockholders were properly permitted to convert into common stock and receive distributions from the monetization of the licenses. PSI also funded a search for a Chief Executive Officer of PCSI. This resulted in the employment of [Knapp], an experienced professional in the industry.

Id. at 1–2. PSI does not seek to value these benefits separately, only to use them to support its request for an award of approximately $20 million.

Alternatively, PSI seeks an award of $4,958,056.43, representing expenses that PSI claims to have incurred. PSI contends it actually incurred $8,257,717.52 in expenses, but it has reduced this amount to account for the value it received in the PSI Settlement Agreement. PSI has supported this amount with a difficult-to-read chart and an affidavit from Downs. *See id.* at 12. Although the court has considered the Downs affidavit, she admitted in deposition that she did not prepare the chart, did not have personal knowledge regarding a number of entries, and could not explain why certain figures were included. *See* Dkt. 529, Ex. 60, at 81, 85, 262.

PSI's chart includes four broad categories. The first collects $4,198,618.40 in expenses under the heading of "LEGAL EXPENSES." Dkt. 479, at 12. Of this amount, perhaps $2 million could be attributed to Judy's litigation efforts. PSI's chart of expenses reflects that it paid $1,052,087.78 to Potter, Anderson & Corroon LLP, Judy's first counsel, and $1,014,395.04 to Duane Morris LLP, Judy's successor counsel. The balance, or approximately another $2 million, went to fund lawyers for different purposes. It is not possible to determine precisely which lawyers did what, because PSI did not provide that information, but many of the law firms listed on PSI's chart represented the myriad of Waugh allies who intervened in this action after Waugh decided to attempt to overwhelm

Austin and the Receiver with objections. Other law firms represented PSI and pursued Waugh's interests in proceedings before the FCC. Still other firms advised PSI on its financing efforts, including on securities law issues. PSI's list of "LEGAL EXPENSES" also includes what are obviously not legal expenses, such as $108,602.25 for "Equicap, Spencer Stuart, Angel Benitez," which apparently includes some degree of executive search expenses, and $1,812.50 for "VirtualCFO." *Id.* at 12.

The second category on PSI's chart is titled "NOTE 4 EXPENSES" and totals $292.520.31. *Id.* It has three subcategories: (i) "Admin Fees" of $147,247.51, (ii) "Commissions" of $79,679.39, and (iii) "Interest Expense" of $65,593.42. These items appear to be fees and expenses that PSI incurred under the Promissory Note that it issued to Smartcomm. Although the PSI Settlement Agreement extinguished the principal, PSI is still seeking to recover these expenses. Downs averred in her affidavit that the "Admin Fee" was for monthly fees charged by Smartcomm to PSI for administrative, back office, management, and consulting services. Dkt. 474, Downs Aff. ¶ 12. It is not clear how the amounts were determined, or what specific services were provided. PSI did not address the "Commissions" or "Interest Expense."[12]

The third category is titled "MGMT/ACCT/CONSULTING EXPENSES" and aggregates categories of expenses totaling $2,259,548.53. This category includes virtually every business expense that PSI incurred to manage its operations over a period

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[12] The "Commissions" heading under the "NOTE 4 EXPENSES" is a different category than the "Commissions" heading under "MGMT/ACCT/CONSULTING EXPENSES," which Downs did describe in her affidavit. *See Id.* ¶ 25.

of eight years. *See* Dkt. 529, Ex. 60, at 143 (Downs: Q: "It was basically everything that – all the conduct that PSI did as a business, correct?" A: "For the most part, yes."). The items include the following:

- $945,000 in "Management Fees" that were paid to members of PSI's Management Committee.
- $608,224.90 in "Smartcomm Agent Services," comprising commissions paid to Smartcomm for locating investors for PSI.
- $354,000 under the heading "Executive Search," which Downs said was incurred to find a new CEO for the Company.
- $172,481.66 in "Commissions" that PSI paid to finders to locate investors for PSI, which Downs described as a subcommittee of PSI's management committee.
- $73,000 in compensation paid to a "Delaware Subcommittee."
- $52,926.25 in "Travel Expenses" that were incurred by PSI officers and employees in the course of raising funds for PSI.
- $18,394.20 for a CPA.
- $2,097.77 in "Office Supplies."
- $1,687.50 for bookkeeping services.
- $461 for "Bank Service Charges."
- $99.99 in "Advertising and Promotion," which covered the cost of photographing Judy so he could appear in advertisements for PSI investors.

The final category is interest. PSI claims to be entitled to $780,551.75 in interest on the amounts identified as "LEGAL EXPENSES," plus $726,478.52 in interest for the amounts identified as "MGMT/ACCT/CONSULTING EXPENSES." PSI calculated interest at "Prime + 5%," without disclosing what rate it used as the "Prime Rate."

II. LEGAL ANALYSIS

"'[L]itigants in Delaware are generally responsible for paying their own counsel fees,' absent special circumstances or a contractual or statutory right to receive fees." *Scion Breckinridge Managing Member, LLC v. ASB Allegiance Real Estate Fund*, 68 A.3d 665, 686 (Del. 2013) (quoting *Burge v. Fid. Bond & Mortg. Co.*, 648 A.2d 414, 421 (Del. 1994)). "[A] Chancellor or Vice Chancellor, 'under his equitable powers, has latitude to shift attorneys' fees.'" *Id.* (quoting *Gatz Props., LLC v. Auriga Capital Corp.*, 59 A.3d 1206, 1222 (Del. 2012)). One circumstance where this power may be exercised is when the litigation creates a common benefit. *Id.* at 686–87. The exception is "founded on the equitable principle that those who have profited from litigation should share its costs." *Goodrich v. E.F. Hutton Gp., Inc*, 681 A.2d 1039, 1044 (Del. 1996).

Under the common benefit doctrine, a litigant may receive an award of attorneys' fees if (i) the action was meritorious when filed, (ii) an ascertainable group received a substantial benefit, and (iii) a causal connection existed between the litigation and the benefit. *Dover Historical Soc'y, Inc. v. City of Dover Planning Comm'n*, 902 A.2d 1084, 1089 (Del. 2006). The benefit may take the form of either a tangible, monetary benefit (*i.e.*, the "common fund" exception), or an intangible benefit to an entity, such as supplemental disclosures or changes in corporate governance (*i.e.*, the "corporate benefit" exception). *Id.* at 1090.

The power to award fees for conferring a common benefit "is a flexible one based on the historic power of the Court of Chancery to do equity in particular situations." *Tandycrafts, Inc. v. Initio P'rs*, 562 A.2d 1162, 1166 (Del. 1989). The equitable nature of the remedy means that even if a litigant technically satisfies the requirements, the court

may still decline to award fees and expenses. When declining to award fees and expenses to a litigant who otherwise meets the requirements of the common benefit doctrine, Delaware courts have considered the potential for the litigant's interests to diverge from those that the litigant purported to benefit or represent.[13] The decisions have also evaluated whether a fee award would serve public policy goals, such as incentivizing plaintiffs' counsel to police fiduciary wrongdoing.[14]

If the court determines that a fee award is warranted, then the court crafts an award using factors that the Delaware Supreme Court identified in *Sugarland Industries, Inc. v. Thomas,* 420 A.2d 142 (Del.1980). "In determining the size of an award of attorney's fees, courts assign the greatest weight to the benefit achieved by the litigation." *Franklin Balance Sheet Inv. Fund v. Crowley*, 2007 WL 2495018, at *8 (Del. Ch. Aug. 30, 2007). Secondary factors include the complexity of the litigation, the standing and skill of counsel, and the contingent nature of the fee arrangement together with the level of contingency risk actually involved in the case. *Gatz v. Ponsoldt*, 2009 WL 1743760, at *3 (Del. Ch. June 12, 2009). In this case, the court need not reach the question of the amount of a fee award, because none is warranted.

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[13] *See, e.g.*, *In re Orchard Enter., Inc. S'holder Litig.*, 2014 WL 4181912, at *10 (Del. Ch. Aug. 22, 2014); *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 789 A.2d 1216, 1227 (Del. Ch. 2001), *aff'd sub nom. Mentor Graphics Corp. v. Shapiro*, 818 A.2d 959 (Del. 2003); *In re Dunkin' Donuts S'holders Litig.*, 1990 WL 189120, at *9 (Del. Ch. Nov. 27, 1990).

[14] *See, e.g.*, *Orchard*, 2014 WL 4181912, at *11; *Mentor Graphics*, 789 A.2d at 1230–31; *Dunkin' Donuts*, 1990 WL 189120, at *10.

A. PSI Lacks Standing Because It Is Not The Plaintiff Or Its Counsel.

PSI's fee application largely glosses over the question of whether PSI has standing to seek a fee award given its role in the Judy Litigation. PSI was neither the plaintiff nor plaintiff's counsel. PSI was a source of financing for the litigation, which it provided gratuitously without any formal agreement with Judy. In my view, PSI cannot seek a fee award because of the nature of its non-role in the Judy Litigation.

Delaware precedent universally assumes that only a litigant or its counsel has standing to seek a fee award.[15] PSI has not cited any precedent suggesting that a non-party can seek a fee award. In its reply brief, PSI concedes that there is no precedent for awarding a fee to a non-party. *See* Dkt. 529, at 12–13.

In lieu of authority, PSI offers a policy argument. According to PSI, awarding fees to a non-party that financed litigation is no different than awarding fees to a figurehead plaintiff who holds a nominal amount of stock. PSI contends that in both cases, fees should be awarded so that those who receive the benefit are obligated to pay for it.

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[15] *See, e.g.*, *Dover Historical Soc'y*, 902 A.2d at 1089 ("A *litigant* may receive an award of attorney's fees.") (emphasis added); *Tandycrafts,* 562 A.2d at 1166 ("[T]he critical inquiry is not the status of *the plaintiff*, but the nature of the corporate or class benefit.") (emphasis added); *Allied Artists Pictures Corp. v. Baron*, 413 A.2d 876, 878 (Del. 1980) ("*Plaintiffs' counsel* would be entitled to attorneys' fees and costs where [the elements of the common benefit rule are met.]") (emphasis added); *Chrysler Corp. v. Dann*, 223 A.2d 384, 386 (Del. 1966) ("The rules governing the award of fees and expenses *to a litigant for payment of his counsel* are well established . . . [W]hen the litigation results in benefit to all members of a class, *the successful litigant* is entitled to an allowance for counsel fees.") (emphases added); *Rosenthal v. Burry Biscuit Corp.*, 209 A.2d 459, 460 (Del. Ch. 1948) ("In [a common benefit case] *the attorney for a successful plaintiff* would in the normal course of events become entitled to a fee.") (emphasis added).

PSI's policy-based argument is too simplistic. "Not everyone who contributes to a benefit gets a fee award." *Orchard*, 2014 WL 4181912, at *9. The common benefit doctrine does not operate as a generalized mechanism for achieving redistributive justice. It is a tool for overcoming the collective action problems that would otherwise prevent socially beneficial litigation from being pursued. *See Raul v. Astoria Fin. Corp.*, 2014 WL 2795312, at *6 (Del. Ch. June 20, 2014); *Bird v. Lida, Inc.*, 681 A.2d 399, 402–03 (Del. Ch. 1996) (Allen, C.). The tool works by providing an incentive for those who actually pursue the litigation, namely the litigant and the litigant's counsel.

Litigation financiers do not need the common benefit doctrine to give them an incentive to finance litigation. They provide financing for the same reason that any lender loans money: to obtain a risk-adjusted return under the terms of a bargained-for agreement. PSI could have entered into an agreement with Judy that would have contemplated some form of repayment, including potentially a repayment that would be funded by a court-ordered fee award. Instead, PSI chose not to document its arrangement with Judy and to provide its financial backing as a gratuitous volunteer. Under the circumstances, PSI cannot now seek an equitable award of attorneys' fees and expenses under the common benefit doctrine.

B. PSI Was Trying To Take Over The Company.

PSI lacks standing to seek a fee award under the common benefit doctrine for a second reason: PSI funded the Judy Litigation as part of an effort to take over the Company.

Consistent with the purpose of the common benefit doctrine, a plaintiff lacks standing to seek and obtain a fee award if the litigant's primary purpose was to advance its personal interests. One recurring scenario is when a party files litigation in support of a takeover effort, where the bidder's primary motivation is to achieve its personal goal of acquiring the company and any common benefit is incidental. *See Mentor Graphics,* 789 A.2d at 1232.

In this case, the record shows that PSI funded the Judy Litigation as part of an effort by Waugh and his allies to take control of the Company. Before the FCC issued its Order to Show Cause, Austin had been acting as a figurehead for Waugh. The Order to Show Cause, however, drove a wedge between Austin and Waugh and caused Austin to assert the authority that he nominally held. Waugh and Downs formed PSI with Judy as part of a plan to regain control of the Company. One of the business purposes identified in PSI's LLC agreement was "to negotiate a loan transaction with the holders of the shares of [the Company's] Class A Common Stock *and the contractual rights to be issued such shares representing a majority of the votes.*" Dkt. 511, Ex. 2, at 2–3 (emphasis added). During the litigation, Waugh strategized with lawyers on how to effectuate the "assignment and/or transfer of control of PCSI." *Id.*, Ex. 10. After Waugh died, Downs continued directing the litigation. *See id.*, Ex. 26. Like Waugh, she attempted to hide her involvement, but she nevertheless funded the bulk of the Judy Litigation with the expectation that the lawsuit would result in her gaining control of the Company. *See id.*, Ex. 49, at 49. In the short-term, the effort worked, with Downs achieving the control she sought through the election of the PSI Nominees. *See, e.g.*, *id.*,

Ex. 48, at 48–49 (Knapp: "Q: Has PCSI ever done anything that Ms. Downs didn't want to happen? A: No.").

PSI funded the Judy Litigation as part of its takeover effort. Any benefits that the Judy Litigation produced for the Company and its other stockholders were incidental. In reality, the litigation was the means by which PSI sought to achieve control. Under the circumstances, PSI cannot seek a fee award for the Judy Litigation.

C. PSI Cannot Claim A Benefit Based On Value Of The Licenses.

Assuming for the sake of argument that PSI had standing to seek a fee award, PSI has failed to justify basing the fee award on the value of the Company's licenses. "[W]hat is relevant is the benefit is *achieved by the litigation*, not simply a benefit that, *post hoc ergo proctor hoc*, is conferred after the litigation commences." *In re Anderson Clayton S'holders Litig.*, 1988 WL 97480, at *2 (Del. Ch. Sept. 19, 1988) (Allen, C.). The litigation need not be the sole or direct cause of the claimed benefit, but there must be a sufficient causal connection to warrant a fee award. *See Dunkin' Donuts*, 1990 WL 189120, at *6. Although a litigant is entitled to a rebuttable presumption of causation if defendants take action that moots a plaintiffs' claim, that presumption does not come into play outside of the mootness context.[16] Here, the question is whether PSI can claim credit

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[16] *See, e.g.*, *EMAK Worldwide, Inc. v. Kurz*, 50 A.3d 429, 433 (Del. 2012) ("Under the 'mootness rule,' when a defendant took an action after the suit was filed that mooted a claim, there is a rebuttable presumption that the suit and the benefit were causally related.") (citing *McDonnell Douglas Corp. v. Palley*, 310 A.2d 635, 637 (Del. 1973)); *United Vanguard Fund, Inc. v. TakeCare, Inc.*, 693 A.2d 1076, 1080 (Del. 1997) ("Where, as here, a corporate defendant, after a complaint is filed, takes action that renders the claims asserted in the complaint moot, Delaware law imposes on it the burden

for benefits that the litigation did not generate as a remedy.[17] In this context, PSI has the burden of establishing the necessary causal link.

PSI argues that causation exists because "but-for PSI and the Litigation, the FCC would have determined PCSI was in breach of the [FCC Settlement Agreement]," which would have resulted in the Company forfeiting its licenses. Dkt. 474, at 17. In reality, through the Judy Litigation, PSI sought to invalidate the FCC Settlement Agreement. Had it succeeded, the Company's licenses would have been jeopardized. Putting aside PSI's change of heart, PSI's argument fails because the Company could have complied with the FCC Settlement Agreement by other means. It is entirely possible that without the Judy Litigation, Austin would have taken steps to fulfill the requirements of the agreement he negotiated.

Equally problematic is the converse contention that the Judy Litigation ensured compliance with the FCC Settlement Agreement. The Judy Litigation resulted in an order requiring an annual meeting. It was then up to the new board of directors to take steps to comply with the FCC Settlement Agreement. The board's actions were an intervening

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of persuasion to show that no causal connection existed."); *Allied Artists*, 413 A.2d at 880 ("[T]he party who takes the action that cures the alleged wrong to the corporation's benefit *and thereby moots or settles the lawsuit* should bear the burden.") (emphasis added).

[17] *See, e.g.*, *In re Infinity Broad. Corp. S'holders Litig.*, 802 A.2d 285, 293 (Del. 2002) ("[T]he mere pendency of litigation alone does not establish the causal connection."); *Waterside P'rs v. C. Brewer & Co.*, 739 A.2d 768, 770 (Del. 2000) ("[T]he establishment of a nexus between the litigation, itself, and the claimed corporate benefit is a *sine qua non*.").

cause that breaks the chain between the Judy Litigation and compliance with the FCC Settlement Agreement. *Cf. Waterside P'rs v. C. Brewer & Co.*, 1999 WL 135245, at *2 (Del. Ch. 1999) (finding no causation between litigation and a resulting corporate benefit when an intervening shareholder vote mooted the litigation), *aff'd*, 739 A.2d 768.

Even more extreme are PSI's claims that the Judy Litigation caused (i) the monetization of the CONUS Licenses through the Sprint Transaction and (ii) an as-yet hypothetical monetization of the PR/VI Licenses. The Judy Litigation did not cause the Sprint Transaction. That was the result of many factors, including action by the Company's directors and its management. As for the PR/VI Licenses, the Judy Litigation obviously has not brought about a transaction that has not occurred yet.

Once again, the converse is equally true. Assume for the sake of argument that, in hindsight, the Judy Litigation was a but-for cause of the Sprint Transaction and will be a but-for cause of some future transaction. That assumption makes the Judy Litigation one cause of those events, but not the *sole* cause of those events. Many other factors also were (and will be) but-for causes, including the founding of the Company, Austin's initial efforts to obtain the licenses, the financing received from various investors, *etc*. PSI has briefed its fee application as if it were the sole cause of the Sprint Transaction and a still hypothetical future transaction. Accepting that the Judy Litigation played some role in helping to resolve problems with the Company's governance structure and was a step along the path to future success, it was not a sufficiently related cause to support the type of sole-credit award that PSI is seeking.

Reduced to its essence, PSI's theory of causation is the proverbial horseshoe nail that lost the kingdom.[18] In PSI's version of the story, the Judy Litigation caused the annual meeting where the stockholders voted to elect the board that complied with the FCC Settlement and appointed the CEO who negotiated with Sprint and obtained the Sprint Transaction. As with the proverb, this attenuated theory of causation is too extreme. An insufficient nexus exists between the Judy Litigation and the Sprint Transaction or some future transaction to support an award based on the proceeds of those events.

D. Quantum Meruit

As its fall-back position, PSI claims it should recover what it spent under a *quantum meruit* theory. A claim of *quantum meruit* is "a quasi-contract claim that allows a party to recover the reasonable value of his or her services if: (i) the party performed the services with the expectation that the recipient would pay for them; and (ii) the

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[18] For want of a nail, the shoe was lost.
For want of a shoe, the horse was lost.
For want of a horse, the rider was lost.
For want of a rider, the message was lost.
For want of a message, the battle was lost.
For want of a battle, the kingdom was lost.
And all for the want of a horseshoe nail.

Oxford Dictionary of Nursery Rhymes 324 (Peter Opie & Iona Opie eds., 1951).

recipient should have known that the party expected to be paid."[19] On these facts, neither element is met.

First, the record belies the claim that PSI advanced funds with the expectation that anyone would pay for them. PSI did not document any type of repayment scheme with Judy, nor did PSI contract with Judy about the possibility of Judy applying for a fee award. Instead, as discussed above, PSI voluntarily paid the amounts necessary to finance the Judy Litigation as part of its effort to take control of the Company.

Second, neither PCSI nor its stockholders had any reason to believe that PSI expected to be paid for financing the Judy Litigation. PSI attempted to negotiate a loan with the Company to fund various attorneys' fees and expenses, and the Company (through Austin) refused. Later, after the Receiver issued his initial recommendation, Waugh and PSI decided to foment litigation by encouraging and financing objections to the Receiver's report. When inducing this litigation, PSI represented that the investors would *not* bear any cost:

> This offer for Legal Representation is **FREE OF COST TO YOU.** The [PSI] Members comprised of 17 PCSI Investors have promoted a plan since January of 2009 to assure every PCSI Investor the right and the opportunity to realize the full benefit of their investment in PCSI at no further cost to them. PSI is actively participating in other wireless communication

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[19] *Petrosky v. Peterson*, 859 A.2d 77, 79 (Del. 2004) (internal citation omitted). PSI separately re-frames its *quantum meruit* theory as a claim to be reimbursed under the guise of unjust enrichment. *See* Dkt. 479, at 25–27. I do not believe that unjust enrichment provides an independent basis for a fee award. Both the common benefit doctrine and the concept of *quantum meruit* are designed to force the parties who received benefits to pay for the value of the benefits they obtained. Both encompass the terrain that unjust enrichment might otherwise occupy.

> investment opportunities that are generating the funds to finance this legal effort on behalf of all PCSI Investors.

Dkt. 529, Ex. 7, at 2. In other communications, PSI communicated the same message, namely that the Company and its investors would not be expected to repay PSI.[20]

Even assuming for the sake of argument that PSI had some ability to recovery its expenses under a *quantum meruit* theory, under no circumstances would PSI be entitled to recover (i) the legal fees and expenses it incurred to finance the objections brought by Waugh's allies to pursue their personal claims against PCSI, (ii) the legal fees and expenses that PSI incurred for proceedings before the FCC, or (iii) the ordinary business expenses that PSI incurred during its eight years of existence. The amount of theoretically recoverable expenses in the Judy Litigation ends up being less than the amount of value that PSI says it already has received from the Company, leaving no room for any further award.

The first category of expenses consists of at least $156,927.48 in legal fees paid to finance the avalanche of shareholder objections to the Receiver's report.[21] These objections conferred no benefit on the Company. Instead, the objectors sought to pursue

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[20] *See, e.g.*, *id.*, Ex. 5, at 5 ("The PSI Management Committee's collective . . . objective is to provide the opportunity for [Company] investors to realize that goal at no additional cost to them."); *id.*, Ex. 8, at 1 ("You will not be billed or expected to pay any portion of the attorneys' fees. That cost has been assumed by PSI.").

[21] *See* Dkt. 530, at 35, 75. It is impossible to determine with certainty whether more of the claimed fees were incurred to fund stockholder objections, as PSI's counsel at oral argument could not explain the role played by several of the listed law firms.

personal claims against the Company, which complicated and prolonged these proceedings.

The second category of expenses consists of at least $192,555.63 in legal fees incurred in other proceedings.[22] Over half of this total was spent defending Caso against criminal charges. For the remaining expenses in this category, PSI counsel either could not establish their connection to the Judy Litigation,[23] or they furthered a purpose inimical to the Company's interests.[24]

The third category of expenses includes a variety of types of overhead and other business expenses that PSI has sought to recover, such as compensation for PSI's management committee, commissions paid to Smartcomm for locating investors for PSI, and "Administrative Fees" paid to Smartcomm. Dkt. 474, Downs Aff. ¶¶ 21, 32, 38. PSI's only justification for including these expenses is a syllogism: (i) PSI's *raison d'etre* was the pursuit of the Judy Litigation; (ii) but-for PSI, the Company would not exist; (iii) therefore, the Company must repay PSI for its costs of doing business.

The fallacy of the second step in PSI's syllogism has already been addressed: it is not true that but for PSI, the Company would not exist. The error in the third step is that

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[22] *See id.* at 34–35, 36, 60, 75–76.

[23] *Id.* at 36–37, 60–61.

[24] *See, e.g.*, *id.* at 61–62 (counsel retained to negotiate with FCC in connection with PSI's efforts to attack the FCC Settlement Agreement).

business expenses are not within the scope of the corporate benefit doctrine.[25] The first step fails as well. This court already held when denying PSI's application to intervene that PSI was not solely focused on the litigation; it was (and remains) a potential competitor of the Company that has other business interests. *See* Dkt. 120. An award of legal fees and expenses is a narrow remedy. Other benefits bestowed on a company, beyond those produced by litigation, are beyond its scope. *See Raul*, 2014 WL 2795312, at *6 ("A general allocation of the costs incurred by good Samaritans untethered to a meritorious (actual or potential) cause of action would drastically expand the jurisdiction of this Court, and usurp a core function of the board of directors.").

The only expense that PSI might hypothetically be able to recover under a *quantum meruit* theory is the approximately $2 million that PSI expended to fund Judy's lawyers in the actual Judy Litigation.[26] In the PSI Settlement Agreement, the Company paid PSI $4,198.618.40. Thus even assuming for the sake of argument that PSI could

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[25] *See United Vanguard Fund, Inc. v. Takecare, Inc.*, 727 A.2d 844, 855 (Del. Ch. 1998) ("I am aware of no authority, nor has any been provided, to support the payment of such fees for non-litigation matters."); *see also Waterside P'rs*, 739 A.2d at 770 (denying award for initiating a proxy fight); *Raul*, 2014 WL 2795312, at *7; *Bird*, 681 A.2d at 407.

[26] Even that figure represents a ceiling, rather than the likely amount that would be awarded. The $2 million figure appears high, because PSI negotiated a substantial discount to the Potter Anderson fee, and Downs did not know whether it had been deducted from the total. Dkt. 529, Ex. 60 at 84–85. The fee totals also included tasks that benefitted PSI but which did not benefit the Company, such as Duane Morris' efforts to compel Potter Anderson to release its attorneys' lien and turn over documents, and the advice Duane Morris provided to represent Downs in her efforts to buy shares from third parties. It is also not clear that a *quantum meruit* award would value the services provided at the full amount of the $2 million that PSI has claimed.

recover those fees, PSI already has received more than the greatest amount to which it might theoretically be entitled.

III. CONCLUSION

PSI's motion to recover an award of attorneys' fees and expenses is denied.

SAM GLASSCOCK III
VICE CHANCELLOR

**COURT OF CHANCERY
OF THE
STATE OF DELAWARE**

COURT OF CHANCERY COURTHOUSE
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Date Submitted: September 12, 2016
Date Decided: September 21, 2016

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Re: *Chrome Systems, Inc. v. Autodata Solutions, Inc., et al.*,
Civil Action No. 11808-VCG

Dear Counsel:

This case involves the Plaintiff's allegations that the Defendants improperly dissolved a joint venture of the parties. By bench ruling of March 10, 2016, I found that the parties had contractually agreed to send all such disputes, including disputes as to arbitrability, to arbitration. The parties contractually retained a carve-out to seek preliminary injunctive relief in this Court. Accordingly, I stayed the substantive claims, but entered injunctive relief to preserve the potential remedy of rescission. I retained jurisdiction in case the arbitrator found some or all issues non-arbitrable.

The parties subsequently moved to an expedited arbitration. The remaining issue before me (in addition to my retention of jurisdiction in case the matter proves

non-arbitrable) involves the Plaintiff's allegations that the Defendants have spoliated evidence and obstructed justice in this case. Because spoliation inhibits the search for truth and the administration of justice, it is anathema to our courts; accordingly, allegations of spoliation are taken seriously. There are, to my mind, two components involved in the appropriate resolution of claims of spoliation: minimizing its effect on the administration of justice, which may require shifting burdens of proof or excluding submissions of evidence by the spoliator to prevent prejudice to the non-spoliating party; and use of the contempt power to vindicate the integrity of the Court and the interest of the public in the preservation and presentation of evidence, in the interest of justice. The former, necessarily here, will be a matter for the arbitrator; the latter, for this Court.

The Plaintiff asked this Court to hold a hearing on, and use the contempt power to redress, the Defendants' alleged spoliation here. In order to efficiently bifurcate the two interests I have described above, I determined, by bench ruling on March 10, 2016 in the exercise of my discretion, to hear only that evidence of spoliation or litigation misconduct occurring after the litigation was filed, which has the potential to have worked a fraud on the Court; other evidence of misconduct should be presented to the arbitrator, who will be able to avoid prejudice to the Plaintiff resulting from any spoliation by the Defendants.

Following that bench ruling, the parties proceeded with arbitration. Arbitration, including of the spoliation issues, is going forward on an expedited basis. I scheduled a hearing on those allegations of spoliation pertinent here for August 31, 2016. Shortly before that, the parties indicated to me that they did not agree on what evidence would be submitted at that hearing. The Plaintiff intended, despite my bench ruling of March 10, 2016, to put on evidence of *all* instances of spoliation, pre- and post-filing. After argument, I again ruled, on August 29, 2016, that I would hear only evidence of post-filing spoliation, in order to avoid redundant consideration, and perhaps inconsistent findings and remedies, with the arbitrator. Shortly after this ruling, the Plaintiff asked me to cancel the hearing and instead pursued this interlocutory appeal. Before me is the Plaintiff's request to certify that appeal; for the reasons that follow, certification is inappropriate.

As Supreme Court Rule 42 makes clear, interlocutory appeal is an extraordinary remedy, which "should be exceptional, not routine, because [such appeals] disrupt the normal procession of litigation, cause delay, and can threaten to exhaust scarce party and judicial resources."[1] Before certifying an appeal, I must determine that an interlocutory appeal would bring "substantial benefits that will outweigh the certain costs that accompany" such an appeal.[2] In evaluating that

[1] Supr. Ct. R. 42(b)(ii).
[2] Supr. Ct. R. 42(b)(ii).

balance I must apply the eight factors set out at Supreme Court Rule 42(b)(iii).[3] The Plaintiff refers to two of these eight factors in their request for certification, arguing that the matter is a question of first impression, that is, that "the interlocutory order involved a question of law resolved for the first time in this State,"[4] and that review of my ruling will serve "considerations of justice."[5] The Plaintiff arrives at the first conclusion by regarding it as a matter of first impression whether spoliation contractually referred to an arbitrator should nonetheless be reviewed redundantly by this Court in its vindication of the interests of justice. The same consideration, according to the Plaintiff, implicates the second factor the Plaintiff cites, that interlocutory appeal may serve considerations of justice.

It appears to me, however, that the consideration here is one of a trial judge's discretion over his docket. In other words, the Plaintiff sought an expedited hearing on spoliation. I agreed to hear arguments on spoliation insofar as they involve the

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[3] *See* Supr. Ct. R. 42(b)(iii) (listing the eight factors: "(A) The interlocutory order involves a question of law resolved for the first time in this State; (B) The decisions of the trial courts are conflicting upon the question of law; (C) The question of law relates to the constitutionality, construction, or application of a statute of this State, which has not been, but should be, settled by this Court in advance of an appeal from a final order; (D) The interlocutory order has sustained the controverted jurisdiction of the trial court; (E) The interlocutory order has reversed or set aside a prior decision of the trial court, a jury, or an administrative agency from which an appeal was taken to the trial court which had decided a significant issue and a review of the interlocutory order may terminate the litigation, substantially reduce further litigation, or otherwise serve considerations of justice; (F) The interlocutory order has vacated or opened a judgment of the trial court; (G) Review of the interlocutory order may terminate the litigation; or (H) Review of the interlocutory order may serve considerations of justice.").

[4] Supr. Ct. R. 42(b)(iii)(A).

[5] Supr. Ct. R. 42(b)(iii)(H).

actions of the Defendants alleged to have traduced the interests of the Court, and the public interest in justice. I declined to hear allegations of spoliation which necessarily must be reviewed by the arbitrator in arriving at a remedy for any detriment to the Plaintiff worked thereby. I retained jurisdiction for those issues which the arbitrator may find non-arbitrable, which may involve issues of spoliation. The Plaintiff's appeal simply seeks to broaden the scope of my contempt hearing, formerly scheduled for August 31, 2016. The only efficiency of such an interlocutory appeal is that it would save a second hearing on pre-filing spoliation if the appeal is successful and I am directed on remand to hear allegations of both pre-and-post filing spoliation. Even this minor efficiency will prove illusory, if, for instance, the arbitrator finds these issues non-arbitrable. In any event, the minor potential for efficiency gains here falls far short of the "substantial benefits" which would favor interlocutory appeal. In other words, the Plaintiff may request a rescheduled post-filing spoliation hearing, receive its expedited arbitration decision, and then with the matter final, take an appeal of all appealable issues, including whether this Court must address pre-filing spoliation under the circumstances here.[6] Such a procedure is not inimical to considerations of justice, and an interlocutory

[6] Because in any event I must deny certification, I have not addressed whether, in light of the fact that the arbitrator will presumably address issues of prejudice to the Plaintiff of any spoliation, the Plaintiff has standing to appeal the scope of a separate hearing on the effect of spoliation held solely to vindicate the interests of the Court and the Public.

appeal is not certifiable under Supreme Court Rule 42. An appropriate form of order follows.

Sincerely,

/s/ Sam Glasscock III

Sam Glasscock III

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

CHROME SYSTEMS, INC.,	)
	)
Plaintiff,	)
	)
v.	) C.A. No. 11808-VCG
	)
AUTODATA SOLUTIONS, INC., AUTODATA SOLUTIONS COMPANY, AUTODATA, INC., INTERNET BRANDS, INC., ROBERT N. BRISCO, SCOTT A FRIEDMAN, and B. LYNN WALSH,	)
	)
Defendants,	)
	)
And	)
	)
CHROME DATA OPERATING, LLC, CHROME DATA SOLUTIONS, LP, and AUTOCHROME COMPANY,	)
	)
Nominal Defendants.	)

ORDER DENYING LEAVE TO APPEAL FROM INTERLOCUTORY ORDER

This 21st day of September, 2016, the Plaintiff having made application under Rule 42 of the Supreme Court for an order certifying an appeal from the interlocutory orders of this Court, dated March 10, 2016 and August 29, 2016; and the Court having found that such orders do not satisfy the criteria of Rule 42(b)(iii);

IT IS ORDERED that certification to the Supreme Court of the State of Delaware for disposition in accordance with Rule 42 of that Court is DENIED.

Dated: September 21, 2016

__/s/Sam Glasscock III_________
Sam Glasscock III, Vice Chancellor

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

PHILIP H. GEIER, Plaintiff, v. MOZIDO, LLC, a Delaware limited liability company, and MOZIDO, INC., a Delaware corporation, Defendants.	: : : : : : : : : : : :	**C.A. No. 10931-VCS**

MEMORANDUM OPINION

Date Submitted: September 1, 2016
Date Decided: September 29, 2016

John M. Seaman, Esquire and David A. Seal, Esquire of Abrams & Bayliss LLP, Wilmington, Delaware, and Phillip Frankel, Esquire of Bond, Schoeneck & King, PLLC, Syracuse, New York, Attorneys for Plaintiff.

Raymond J. DiCamillo, Esquire and Sarah A. Clark, Esquire of Richards, Layton & Finger, P.A., Wilmington, Delaware; Marc E. Kasowitz, Esquire, Albert Shemmy Mishaan, Esquire, Kanchana Wangkeo Leung, Esquire, and Danielle R. Gill, Esquire of Kasowitz, Benson, Torres & Friedman LLP, New York, New York; and Constantine Z. Pamphilis, Esquire of Kasowitz, Benson, Torres & Friedman LLP, Houston, Texas, Attorneys for Defendant Mozido, LLC.

John G. Harris, Esquire of Berger Harris LLP, Wilmington, Delaware; Stephen G. Grygiel, Esquire of Silverman, Thompson, Slutkin & White, LLC, Baltimore, Maryland Attorneys for Defendant Mozido, Inc.

SLIGHTS, Vice Chancellor

Plaintiff, Philip H. Geier, initiated this action to recover damages for the value of incentive options that allegedly were promised to him by Mozido LLC ("LLC") in exchange for his service on LLC's board of directors but never delivered.[1] The options in question would have allowed Geier to acquire 1% of the equity of LLC for $135,000—a stake he now alleges to be worth millions of dollars. His claims sound in breach of contract, unjust enrichment and, as to Inc., tortious interference with contract.

Defendants have moved to dismiss all claims under Court of Chancery Rule 12(b)(6). They argue first and foremost that the operative complaint fails to plead the existence of a contract and therefore has failed to state a claim for breach of contract. Next they argue that Geier cannot plead in the alternative that he is entitled to recover from LLC for unjust enrichment because he has elected to plead that his rights to the options arise from contract. Even if the Court determines that Geier has stated a claim for either breach of contract or unjust enrichment, however, Defendants argue that the complaint must be dismissed in any event because Geier released any claim he may have had to the options when entities affiliated with Geier executed a general release of claims to settle related litigation

[1] The defendants are Mozido LLC and Mozido, Inc. In their briefs, for ease of reference, the parties referred to Mozido LLC as "LLC" and Mozida Inc. as "Inc." I will adopt these abbreviations here.

in New York state court. Because I find that Geier released all claims asserted here as part of this previous settlement, the motions to dismiss must be granted.

I. FACTS

Consistent with Court of Chancery Rule 12(b)(6), I have drawn the facts from the well-pled allegations in the Second Amended Verified Complaint, documents incorporated therein by reference and other judicially noticeable facts.[2]

Beginning in 2011, various representatives of LLC asked Geier more than once to join LLC's Board of Directors ("the Board") and to make an investment in LLC. In several letters offering Geier a position on the Board, Michael Liberty, a majority investor and Vice Chairman of LLC, offered Geier the option to acquire membership units in LLC. By letter dated March 6, 2012, Gregory Corona, then-CEO of LLC, renewed the invitation for Geier to join LLC's Board and again referenced incentive options for Geier to acquire 1% of the then-issued and outstanding membership units in LLC (the "Options").

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[2] *See Solomon v. Armstrong*, 747 A.2d 1098, 1126 n.72 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000); *see also Vanderbilt Income & Growth Assocs., L.L.C. v. Arvida/JB Managers, Inc.*, 691 A.2d 609, 613 (Del. 1996) (noting that the Court may consider documents "integral to a plaintiff's claim and incorporated into the complaint" when deciding a motion to dismiss).

Geier agreed to join the Board and countersigned the March 6, 2012 letter.[3] He served on the LLC Board from March 2012 until he resigned on or about May 10, 2013.

In the spring of 2012, Liberty approached Geier about making a loan to LLC because LLC needed to raise cash quickly. In July 2012, Geier caused the Philip H. Geier Irrevocable Trust (the "Geier Trust") and The Geier Group, LLC (the "Geier Group") to loan $3 million to Mobile Money Partners, LLC, a Liberty affiliate that appears also to be a member of LLC, pursuant to a promissory note and a related consulting agreement. Geier is a trustee of the Geier Trust and Chairman of the Geier Group. The Promissory Note was personally guaranteed by Liberty and Richard Braddock, who was then on the Board and a member of LLC.

After a default on the Note, the Geier Trust and the Geier Group commenced an action in the New York Supreme Court to enforce the promissory note and recover the loan with interest. To resolve this litigation Liberty and Braddock executed a confession of judgment in favor of both the Geier Trust and the Geier Group. Braddock paid the judgment and then sought reimbursement from Liberty and his affiliates, including LLC, by commencing a separate action in Florida.

[3] The parties dispute the extent to which this letter constitutes a binding contract to grant the Options to Geier—Geier argues that the March 6 letter is an enforceable contract; the Defendants argue that it is at best an unenforceable agreement to agree.

On November 18, 2013, Braddock executed a settlement agreement with Liberty, LLC and others pursuant to which he released several claims, including any claims to any equity interest in LLC (the "Braddock Settlement"). At the same time, Liberty and LLC also sought to obtain a release from Geier, the Geier Trust and Geier Holdings.[4] An early draft of this release specifically listed Geier individually as a releasor and included a carve-out for Geier's claim to the Options.[5] The final version of the release, titled simply "General Release," dated November 18, 2013, removed Geier as a signatory, leaving the Geier Trust and the Geier Group as the named releasors. It contained no carve-out for any claim Geier may have had against LLC, including any claim relating to the Options.[6] The General Release was executed on behalf of the releasors by Hope Smith, a trustee of the Geier Trust and manager of the Geier Group.

In November 2013, LLC assigned all its rights and interests in United States common law and federally registered trademarks, international trademark applications and registrations, U.S. patents, and goodwill to Inc., a subsidiary of

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[4] The Braddock Settlement Agreement references the General Release at issue here and notes that it is "to [be] deliver[ed] to the "Mozido Parties," as defined in the Braddock Settlement Agreement. The reference does not describe the scope of the General Release but does note that the release is "from . . . the Geier Parties" defined as the "Philip H. Geier Jr. Irrevocable Trust and the Geier Group, LLC." Verified Second Amended Complaint ("Compl.") Ex. G, ¶ 2(1).

[5] Compl. Ex. H.

[6] Compl. Ex. I.

LLC that was formed as part of a significant capital infusion and restructuring. Inc. assumed certain liabilities of LLC but purportedly did not assume any liability for the Options.

Geier alleges that he has repeatedly demanded that LLC or Inc. issue his Options and has unsuccessfully attempted to exercise the Options since he left the Board in May 2013. Geier did not make a formal demand to exercise his rights to the Options, however, until October 10, 2014, when he sent a letter to that effect to Robert E. Turner, who was then the Chairman of LLC.

II. STANDARD OF REVIEW

The standard of review is well settled. A motion to dismiss under Rule 12(b)(6) should be denied if the plaintiff could recover "under any reasonably conceivable set of circumstances susceptible of proof."[7] The Court will assume the truth of all well-pled facts in the complaint and draw all reasonable inferences in the plaintiff's favor,[8] but need not give weight to conclusory allegations.[9]

III. ANALYSIS

If the General Release extends to Geier in his individual capacity and releases his claims against LLC and Inc. related to the Options ("the Option

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[7] *Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Hldgs.*, LLC, 27 A.3d 531, 536 (Del. 2011).

[8] *Id.*

[9] *Malpiede v. Townson*, 780 A.2d 1075, 1082–83 (Del. 2001).

claims”), then I need not address the parties’ arguments regarding the merits of the Option claims and the motions to dismiss must be granted. Therefore, I turn first to the scope and effect of the General Release.

A. Applicable Tenets of Contract Construction Relating to Releases

The General Release, by its terms, is governed by New York Law. According to New York law, the interpretation of a release is for the court to undertake as a matter of law, and therefore is appropriate for disposition on a motion to dismiss.[10] This is especially so if the Court determines that the agreement is unambiguous and can be interpreted by reference to the document itself.[11]

When the language of a release is clear and unambiguous, the Court will give effect to the intention of the parties as evidenced by the language within the four corners of the document.[12] The court will consider extrinsic evidence to ascertain the meaning or scope of the release only when there is an ambiguity in

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[10] *See, e.g.*, *LeMay v. H.W. Keeney, Inc.*, 508 N.Y.S.2d 769, 770 (N.Y. App. Div. 1986).

[11] *Id.*

[12] *Id.*

the release itself.[13] However, the parties may not offer, and the court may not consider, extrinsic evidence to create ambiguity.[14]

Where parties are sophisticated and represented by counsel, and the language of the release is clear, New York courts are even more inclined to look only to the language of the release to ascertain objectively the parties' intent with respect to the scope of the release.[15] In this regard, I note that New York courts do draw a distinction between releases among sophisticated parties on the one hand, and releases among individuals or among less sophisticated individuals and businesses on the other (for instance in the personal injury context).[16] As between businesses and other sophisticated parties, New York courts will construe releases strictly and in accordance with their express terms.[17] In cases involving less sophisticated parties, the courts are more inclined to look beyond the release at the context of the settlement and other surrounding circumstances in order to discern

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[13] *Innophos, Inc. v. Rhodia, S.A.*, 882 N.E.2d 389, 392 (N.Y. 2008).

[14] *See Rubycz-Boyar v. Mondragon*, 790 N.Y.S.2d 266, 267 (N.Y. App. Div. 2005).

[15] *Locafrance U.S. Corp. v. Intermodal Systems Leasing, Inc.*, 558 F.2d 1113, 1115 (2d Cir. 1977) (applying New York law).

[16] *See id.* at 1114–15 (describing the different approaches courts take when construing releases entered into by sophisticated versus unsophisticated parties).

[17] *Id.* at 1115.

the intent of the parties to the release.[18] The General Release at issue here was between sophisticated parties represented by competent counsel.[19] The Court's focus, therefore, must be on the terms of the General Release itself.

A general release will be construed most strongly against the releasor, [20] and will "bar[] an action on any cause of action arising prior to its execution."[21] Since a general release bars all pre-existing claims between the releasor and releasee, if a releasor seeks to limit the release, New York courts require that the releasor expressly do so in the release itself.[22]

B. The General Release Bars the Option Claims

Geier offers two arguments as to why the General Release should not be interpreted as a bar to the Option claims. First, he contends that the General Release must be read in conjunction with documents executed by the parties to the

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[18] *Id.* at 1114–15 (stating that the courts will generally look to the intent of the parties when a release contains no ambiguities within its four corners in personal injury and other similar cases involving unsophisticated parties only "where mistake, fraud, or overreaching against an individual is suspected").

[19] Compl. ¶ 6 ("Plaintiff is a respected business leader, internationally recognized in the fields of communication, venture capital, marketing, entrepreneurship and business development, and is the former chair and CEO of Interpublic Group of Companies, where he served for over 20 years"); ¶ 12 ("Liberty valued Plaintiff's personal reputation and business acumen as assets. . . .").

[20] *Consorcio Prodipe v. Vinci*, 544 F.Supp. 2d 178, 189 (S.D.N.Y. 2008) (applying New York law).

[21] *Mergler v. Crystal Props. Assoc.*, 583 N.Y.S.2d 229, 230 (N.Y. App. Div. 1992).

[22] *In re Schaefer*, 221 N.E.2d 538, 540 (N.Y. 1966).

Braddock Settlement, which reflect that the General Release actually was intended to release only claims relating to the $3 million loan the Geier Trust and the Geier Group made to the Liberty affiliate. Second, he contends that the terms of the General Release reveal that he was not an intended releasor. I disagree on both counts.

1. The General Release Was Not Modified by the Braddock Settlement

The General Release is expressly captioned "General Release;" it contains no carve-outs or limitations.[23] Nor does it contain any recitals that might add

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[23] The General Release, in its entirety, reads:

> ***To All To Whom These Presents Shall Come Or May Concern, Know That:***
>
> Philip H. Geier Jr. Irrevocable Trust and The Geier Group, LLC, as RELEASORS, in consideration of the sum of Ten Dollars (10.00) and other good and valuable consideration, received from Michael Liberty, Peter Smith, Greg Corona, Ric Duques, Robert Selander, Ira Levy, Mozido, LLC, Brentwood Investments, LLC, Brentwood Financial, LLC, Mobile Money Partners, LLC, and Family Mobile, LLC, as RELEASEES, receipt whereof is hereby conclusively acknowledged, release and discharge the RELEASEES and the RELEASEES' affiliates, subsidiaries, parents, heirs, executors, administrators, successors, predecessors and assigns or anyone acting on behalf of any or all of the foregoing persons, from all actions, causes of action, suits, debts, dues, sums of money, accounts, reckonings, bonds, bills, specialties, covenants, contracts, controversies, agreements, promises, variances, trespasses, damages, judgments, extents, executions, claims, and demands whatsoever, known or unknown, in law, admiralty or equity, which against the RELEASEES, the RELEASORS and the RELEASORS' affiliates, subsidiaries, parents, heirs, executors, administrators, successors, predecessors and assigns ever had, now have or hereafter can, shall or may, have for, upon, or by reason of any matter,

context or reflect the intent of the parties. Since there is no ambiguity within the four corners of the General Release, and it was prepared by sophisticated parties and their counsel, neither the Braddock Settlement documents nor the earlier drafts of the release may be used to construe the agreement or create ambiguity about whether Geier was intended as a party or whether the Option claims were intended to be excluded from the General Release.

Geier contends that the General Release is a component part of the Braddock Settlement and, therefore, should be construed along with the recitals in the Braddock Settlement documents that expressly limit the scope of that settlement. He argues under New York law that writings that "form part of a single transaction and are designed to effectuate the same purpose [must] be read together."[24]

> cause or thing whatsoever from the beginning of the world to the day of the date of this RELEASE.
>
> In addition, the RELEASORS agree not to issue, make or publish any statement, whether orally or in writing, by electronic or any other means, to any person or persons, that disparages any of the RELEASEES.
>
> The words "RELEASORS" and "RELEASEES" include all releasors and all releasees under this RELEASE.
>
> This RELEASE may not be changed orally.
>
> This release shall be governed by and construed in accordance with the laws of the State of New York.

Compl. Ex. I.

[24] *Genger v. Genger*, 76 F.Supp. 3d 488, 496 (S.D.N.Y. 2015) (alteration in original) (internal quotation marks omitted) (applying New York law).

Geier's recitation of New York law regarding the construction of demonstrably unified contracts is accurate as far as it goes but it stops short of being complete. New York also embraces the general notion that contracts should be read separately unless their "history and subject matter show them to be unified."[25] While this inquiry often is fact intensive, it should be performed by the court as a matter of law where the parties' intent may be determined by looking only within the four corners of the contract.[26] Factors such as the identities of the parties, mutual dependence of the contracts, absence or presence of any cross-reference, and the contracts' different purposes are relevant to determining the intent of the parties.[27] While "form" is not dispositive, "that the parties entered into separate written agreements with 'separate assents' rather than a 'single assent' is influential."[28] And a conclusory allegation within a complaint that otherwise clear language in a standalone contract actually means something else

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[25] *Cty. of Suffolk v. Long Island Power Auth.*, 954 N.Y.S.2d 619, 623 (N.Y. App. Div. 2014) (quoting *131 Heartland Blvd. Corp. v. C.J. Jon Corp.*, 921 N.Y.S.2d 94, 97 (N.Y. App. Div. 2011)).

[26] *Schron v. Grunstein*, 917 N.Y.S.2d 820, 824 (N.Y. Sup. Ct. 2011); *aff'd sub nom. Schron v. Troutman Sanders LLP*, 963 N.Y.S.2d 613 (N.Y. 2013).

[27] *Id.*

[28] *Rudman v. Cowles Commc'ns, Inc.*, 280 N.E.2d 867, 873 (N.Y. 1972) (internal citations omitted) (holding that "the conclusion of separateness" was "all but inescapable" when the agreements at issue involved "formally different parties" and were executed on different dates within the same month).

when read alongside a separate but allegedly related contract "is not enough to create an ambiguity sufficient to raise a triable issue of fact."[29]

Here, the General Release and the Braddock Settlement were executed separately, and among different parties. There are separate assents and no indication that the parties intended that the General Release would not stand on its own. While the General Release was referenced in and attached to the Braddock Settlement documents, nothing within the four corners of the General Release indicates that it is contingent upon or related to the Braddock Settlement. Any professed fealty to New York's objective theory of contracts would be hollow if I was to take the General Release, which is clear on its face, and inject it with terms from the Braddock Settlement documents in order to alter the intent of the contracting parties as expressed in the General Release. The General Release must be interpreted within its four corners.[30]

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[29] *Schron,* 917 N.Y.S.2d at 825 (quoting *Innophos, Inc. v. Rhodia, S.A.*, 832 N.Y.S.2d 197, 199 (N.Y. App. Div. 2007)).

[30] While I appreciate that evidence of the circumstances or context in which a contract is executed may be admitted to assist in the construction of the contract's terms, *see, e.g.*, *67 Wall St. Co. v. Franklin Nat. Bank*, 333 N.E.2d 184, 186–87 (N.Y. 1975), I cannot conclude that any such circumstantial evidence would alter the construction of the General Release, particularly given the sophistication of the parties and the breadth of its clear and unambiguous terms. *Id.* (explaining that while evidence of surrounding circumstances of a contract may be admissible to explain ambiguities or aid in the construction of its terms, it must be excluded where it is offered to vary or contradict the unambiguous terms of the contract).

2. Geier is a Releasor

The General Release expressly identifies the Geier Trust and the Geier Group as releasors. It also expressly provides that claims the releasors' "affiliates, subsidiaries, and parents" "ever had, now have or hereafter can have" against the releasees are released.[31] The parties disagree whether the term "affiliate" would include Geier individually. Defendants contend that Geier is clearly an "affiliate" of the Geier Trust and the Geier Group based on that term's ordinary meaning. Geier urges the Court to determine that "affiliate" is ambiguous and to allow the parties to take discovery regarding the parties' intent with respect to this term.

Contract provisions should be interpreted consistently with the general purpose of the contract.[32] Since one can discern on the face of the General Release that its purpose is to effect a broad release of claims, intended to cover any pre-existing claims the releasors may have against the releasees, it is appropriate to interpret the term "affiliate," as used in the General Release, broadly as well.[33] In determining the meaning of "affiliate," standard dictionary definitions are

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[31] Compl. Ex. I.

[32] *Smith v. City of Buffalo*, 992 N.Y.S.2d 816, 818 (N.Y. App. Div. 2014).

[33] *See In re El-Roh Realty Corp.*, 902 N.Y.S.2d 727, 730 (N.Y. App. Div. 2010) (interpreting provisions of an agreement which had the primary purpose of preserving the closely-held nature of a corporation consistently with and to give effect to that purpose).

instructive,[34] including: "an affiliated person or organization,"[35] "being close in connection, allied, associated, or attached as a member or branch,"[36] or "[s]omeone who controls, is controlled by, or under common control with an issuer of a security."[37]

Geier's complaint indicates that he was in control of both the Geier Trust and the Geier Group. Indeed, the complaint alleges that when LLC sought a loan from Geier, he directed the Geier Trust and Geier Group to make the loan.[38] Moreover, as noted, he is a co-trustee of the Geier Trust and Chairman of the Geier Group. While Geier has argued that the term "affiliate" should not apply to him since he is not an entity, I find no principled basis to draw that distinction. If the term "affiliate" would include an entity in control of the Geier Trust or the Geier Group, there is no reason to limit the definition so that an individual in that same position of control would not likewise be deemed an affiliate of the releasors.[39]

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[34] New York courts, like Delaware courts, will refer to dictionaries to assist in the construction of undefined terms within a contract without offense to the parol evidence rule. *Mazzola v. Cty. of Suffolk*, 533 N.Y.S.2d 297, 297 (N.Y. App. 1988).

[35] Merriam-Webster's Collegiate Dictionary 21 (11th ed. 2003).

[36] *VKK Corp. v. Nat'l Football League*, 244 F.3d 114, 130 (2d Cir. 2001) (quoting BLACK'S LAW DICTIONARY, 1446 (7th ed. 1999) (applying New York law).

[37] BLACK'S LAW DICTIONARY (10th ed. 2014).

[38] Compl. ¶¶ 46–47.

[39] *See Wachter v. Kim*, 920 N.Y.S.2d 66, 71 (N.Y. App. Div. 2011) ("The word 'affiliate' is not commonly understood to apply only to entities").

Even if Geier did not "control" the Geier Trust or the Geier Group, the only reasonable construction of "affiliate" would still apply to Geier in his individual capacity. Geier indisputably had a "close connection" and "association" with both the Geier Trust as a co-trustee and the Geier Group as Chairman.

I am satisfied that the only reasonable interpretation of the term "affiliate" is that it includes Geier individually as an affiliate of the Geier Trust and the Geier Group. Having interpreted the term in that manner, by the express, unambiguous terms of the General Release, Geier must be deemed a releasor.

3. Geier Has Released the Option Claims Against Both Defendants

While Inc. is not explicitly named in the General Release as a releasee, the broad language defining releasee includes any subsidiaries of LLC and the other named releasees. Since Inc. is a subsidiary of LLC, it is a releasee. Accordingly, if the General Release releases Geier's claims against LLC, it also releases his claims against Inc.

According to the General Release, the releasors agreed to release "all actions, causes of action, suits, debts, dues, sums of money, accounts, reckonings, bonds, bills, specialties, covenants, contracts, controversies, agreements, promises, variances, trespasses, damages, judgments, extents, executions, claims, and demands whatsoever, known or unknown, in law . . . or equity, which against the RELEASEES, the RELEASORS and the RELEASORS' affiliates . . . ever had,

now have or hereafter can, shall or may, have for, upon or by reason of any matter, cause or thing whatsoever from the beginning of the world to the day of the date of this RELEASE."[40] This is the classic model of a general release and the Option claims are clearly captured within this broad release language. How could they not be? The Option claims arose prior to the execution of the General Release, were or should have been well known to Geier at that time and are not specifically or even implicitly carved out.[41] They are, therefore, barred by the General Release.

IV. CONCLUSION

Based on the foregoing, the motions to dismiss must be GRANTED.

IT IS SO ORDERED.

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[40] Compl. Ex. I.

[41] *See* Compl. ¶¶ 29–31 (stating that Geier believed no further documentation for his Option was necessary when he began serving on the Board in March 2012 and that he resigned on or about May 10, 2013); ¶ 59 (stating that Geier had repeatedly attempted to assert his Option claims since leaving the Board, on or about May 10, 2013); ¶¶ 52–53 (discussing the drafting of the Geier Release, where earlier drafts included a carve-out for Geier's claims to the Option); Ex. H (showing an earlier draft of the release specifically excluding Geier's claims to the Option).

COURT OF CHANCERY
OF THE
STATE OF DELAWARE

SAM GLASSCOCK III
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COURT OF CHANCERY COURTHOUSE
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Date Submitted: October 7, 2016
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Re: *Jay Frechter v. Cryo-Cell International, Inc.*
Civil Action No. 11915-VCG

Dear Counsel:

This matter involves the application for a fee award in a mootness proceeding. The Plaintiff, a stockholder of Cryo-Cell International ("the Company"), sued the Company, seeking a declaration that a provision in its bylaws (the "Provision") was illegal. The Provision indicated that directors could be removed "for cause" at a "special meeting" of stockholders. Under Section 141(k) of the Delaware General Corporation Law, stockholders have the right to remove directors without cause. After the Plaintiff moved for summary judgment, the Company amended its bylaw to remove the language complained of, mooting the action.

I find that the Provision, while not explicitly illegal, was misleading to stockholders and could have a chilling effect on the exercise of their franchise under Section 141, because providing a procedure to remove directors for cause (and remaining silent as to removal without cause) could indicate to a reasonable stockholder that cause was a requisite for removal. Thus, this suit was meritorious when filed. The Company concedes that it removed the provision as a result of the litigation. Since, as I have found, a potential chilling effect on the exercise of the stockholder franchise was removed by the action, a benefit was worked on the stockholders. Therefore, a mootness fee is appropriate under the Corporate Benefit Doctrine. The remaining issue is the appropriate size of the fee.

I have evaluated this matter using the *Sugarland* factors.[1] Most important here is the value of the benefit. I find that the benefit resulting from removing the Provision is mostly theoretical. I note that the Company has never attempted to use the Provision defensively, and that the current board was seated following a proxy contest, as a result of which prior board members were removed *without* cause. While it is impossible to determine whether stockholders have ever been dissuaded from mounting a proxy contest by the misleading language of the bylaw, I note that sophisticated investors, or those interested enough to hire counsel, would likely have been undeterred. In light of the theoretical modest benefit worked here, and the other

[1] *Sugarland Indus., Inc. v. Thomas*, 420 A.2d 142 (Del. 1980).

factors addressed below, I find a fee in the amount of $50,000, inclusive of expenses, to be reasonable.

First, I note that this action—unlike the action in *In re VAALCO Energy, Inc. Stockholder Litigation*,[2] which generated a higher award—was not brought in light of any pending proxy contest, or indeed, any contemplated action which might have been deterred by the Provision. It was entirely an action to remove a bylaw provision that was theoretically improper, in a vacuum, untethered to any immediate practical result. Next, I consider that one of the factors mandated by the Supreme Court in *Sugarland* is consideration of the contingent nature of the litigation. This is because a fee award should reflect the risk undertaken by Plaintiff's counsel, in computing a fee which encourages wholesome litigation. Here, in light of the outcome in *VAALCO* which provided the impetus for this action, this was largely a risk-free pursuit, and the contingency factor is of negligible importance. It is worth pointing out, I think, that had the Company changed its bylaw upon suit being filed (or upon pre-suit demand, had one been made), rather than resisting the relief requested through the time of the filing of an amended complaint and a nine-page summary judgment motion, a nominal fee at most would have been warranted. Some effort was required here on the part of the Plaintiff and his counsel, however, making a more-than-nominal fee appropriate.

[2] C.A. No. 11775-VCL (Del. Ch. Dec. 21, 2015) (TRANSCRIPT).

I also note that the original complaint included a second count, seeking to hold the Company's directors liable for breaches of fiduciary duty in enacting the Provision. In fact, the current directors did not create the Provision. While that count was withdrawn, it required some effort by the Corporation and its counsel, which was a cost imposed, ultimately, on stockholders. This count was not meritorious when filed, and I have adjusted the contemplated fee downward, as I believe equity requires, in reaching a fee award of $50,000.

I find the other *Sugarland* factors (including effort expended by Plaintiff's counsel) do not militate against a $50,000 fee award.

Therefore, a mootness fee in the amount of $50,000, inclusive of expenses, in favor of the Plaintiff is appropriate. To the extent the foregoing requires an Order to take effect, IT IS SO ORDERED.

Sincerely,

/s/ Sam Glasscock III

Sam Glasscock III

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE BOOKS-A-MILLION, INC.	)	Consolidated
STOCKHOLDERS LITIGATION	)	C.A. No. 11343-VCL

MEMORANDUM OPINION

Date Submitted: September 22, 2016
Date Decided: October 10, 2016

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LASTER, Vice Chancellor.

In 2015, the controlling stockholders of Books-A-Million, Inc. ("BAM" or the "Company") took the Company private through a squeeze-out merger (the "Merger"). Each publicly held share of common stock was converted into the right to receive $3.25 per share, subject to the potential exercise of appraisal rights.

The plaintiffs are minority stockholders who contend that the Company's directors, its controlling stockholders, and several of its officers breached their fiduciary duties in connection with the Merger. They also contend that the transaction vehicles that the controlling stockholders used to complete the Merger aided and abetted the fiduciaries in breaching their duties. The defendants have moved to dismiss the complaint for failing to state a claim on which relief can be granted.

The Merger followed the framework approved by the Delaware Supreme Court in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014). Consequently, unless the plaintiffs can plead facts supporting a reasonable inference that one of the elements of the framework was not met, the business judgment rule provides the operative standard of review. Under that standard of review, the court will defer to the judgments made by the corporation's fiduciaries unless the Merger is so extreme as to suggest waste.

The plaintiffs' complaint has not pled grounds to take the transaction outside of the *M&F Worldwide* framework. The business judgment rule applies. The Merger cannot be viewed as an act of waste. The complaint is therefore dismissed with prejudice.

I. FACTUAL BACKGROUND

The relevant facts are drawn from the currently operative pleading, which is the Verified Consolidated Amended Class Action Complaint (the "Complaint"), and the

documents it incorporates by reference. The principal document that the Complaint incorporates is the definitive proxy statement filed with the Securities and Exchange Commission in connection with the Merger (the "Proxy Statement" or "Proxy"). This court may consider the Proxy Statement to establish what was disclosed to stockholders and other facts that are not subject to reasonable dispute. *See In re Gen. Motors (Hughes) S'holder Litig.*, 897 A.2d 162, 170 (Del. 2006); *Abbey v. E.W. Scripps Co.*, 1995 WL 478957, at *1 n.1 (Del. Ch. Aug. 9, 1995).

A. The Company

BAM is a Delaware corporation that is engaged in the retail book business. It operates over 250 bookstores, principally in the southeastern United States. BAM also sells books over the internet, engages in wholesale book sales and distribution, and has an internet development and services company. It owns a majority stake in a yogurt business, and it also develops and manages real estate through its approximately 95% stake in Preferred Growth Properties, LLC. Before the Merger, BAM's common stock traded on the NASDAQ Global Select Exchange under the ticker symbol "BAMM."

BAM was founded in 1917 by Clyde W. Anderson, and his descendants (the "Anderson Family") continue to control the Company.[1] At all times since BAM's initial

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[1] The members of the Anderson Family include Charles C. Anderson; Hilda B. Anderson; Joel R. Anderson; Ashley Ruth Anderson; Charles C. Anderson, Jr.; Harold M. Anderson; Kayrita Anderson; Charles C. Anderson, III; Hayley Anderson Milam; Anderson BAMM Holdings, LLC; the Ashley Anderson Trust; the Lauren A. Anderson Irrevocable Trust; the Olivia Barbour 1995 Trust; the Alexandra Ruth Anderson Irrevocable Trust; the First Anderson Grandchildren's Trust FBO Charles C. Anderson, III; the First Anderson Grandchildren's Trust FBO Hayley E. Anderson; the First Anderson Grandchildren's Trust FBO Lauren A. Anderson; the Second Anderson Grandchildren's Trust FBO Alexandra R. Anderson;

public offering in 1992, the Anderson Family has controlled a majority of the Company's shares. Collectively, before the Merger, the Anderson Family controlled shares carrying approximately 57.6% of the Company's outstanding voting power. An Anderson Family vehicle also owns the minority interest in the Company's yogurt business.

At the time of the Merger, the board of directors (the "Board") had five members. Two were members of the Anderson Family: Executive Chairman Clyde B. Anderson and Terrence C. Anderson. The other three were Ronald G. Bruno, Ronald J. Domanico and Edward W. Wilhelm. The Complaint names all five directors as defendants.

Bruno joined the Board in 1992. He was formerly the chairman and CEO of a supermarket chain. At the time of the Merger, he was serving as president of an investment company and chairman of a sports marketing firm. He also had served for fourteen years on the board of Russell Corporation and for eighteen years on the board of SouthTrust Bank.

Domanico joined the Board in 2014. At the time of the Merger, he was serving as Senior Vice President of Strategic Initiatives and Capital Markets of Recall Corporation, a management services company, and as a director of NanoLumens, a private LED display designer and manufacturer. He also had served as CFO of HD Supply for several years and as CFO and director of Caraustar Industries, Inc. for seven years.

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the Third Anderson Grandchildren's Trust FBO Taylor C. Anderson; the Fourth Anderson Grandchildren's Trust FBO Carson C. Anderson; the Fifth Anderson Grandchildren's Trust FBO Harold M. Anderson; the Sixth Anderson Grandchildren's Trust FBO Bentley B. Anderson; the Charles C. Anderson Family Foundation; the Joel R. Anderson Family Foundation; and the Clyde and Summer Anderson Foundation.

Wilhelm joined the Board in 2013. At the time of the Merger, he was serving as CFO of The Finish Line, Inc., an athletic shoe retailer. He is a certified public accountant with experience in the bookstore industry, including fifteen years as an executive and nine years as a board member with Borders Group, Inc.

None of the directors were members of management. The Company's President and CEO was defendant Terrance G. Finley. The Company's Executive Vice President and CFO was defendant R. Todd Noden. The Company's Executive Vice President of Real Estate and Business Development was defendant James F. Turner. At the time of the Merger, Finley, Noden, and Turner owned approximately 6.2% of the Company's equity. They also owned the minority stake in the Company's real estate development subsidiary. In connection with the Merger, Finley, Noden, and Turner agreed to roll over their equity in the Company in return for equity in the holding company that owns, post-Merger, 100% of the stock of the Company. The executives have maintained their management positions with the Company.

B. Prior Discussions About A Potential Merger

At various times during the past four years, the Anderson Family and the Company have discussed a potential business combination. In April 2012, the Anderson Family proposed to acquire the outstanding BAM shares for $3.05 per share, representing a 20% premium over BAM's closing price the previous day. The Board formed a special committee, which evaluated the proposal. The special committee concluded that the proposal undervalued the Company and asked the Anderson Family to raise their price. In July 2012, after further negotiations, the Anderson Family withdrew their proposal.

During the summer of 2013, an entity that the Proxy Statement calls "Party Y" approached BAM about a potential transaction. Party Y appears to have been a financial buyer. BAM and Party Y entered into a confidentiality agreement, and Party Y visited BAM's facilities and stores. In September, Party Y provided Clyde Anderson with an expression of interest in acquiring the Anderson Family's block for $3.30 per share in cash. Party Y indicated that it planned to cause the Company to sell its real estate holdings. Party Y also said that it might be willing to acquire all of the Company's shares. In October, Party Y confirmed its interest in potentially acquiring all of the Company's shares. The Board directed management to engage in discussions with Party Y. Clyde Anderson also participated in the discussions. According to the Proxy Statement, "[t]he Company began to question the seriousness of the discussions when Party Y did not retain an investment banking firm, and its advisors did not engage in discussions with the Company's advisors, and Party Y made no visible efforts to conduct diligence." Proxy at 15. "[O]n December 3, 2013, Clyde B. Anderson informed the Board that discussions with Party Y would be discontinued." *Id.*

In early 2014, Party Y approached BAM again. This time, Party Y proposed to acquire all of the outstanding shares of BAM for $4.15 per share. Consistent with the position it took when it first approached the Company in summer 2013, Party Y stated that did not want to retain all of the Company's business segments; Party Y only wanted the retail trade and e-commerce segments. According to the Proxy Statement, "[t]he proposal indicated that the buyer did not have sufficient capital to acquire the whole business." *Id.* The proposal was subject to the Anderson Family (i) providing a backstop

commitment to acquire BAM's real estate holdings for at least $19 million and (ii) buying certain other assets for approximately $2.8 million. *Id.* On April 1, 2014, the Anderson Family advised the Board that they "would not support this proposal which relied on a backstop from [them]." *Id.*

On April 16, 2014, Party Y, the Company's general counsel, and members of the Anderson Family met in person in New York, New York. After the meeting, Party Y raised its bid to $4.21 per share with the same conditions. The Anderson Family maintained that they would not support Party Y's proposal. The Proxy Statement states:

> [O]ur Board unanimously resolved to terminate discussions with Party Y given, among other things, Party Y's lack of substantial assets of its own, and its apparent inability to identify any source to finance the transaction in full, the Anderson family's unwillingness to sell their shares of the Company, Party Y's reliance on the Anderson Family committing to acquire the Company's real estate holdings for at least $19 million and the Anderson Family's unwillingness to do so.

Id.

C. The Anderson Family's Proposal

On January 29, 2015, the Board received an unsolicited proposal from the Anderson Family to acquire the outstanding shares of BAM common stock that they did not already own for $2.75 per share in a negotiated transaction. The price represented a 64% premium over BAM's closing price the day of the bid and a 65% premium over the average closing price for the past 90 trading days. The proposal anticipated that the transaction would take the form of merger between the Company and a newly formed acquisition vehicle, that management would remain in place following the merger, and

that the transaction would be financed using borrowings available under the Company's existing credit facility. Dkt. 19, Ex. D.

The proposal stated that the Anderson Family expected the Board to establish a special committee of independent directors with its own financial and legal advisors. The proposal represented that the Anderson Family "will not move forward with the transaction unless it is approved by the Special Committee." *Id.* The proposal also stated that "any definitive acquisition agreement would need to include a non-waivable majority of the minority vote condition." *Id.* The proposal stated that the Anderson Family was only interested in acquiring the shares that it did not already own and that it was not interested in selling its shares to a third party.

D. The Committee And Its Advisors

On January 30, 2015, the Board met to discuss the Anderson Family's proposal. The Board formed a special committee (the "Committee") to review, evaluate, and negotiate the terms of a potential transaction. The initial members of the Committee were the three directors who were not affiliated with the Anderson Family: Bruno, Domanico, and Wilhelm. The Board authorized the Committee to retain legal and financial advisors, to establish rules and procedures for the process, and to take any other actions that might be required. The Board noted that although it expected the Committee to begin work immediately, it also expected that the members of the Committee would hire their own legal counsel, who would help craft resolutions specifying the Committee's powers and mandate in greater detail.

After the full Board meeting, the Committee met and discussed a process for selecting a legal advisor. On February 3, 2015, after interviewing two law firms, the Committee retained King & Spalding LLP. On February 5, the Committee elected Wilhelm as chair and discussed a process for selecting a financial advisor.

On February 6, 2015, Bruno discussed with King & Spalding his "social and civic relationships with the Anderson Family." Proxy at 16. Later that day, King & Spalding met with Domanico and Wilhelm, without Bruno, to discuss the relationships. They decided it would be preferable if Bruno did not serve on the Committee. Bruno concurred and resigned that day.

On February 16, 2015, the Committee retained Morris, Nichols, Arsht & Tunnell LLP as Delaware counsel. On February 23, after vetting three firms, the Committee selected Houlihan Lokey to serve as its financial advisor. Before hiring Houlihan Lokey, the Committee considered that in 2012 and 2013, Houlihan Lokey had provided transactional advisory services to an entity affiliated with the Anderson Family and received aggregate fees of approximately $260,000.

On February 24, 2015, King & Spalding forwarded to the Company's general counsel detailed resolutions establishing the Committee's authority and mandate.

> Pursuant to those resolutions, the Special Committee was authorized to conduct the evaluation and negotiation of the potential transaction, evaluate and negotiate the terms of any proposed definitive or other documents in respect of the proposal (subject to the approval of our Board), report its recommendations and conclusions to our Board, including a determination and recommendation as to whether the proposal was fair, advisable and in the best interest of the Company and the Company's stockholders, and specifically the Company's stockholders not affiliated with the Anderson Family, investigate the Company and the proposal, review, evaluate and, if

> necessary, negotiate other strategic options available to the Company, determine, in its sole discretion, to elect not to pursue the proposal and to retain its own independent legal and financial advisors at the Company's expense. The resolutions also authorized the Special Committee to review, evaluate and negotiate other strategic options available to the Company. In addition, the resolutions stated that the Board would not approve the proposal without a favorable recommendation from the Special Committee.

Proxy at 17. The full Board approved the resolutions by written consent.

E. The Committee Starts Work.

Having retained its legal and financial advisors and clarified the scope of its authority and mandate, the Committee worked with its advisors to develop a strategy for evaluating the Anderson Family's proposal. Despite the Anderson Family's statements about not intending to sell any shares, the Committee decided to solicit offers for BAM from various other parties, which would enable the Committee to better assess the value of BAM and the attractiveness of the Anderson Family's offer. Particularly in light of the Anderson Family's plan to finance its proposal using the Company's existing credit facility, the Committee decided to evaluate alternative transaction structures, such as a leveraged recapitalization or special dividend.

In April 2015, Houlihan Lokey evaluated alternative structures. Houlihan Lokey also contacted three entities—Parties X, Y, and Z—that had previously expressed interest in acquiring BAM. All three initially expressed interest in a potential transaction. King & Spalding informed the Anderson Family's counsel about the existence of potential competition.

Ultimately, only Party Y submitted an indication of interest. In a letter dated April 22, 2015, Party Y proposed to acquire all of the shares of BAM for $4.21 per share,

conditioned on due diligence, financing the transaction using BAM's existing credit facility, and a no-shop provision in the definitive transaction agreement. A representative of the Anderson Family called Houlihan Lokey and reiterated that the Anderson Family was only interested in acquiring the shares it did not already own and was not interested in selling its shares.

The Committee considered Party Y's proposal and the Anderson Family's position. The Committee instructed its advisors to determine whether Party Y would consider a minority investment. Party Y indicated that it was only interested in purchasing a controlling stake in the Company.

F. Negotiations With The Anderson Family

The Committee decided that its best course was to negotiate with the Anderson Family. On April 29, 2015, the Committee decided to reject the Anderson Family's proposal and counter at $3.36 per share. On May 4, in response to the Committee's counteroffer, the Anderson Family increased its offer to $3.10 per share, conditioned on a right to terminate the transaction if more than 5% of the Company's stockholders sought appraisal. On May 5, the Committee countered at $3.25 per share without any appraisal rights condition. On May 7, the Anderson Family raised its offer to $3.25 per share but with the 5% appraisal rights condition.

Negotiations briefly stalled over the inclusion of the appraisal rights condition. On May 11, 2015, the Committee decided to accept the concept of a condition, but to negotiate for a higher threshold. On May 13, the parties agreed to increase the appraisal

rights condition to 10% or more of the outstanding shares. With the key business terms resolved, counsel began preparing a transaction agreement.

On May 29, 2015, Party Y sent a letter to Houlihan Lokey reaffirming its interest in acquiring 100% of the shares of BAM for $4.21 per share, subject to the same conditions set out in its April 22 proposal. Counsel to the Committee and the Anderson Family continued negotiating the terms of the transaction agreement.

On June 30, 2015, King & Spalding advised the Committee that because the potential transaction with the Anderson Family would be financed through the use of the Company's existing credit facility, it would be prudent to obtain a solvency opinion. The Committee instructed King & Spalding to discuss the cost of an opinion with the Company's general counsel.

G. The Committee Approves The Merger.

On July 13, 2015, the Committee members met in person to consider the proposed transaction. Representatives from King & Spalding advised the Committee regarding their legal duties and other matters. At that point, as a matter of efficiency, the Committee invited Bruno to listen to counsel's description of the proposed transaction and a presentation from Houlihan Lokey regarding the fairness of the transaction. Because Clyde and Terrence Anderson had recused themselves, Bruno was the only other member of the Board who would need to hear the presentations before considering whether to approve the Merger. By allowing Bruno to sit in on the presentations, the Committee members avoided needing to have the advisors go through their presentations a second

time, just for Bruno, if the Committee decided to recommend the Anderson Family's proposal to the Board.

King & Spalding reviewed the principal terms of the proposed transaction with the Committee and Bruno. Counsel noted that the closing of the transaction was conditioned on approval by the holders of a majority of the Company's outstanding common stock not beneficially owned by the purchaser group or the Company's Section 16 officers. Houlihan Lokey advised the Company that no one other than Party Y had submitted an alternative proposal. The Proxy Statement states:

> The Special Committee concluded that the proposal from Party Y was not viable for various reasons, including the conditions imposed and the fact that the Anderson Family would be required to sell their ownership interest in the Company under Party Y's proposal (which the Anderson Family had confirmed that they were unwilling to do).

Proxy at 23.

Houlihan Lokey then presented its financial analysis of the merger consideration. At the conclusion of its analysis, Houlihan Lokey delivered an oral opinion, subsequently confirmed in writing, that the $3.25 per share contemplated by the Anderson Family's proposal was fair to the Company's minority stockholders from a financial point of view.

At that point, Noden, the Company's CFO, joined the meeting to discuss a proposed solvency opinion from a third-party valuation firm. After his presentation, the Committee excused Noden, Bruno, and the Houlihan Lokey representatives. The Committee members then deliberated and voted to recommend the Anderson Family's offer to the full Board.

Later on July 13, 2015, the full Board met in person in Birmingham, Alabama to receive and consider the Committee's recommendation. Clyde and Terrence Anderson abstained from the vote. The other three directors voted in favor of the transaction, approved the merger agreement, and resolved to recommend it to the Company's stockholders.

H. The Stockholder Vote

The terms of the Merger were set forth in an agreement and plan of merger dated July 13, 2015 (the "Merger Agreement") between and among the Company and two acquisition vehicles formed by the Anderson Family: Family Merger Sub, Inc. ("Merger Sub") and Family Acquisition Holdings, Inc. ("Parent"). The Merger Agreement contemplated a reverse triangular merger in which Merger Sub would merge with and into the Company, the separate corporate existence of Merger Sub would cease, and the Company would survive as a subsidiary of Parent. The merger consideration of $3.25 per share valued the Company's minority interest at $21 million. The Merger was financed through borrowings under the Company's credit facilities. In connection with the Merger, the Company's three top executives (Finley, Nolen, and Turner) entered into roll-over agreements in which they committed to contribute their BAM common stock to Parent in return for an equity interest in Parent. The members of the Anderson Family entered into a voting agreement in which they committed to voting all of their common stock in favor of the Merger. Clyde and Terrence Anderson executed the voting agreement on behalf of the members of the Anderson Family.

On August 21, 2015, BAM filed a 93-page preliminary proxy statement with the SEC. On August 27, 2015, the Company obtained a solvency opinion from Cappello Group, Inc. On October 22, BAM filed its definitive proxy statement, followed by a revised version on October 23.

The Merger Agreement was submitted to the Company's stockholders at a meeting held on December 8, 2015. Holders of approximately 66.3% of the shares who were not affiliated with the Anderson Family or any Section 16 officer of the Company approved the Merger. The transaction closed on December 10.

I. This Litigation

A stockholder plaintiff filed suit in July 2015 and another in October. The same law firms represented both plaintiffs. In February 2016, the cases were consolidated. After the defendants moved to dismiss the consolidated complaint and filed their opening briefs, the plaintiffs elected to amend their complaint, resulting in the currently operative pleading. The defendants renewed their motions to dismiss.

II. LEGAL ANALYSIS

The defendants have moved to dismiss the complaint for failing to state a claim on which relief can be granted. *See* Ct. Ch. R. 12(b)(6). When considering such a motion,

> (i) all well-pleaded factual allegations are accepted as true; (ii) even vague allegations are well-pleaded if they give the opposing party notice of the claim; (iii) the Court must draw all reasonable inferences in favor of the non-moving party; and [(iv)] dismissal is inappropriate unless the plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances susceptible of proof.

Savor, Inc. v. FMR Corp., 812 A.2d 894, 896–97 (Del. 2002) (footnotes and internal quotation marks omitted).

The Complaint names eight individuals and two entities as defendants. The individual defendants are (i) Domanico and Wilhelm, as the two members of the Committee who negotiated and recommended the Merger, (ii) Bruno, as a director who voted with Domanico and Wilhelm to approve the Merger, (iii) Clyde Anderson and Terrence Anderson, as the representatives of the Anderson Family, and (iv) Finley, Noden, and Turner, as members of management. The two entity defendants are the two acquisition vehicles, Parent and Merger Sub.

The Complaint contains three counts. Count I asserts that all of the individual defendants breached their fiduciary duties in connection with the Merger. Count I primarily focuses on the members of the Committee, but it also alleges that Bruno tainted the Committee's process and contends that all three directors breached their duties by voting in favor of the Merger at the Board level. Count I also alleges that the three executives breached their duties by rolling over their shares as part of the Merger. It further contends that Clyde and Terrence Anderson somehow breached their duties as directors, even though they did not participate in the process as directors and recused themselves from the vote. Count II separately contends that the Andersons breached their fiduciary duties under the more comprehensible theory that they did so as controlling stockholders. Compl. ¶ 114. Count III alleges that the acquisition vehicles aided and abetted the individual defendants in breaching their duties.

In this case, it is not necessary to parse finely among the defendants and counts. The plaintiffs' core contention is that the fiduciaries involved in the Merger breached their duties. The members of the Anderson Family, embodied by Clyde and Terrence Anderson, breached their fiduciary duties as the Company's controlling stockholders by proposing, negotiating, and engaging in the Merger. The committee members breached their fiduciary duties by negotiating the Merger and recommending it to the Board. And the members of the Board who followed the Committee's recommendation breached their fiduciary duties by approving the Merger and recommending it to the stockholders. If that central theory fails to state a claim, then the members of management cannot have breached their fiduciary duties by rolling over their shares as part of a transaction untainted by any other breach. Likewise, if there is no underlying breach of duty, then the acquisition vehicles cannot have aided and abetted anything.

Whether the plaintiffs' core contention states a claim for breach of fiduciary duty depends on the applicable standard of review. Ordinarily, when a controlling stockholder takes a company private, the operative standard of review is the entire fairness test. *See Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997). In *M&F Worldwide*, the Delaware Supreme Court held that the business judgment rule would provide the operative standard of review if the controller satisfied the following six elements:

> (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitely; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.

88 A.3d at 645. When the business judgment rule provides the operative standard of review, then a court will not consider the substance of the transaction unless its terms are so extreme as to constitute waste and thereby support an inference of subjective bad faith. *See In re MFW S'holders Litig.*, 67 A.3d 496, 519 & nn.107 & 109 (Del. Ch. 2013) (Strine, C.), *aff'd sub nom. M&F Worldwide*, 88 A.3d 635 (Del. 2014).

Compliance with the *M&F Worldwide* structure can be tested on a motion to dismiss.[2] If the defendants have described their adherence to the elements identified in *M&F Worldwide* "in a public way suitable for judicial notice, such as board resolutions and a proxy statement," then the court will apply the business judgment rule at the motion to dismiss stage unless the plaintiff has "pled facts sufficient to call into question the existence of those elements." *Swomley*, 2014 WL 4470947, at *20.

In this case, the allegations of the Complaint do not support a reasonably conceivable inference that any of the *M&F Worldwide* conditions were not met. The business judgment rule therefore applies. The Complaint also does not support a reasonably conceivable inference that the Merger constituted waste. Consequently, the defendants' motion is granted.

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[2] *Swomley v. Schlecht*, 2014 WL 4470947, at *20 (Del. Ch. Aug. 27, 2014) (TRANSCRIPT), *aff'd*, 128 A.3d 992 (Del. 2015) (TABLE); *see MFW*, 67 A.3d at 504 (explaining that one purpose of the *M&F Worldwide* structure was to remedy a doctrinal situation in which there was "no feasible way for defendants to get [cases] dismissed on the pleadings"); *see also In re Cox Commcn's, Inc. S'holders Litig.*, 879 A.2d 604, 618, 628, 633, 644, 647 (Del. Ch. 2005) (proposing the framework eventually adopted in *M&F Worldwide* and noting problems with the then-existing regime under which defendants lacked a meaningful chance of prevailing on a motion to dismiss).

A. The Dual Upfront Conditions

The first requirement of *M&F Worldwide* is that the controller condition the transaction "*ab initio* upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders." 88 A.3d at 644.

The offer letter dated January 29, 2015, that the Anderson Family sent to the Company conditioned any transaction, from the outset, on approval by both a special committee of independent directors and a non-waivable vote of disinterested stockholders. The operative text in the Anderson Family's offer letter was substantively identical to what was held to be sufficient in *M&F Worldwide*. *See MFW*, 67 A.3d at 506. The Complaint does not allege that the Anderson Family delayed establishing the conditions, wavered from them, or sought to circumvent them.

The plaintiffs' sole argument on the first element is that the 2015 proposal was a continuation of the Anderson Family's 2012 proposal, which did not have the twin conditions necessary for the *M&F Worldwide* framework. That is not a reasonably conceivable inference. The Complaint recognizes that a special committee rejected the 2012 offer, thereby terminating it. *See, e.g.*, ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 3.41 (Matthew Bender 2016) (explaining that "a definite rejection terminates the offeree's power to accept"). The 2015 offer came nearly three years after the 2012 offer and contained a different price and different terms. The 2015 proposal was a different offer, and it generated a separate process. The first requirement for the *M&F Worldwide* framework is therefore satisfied.

B. The Committee's Independence

The second requirement under *M&F Worldwide* is that the members of the special committee are disinterested and independent. 88 A.3d at 645. To plead that a director is interested in a manner sufficient to challenge the *M&F Worldwide* framework, a plaintiff must allege facts supporting a reasonably conceivable inference that the director received "a personal financial benefit from a transaction that is not equally shared by the stockholders."[3] To plead that a director is not independent in a manner sufficient to challenge the *M&F Worldwide* framework, a plaintiff must allege facts supporting a reasonable inference that a director is sufficiently loyal to, beholden to, or otherwise

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[3] *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993) (citations omitted); *accord Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362 (Del. 1993) ("Classic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally.") (footnotes omitted); *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984) ("Directorial interest exists whenever . . . a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders.") (footnote omitted). "[A] subjective 'actual person' standard [is used] to determine whether a 'given' director was likely to be affected in the same or similar circumstances." *McMullin v. Beran*, 765 A.2d 910, 923 (Del. 2000) (citing *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1167 (Del. 1995)). "[T]he benefit received by the director and not shared with stockholders must be 'of a sufficiently material importance, in the context of the director's economic circumstances, as to have made it improbable that the director could perform her fiduciary duties . . . without being influenced by her overriding personal interest.'" *In re Trados Inc. S'holder Litig.*, 2009 WL 2225958, at *6 (Del. Ch. July 24, 2009) (quoting *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d 611, 617 (Del. Ch. 1999)).

In *Brehm v. Eisner*, the Delaware Supreme Court overruled seven precedents, including *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984) and *Pogostin*, to the extent they reviewed a Rule 23.1 decision by the Court of Chancery under an abuse of discretion standard or otherwise suggested deferential appellate review. 746 A.2d 244, 253 n.13 (Del. 2000),. The *Brehm* court held that, going forward, appellate review of a Rule 23.1 determination would be *de novo* and plenary. *Id.* at 253. This decision does not rely on *Aronson* or *Pogostin* for the standard of appellate review and therefore omits the cumbersome subsequent history.

influenced by an interested party so as to undermine the director's ability to judge the matter on its merits.[4]

The plaintiffs do not directly challenge the independence or disinterestedness of Wilhelm or Domanico, who were the two individuals who served on the Committee, negotiated with the Anderson Family, and decided to recommend the Anderson Family's offer to the Board. The Complaint does not allege, for example, that Wilhelm or Domanico are related to the Anderson Family. They each held a 0.2% interest in BAM

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[4] *Aronson*, 473 A.2d at 815 (stating that one way to allege successfully that an individual director is under the control of another is by pleading "such facts as would demonstrate that through personal or other relationships the directors are beholden to the controlling person"); *accord Friedman v. Beningson*, 1995 WL 716762, at *4 (Del. Ch. Dec. 4, 1995) (Allen, C.) ("The requirement that directors exercise *independent judgment,* (*insofar as it is a distinct prerequisite to business judgment review from a requirement that directors exercise financially disinterested judgment*), directs a court to an inquiry into all of the circumstances that are alleged to have inappropriately affected the exercise of board power. This inquiry may include the subject whether some or all directors are 'beholden' to or under the control, domination or strong influence of a party with a material financial interest in the transaction under attack, which interest is adverse to that of the corporation."). A classic example is a close familial relationship. *See, e.g.*, *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 889 (Del. Ch. 1999) ("That Hudson also happens to be Huizenga's brother-in-law makes me incredulous about Hudson's impartiality. Close familial relationships between directors can create a reasonable doubt as to impartiality. The plaintiff bears no burden to plead facts demonstrating that directors who are closely related have no history of discord or enmity that renders the natural inference of mutual loyalty and affection unreasonable.") (footnote omitted); *Chaffin v. GNI Gp., Inc.*, 1999 WL 721569, at *5 (Del. Ch. Sept. 3, 1999) (holding that a father-son relationship was sufficient to rebut the presumption of independence: "Inherent in the parental relationship is the parent's natural desire to help his or her child succeed. . . . [M]ost parents would find it highly difficult, if not impossible, to maintain a completely neutral, disinterested position on an issue, where his or her own child would benefit substantially if the parent decides the issue a certain way"); *see also London v. Tyrrell*, 2010 WL 877528, at *14 n.60 (Del. Ch. Mar. 11, 2010) ("[I]n the pre-suit demand context, plaintiffs can often meet their burden of establishing a lack of independence with a simple allegation of a familial relationship. Surely then . . . it will be nigh unto impossible for a corporation bearing the burden of proof to demonstrate that an SLC member is independent in the face of plaintiffs' allegation that the SLC member and a director defendant have a family relationship.").

common stock at the time of the Merger, but their stock was not treated any differently than the minority shares. Although the Complaint notes in a footnote that each member of the Committee "receive[d] $35,000 in cash" for serving, the payment was not contingent on the success of the Merger. Compl. ¶ 62 n.2; Proxy at 53. *See Swomley,* 2014 WL 4470947, at *21 (holding that receipt of a non-contingent fee by a special committee member does not render that committee member interested or not independent).

Instead, the plaintiffs raise two collateral attacks on the independence and disinterestedness of the Committee: (i) they allege that Bruno, who purportedly was not independent, tainted the independence of the Committee by sitting in on Houlihan Lokey's fairness opinion presentation; and (ii) they allege that Wilhelm and Domanico approved the Merger in bad faith, thereby displaying a lack of independence in fact.

In challenging the independence of Bruno, the plaintiffs point to language in the Proxy disclosing that Bruno resigned from the Committee after identifying his "social and civic relationships with the Anderson Family." Precisely because Bruno resigned from the Committee at an early stage, this decision need not determine whether the Complaint supports a reasonably conceivable inference that Bruno could not be independent. He only served on the Committee for a matter of days, and he did not participate in the negotiation of the Merger. He voluntarily resigned after receiving feedback from his fellow Committee members that it would be preferable if he did not serve. That was a commendable step for Bruno and the Committee to take. The same thing happened in *MFW*, where a director initially was appointed to the special committee because he was independent under the rules of the New York Stock Exchange,

but resigned shortly thereafter when it was determined that he had "some current relationships that could raise questions about his independence for purposes of serving on the special committee." 67 A.3d at 507. Just as a prompt resignation did not undermine the effectiveness of the *M&F Worldwide* framework in the seminal case, it does not undermine the Committee's independence here.

The plaintiffs argue that Bruno tainted the Committee's independence by sitting in on Houlihan Lokey's fairness presentation after the negotiations were completed. Clyde and Terrence Anderson had recused themselves from the sale process because of their role on the buy side, leaving Wilhelm, Domanico, and Bruno to comprise the quorum necessary for transactional approval. As a member of the Board who ultimately would vote on the Merger, Bruno needed to hear the fairness presentation.

To create a truly pristine process, Houlihan Lokey could have given its presentation twice: once to Wilhelm and Domanico as members of the Committee, then, if they recommended the transaction, a second time to Wilhelm, Domanico, and Bruno as members of the Board. The directors decided to avoid the need for a repeat performance by having Bruno sit in when Houlihan Lokey made its presentation to the Committee. After hearing the presentation, Bruno was excused, as was Houlihan Lokey and Noden, the Company's CFO. Wilhelm and Domanico then deliberated and voted to accept the Anderson Family's offer. Under different circumstances, the participation of a director whose independence was compromised might be problematic. But in this case, the allegations of the Complaint do not support a reasonably conceivable inference that having Bruno present solely for Houlihan Lokey's fairness presentation prevents the

Merger from meeting this element of the *M&F Worldwide* test.

The plaintiffs' second argument regarding Wilhelm and Domanico's independence and disinterestedness goes to the core of their case. The plaintiffs contend that even if Wilhelm and Domanico appeared to be independent, disinterested, and uninfluenced by Bruno's purportedly tainting presence, that appearance is belied by their bad faith actions. The plaintiffs allege that by recommending the Anderson Family's offer, Wilhelm and Domanico elevated the interests of the Anderson Family over those of the minority stockholders, so they must have lacked independence in fact.

It is not immediately clear how an argument regarding bad faith fits within the *M&F Worldwide* framework. The Delaware Supreme Court did not discuss whether a plaintiff could seek to call into question the independence of a director by contending that although appearing independent, the director did not in fact act independently for the benefit of the stockholders but rather in pursuit of some other interest, such as to benefit the controlling stockholder. The trial court opinion did not devote significant attention to the issue, but it did state, after concluding that the committee in that case had met its duty of care, that "[b]ecause the special committee was comprised entirely of independent directors, there is no basis to infer that they did not attempt in good faith to obtain the most favorable price they could secure for the minority or believe they had done so." *MFW*, 67 A.3d at 516.

In light of this comment, it seems that the difficult route of pleading subjective bad faith is theoretically viable means of attacking the *M&F Worldwide* framework. This makes sense, because pleading facts sufficient to support an inference of subjective bad

faith is one of the traditional ways that a plaintiff can establish disloyalty sufficient to rebut the business judgment rule.[5] "[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally." *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (citations omitted). "[T]he requirement to act in good faith is a subsidiary element, i.e., a condition, of the fundamental duty of loyalty." *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (internal quotation marks and citations omitted). Subjective bad faith can take the form of "an intent to harm" or an "intentional dereliction of duty."[6] "A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other

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[5] *See In re Walt Disney Co. Derivative Litig. (Disney II)*, 906 A.2d 27, 53 (Del. 2006). ("Our law clearly permits a judicial assessment of director good faith for that former purpose [of rebutting the business judgment rule]."); *eBay Domestic Hldgs., Inc. v. Newmark*, 16 A.3d 1, 40 (Del. Ch. 2010) ("Under Delaware law, when a plaintiff demonstrates the directors made a challenged decision in bad faith, the plaintiff rebuts the business judgment rule presumption, and the burden shifts to the directors to prove that the decision was entirely fair to the corporation and its stockholders."); *In re Walt Disney Co. Derivative Litig.* (*Disney I*), 907 A.2d 693, 760–79 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) (conducting a director-by-director analysis to determine if the individual members of the board, none of whom were directly interested in the hiring or termination of the corporation's President, acted in bad faith).

[6] *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 240 (Del. 2009); *accord Disney II*, 906 A.2d at 64–66 (defining "subjective bad faith" as "conduct motivated by an actual intent to do harm," which "constitutes classic, quintessential bad faith," and "intentional dereliction of duty" as "a conscious disregard for one's responsibilities"); *see also Stone*, 911 A.2d at 370 (holding, in the context of an oversight claim, that "utter[] fail[ure] to implement any reporting or information system or controls" or, "having implemented such a system or controls, conscious[] fail[ure] to monitor or oversee its operations" demonstrated "a conscious disregard" for directors' fiduciary responsibilities).

than that of advancing the best interests of the corporation."[7] "It makes no difference the reason why the director intentionally fails to pursue the best interests of the corporation."[8] Bad faith can be the result of "any human emotion [that] may cause a director to place his own interests, preferences or appetites before the welfare of the corporation," including greed, "hatred, lust, envy, revenge, . . . shame or pride."[9]

In this case, the centerpiece of the plaintiffs' argument that the independent directors acted in bad faith is Party Y's offer, which the Complaint describes as a "substantially superior offer—$0.96 more per share, or nearly 30% higher than the Anderson Family's offer." Compl. ¶ 4. The Complaint contends that it is not rational for a director to take a lower priced offer when a comparable, higher priced offer is available. Because no one rationally would do that, the plaintiffs contend that the independent

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[7] *Disney II*, 906 A.2d at 67 (quoting *Disney I*, 907 A.2d at 755); *accord Stone*, 911 A.2d at 369 ("A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation . . . .") (quoting *Disney II*, 906 A.2d at 67); *see Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1051 n.2 (Del. Ch. 1996) (Allen, C.) (defining a "bad faith" transaction as one "that is authorized for some purpose other than a genuine attempt to advance corporate welfare or is known to constitute a violation of applicable positive law") (emphasis omitted); *In re RJR Nabisco, Inc. S'holders Litig.*, 1989 WL 7036, at *15 (Del. Ch. Jan. 31, 1989) (Allen, C.) (explaining that the business judgment rule would not protect "a fiduciary who could be shown to have caused a transaction to be effectuated (even one in which he had no financial interest) for a reason unrelated to a pursuit of the corporation's best interests").

[8] *Disney I*, 907 A.2d at 754; *see Nagy v. Bistricer*, 770 A.2d 43, 48 n.2 (Del. Ch. 2000) ("[R]egardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes," even if for a reason "other than personal pecuniary interest.").

[9] *RJR Nabisco*, 1989 WL 7036, at *15; *see Guttman v. Huang*, 823 A.2d at 506 n.34 ("The reason for the disloyalty (the faithlessness) is irrelevant, [and] the underlying motive (be it venal, familial, collegial, or nihilistic) for conscious action not in the corporation's best interest does not make it faithful, as opposed to faithless.").

directors must have had some ulterior motive for not pursuing Party Y's offer. As the plaintiffs see it, the failure to pursue Party Y's offer supports an inference that the independent directors disloyally favored the interests of the Anderson Family. Although they may have been independent in appearance, the plaintiffs seek an inference that they were not independent in fact.

Chancellor Allen addressed the duties of directors under comparable circumstances in *Mendel v. Carroll*, 651 A.3d 297 (Del. Ch. 1994). The case arose out of a proposal by members of the Carroll family, who were the controlling stockholders of Katy Industries, Inc. ("Katy"), to acquire all of Katy's unaffiliated shares for $22 each. The family informed the board that they only were interested in buying and had no interest in selling any of their shares. The board appointed a special committee, which negotiated with the family and eventually agreed to a transaction at $25.75 per share.

After the special committee had reached its deal with the Carroll family, an acquisition vehicle sponsored by Pensler Capital Corporation proposed to purchase all of Katy's outstanding shares for at least $29 per share. The higher price led the special committee to determine that it could no longer endorse the merger with the Carroll family. After changing its investment partner, Pensler reduced its offer to $28, then to $27.80.

With the special committee having withdrawn its recommendation, the Carroll family exercised its right to terminate its merger agreement with Katy. Over the Carroll family's objection, the board authorized the special committee to negotiate with Pensler. To get around the Carroll family's refusal to sell, Pensler proposed that Katy issue it an

option to purchase a number of Katy shares at the transaction price which, if exercised, would be sufficient to dilute the Carroll family's ownership to approximately 40%. Not surprisingly, the Carroll family strongly objected to that course of action, contending that it would constitute a breach of fiduciary duty. The special committee was willing to pursue the idea, as long as Delaware counsel could opine that the option was legal. When the committee's Delaware counsel could not render a definitive opinion, the Pensler deal fell apart, and the committee discontinued the negotiations. The board resolved instead to declare a special dividend of $14 per share.

A stockholder plaintiff sought a mandatory injunction requiring the Katy board to issue the dilutive option to facilitate the Pensler transaction. Citing *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), the plaintiff argued that the board had breached its fiduciary duties by not issuing the dilutive option because the Pensler deal constituted the best transaction reasonably available for the minority stockholders. Chancellor Allen held that *Revlon* did not apply, but he agreed that the "obligation the board faces is rather similar" to "the obligation that the board assumes when it bears what have been called 'Revlon duties.'" *Mendel*, 651 A.3d at 306. This was because

> *if* the board were to approve a proposed cash-out merger, it would have to bear in mind that the transaction is a final-stage transaction for the public shareholders. Thus, the time frame for analysis, insofar as those shareholders are concerned, is immediate value maximization. The directors are obliged in such a situation to try, within their fiduciary obligation, to maximize the current value of the minority shares.

Id. (emphasis in original).

The critical issues were how far directors could go "within their fiduciary obligation" to maximize the value of the minority shares and whether their powers included the ability to facilitate a third-party transaction by diluting an existing control block. Chancellor Allen did not rule out the power of a board to dilute a majority holder. As he had in three prior decisions, Chancellor Allen explained that incumbent directors could not dilute an existing block of stock for the purpose of maintaining their control, but they could permissibly dilute a dominant block if the directors acted "in good faith and on the reasonable belief that a controlling shareholder is abusing its power and is exploiting or threatening to exploit the vulnerability of minority shareholders."[10] Under this rubric, if the Carroll family's refusal to sell their shares could be considered an abuse of power or exploitation of the minority, then Katy's board could have authorized the dilutive option and a court would have the ability, on an appropriate factual record, to issue mandatory injunctive relief.

Chancellor Allen concluded that the Carroll family's proposal and its refusal to support the Pensler offer did not present the type of "threat of exploitation or even unfairness towards a vulnerable minority that might arguably justify discrimination against a controlling block." *Mendel*, 651 A.2d at 304. He began by explaining why the

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[10] *Id.* at 304. The earlier cases in which Chancellor Allen had expressed similar views were *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 662 n.5 (Del. Ch. 1988), *Freedman v. Rest. Assocs. Indus., Inc.*, 1987 WL 14323, at *8 (Del. Ch. Oct. 16, 1987); and *Philips v. Insituform of N. Am., Inc.*, 1987 WL 16285, at *8 (Del. Ch. Aug. 27, 1987). Chancellor Allen drew support for the underlying premise that a board could deploy corporate power to address a threat posed by an existing stockholder from *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

two offers were not directly comparable, such that the Carroll family's refusal to support the numerically higher Pensler offer could not by itself give rise to an inference of exploitation or unfairness:

> Plaintiffs see in the Carroll Group's unwillingness to sell at $27.80 or to buy at that price, a denial of plaintiffs' ability to realize such a price, and see this as exploitation or breach of duty. This view implicitly regards the $27.80 per share price and the Carroll Family Merger price of $25.75 as comparable sorts of things. But they are legally and financially quite different. *It is, for example, quite possible that the Carroll $25.75 price may have been fair, even generous, while the $27.80 Pensler price may be inadequate.* If one understands why this is so, one will understand one reason why the injunction now sought cannot be granted.
>
> The fundamental difference between these two possible transactions arises from the fact that the Carroll Family already in fact had a committed block of controlling stock. Financial markets in widely traded corporate stock accord a premium to a block of stock that can assure corporate control. Analysts differ as to the source of any such premium but not on its existence. Optimists see the control premium as a reflection of the efficiency enhancing changes that the buyer of control is planning on making to the organization. Others tend to see it, at least sometimes, as the price that a prospective wrongdoer is willing to pay in order to put himself in the position to exploit vulnerable others, or simply as a function of a downward sloping demand curve demonstrating investors' heterogeneous beliefs about the subject stock's value. In all events, it is widely understood that buyers of corporate control will be required to pay a premium above the market price for the company's traded securities.
>
> The law has acknowledged, albeit in a guarded and complex way, the legitimacy of the acceptance by controlling shareholders of a control premium.
>
> The significant fact is that in the Carroll Family Merger, the buyers were not buying corporate control. With either 48% or 52% of the outstanding stock they already had it. Therefore, in evaluating the fairness of the Carroll proposal, the Special Committee and its financial advisors were in a distinctly different position than would be a seller in a transaction in which corporate control was to pass.
>
> The Pensler offer, of course, was fundamentally different. It was an offer, in effect, to the controlling shareholder to purchase corporate control, and

> to all public shareholders, to purchase the remaining part of the company's shares, all at a single price. It distributed the control premium evenly over all shares. Because the Pensler proposed $27.80 price was a price that contemplated not simply the purchase of non-controlling stock, as did the Carroll Family Merger, but complete control over the corporation, it was not fairly comparable to the per-share price proposed by the Carroll Group.

Id. at 304–05 (citations omitted).

The fact that the offers were fundamentally different, however, did not end the analysis. As Chancellor Allen explained, "[t]o note that these proposals are fundamentally different does not, of course, mean that the board owes fiduciary duties in one instance but not the other." *Id.* at 305. Instead, the directors were "obligated to take note of the circumstance that the proposal was being advanced by a group of shareholders that constituted approximately 50% of all share ownership," and that in that circumstance, "the board's duty was to respect the rights of the Carroll Family, while assuring that if any transaction of the type proposed was to be accomplished, it would be accomplished only on terms that were fair to the public stockholders and represented the best available terms from their point of view." *Id.* The rights of the Carroll family included the right not to have to sell their shares.[11]

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[11] *Mendel*, 651 A.2d at 306 ("No part of their fiduciary duty as controlling shareholders requires them to sell their interest."); *accord Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 844–45 (Del. 1987); *MFW*, 67 A.3d at 508; *see Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 598 (Del. Ch. 1986) (Allen, C.) ("While the law requires that corporate fiduciaries observe high standards of fidelity and, when self-dealing is involved, places upon them the burden of demonstrating the intrinsic fairness of transactions they authorize, the law does not require more than fairness. Specifically, it does not, absent a showing of culpability, require that directors or controlling shareholders sacrifice their own financial interest in the enterprise for the sake of the corporation or its minority shareholders."); *see also In re Trans World Airlines, Inc. S'holders Litig.*, 1988 WL 111271, at *8 (Del. Ch. Oct. 21, 1988) ("[A] controlling shareholder who bears fiduciary obligations . . . also has rights that may not be ignored . . . includ[ing] a right to

> The board's fiduciary obligation to the corporation and its shareholders, in this setting, requires it to be a protective guardian of the rightful interest of the public shareholders. But while that obligation may authorize the board to take extraordinary steps to protect the minority from plain overreaching, it does not authorize the board to deploy corporate power *against* the majority stockholders, in the absence of a threatened serious breach of fiduciary duty by the controlling stock.

Mendel, 651 A.2d at 306. Chancellor Allen found no indication that the $25.75 price that the Carroll family proposed to pay was an inadequate or unfair price for the non-controlling stock, or that the Carroll family had abused its control by proposing the transaction or refusing to sell.

Applied to this case, *Mendel*'s teachings defeat any reasonably conceivable inference of bad faith. Like the Carroll family in *Mendel*, the Anderson Family did not breach its duties by refusing to sell its shares to Party Y. Also like the Carroll family, the Anderson Family did not breach any duty to the corporation or its minority, nor did it overreach or threaten exploitation, by proposing a going-private transaction at a substantial premium to the market price. Since *Mendel*, the Delaware Supreme Court has approved the *M&F Worldwide* framework as a means of implementing a non-coercive, arms' length process for negotiating a squeeze-out. The Anderson Family followed the *M&F Worldwide* framework and conditioned its proposal on both an affirmative recommendation by an independent committee and the affirmative vote of a majority of the Company's unaffiliated shares. The Anderson Family thus ensured up front that the

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effectuate a [squeeze-out] so long as the terms are intrinsically fair to the minority considering all relevant circumstances . . . .").

Company's minority stockholders would be able to determine for themselves whether to accept any offer that the committee recommended. Having followed *M&F Worldwide*, the members of the Anderson Family have an even stronger argument than the Carroll family that they did not overreach or exploit the minority by making their proposal.

Under the rule of law articulated in *Mendel*, the Committee could not have acted loyally by deploying corporate power *against* the Anderson Family to facilitate a third-party deal. The Committee could explore third-party offers to test whether the members of the Anderson Family would stick to their buyer-only stance when presented with an opportunity to sell. The Committee also could use a third-party offer to assess the value of the Company and determine whether the Anderson Family's bid was so low as to warrant rejecting it outright without presenting it to the minority. This is what the Committee did. Rather than supporting an inference of bad faith, the Committee's actions support an inference of good faith.

To defeat the logic of *Mendel*, the plaintiffs have argued that it cannot be assumed that Party Y's offer incorporated a control premium and that the Proxy Statement does not support such an inference. To the contrary Delaware law recognizes that third party offers typically include a control premium[12] and that that minority shares conversely

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[12] *See, e.g., Paramount Commc'ns Inc. v. QVC Network, Inc.*, 637 A.2d 34, 43 (Del. 1994) ("The acquisition of majority status and the consequent privilege of exerting the powers of majority ownership come at a price. That price is usually a control premium . . . ."); *Cheff v. Mathes*, 199 A.2d 548, 555 (Del. 1964) ("[I]t is elementary that a holder of a substantial number of shares would expect to receive the control premium as part of his selling price . . . ."); *In re Marriott Hotel Props. II Ltd. P'ship Unitholders Litig.*, 1996 WL 342040, at *4 (Del. Ch. June

trade at a discount when a dominant or controlling stockholder is present.[13] Scholars have documented the same propositions[14] with the premiums and discounts varying across

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12, 1996) ("[T]he right to direct the management of the firm's assets . . . gives rise to the phenomena of control premia.").

[13] *See, e.g.*, *ONTI, Inc. v. Integra Bank*, 751 A.2d 904, 912 (Del. Ch. 1999) ("[B]ecause the market ascribed a control premium to the publicly-held majority ownership, it similarly ascribed a minority share discount to the publicly-traded shares . . . ."); *Robotti & Co., LLC v. Gulfport Energy Co.*, 2007 WL 2019796, at *2 (Del. Ch. July 3, 2007) ("References to trading price may not be especially useful . . . in this instance, because the trading . . . was limited and [the company] had a control shareholder."); *Andaloro v. PFPC Worldwide, Inc.*, 2005 WL 2045640, at *8 (Del. Ch. Aug. 19, 2005) (Strine, V.C.) (pointing out that in the appraisal context, "the fair value standard itself is, in many respects, a pro-petitioner standard that takes into account that many transactions giving rise to appraisal involve mergers effected by controlling stockholders. The elimination of minority discounts, for example, represents a deviation from the fair market value of minority shares as a real world matter in order to give the minority a pro rata share of the entire firm's value—their proportionate share of the company valued as a going concern."); *Klang v. Smith's Food & Drug Ctrs., Inc.*, 1997 WL 257463, at *11 (Del. Ch. May 13, 1997) (recognizing that "factors that tend to minimize or discount [a] premium [include] the fact that the . . . stock price contain[s] a minority trading discount as a result of [a party's] control" of a company); *MacLane Gas Co. Ltd., Partnership v. Enserch Corp.*, 1992 368614, at *9 (Del. Ch. Dec. 9, 1992) (finding that the "the stock price . . . was not a reliable indication of the value of the [shares of the company at issue because] . . . the trading price contained an implicit minority discount as a result of [the defendant's] control over [the company]"); *see also Goemaat v. Goemaat*, 1993 WL 339306, at *6 (Del. Fam. May 19, 1993) (applying a minority discount to wife's 11% ownership in a private family business in a divorce proceeding because wife's sister controlled and owned 60% of the business).

[14] *Compare* John C. Coates IV, *"Fair Value" As an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions*, 147 U. PA. L. REV. 1251, 1273–74 (1999) ("Whether measured against very small blocks that trade on the public stock markets daily or against larger but noncontrol share blocks, control shares command premium prices."), *with* James H. Eggart, *Replacing the Sword with A Scalpel: The Case for A Bright-Line Rule Disallowing the Application of Lack of Marketability Discounts in Shareholder Oppression Cases*, 44 ARIZ. L. REV. 213, 220 (2002) ("A minority discount accounts for the fact that a minority interest, because it lacks the power to dictate corporate management and policies, is worth less to third-party purchasers than a controlling interest."). *See also* Matthew D. Cain, Jill E. Fisch, Sean J. Griffith & Steven Davidoff Solomon, *How Corporate Governance is Made: The Case of the Golden Leash*, 164 U. PA. L. REV. 649, 657 (2016) ("[P]ublically traded shares of firms with a controlling shareholder trade at a so-called 'minority discount.' Because minority shares in a controlled corporation lack the ability to influence the management of the firm, they trade at a discount relative to other shares.") (citations omitted); Ronald J. Gilson & Jeffrey N.

legal systems depending on the extent of the protections that a particular legal system provides to minority stockholders.[15]

On the facts alleged, one can reasonably infer that Party Y's offer was higher because Party Y was seeking to acquire control and that the Anderson Family's offer was lower because it took into account the family's existing control over the Company. It is not possible to infer the exact amount of the premium or discount, because although it is reasonable to regard Party Y's offer as an arms' length price for the Company as a whole, the premium that the Anderson Family offered over the market price may have included some sharing of the value otherwise attributable to the Anderson Family's block. Using the two offers as guideposts, Party Y's offer of $4.21 per share for the whole company represented a premium of $0.96 per share, or approximate 30%, over the Anderson Family's offer of $3.25 per share for the minority. Put another way, the Anderson Family's offer of $3.25 per share for the minority shares contemplated a discount of

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Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 787 (2003) ("[T]he controlling shareholder secures value from its control position that is not received by the non-controlling shareholders. In turn, the controlling shareholder can extract the same value from control by selling it at a premium to the value of the non-controlling shares.").

[15] *See,* e.g., Alexander Dyck & Luigi Zingales, *Control Premiums and the Effectiveness of Corporate Governance Systems*, 16 J. APPLIED CORP. FIN. 51 (2004); Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison* (Nat'l Bureau of Econ. Research, Working Paper No. 8711, 2002). Rafael La Porta, *et al.*, *Investor Protection and Corporate Governance* 14 & n.4 (July 27, 2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=183908; Luigi Zingales, *The Value of the Voting Right: A Study of the Milan Stock Exchange Experience*, 7 REV. FIN. STUD. (1994); Michael J. Barclay & Clifford G. Holderness, *Private Benefits from Control of Public Corporations*, 25 J. FIN. ECON. 371 (1989). Other factors can affect control premiums, including "an independent and widely circulating press, high rates of tax compliance, and a high degree of product market competition." Dyck & Zingales, *Control Premiums*, *supra*, at 53.

approximately 23% from the $4.21 that Party Y, a third-party purchaser, would pay for the Company as a whole.

If the independent directors facilitated a grossly inadequate offer, then it might be possible to infer that they acted in bad faith. If the amount of the minority discount was extreme, then one might infer that the independent directors sought to serve the interests of the controller, confident that stockholders focused on short-term gains would approve any transaction at a premium to market. This is not such a case, because the bargained-for consideration falls within a rational range of discounts and premiums.[16] In other words, the difference is not so facially large as to suggest that the Committee was attempting to

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[16] *See, e.g., Wilmington Sav. Fund Soc'y, FSB v. Foresight Energy LLC*, 2015 WL 7889552, at *9 n.3 (Del. Ch. Dec. 4, 2015) ("[A] number of studies have found that control premia in mergers and acquisitions typically range between 30% and 50%.") (citing FACTSET MERGERSTAT, CONTROL PREMIUM STUDY 1ST QUARTER 2012, at 2 (2012); Jens Kengelbach & Alexander Roos, The Boston Consulting Group, *Riding the Next Wave in M & A: Where Are the Opportunities to Create Value?* 10 (2011)); *In re Southern Peru Copper Corp. S'holder Deriv. Litig.*, 52 A.3d 761, 819 (Del. Ch. 2011) (applying a "conservative" control premium of 23.4%, which was the "median premium for merger transactions in 2004 calculated by Mergerstat"); *Prescott Gp. Small Cap, L.P. v. Coleman Co.*, 2004 WL 2059515, at *13 n.77, *28 (Del. Ch. Sept. 8, 2004) (accepting as "consistent with Delaware law" a control premium valuation range of "30 to 40 percent"); *Agranoff v. Miller*, 791 A.2d 880, 900 (Del. Ch. 2001) (applying a 30% discount to a comparable companies analysis to adjust for an implicit minority discount, noting that the discount in the relevant market sector "tended to be lower on average than that for the entire marketplace"); *Kleinwort Benson Ltd. v. Silgan Corp.*, 1995 WL 376911, at *5 (Del.Ch. June 15, 1995) (citing available premium data ranging from 34%–48%); *see also* Coates, *supra* note 13, at 1274 n.72 (citing data for the period from 1981 through 1994, indicating that "prices paid in acquisitions by negotiated purchase or tender offer of control shares in public companies exceeded the market prices for the targets' outstanding stock by an average of approximately 38%" and that during the same period, "average prices paid in the same types of acquisitions of large (>10%) but noncontrolling blocks of shares in public companies also exceeded market prices for the targets' outstanding stock, but premiums for these noncontrol share blocks averaged only 34.5%"); Gary Fodor & Edward Mazza, *Business Valuation Fundamentals for Planners*, 5 J. FIN. PLAN. 170, 177 (1992) (stating that control premiums paid for public companies averaged 30% to 40% from the late 1960s to the late 1980s).

facilitate a sweetheart deal for the Anderson Family. The Committee instead was entitled to consider the fact that the minority stockholders would be able to determine for themselves whether to accept the Anderson Family's offer. When deciding on a course of action, a board can "take into account that its stockholders would have a fair chance to evaluate the board's decision for themselves." *C&J Energy Servs., Inc. v. City of Miami Gen. Empls.' Ret. Tr.*, 107 A.3d 1049, 1070 (Del. 2014).

Appraisal acts as a further check on expropriation by the Anderson Family, because when valuing the BAM shares in an appraisal proceeding, a court would exclude any minority discount.[17] That is why the Anderson Family insisted on an appraisal condition and why the deal almost broke down over that issue. The Committee rationally could have believed that if stockholders felt aggrieved over a price that implied a minority discount, they could protect themselves by pursuing appraisal, and that if enough stockholders exercised their appraisal rights, then the Anderson Family might rely on the appraisal condition to back out of the deal. A minority of the minority thus had the ability to influence the outcome of the transaction, although they lacked an explicit veto right.

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[17] *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1145 (Del. 1989) ("The application of a discount to a minority shareholder is contrary to the requirement that the company be viewed as a 'going concern.'"); *see Paskill Corp. v. Alcoma Corp.*, 747 A.2d 549, 557 (Del. 2000) ("[T]here can be no discounting at the shareholder level."); *Rapid-Am. Corp. v. Harris*, 603 A.2d 796, 804 (Del. 1992) ("[A] court cannot adjust its valuation to reflect a shareholder's individual interest in the enterprise."). *See generally* Jesse A. Finkelstein & John D. Hendershot, *Appraisal Rights in Mergers & Consolidations*, 38–5th C.P.S. § V(I), at A-65 (BNA) ("Delaware law precludes the application of a minority discount in an appraisal proceeding at the stockholder level.").

There are other indications in the record that foreclose an inference of bad faith on the part of the independent directors. To draw that inference, it would be necessary to believe that the only rational course of action for the Committee was to reject the Anderson Family's offer and not allow it to be presented to the stockholders. But the $3.25 per share that was offered by the Anderson Family was 93% higher than the trading price the day before the Anderson Family first proposed a merger, 23% higher than the trading price the day before the Merger was announced, and 20% higher than the Anderson Family's initial offer of $2.75, which the Committee rejected. The Committee rationally could believe that stockholders might prefer liquidity at a premium to market. In addition to explaining this rationale, the Proxy Statement identifies nine other bulleted reasons, some with sub-bullets, why the Committee viewed the Merger favorably and recommended it to the stockholders.

The allegations of the Complaint thus do not support a reasonable inference that the Committee acted in bad faith. Nor does the Complaint offer any other reason to infer that the members of the Committee were not disinterested or independent. The second element of the *M&F Worldwide* framework is met.

C. The Committee's Authority

The third requirement under *M&F Worldwide* is that "the Special Committee is empowered to freely select its own advisors and to say no definitively." 88 A.3d at 645. The plaintiffs do not contest this requirement. The Proxy Statement describes the resolutions that granted the Committee the power to hire its own legal and financial advisors, and the Committee exercised that authority by hiring King & Spalding, Morris

Nichols, and Houlihan Lokey. The Proxy Statement's description of the resolutions also makes clear that the Board committed not to proceed with a transaction without a favorable recommendation from the Committee. The third element of the *M&F Worldwide* framework is met.

D. The Duty Of Care

The fourth requirement under *M&F Worldwide* is that "[t]he Special Committee meets its duty of care in negotiating a fair price." 88 A.3d at 645. The standard of conduct for the duty of care requires that directors "inform themselves, prior to making a business decision, of all material information reasonably available to them." *Aronson*, 473 A.2d at 812. For purposes of applying the *M&F Worldwide* framework on a motion to dismiss, the standard of review for measuring compliance with the duty of care is whether the complaint has alleged facts supporting a reasonably conceivable inference that the directors were grossly negligent.

The special committee in *MFW* met a total of eight times. It interviewed multiple financial advisors before selecting a firm. It obtained up-to-date projections from company management, then had its financial advisor prepare detailed financial analyses. The committee did not seek third-party offers, but it had its financial advisor assess the possibilities. The committee negotiated with the controller and achieved an increase in the price from $24 per share to $25 per share. 67 A.3d at 515. The court observed that in attacking the committee's process,

> the plaintiffs make a number of arguments in which they question the business judgment of the special committee, in terms of issues such as whether the special committee could have extracted another higher bid

> from MacAndrews & Forbes if it had said no to the $25 per share offer, and whether the special committee was too conservative in valuing MFW's future prospects. These are the sorts of questions that can be asked about any business negotiation, and that are, of course, the core of an appraisal proceeding and relevant when a court has to make a determination itself about the financial fairness of a merger transaction under the entire fairness standard.

Id. at 516. The court rejected these arguments as bases for questioning whether the directors complied with their duty of care, holding that "[t]he record is clear that the special committee met frequently and was presented with a rich body of financial information relevant to whether and at what price a going private transaction was advisable." *Id.*

The Committee in this case met thirty-three times, negotiated with the Anderson Family for over five months, sought alternative buyers for the whole company, considered alternative transaction structures, rejected the Anderson Family's initial offer, submitted two counteroffers, negotiated over non-economic terms, and obtained a sale price 20% higher than the Anderson Family's initial offer. The resulting sale price was more than 90% above BAM's closing price on the day before the Anderson Family announced its bid. These facts do not support a reasonable inference that the Committee was grossly negligent.

Once again, the plaintiffs focus on Party Y's offer as the linchpin of their argument, suggesting that that the Committee was grossly negligent in accepting the Anderson Family's offer when a higher offer was available. For reasons that this decision already has discussed, the Committee could not force the Anderson Family to accept Party Y's offer, nor was it in a position to take action against the Anderson Family to

facilitate Party Y's offer. Given those constraints, some might say that exploring potential third-party actions was a vain act. In my view, however, the Committee's decision to do so definitively undercuts any possible inference of gross negligence. Rather than only negotiating with the Anderson Family or relying exclusively on the advice from Houlihan Lokey, the Committee sought additional information in the form of third-party expressions of interest. "A decent respect for reality forces one to admit that [a financial advisor's opinion] is frequently a pale substitute for the dependable information that a canvas of the relevant market can provide." *In re Amsted Indus. Inc. Litig.*, 1988 WL 92736, at *7 (Del. Ch. Aug. 24, 1988) (Allen, C.), *aff'd sub nom. Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279 (Del. 1989).

A committee can satisfy its duty of care by negotiating diligently with the assistance of advisors. *See MFW*, 67 A.3d at 514–16. A committee goes one better when it takes the additional step of gathering additional information through a market canvass. Doing so in this case allowed the Committee to test the Anderson Family's conviction about not being a seller. Having the offer in hand also helped the Committee negotiate, because the offer would be a data point in any post-closing appraisal action, giving the Anderson Family a reason to bump their offer to decrease the risk that dissenting stockholders would seek appraisal.

As in *MFW*, the plaintiffs advance other arguments. They erroneously contend that because BAM owned approximately $20 million in equity in its properties, the Anderson Family only paid $600,000 for the rest of the business. That is incorrect. The Anderson Family owned 57.6% of the Company, and the $21 million Merger value was only for the

shares that the Anderson Family did not already own. The plaintiffs also argue about inputs in Houlihan Lokey's valuation analysis. Neither supports an inference of gross negligence.

E. The Information Provided To The Minority Stockholders

The fifth requirement of *M&F Worldwide* is that "the vote of the minority is informed." 88 A.3d at 645. The plaintiffs have never asserted any disclosure claims.

F. The Absence Of Any Coercion

The sixth and final requirement of *M&F Worldwide* is that "there is no coercion of the minority." 88 A.3d at 645. The plaintiffs do not argue that there was.

G. The Operation Of The Business Judgment Rule

Once the elements of *M&F Worldwide* are met, the business judgment rule provides the operative standard of review. "Under that rule, the court is precluded from inquiring into the substantive fairness of the merger, and must dismiss the challenge to the merger unless the merger's terms were so disparate that no rational person acting in good faith could have thought the merger was fair to the minority." *MFW*, 67 A.3d 496 at 500. "[It is] logically difficult to conceptualize how a plaintiff can ultimately prove a waste or gift claim in the face of a decision by fully informed, uncoerced, independent stockholders to ratify the transaction." *Huizenga*, 751 A.2d at 901. By definition, at that point, rational people who were members of the minority thought the merger was fair.

In *M&F Worldwide*, Chief Justice Strine, then Chancellor, held that the evidence presented failed to "raise a triable issue of fact under the business judgment rule" where "[t]he merger was effected at a 47% premium[,] . . . [a] financial advisor for the special

committee found that the price was fair in light of various analyses," and "[a]fter disclosure of the material facts, 65% of the minority stockholders decided for themselves that the price was favorable." *MFW*, 67 A.3d at 519. In this case, the Merger provided the minority stockholders with a 90% premium, Houlihan Lokey opined that it was fair, and after disclosure of the material facts, 66.3% of the minority stockholders approved it.

It is not possible to infer that no rational person acting in good faith could have thought the Merger was fair to the minority. The only possible inference is that many rational people, including the members of the Committee and numerous minority stockholders, thought the Merger was fair to the minority.

III. CONCLUSION

The Merger satisfied the *M&F Worldwide* framework. The Complaint is dismissed with prejudice.

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

MICHAEL REITER, Derivatively on Behalf of CAPITAL ONE FINANCIAL CORPORATION,	)	
Plaintiff,	)	
v.	)	C.A. No. 11693-CB
RICHARD D. FAIRBANK, PATRICK W. GROSS, LEWIS HAY, III, MAYO A. SHATTUCK III, ANN FRITZ HACKETT, PIERRE E. LEROY, BRADFORD H. WARNER, PETER E. RASKIND, BENJAMIN P. JENKINS, III, and CATHERINE G. WEST,	)	
Defendants,	)	
and	)	
CAPITAL ONE FINANCIAL CORPORATION, a Delaware corporation,	)	
Nominal Defendant.	)	

MEMORANDUM OPINION

Date Submitted: July 22, 2016
Date Decided: October 18, 2016

Blake A. Bennett, COOCH AND TAYLOR, P.A., Wilmington, Delaware; Brian J. Robbins, George C. Aguilar and Jay N. Razzouk, ROBBINS ARROYO LLP, San Diego, California, *Attorneys for Plaintiff*.

S. Mark Hurd, Richard Li and Dean J. Shauger, MORRIS, NICHOLS, ARSHT & TUNNELL LLP, Wilmington, Delaware; Maeve L. O'Connor, DEBEVOISE & PLIMPTON LLP, New York, New York; Jonathan R. Tuttle and Anna A. Moody, DEBEVOISE & PLIMPTON LLP, Washington, District of Columbia, *Attorneys for Defendants and Nominal Defendant*.

BOUCHARD, C.

In this derivative action, a stockholder of Capital One Financial Corporation asserts that its directors breached their fiduciary duty of loyalty and unjustly enriched themselves by consciously disregarding their responsibility to oversee Capital One's compliance with the Bank Secrecy Act and other anti-money laundering laws ("BSA/AML"). Plaintiff's central allegation is that the directors ignored red flags that Capital One's BSA/AML compliance program failed to satisfy statutory requirements relating to services Capital One provided to clients engaged in check cashing, a business that poses an inherent risk for money laundering.

Before filing this action, plaintiff prudently sought and obtained books and records from Capital One under 8 *Del. C.* § 220. Those documents, which are incorporated into the complaint, show that the board's Audit and Risk Committee and its successor committees received at least twenty-five reports over a three-and-a-half-year period explaining the company's BSA/AML compliance risk, which escalated from "low" in early 2011 to "high" in early 2013, where it remained in 2014. Significantly, those same reports explained to the directors in meaningful detail on a regular basis the initiatives management was taking to ameliorate Capital One's BSA/AML compliance risk, including management's decision in early 2014 to exit the check cashing business altogether, and none of those reports reflected that the Company's BSA/AML controls and procedures had been found

to violate statutory requirements or that anyone within Capital One had engaged in fraudulent or illegal conduct.

Defendants have moved to dismiss the complaint under Court of Chancery Rule 12(b)(6) for failure to state a claim for relief, and under Rule 23.1 for failure to make a demand on the board before filing suit. As to the latter issue, plaintiff contends that demand would have been futile because all ten members of Capital One's board when suit was filed, including nine outside directors whose independence is unquestioned, face a substantial likelihood of personal liability for the underlying claims.

The standard under Delaware law for imposing oversight liability on a director is an exacting one that requires evidence of bad faith, meaning that "the directors knew that they were not discharging their fiduciary obligations."[1] For the reasons explained below, I conclude after carefully reviewing the allegations of the complaint and the documents incorporated therein, that plaintiff has failed to allege facts from which it reasonably may be inferred that the defendants consciously allowed Capital One to violate BSA/AML statutory requirements so as to demonstrate that they acted in bad faith. Plaintiff thus has failed to plead with particularity that a majority of Capital One's directors face a substantial likelihood

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[1] *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

of liability for the claims asserted in this case. Accordingly, demand would not have been futile and the complaint will be dismissed with prejudice.

I. BACKGROUND

Unless noted otherwise, the facts recited in this opinion are based on the allegations in the Verified Stockholder Derivative Complaint (the "Complaint") and the documents incorporated therein.[2]

A. The Parties

Capital One Financial Corporation ("Capital One" or the "Company") is a Delaware corporation headquartered in Virginia. It offers a broad spectrum of financial products and services through its banking and non-banking subsidiaries.

The defendants were the ten members of Capital One's board of directors when plaintiff filed this action: Richard D. Fairbank, Patrick W. Gross, Lewis Hay, III, Mayo A. Shattuck III, Ann Fritz Hackett, Pierre E. Leroy, Bradford H. Warner, Peter E. Raskind, Benjamin P. Jenkins, III, and Catherine G. West. Fairbank, the President and Chief Executive Officer of Capital One, was the only employee director on the board.

In May 2013, the Audit and Risk Committee of Capital One's board of directors was split into two separate committees: the Risk Committee and the

[2] I consider these documents in accordance with the incorporation-by-reference doctrine discussed below. *See* Part II.A.1.

Audit Committee. All defendants except Fairbank served on Capital One's Audit and Risk Committee or at least one of its two successor committees at some point between June 2011 and January 2015, the time period relevant to this case.[3]

Plaintiff Michael Reiter alleges he was a stockholder of Capital One at the time of the "wrongdoing complained of" and has been a stockholder continuously since then.[4]

B. Capital One Begins Servicing Check Cashing Businesses

In December 2006, Capital One acquired North Fork Bancorporation, Inc. and began providing banking services to check cashing and related money services businesses in New York and New Jersey. The year before the acquisition, North Fork entered into a memorandum of understanding with the Federal Deposit Insurance Corporation and the New York State Banking Department concerning weaknesses in North Fork's program to comply with anti-money laundering laws and the Bank Secrecy Act of 1970. As a result of the acquisition, Capital One assumed North Fork's obligations under the memorandum of understanding.

According to a 2014 report, Capital One considered exiting the business of serving check cashers after the North Fork acquisition, but the New York State Department of Financial Services encouraged the Company "to keep the business

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[3] *Compl.* ¶¶ 12-21.

[4] *Id.* ¶ 10.

to serve the unbanked and underbanked."[5] Capital One continued to serve check cashing businesses in the decade following its acquisition of North Fork.

C. Regulatory Scrutiny of Check Cashing Businesses

Check cashing businesses are a significant focus of anti-money laundering laws and regulations ("AML"), including the Bank Secrecy Act of 1970 ("BSA") (together, as defined above, the "BSA/AML").

The Bank Secrecy Act of 1970,[6] as amended, requires financial institutions in the United States to assist government agencies to detect and prevent money laundering activities. It "establishes program, recordkeeping, and reporting requirements for national banks, federal savings associations, federal branches, and agencies of foreign banks."[7] The implementing regulations of the BSA impose various requirements on financial institutions, including:

- Maintaining a system of internal controls to ensure ongoing BSA/AML compliance and independent testing for compliance;
- Designating an individual responsible for coordinating and monitoring day-to-day compliance;
- Providing training for appropriate personnel;

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[5] *Id.* ¶ 46 (quoting Capital One's Commercial Banking: Compliance and Reputation Risk Management report to the Risk Committee, dated June 11, 2014).

[6] 31 U.S.C. 5311 *et seq*.

[7] Compl. ¶ 33.

- Filing Suspicious Activity Reports ("SARs") when certain suspected violations of federal law or regulation are detected; and
- Implementing a written Customer Identification Program appropriate for the bank's size and risk profile.

In 2005, six regulatory agencies issued the Interagency Interpretive Guidance on Providing Banking Services to Money Services Businesses Operating in the United States setting forth guidelines for financial institutions, such as Capital One, to incorporate into their BSA/AML programs. Those guidelines include certain minimum internal policies, procedures, and controls relating to providing banking services to check cashing businesses. In 2010, regulators jointly released guidance concerning BSA/AML compliance stating that:

> The cornerstone of a strong Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance program is the adoption and implementation of internal controls . . . . The requirement that a financial institution know its customers, and the risks presented by its customers, is basic and fundamental to the development and implementation of an effective BSA/AML compliance program.[8]

According to the Complaint, to comply with United States anti-money laundering laws and regulations, Capital One's BSA/AML program must include standards and guidelines, approved by the board, regarding "whether to close a suspicious account and when to report suspicious activity, or activity known by the

[8] *Id.* ¶ 49.

Company to be under investigation or in violation of the U.S. anti-money laundering regime, via SARs."[9] The Complaint further alleges that Capital One must establish an internal control system that ensures the board "is informed of compliance deficiencies, BSA/AML program deficiencies, corrective action taken, and SARs filed related to all of the foregoing."[10]

As new BSA/AML regulations and guidance have been issued, regulators have stepped up their enforcement efforts. In 2005, the Financial Crimes Enforcement Network ("FinCEN") fined ABN Amro $40 million "because ABN's New York branch failed to set up an adequate Bank Secrecy Act program, including an anti-money laundering system."[11] Several months later, FinCEN fined BankAtlantic $10 million for similar violations. In 2007, *The Wall Street Journal* reported that BSA/AML-related fines over the preceding two years totaled at least $87 million, compared to $1 million in 2001 and 2002.

D. Capital One's Directors Receive Regular Reports on the Company's BSA/AML Program

Providing commercial banking services to check cashing businesses, particularly in New York's urban area, presents an inherent risk for violating anti-money laundering laws and regulations. As stated in a June 2011 report to the

[9] *Id.* ¶ 42.

[10] *Id.*

[11] *Id.* ¶ 48.

Audit and Risk Committee, the Company's "Bank Segment . . . features high risk products and services, a large branch network located in high intensity drug trafficking and metropolitan areas, and a high risk customer base that includes most large New York check cashing businesses."[12]

Capital One's Audit and Risk Committee, and later its separate Audit Committee and Risk Committee, received regular reports from management regarding the Company's BSA/AML compliance program from June 2011 to January 2015, the time period relevant to this action.[13] The Complaint cites to and quotes extensively from at least twenty-five such reports, which include quarterly Enterprise State of Compliance reports,[14] Enterprise Risk Profile reports,[15] periodic Compliance Risk Updates,[16] and various other AML program assessments and updates.[17] The committee members also received updates on regulatory

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[12] *Id.* ¶ 51 (quoting Capital One's 1Q 2011 Enterprise State of Compliance report dated June 2011).

[13] *Id.* ¶ 95.

[14] *See id.* ¶¶ 51, 52, 55, 57, 61, 63, 68, 70, 77.

[15] *See id.* ¶¶ 62, 66, 71, 74, 76.

[16] *See id.* ¶¶ 53, 56.

[17] *E.g.*, Chief Risk Officer Report, *id.* ¶ 54; AML and OFAC Compliance Risk Assessment, *id.* ¶ 58; Anti-Money Laundering (AML) Assessment, *id.* ¶ 64; and Independent Compliance Transaction Testing Program Update, *id.*

movements and discussed BSA/AML compliance issues during their committee meetings.[18]

Capital One performed periodic internal audits of its risk compliance programs, the results of which were reported to the Audit and Risk Committee, and after May 2013, to the Audit Committee. In a July 2013 report to the Audit Committee, the internal auditors rated Capital One's AML program as "Needs Strengthening;"[19] in two later audits, covering the first and fourth quarters of 2014, the auditors rated the Company's AML program as "Inadequate."[20]

E. Capital One Becomes the Subject of Regulatory Investigations and Decides to Exit the Check Cashing Business

On December 3, 2013, Capital One received a grand jury subpoena from the New York District Attorney requesting information concerning the Company's AML controls and check cashing clients. It was reported to the Audit Committee the next month, on January 23, 2014, that "management has decided to exit the business of banking check cashers" in parallel with the "ongoing investigation into potential violations of anti-money laundering laws by several of the company's

[18] *See id.* ¶¶ 59, 60, 65, 67.

[19] *Id.* ¶ 67.

[20] *Id.* ¶¶ 73, 80.

commercial clients."[21] Later in 2014, Capital One received another four grand jury subpoenas from the New York District Attorney requesting additional information concerning the Company's AML controls and check cashing clients.[22]

On February 6, 2015, Capital One received a grand jury subpoena from the United States Department of Justice requesting, among other things, all documents previously produced in response to the New York District Attorney's subpoenas, Capital One's BSA/AML policies and procedures, related board and committee meeting minutes, compliance audits and testing reports, and details on specific customers and clients.[23]

On July 10, 2015, Capital One consented to the entry of an order issued by the Office of the Comptroller of Currency ("OCC") concerning the Company's BSA/AML controls (the "Consent Order").[24] In the Consent Order, the OCC found that Capital One had "failed to adopt and implement a compliance program that adequately covers the required BSA/AML program elements due to an

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[21] *Id.* ¶ 70 (quoting Capital One's Compliance Report for the Fourth Quarter of 2013 dated January 23, 2014).

[22] *Id.* ¶¶ 75, 79.

[23] *Id.* ¶ 81.

[24] *Id.* ¶ 8. The stipulation documenting Capital One's consent reflects that it did so "without admitting or denying any wrongdoing." Bennett Aff. Ex. 12 (Stipulation and Consent to the Issuance of a Consent Order) at 2.

inadequate system of internal controls and ineffective independent testing."[25] The OCC thus ordered Capital One to adopt a series of remedial actions. The OCC proceeding against Capital One has concluded, but the investigations of the New York District Attorney and the Department of Justice remain open, along with another investigation by the FinCEN. These investigations pertain to "certain check casher clients of the Commercial Banking business and Capital One's anti-money laundering ("AML") program."[26]

F. Procedural History

On November 10, 2015, after obtaining books and records from the Company under 8 *Del. C.* § 220, plaintiff filed the Complaint, which asserts two derivative claims on behalf of Capital One. Count I asserts an oversight claim for breach of the fiduciary duty of loyalty against all defendants. Count II asserts a claim of unjust enrichment against all defendants concerning their receipt of compensation and director remuneration.

On January 29, 2016, defendants filed a motion (1) to dismiss the Complaint under Court of Chancery Rule 23.1 for failure to make a pre-suit demand and under Court of Chancery Rule 12(b)(6) for failure to state a claim upon which

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[25] Compl. ¶ 83 (quoting Consent Order).

[26] *Id.* ¶ 85 (quoting the Company's Quarterly Report on Form 10-Q filed with the SEC on August 3, 2015).

relief can be granted, and (2) in the alternative, to stay the action pending the resolution of the ongoing regulatory investigations.

II. ANALYSIS

For the reasons explained below, I conclude that demand was not excused under Rule 23.1 for either of the claims asserted in the Complaint. Accordingly, I do not reach defendants' arguments under Rule 12(b)(6) or for a stay.

A. Legal Standards

1. Pleading Principles under Rule 23.1

Under Court of Chancery Rule 23.1, a plaintiff in a derivative action must "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort."[27] The rationale behind this rule is that "directors are entitled to a presumption that they were faithful to their fiduciary duties," and it is the plaintiff's burden to overcome that presumption in the context of a pre-suit demand.[28]

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[27] Ch. Ct. R. 23.1(a).

[28] *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048-49 (Del. 2004).

"On a motion to dismiss pursuant to Rule 23.1, the Court considers the same documents, similarly accepts well-pled allegations as true, and makes reasonable inferences in favor of the plaintiff—all as it does in considering a motion to dismiss under Rule 12(b)(6)."[29] Additionally, where a complaint quotes or characterizes some parts of a document but omits other parts of the same document, the Court may apply the incorporation-by-reference doctrine to guard against the cherry-picking of words in the document out of context.

Under the incorporation-by-reference doctrine, "[a] plaintiff may not reference certain documents outside the complaint and at the same time prevent the court from considering those documents' actual terms."[30] Vice Chancellor Laster recently provided the following helpful summary of the doctrine:

> The incorporation-by-reference doctrine permits a court to review the actual document to ensure that the plaintiff has not misrepresented its contents and that any inference the plaintiff seeks to have drawn is a reasonable one. The doctrine limits the ability of the plaintiff to take language out of context, because the defendants can point the court to the entire document. The doctrine also enables courts to dispose of meritless complaints at the pleading stage. Without the ability to consider the document at issue in its entirety, complaints that quoted only selected and misleading portions of such documents could not be dismissed under Rule 12(b)(6) even though they would be doomed to failure. With the incorporation-by-reference doctrine, a complaint may, despite allegations to the contrary, be dismissed where the

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[29] *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 976 (Del. Ch. 2003), *aff'd*, 845 A.2d 1040 (Del. 2004).

[30] *Winshall v. Viacom Int'l, Inc.*, 76 A.3d 808, 818 (Del. 2013).

> unambiguous language of documents upon which the claims are based contradict the complaint's allegations. Likewise, a claim may be dismissed if allegations in the complaint or in the exhibits incorporated into the complaint effectively negate the claim as a matter of law.[31]

The Complaint here extensively cites to and quotes from documents plaintiff obtained from the Company through a books and records inspection demand under 8 *Del. C.* § 220. Accordingly, I may apply the incorporation-by-reference doctrine with respect to the documents referenced in the Complaint in evaluating the sufficiency of the Complaint's allegations to demonstrate demand futility.

2. The Demand Futility Standard

Under Delaware law, the Court applies one of two tests to determine whether a plaintiff's demand upon the board would be futile. The first test, established in *Aronson v. Lewis*, applies when a plaintiff is challenging a decision of the board of directors.[32] The second test, established in *Rales v. Blasband*,[33] applies when the derivative action is based on a board's inaction or a violation of

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[31] *Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752, 797 (Del. Ch. 2016) (internal citations and quotations omitted).

[32] *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984), *overruled* on other grounds by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

[33] 634 A.2d 927 (Del. 1993).

the board's oversight duties.[34] Because plaintiff's claims in this action are predicated upon an alleged failure of the board to act, the *Rales* test applies.[35]

Under the *Rales* test, the Court "must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[36] A reasonable doubt as to the board's independence and disinterestedness exists when plaintiff's demand exposes a majority of the board of directors to "a substantial likelihood" of personal liability.[37] "[T]he mere threat of personal liability . . . is insufficient;"[38] rather, the complained-of conduct must "be 'so egregious on its face' that the board could not have exercised its

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[34] *See Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008) ("The [*Rales*] test applies where the subject of a derivative suit is not a business decision of the Board but rather a violation of the Board's oversight duties.").

[35] Whether the *Rales* test or the *Aronson* test applies ultimately makes no substantive difference in my view because "the *Rales* test, in reality, folds the two-pronged *Aronson* test into one broader examination." *See Teamsters Union 25 Health Servs. & Ins. Plan v. Baiera*, 119 A.3d 44, 67 n.131 (Del. Ch. 2015) (internal quotation omitted).

[36] *Rales*, 634 A.2d at 934.

[37] *Id.* at 936 (quoting *Aronson*, 473 A.2d at 815).

[38] *Aronson*, 473 A.2d at 815.

business judgment in responding to a stockholder demand to pursue those claims."[39] Courts assess demand futility on a claim-by-claim basis.[40]

B. Demand Is Not Excused for the *Caremark* Claim

In Count I of the Complaint, plaintiff asserts that defendants breached their fiduciary duty of loyalty as members of Capital One's board by "purposefully, knowingly, or recklessly causing or allowing the Company to violate the BSA/AML, as well as other applicable law."[41] Plaintiff further asserts that demand would be futile as to Count I because all ten defendants, including the nine outside directors whose independence is unquestioned, have a disqualifying interest in deciding whether the Company should pursue this claim because they each allegedly "face a substantial likelihood of liability for such breach."[42] This is a quintessential *Caremark* oversight claim.[43]

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[39] *Melbourne Municipal Firefighters' Pension Trust Fund v. Jacobs*, 2016 WL 4076369, at *6 (Del. Ch. Aug. 1, 2016) (citing *Aronson*, 473 A.2d at 815).

[40] *MCG Capital Corp. v. Maginn*, 2010 WL 1782271, at *18 (Del. Ch. May 5, 2010) ("Demand futility must be determined on a claim-by-claim basis.").

[41] Compl. ¶¶ 105-6. The Complaint does not allege that defendants breached their duty of care. The defendants would be exculpated from such a claim in any event under Capital One's Restated Certificate of Incorporation, which contains a Section 102(b)(7) provision. *See* Defs.' Op. Br. 17.

[42] Compl. ¶¶ 96, 98, 100, 102.

[43] Although the Complaint and plaintiff's answering brief assert that Capital One's Code of Conduct and Code of Ethics impose additional duties on all defendants, and that Capital One's charter imposes additional oversight duties on those defendants who served

1. The *Caremark* Liability Standard

In 1996, Chancellor Allen famously reviewed the duties of directors to monitor corporate operations in *Caremark*, where it had been alleged that the company's "directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability."[44] Commenting that the theory "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment,"[45] the Chancellor opined that to demonstrate that the directors had breached a fiduciary duty by failing to adequately control the company's employees, "plaintiffs would have to show either (1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of."[46]

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on the Audit and Risk Committee or its successor committees, plaintiff has not sought relief based on those provisions. *See* Compl. ¶¶ 28-31, 103-112; Pl.'s Ans. Br. 39-40.

[44] *In re Caremark Int'l Inc. Derivative Litigation*, 698 A.2d 959, 967 (Del. Ch. 1996).

[45] *Id.*

[46] *Id.* at 971. Chancellor Allen appeared to conceive of the claim as implicating the duty of care. The Delaware Supreme Court later clarified that the obligation to act in good faith, which was central to *Caremark*'s formulation of the standard for oversight liability, is a component of the duty of loyalty. *Stone*, 911 A.2d at 370.

Ten years later, the Delaware Supreme Court explained in *Disney* that "intentional dereliction of duty" or "a conscious disregard for one's responsibilities," which "is more culpable than simple inattention or failure to be informed of all facts material to the decision," falls within the ambit of fiduciary misconduct that would violate the obligation to act in good faith.[47] Later that year, in *Stone v. Ritter*, the Delaware Supreme Court embraced the *Caremark* framework for director oversight liability and clarified, consistent with its decision in *Disney*, that to impose personal liability on a director for a failure of oversight requires evidence that "the directors knew that they were not discharging their fiduciary obligations."[48]

> *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.[49]

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[47] *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 66 (Del. 2006).

[48] *Stone*, 911 A.2d at 370.

[49] *Id.*

The need to demonstrate scienter to establish liability under an oversight theory follows not only from *Caremark* itself, but from the existence of charter provisions exculpating directors from liability for breaches of the duty of care that have become ubiquitous in corporate America. As then-Vice Chancellor Strine explained in the *Massey* case:

> The Massey charter also includes an exculpatory charter provision insulating the directors from claims of even gross negligence. As a result, in order to receive a monetary judgment against the Massey directors and officers, the plaintiffs will have to prove that the directors and officers acted with scienter. That reality also exists because of the *Caremark* decision itself, which our Supreme Court has embraced as setting the liability standard in this context. The *Caremark* liability standard is a high one, and requires proof that a director acted inconsistent with his fiduciary duties and, most importantly, that the director *knew* he was so acting. For obvious reasons, the motive of independent directors to put profits ahead of compliance with the law is weaker than for managers and thus the challenge for a plaintiff to convince a fact-finder of any specific independent director's culpability has to be regarded as at best difficult.[50]

Because "directors' good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both,"[51] a plaintiff asserting a *Caremark* oversight claim must plead with particularity "a sufficient connection

[50] *In re Massey Energy Co.*, 2011 WL 2176479, at *22 (Del. Ch. May 31, 2011).

[51] *Stone*, 911 A.2d at 373.

between the corporate trauma and the board."[52] To establish such a connection, a plaintiff may plead that the board knew of evidence of corporate misconduct—the proverbial "red flag"—yet acted in bad faith by consciously disregarding its duty to address that misconduct.[53]

In applying the *Caremark* theory of liability, even in the face of alleged red flags, this Court has been careful to distinguish between failing to fulfill one's oversight obligations with respect to fraudulent or criminal conduct as opposed to monitoring the business risk of the enterprise:

> There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk. Directors should, indeed must under Delaware law, ensure that reasonable information and reporting systems exist that would put them on notice of fraudulent or criminal conduct within the company. Such oversight programs allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct.[54]

As this Court stated more recently, "imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different from imposing on directors a duty to monitor fraud and illegal activity."[55]

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[52] *Louisiana Mun. Police Empls.' Ret. Sys. v. Pyott*, 46 A.3d 313, 340 (Del. Ch. 2012), *rev'd* on other grounds, 74 A.3d 612 (Del. 2013).

[53] *Id.* at 341.

[54] *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 131 (Del. Ch. 2009).

[55] *In re The Goldman Sachs Group, Inc. S'holder Litig.*, 2011 WL 4826104, at *22 (Del. Ch. Oct. 12, 2011) (internal quotation omitted).

2. The Complaint Fails to Plead Particularized Facts from Which it Reasonably May be Inferred that Defendants Acted in Bad Faith

In this case, plaintiff does not contend that Capital One's directors failed to implement any reporting or information systems or controls with respect to BSA/AML compliance.[56] Plaintiff would be hard-pressed to advance such an argument given the numerous documents he obtained from the Company through his Section 220 demand that show the opposite. Those documents, which are referenced throughout the Complaint, show that the members of the Audit and Risk Committee and its successor committees received at least twenty-five reports on a regular basis during the three-and-a-half-year period in question (June 2011 to January 2015) explaining the Company's AML risk exposure and detailing management's plans to address the exposure,[57] and that similar reports also were provided to the full board periodically.[58]

Plaintiff instead contends that the Capital One board consciously failed to act after learning about "evidence of illegality."[59] More specifically, plaintiff contends that, despite the Company's statutory obligation to maintain BSA/AML

[56] Pl.'s Ans. Br. 32-33.

[57] *See* Compl. ¶¶ 51-68, 70-71, 73-74, 76-77, 80 (describing over twenty-five reports provided to the Audit and Risk Committee and its successor committees).

[58] *Id.* ¶¶ 72, 78.

[59] Pl.'s Ans. Br. 31 (internal quotation omitted).

controls and procedures, its directors consciously ignored "numerous red flags demonstrating the statutory inadequacy of those control and procedures."[60] The gravamen of the Complaint is that these alleged inadequacies concerned the Company's provision of banking services to check cashing businesses, which exposed Capital One to liability for money-laundering activities they committed.[61]

Plaintiff does not identify a key event or particular document allegedly constituting a red flag, but instead advances a much more diffuse theory. Specifically, plaintiff contends that the numerous reports that were provided regularly to the Capital One directors from June 2011 to January 2015 constituted a series of red flags that should have triggered a duty for the board to act.[62] According to plaintiff, armed with the information in these reports, the board should have intervened and independently conducted "some type of compliance check" at some point during this three-and-a-half-year period,[63] and the board's failure to do so justifies a reasonable inference that the defendants "conscious[ly]

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[60] *Id.* 33-34.

[61] *See* Compl. ¶¶ 2-3, 5-6, 105-6.

[62] Tr. Oral Arg. at 23.

[63] Tr. Oral Arg. at 30.

disregard[ed] . . . their duty to implement internal controls required by BSA/AML regulations" and therefore breached their fiduciary duty of loyalty.[64]

When pressed to be more specific, plaintiff identified five reports, one for each year from 2011 to 2015, as his "best" evidence of red flags.[65] Using that framework, I next review the allegations in the Complaint concerning these five reports along with other statements in them and from other reports referenced in the Complaint that I may consider under the incorporation-by-reference doctrine.[66] In conducting this review, I do not rely on the truth of the matters asserted in the reports that are not repeated in the Complaint, but I consider those parts for the purpose of assessing what information was made available to the directors, which speaks to the directors' states of mind and bears on whether it would be reasonable to infer that they intentionally disregarded their fiduciary duties in bad faith—the core inquiry in a *Caremark* oversight claim.[67]

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[64] Pl.'s Ans. Br. 28.

[65] Tr. Oral Arg. at 23.

[66] *See supra* Part II.A.1.

[67] *See Vanderbilt Income and Growth Assocs., L.L.C. v. Arvida/JMB Managers, Inc.*, 691 A.2d 609, 613 (Del. 1996) ("The exceptions to the general Rule 12(b)(6) prohibition against considering documents outside of the pleadings are usually limited to two situations. The first exception is when the document is integral to a plaintiff's claim and incorporated into the complaint. The second exception is when the document is not being relied upon to prove the truth of its contents.") (internal quotation omitted).

For 2011, plaintiff referred to the Audit and Risk Committee's "1Q 2011 Enterprise State of Compliance" report dated June 2011.[68] The Complaint alleges this report:

> . . . shows high quantity of AML risk, high future risk, and poor and worsening quality of AML risk management. It also shows the high quantity of risk and future risk as unchanged, implying that the Audit and Risk Committee Defendants had been aware of these risk levels before the first quarter of 2011. The high quantity of AML risk shown in the report was attributed specifically to "high risk products and services, a large branch network located in high intensity drug trafficking and metropolitan areas, and a high risk customer base that includes most large New York check cashing businesses." The poor and worsening quality of AML risk management was attributed to "operational process breakdowns."[69]

Other parts of the same report stated that: "Net AML Risk remained low, trending steady during the quarter. . . . AML Compliance is engaged in all projects to ensure compensating controls are in place. . . . Remediation is underway. . . . AML and Fraud working to deliver enhanced fraud monitoring of ACH payments which will decrease risk."[70]

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[68] Tr. Oral Arg. at 24.

[69] Compl. ¶ 51.

[70] Shauger Aff. Ex. H (1Q 2011 Enterprise State of Compliance report to the Audit and Risk Committee, dated June 2011) at CONADEL0001187.

For 2012, plaintiff pointed to the Audit and Risk Committee's "1Q 2012 Enterprise State of Compliance" report dated June 5, 2012.[71] The Complaint alleges that this report:

> . . . highlighted the Company's "At Risk" and "Worsening" AML internal control environment. The report stated that "Enterprise Net Risk has been downgraded" and described AML "Inherent Risk" as "High," due to "high risk products and services, large branch network located in high intensity drug trafficking and metropolitan areas, high risk customer base that includes most large New York check cashing businesses," AML "Governance & Control" as "At Risk," and the "Future Trend" as "Worsening." The report further stated that in March over 10% of AML controls were "operating ineffectively," and suffered from "elongated time to resolve exceptions," specifically including AML-critical CIP exceptions.[72]

Other parts of the same report stated that the "Medium" risk rating was partially due to "inadequate control environment in Canada . . . and the anticipated complexities of integrating HSBC and ING"[73] and listed a series of "[a]ctions needed to get back into stated [risk] appetite."[74] In other words, management had identified to the Audit and Risk Committee the actions they believed necessary to achieve the Company's compliance goal.

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[71] Tr. Oral Arg. at 26.

[72] Compl. ¶ 55.

[73] Shauger Aff. Ex. F (1Q 2012 Enterprise State of Compliance report to the Audit and Risk Committee, dated June 5, 2012) at CONADEL0001528.

[74] *Id.*

Additionally, a memo from the Chief Compliance Officer to the Audit and Risk Committee from the month before stated that management was preparing a detailed assessment of the AML program deficiencies noted in a recent regulatory action against Citibank to make sure Capital One's own program was adequate.[75] A few months later, in October 2012, the Chief Compliance Officer reported to the Audit and Risk Committee in another memo that: "We are watching several trends that may impact our risk profile and compel us to modify our approach or control environment. The most significant issue arises from recent enforcement orders against financial institutions in their AML and OFAC Programs and the shift the OCC will take in examining our Program."[76] That same month, the Audit and Risk Committee recommended to the board certain revisions to the Company's AML policy.[77]

For 2013, plaintiff focused on the Audit and Risk Committee's "Enterprise Risk Profile: Summary Report" dated February 12, 2013.[78] The Complaint alleges this report:

> . . . provided the Audit and Risk Committee Defendants with additional warnings about the Company's "High" AML compliance

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[75] Shauger Aff. Ex. C (memo re May 2012 Compliance Risk Update, dated May 7, 2012) at CONADEL0001469.

[76] Shauger Aff. Ex. B (memo re 2012 AML and OFAC Compliance Risk Assessment, dated October 22, 2012) at CONADEL0002458.

[77] Tr. Oral Arg. at 31.

> risk. The report warned that "[f]ailing to mitigate [this] risk[] could result in non-compliance with applicable requirements and, in a worst case scenario, fines and reputational exposure similar to those incurred under recent consent orders." The report further described AML as the "Top Risk" and described how "based on recent enforcement actions left unchecked the consequences of unmanaged risks in this area could result in violations of law."[79]

Another part of the same report reiterated the regulatory actions that had been taken against other financial institutions and the inherent risk posed by money laundering activity: "While the corporate AML program is sound, regulatory actions at other financial institutions have been well publicized. Inherently, money laundering, terrorist financing, and economic sanctions remain a top risk for financial institutions. Management is proactively ensuring the corporate AML program is strengthened to meet evolving expectations."[80] A second presentation provided to the Audit and Risk Committee on the same date elaborated on management's initiatives to address the Company's AML risk:

> Management is taking action to put remediation plans and dates in place. Focus is on establishing the correct governance in Enterprise Payments to address cash handling policy and operational needs, continued build of AML Model Governance processes, and moving/revising first line of defense controls for CIP.[81]

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[78] Tr. Oral Arg. at 26.

[79] Compl. ¶ 62.

[80] Shauger Aff. Ex. M (Enterprise Risk Profile report to the Audit and Risk Committee, dated February 12, 2013) at CONADEL0000656.

[81] Shauger Aff. Ex. N (Q4 2012 Enterprise State of Compliance report to the Audit and Risk Committee, dated February 12, 2013) at CONADEL0000757.

According to the Complaint, yet another report provided to the Audit Committee on October 24, 2013, "seemed to spark in earnest the Board's reactive mad dash efforts—ultimately far too little too late—to rectify Capital One's critically deficient AML controls."[82] In an unusual twist, plaintiff's counsel disclaimed this exculpatory allegation of his own Complaint, which is repeated elsewhere in the Complaint,[83] as not "well-pled."[84]

A few months later, in a compliance report for the fourth quarter of 2013 dated January 23, 2014, the members of the Audit Committee were informed that management had decided to exit the business of serving check cashers "in parallel" with an investigation of potential violations of anti-money laundering laws that was being conducted of several of the Company's clients.[85] A memorandum sent to the members of the Audit and Risk Committee on the same day further explained that management's decision to exit the check cashing business was expected to be executed in 2014, and that Capital One's "AML Compliance Program is operating within tolerance" outside of the "Check Casher Group:"

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[82] Compl. ¶ 68.

[83] *See id.* ¶ 70.

[84] Tr. Oral Arg. at 46.

[85] Compl. ¶ 70.

- Management has decided to exit the Check Cashing business and a plan is underway to execute this decision throughout 2014. AML is closely monitoring these account relationships and performing additional due diligence as they wind down.

- With the exception of the Check Casher Group, the core AML Compliance Management Program is operating with tolerance; however, AML inherently remains a top risk to the company.[86]

For 2014, plaintiff relied on the Audit Committee's "Corporate Audit & Security Services First Quarter 2014" report dated April 25, 2014.[87] The Complaint alleges that this report:

> . . . described Capital One's internal audit findings. Far from showing improvement following the stark warnings received by the Individual Defendants in the preceding months, the Company's "High" risk AML Compliance Risk Management program was rated "Inadequate," the worst possible rating. This would begin a series of internal reports showing that in the face of extreme risk and regulatory scrutiny, the Individual Defendants continued to fail improving Capital One's AML controls to an acceptable level. The report cites a need for robust procedures, well-trained associates, and a strong management review function to comply with FinCEN and bank regulators' expectations. It also identified other key issues of concern, including inconsistencies in investigation and narrative preparation related to alerted transactions, lack of associate training, and a weak management review process that failed to make robust notations, pose questions, or challenge conclusions.[88]

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[86] Bennett Aff. Ex. 5 (memo re 2013 AML and OFAC Compliance Risk Assessment, dated January 23, 2014) at CONADEL0000903.

[87] Tr. Oral Arg. at 28.

[88] Compl. ¶ 73.

Other parts of the same report stated that the audit department concluded that Capital One's "Bank Secrecy Act Operations Procedures are quite detailed," that the "unplanned use of consultants in the compliance area required to support one-time efforts related to enhancing the BSA/AML risk assessment methodology and audit program" had caused the department to go over budget, and that the department's contractor usage "is primarily driven by additional projects supporting the compliance audit team in areas including quality assurance and enhancements of the BSA/AML risk assessment process."[89]

In a memo to the Audit Committee for the next quarter, the Chief Compliance Officer reported that the Company had launched a comprehensive initiative to improve its AML compliance program:

> AML remains a top compliance risk for the company, primarily due to heightened regulatory expectations; high alert volumes; a need to enhance AML controls and strengthen the AML organization; and an ongoing law enforcement investigation into alleged criminal activity by certain of the company's commercial clients.
>
> * * * * *
>
> In coordination, the Chief Risk Officer, the Chief Compliance Officer and the new Chief AML Officer have launched a comprehensive initiative to improve our enterprise AML compliance program, including all core controls, processes, and policies.[90]

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[89] Shauger Aff. Ex. S (Corporate Audit & Security Services First Quarter 2014 Audit Committee Report, dated April 25, 2014) at CONADEL0001062, CONADEL0001069.

[90] Shauger Aff. Ex. V (memo re Quarterly Compliance Report for the Second Quarter of 2014, dated July 24, 2014) at CONADEL0001276.

The fifth and final report plaintiff identified as his best evidence of red flags is the Audit Committee's "Corporate Audit & Security Services Fourth Quarter 2014" report dated January 22, 2015.[91] The Complaint discusses two statements in this report: that it "confirmed the Company's AML Program was still rated 'At Risk' and described as 'Inadequate,'" and that it "reported on 'risk management and control issues,' warning 'significant effort remains to enhance the overall AML [Compliance Management Program].'"[92] But the report also said the following:

> Management is in the process of addressing ineffective model governance practices. . . . The Model Risk Office issued an AML Notice, . . . , which requires high risk AML models to be compliant with the Model Policy by April 2015, while medium and low risk AML models are expected to be fully compliant by October 2015. . . . Management self-identified the need to ensure a uniform and coordinated approach to referring fraud cases for potential SAR and STR reporting. . . . Prior to the conclusion of this audit, management established a dedicated workstream in the AML Strategic Plan to address this concern by December 31, 2014.[93]

Additionally, in a section entitled "AML Strategic Plan," the report included the observations that "[w]here specific needs have been identified, the [AML

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[91] Tr. Oral Arg. at 29.

[92] Compl. ¶ 80.

[93] Bennett Aff. Ex. 6 (Corporate Audit & Security Services Fourth Quarter 2014 Audit Committee Report, dated January 22, 2015) at CONADEL0002577, CONADEL0002582.

compliance program] has elevated recruiting activities to support delivery commitments" and that "[d]uring the fourth quarter, management made a deliberate decision to focus efforts on completing deliverable commitments."[94]

To summarize, the five reports plaintiff identified as his best evidence of red flags show that Capital One's directors were made aware that (1) the Company's assessment of its AML compliance risk had escalated from "low" in the first quarter of 2011,[95] to "medium" in the first quarter of 2012,[96] and then to "high" as of February 2013,[97] (2) that management had decided to exit the business of serving check cashers by January 2014, and (3) that the Company's AML risk exposure remained high in 2014 as it implemented its plan to exit the check cashing business.[98] None of these reports, however, states that the Company's

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[94] Defs.' Reply Br. Ex. B (Corporate Audit & Security Services Fourth Quarter 2014 Audit Committee Report, dated January 22, 2015) at CONADEL0002576.

[95] Shauger Aff. Ex. H (1Q 2011 Enterprise State of Compliance report to the Audit and Risk Committee, dated June 2011) at CONADEL0001187.

[96] Shauger Aff. Ex. F (1Q 2012 Enterprise State of Compliance report to the Audit and Risk Committee, dated June 5, 2012) at CONADEL0001528.

[97] Shauger Aff. Ex. M (Enterprise Risk Profile report to the Audit and Risk Committee, dated February 12, 2013) at CONADEL0000675; *see also id.* Ex. N (Q4 2012 Enterprise State of Compliance report to the Audit and Risk Committee, dated February 12, 2013) at CONADEL0000757.

[98] *See* Shauger Aff. Ex. S (Corporate Audit & Security Services First Quarter 2014 Audit Committee Report, dated April 25, 2014) at CONADL0001062; Bennett Aff. Ex. 6 (Corporate Audit & Security Services Fourth Quarter 2014 Audit Committee Report, dated January 22, 2015) at CONADEL0002577.

BSA/AML controls and procedures actually had been found to violate statutory requirements at any time or that anyone within Capital One had engaged in fraudulent or criminal conduct. In other words, the core factual allegations of the Complaint do not amount to red flags of illegal conduct.[99]

Giving plaintiff all reasonable inferences, the allegations of the Complaint plead at most flags of a different hue, namely yellow flags of caution concerning the Company's escalating AML compliance risk that was occurring in tandem with heightened regulatory scrutiny of AML compliance in the financial services industry. The escalation occurred over a two-year period and led to management's decision less than one year later to exit the business of serving check cashers, which was the root cause of Capital One's AML compliance exposure according to the Complaint. Significantly, the reports the directors received did not place them on notice that management had refused to act or displayed an indifference to complying with the BSA/AML. To the contrary, the same reports that described the Company's heightened compliance risk simultaneously explained to the directors in considerable detail on a regular basis the initiatives management was taking to address those problems and to ameliorate the AML compliance risk.

[99] Although the OCC found in July 2015 "regulatory deficiencies in [Capital One's] AML program emanating from [its] former Check Cashing Group within the Commercial Banking business," Compl. ¶ 83, this event occurred in July 2015 *after* the Company had decided to exit the check cashing business, which explains why plaintiff does not view that event to have been a red flag. Tr. Oral Arg. at 33-34.

Thus the factual context here is fundamentally inconsistent with the inference plaintiff asks the Court to draw—that the directors must have known they were breaching their fiduciary duties by tolerating a climate in which the Company was operating part of its business in defiance of the law.

The factual allegations of this case stand in stark contrast to the two key authorities on which plaintiff relies: this Court's decisions in the *Massey* and *Pyott* cases. In *Massey*, the company "had pled guilty to criminal charges, had suffered other serious judgments and settlements as a result of violations of law, had been caught trying to hide violations of law and suppress material evidence, and had miners suffer death and serious injuries at its facilities."[100] Based on these and other "objective facts" of the company's record as a "recidivist" law-breaker, the Court found it was reasonably inferable "that the Board and management were aware of a troubling continuing pattern of non-compliance in fact and of a managerial attitude suggestive of a desire to fight with and hide evidence from the company's regulators," and thus opined that a viable *Caremark* claim likely had been pled.[101]

In *Pyott*, plaintiff's particularized allegations allowed the Court to draw an inference that the Allergen board "knowingly approved and subsequently oversaw

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[100] *Massey*, 2011 WL 2176479, at *20.

[101] *Id.* at *20-21.

a business plan that required illegal off-label marketing and support initiatives for Botox."[102] In other words, *Pyott* involved the board's "knowing use of illegal means to pursue profit"[103] in contravention of the common sense principle that "a fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profits by violating the law."[104]

Unlike in *Massey* and *Pyott*, plaintiff does not contend, and the pled facts would not warrant the inference, that Capital One's management embraced a strategy to pursue profits by employing illegal means, much less that its directors were knowingly complicit in such a strategy. To the contrary, the Complaint's allegations evidence that Capital One's management made efforts to cope with tightening regulations and more aggressive AML enforcement actions, and regularly kept the directors informed of those efforts along the way. Those efforts included designation of a new Chief AML Officer, monthly training, quarterly internal audits, other initiatives taken in response to the changing regulatory

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[102] *Pyott*, 46 A.3d at 356.

[103] *Id.* at 352.

[104] *Id.*

landscape,[105] and ultimately, the decision to exit altogether the check cashing business that presented the most acute BSA/AML challenges.[106]

As discussed previously, the Delaware Supreme Court made clear a decade ago that directors can be found liable for a *Caremark* oversight claim only if they fail to discharge their fiduciary duties in good faith, meaning that "the directors knew that they were not discharging their fiduciary obligations."[107] "Good faith, not a good result, is what is required of the board."[108] As our Supreme Court explained more recently in *Lyondell Chemical Co. v. Ryan*, "there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties."[109]

Here, the allegations of the Complaint and the documents incorporated therein would allow reasonable minds to argue either side of a debate over whether the directors' oversight of the Company's BSA/AML compliance program was sufficiently robust or flawed. But what those allegations do not reasonably permit

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[105] Shauger Aff. Ex. Q (Anti-Money Laundering (AML) Assessment report to the Audit and Risk Committee, dated February 12, 2013) at CONADEL0000762.

[106] Bennett Aff. Ex. 5 (memo re 2013 AML and OFAC Compliance Risk Assessment, dated January 23, 2014) at CONADEL0000903.

[107] *Stone*, 911 A.2d at 370.

[108] *In re The Goldman Sachs Group, Inc. S'holder Litig.*, 2011 WL 4826104, at *23.

[109] *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235, 243 (Del. 2009).

for the reasons explained above is an inference that the defendants *consciously* allowed Capital One to violate the law so as to sustain a finding they acted in bad faith. As such, plaintiff has failed to plead with particularity that a majority of Capital One's ten-member board acted in such an egregious manner that they would face a substantial likelihood of liability for breaching their fiduciary duty of loyalty so as to disqualify them from applying disinterested and independent consideration to a stockholder demand. Thus, demand is not excused as to Count I.

C. Demand Is Not Excused for the Unjust Enrichment Claim

Count II of the Complaint asserts that defendants "were unjustly enriched as a result of the compensation and director remuneration they received while breaching fiduciary duties owed to Capital One."[110] Plaintiff readily acknowledges that this claim rises or falls with the viability of Count I.[111] Thus, because plaintiff has failed to allege particularized facts to excuse his failure to make a demand concerning Count I, it necessarily follows that demand would not have been futile as to Count II.

III. CONCLUSION

For the foregoing reasons, plaintiff has failed to demonstrate that demand would have been futile with respect to either of the two claims in the Complaint.

[110] Compl. ¶ 110.

[111] Tr. Oral Arg. at 39.

Accordingly, defendants' motion to dismiss the Complaint with prejudice is GRANTED.

IT IS SO ORDERED.

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

THE HUFF ENERGY FUND, L.P.,	:	
Plaintiff,	:	
v.	:	**C.A. No. 11116-VCS**
ROBERT D. GERSHEN, RICK M. PEARCE, D. RANDOLPH WAESCHE, THOMAS VESSELS, GEORGE KEANE, HAROLD CARTER, and LONGVIEW ENERGY COMPANY,	:	
Defendants.	:	

MEMORANDUM OPINION

Date Submitted: July 8, 2016
Date Decided: September 29, 2016

Pamela S. Tikellis, Esquire, Robert J. Kriner, Jr., Esquire, A. Zachary Naylor, Esquire, and Tiffany J. Cramer, Esquire of Chimicles & Tikellis LLP, Wilmington, Delaware, Attorneys for Plaintiff.

Donald J. Wolfe, Jr., Esquire, Timothy R. Dudderar, Esquire, Aaron R. Sims, Esquire, and Frank R. Martin, Esquire of Potter Anderson & Corroon LLP, Wilmington, Delaware, Attorneys for Defendants.

SLIGHTS, Vice Chancellor

Plaintiff, The Huff Energy Fund, L.P. ("Huff Energy"),[1] brought this action to challenge Longview Energy Company's decision, approved by its board of directors (the "Board," and together with Longview, the "Defendants") and its stockholders, to dissolve Longview following a sale of a significant portion of its assets. Huff Energy was a stockholder of Longview at all relevant times and, upon its initial investment, entered into a shareholders agreement (the "Shareholders Agreement") with Longview that, *inter alia*, required a unanimous vote of the Board for any act that would have "a material adverse effect" on the rights of Longview's stockholders as "set forth" in the agreement.

In April 2014, the Board decided to sell Longview's California oil and gas properties and related assets ("the California Assets"). In September 2014, Longview circulated to stockholders a fully-negotiated, but yet unsigned, purchase and sale agreement for the California Assets at a proposed price of $43.1 million. To alleviate the potential tax burden to stockholders, the Board, at the behest of the two directors designated by Huff Energy, agreed to dissolve Longview following the asset sale as part of the transaction. Within a month of this proposal, oil prices collapsed, the value of the California Assets decreased and the buyer elected to walk away from the proposed transaction.

[1] Huff Energy is so designated to avoid confusion with its namesake, William R. Huff.

In May 2015, Longview circulated a new purchase and sale agreement for the California Assets, including a plan of dissolution, at a price of $28 million. The Board approved the transaction over the abstention of the one Huff Energy designee who was present for the vote. Longview's stockholders approved the asset sale and plan of dissolution the following month, on June 11, 2015.

Huff Energy's Verified Amended Complaint ("the Complaint") alleges that: (1) because the plan of dissolution had a material adverse effect on Longview's stockholders, particularly Huff Energy, unanimous board approval was required, and since the director designated by Huff Energy abstained, the less-than-unanimous approval of the plan constituted a breach of the Shareholders Agreement (Count I); and (2) the Board breached its fiduciary duties by adopting the plan of dissolution without exploring more favorable alternatives in violation of *Revlon*[2] and as an unreasonable response to a perceived threat in violation of *Unocal*[3] (Count II).

Defendants respond by arguing that (1) the individual Board members, as non-parties to the Shareholders Agreement, cannot be held liable for any alleged breach of that contract by Longview; (2) unanimous Board approval of the plan of dissolution was not necessary because it in no way harmed Longview's

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[2] *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 174 (Del. 1986).

[3] *Unocal Corp. v. Mesa Petr. Co.*, 493 A.2d 946 (Del. 1985).

stockholders and certainly did not have a material adverse effect on the rights of Huff Energy as set forth in the Shareholders Agreement; and (3) *Revlon* and *Unocal* are not implicated here and, in any event, the business judgment rule irrebuttably applies and is dispositive of Huff Energy's breach of fiduciary duty claims by virtue of the uncoerced, fully informed approval of the plan of dissolution by Longview stockholders.

For the reasons set forth below, I agree with Defendants on all points. The Motion to Dismiss is granted.

I. BACKGROUND

I draw the facts from allegations in the Complaint, documents integral to the Complaint and matters of which I may take judicial notice, including public filings.[4] The well-pled facts alleged in the Complaint, while disputed by the Defendants, are deemed true at this stage of the proceedings.[5]

A. The Parties

Huff Energy is a Delaware limited partnership that owned 2,275,627 shares, or approximately 40%, of Longview's outstanding common stock, making it Longview's largest stockholder. Longview was a Delaware corporation with its

[4] *In re Gardner Denver, Inc.*, 2014 WL 715705, at *2 (Del. Ch. Feb. 21, 2014); *Narrowstep, Inc. v. Onstream Media Corp.*, 2010 WL 5422405, at *5 (Del. Ch. Dec. 22, 2010).

[5] *Id.*

principal place of business in Dallas, Texas. Longview's Board was authorized to be comprised of nine seats, although only eight were filled during the times relevant to this action. Pursuant to its right in the Shareholders Agreement to name two Board members, Huff Energy appointed William R. Huff ("Huff") and Richard D'Angelo as its designees.

Defendant Robert D. Gershen was Longview's Chief Executive Officer and a member of the Board. Defendant Rick M. Pearce was Longview's Chief Operating Officer and a member of the Board. Defendants D. Randolph Waesche, Thomas Vessels, George Keane and Harold Carter comprised the remaining non-Huff Energy directors (together with Gershen and Pearce, the "Director Defendants"). Gershen had sundry outside business relationships with other Board members, including serving on the board of Energy Finance Limited with Vessels, serving on the board of Energy Partners Ltd. with Waesche and Carter, serving on the board of Vessels Coal Gas Inc. (upon which Waesche and Carter had previously served) with Vessels, serving on the board of Saxon Oil Co. Ltd. with Vessels and Carter and serving on the board of the Common Fund, now known as the Common Fund Group, of which Keane is a founder, with Carter.

Gershen and Pearce also had employment agreements with Longview that provided for a severance payment upon a change of control, defined to include "a sale or other transaction whereby more than fifty (50) percent in value of the assets

of the Company are no longer owned by the Company."[6] Gershen's employment agreement provided for a severance payment of at least one year's salary. Pearce's employment agreement provided for a severance payment of at least two years' salary.

B. The Shareholders Agreement

In 2006, Huff Energy purchased 20% of Longview's outstanding stock at $19 per share. In connection with its purchase, Huff Energy and Longview executed the Shareholders Agreement. Relevant to this dispute, the Shareholders Agreement provided that (1) any transfer by Huff Energy of its Longview stock was subject to a right of first offer to Longview and other conditions not relevant here; (2) Huff Energy could designate two directors to Longview's Board; (3) Longview would continue to exist and remain in good standing under Delaware law by making timely filings and payments of required fees; (4) Longview would make reasonable efforts to ensure that the rights granted in the Shareholders Agreement are effective; (5) a two-thirds vote of the Board was required for "any resolution authorizing or approving any fundamental changes in [Longview's] business or business plan" or "any merger or sale of all or substantially all of [Longview's] assets"; and (6) a unanimous vote of the Board was required for any

[6] Compl. ¶ 19.

act or omission that would have "a material adverse effect on the rights of any Shareholder as set forth in this Agreement."[7]

C. Gershen Attempts to Sell Longview to Achieve Liquidity and Trigger Contractual Severance Payments

During the four years following its initial investment, Huff Energy increased its stake in Longview to approximately 40%. The Complaint alleges that Gershen expressed displeasure with Huff Energy's increasing stake, viewing the investment as a threat to his otherwise unfettered influence over Longview.[8] Beginning in 2008, at Gershen's urging, Longview began actively to pursue a liquidity event either through a sale of assets or merger. According to Huff Energy, this priority was fueled in part by Gershen and Pearce's desire to trigger the substantial severance payments required by their respective employment agreements in the event of a change of control, and persisted notwithstanding the best interests of Longview's stockholders.[9]

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[7] Pl.'s Answering Br. in Opp'n to Defs.' Mot. to Dismiss ("Pl.'s Answering Br.") Ex. F (the "Shareholders Agreement") § 2(b) (designation by Huff Energy of two Board members); § 6(a) (Longview's right of first offer for Huff Energy's shares); § 9(a) (maintenance of corporate existence); § 9(d) (Longview to make best efforts to ensure that Huff Energy's rights under the Shareholders Agreement are protected); § 10(a)(ii), (iv) (sale of all or substantially all assets, merger or fundamental change in business requires two-thirds Board approval); § 10(b)(iii) (action having "material adverse effect" on stockholders' rights as "set forth" in the Shareholders Agreement, requires unanimous Board approval).

[8] Compl. ¶¶ 30–33.

[9] Compl. ¶ 75.

When the 2008 financial crisis hindered Longview's chances to achieve a liquidity event, Huff Energy and its Board representatives encouraged Longview to purchase distressed assets in furtherance of an overall growth strategy. To that end, the Board authorized Longview to interview bankers to seek out and assist with potential acquisitions. Gershen, however, ignored this Board directive and instead dispatched the banker engaged by the Board to seek out either a merger partner or a buyer for Longview assets.

In January 2010, the Board decided to sell Longview's Oklahoma properties. D'Angelo objected to the sale arguing that the Board had failed adequately to analyze the transaction and negotiate the best price for the assets. Notwithstanding the Board's approval of the transaction, Longview management ultimately ignored the Board's directive to sell the Oklahoma properties after unilaterally determining that it would be preferable to sell Longview as a whole rather than in parts.

In 2010 and 2011, Gershen pursued a merger with a Canadian oil and gas company. Huff Energy's Board representatives opposed the merger after Longview management reported that the prospective merger partner had engaged in misleading and potentially fraudulent accounting practices. Gershen, however, continued to support the merger, claiming that the Longview stockholders could avoid harm by selling their post-merger stock before the fraud became public. The

proposed merger failed, however, when the acquirer was unable to obtain financing.

D. The Sale of the California Assets

In 2011, Longview retained Parkman Whaling, a boutique oil and gas investment banking firm, to assist in identifying and evaluating potential merger partners. Over the following three years, Parkman Whaling was unable to find a suitor interested in acquiring the entire company. The Board was advised, however, that several potential buyers were interested in Longview's California Assets, consisting primarily of oil and gas properties and drilling and coring assets. For reasons unclear, Longview's Oklahoma oil and gas assets were not drawing interest. The Board relented and focused its efforts on a sale of the California Assets separate from the remainder of Longview. These assets generated approximately 90% of Longview's operating revenue.

In September 2014, Longview circulated to the Board a "fully negotiated" purchase and sale agreement ("PSA") for the California Assets at $43.1 million. By its terms the PSA anticipated that execution would occur only after Board approval with the closing conditioned on subsequent stockholder approval.

Upon receipt of the Board materials, Huff Energy's Board representatives requested basic analytic information not yet disclosed, including a fairness opinion from Parkman Whaling and information about the post-sale operation of Longview's remaining assets. Huff Energy also expressed its concern to Longview that the transaction as contemplated could result in negative tax consequences when proceeds from the sale were distributed to Longview's stockholders. Specifically, as structured, the proposed distribution to Longview's stockholders "would have been taxed as a dividend, notwithstanding the fact that many stockholders ha[d] a tax basis well in excess of the amount of cash to be distributed."[10] To alleviate the tax burden, Huff Energy suggested that Longview adopt a plan of liquidation and distribute the sale proceeds in connection with that plan. Longview acquiesced to Huff Energy's requests and, several weeks later, recirculated the transaction materials which now included a disclosure that Parkman Whaling would provide a fairness opinion and that Longview would adopt a plan of liquidation given the impending distribution to Longview's stockholders.

[10] Compl. ¶ 38.

In early October 2014, prior to the scheduled Board meeting to vote on the proposed sale, oil prices collapsed and the value of the California Assets tumbled. Because the parties had not yet executed the PSA, the buyer elected to withdraw from the transaction.

Notwithstanding the low oil prices, Longview management continued to seek a buyer for the California Assets. On May 14, 2015, management circulated a new proposed transaction with White Knight Production, LLC ("White Knight") for the same California Assets at a sale price of $28 million. The Board materials represented that Longview was in covenant default under a loan agreement, and that the lender reduced Longview's borrowing base from $31.5 million to $17 million (which was still in excess of the loan balance). The lender also accelerated the loan's maturity date from January 2016 to September 2015. Longview was in need of cash.

The May 14, 2015 Board materials also included a proposed proxy statement indicating that the Board would seek stockholder approval for (1) the sale of the California assets and, separately, (2) the adoption of a plan of dissolution ("the Plan of Dissolution"). The draft proxy statement, circulated later the same day, indicated that the transaction would result in a distribution to stockholders but omitted the amount.

Two business days later, on May 18, 2015, the Board met telephonically to approve the transaction, at which time Huff Energy learned for the first time that Longview would make no distribution to stockholders, and would instead retain all net sale proceeds. The final proxy statement (the "Proxy Statement") delivered to Longview's stockholders makes this clear: "The Company anticipates that the process to determine the proper amount of contingency reserve may be lengthy and that Stockholders will not receive any liquidating distributions for an extended period of time following filing of the Certificate of Dissolution."[11] Though the Board approved the transaction, adoption of the Plan of Dissolution and distribution of the Proxy Statement, D'Angelo, the lone Huff Energy director present during the meeting, abstained due to "the insufficiency of information and rushed nature of the approval and deliberation process."[12]

During the Board meeting on May 18, a Huff Energy representative attempted to give comments regarding the draft proxy statement. The Board shut this discussion down, however, and directed Huff Energy to forward any comments to Longview's in-house counsel and an attorney from Longview's outside counsel. Though certain of Huff Energy's suggestions were accepted and implemented, others, including disclosures regarding D'Angelo's abstention and

[11] Compl. ¶ 46.

[12] Compl. ¶ 48.

recent developments in the Texas Litigation (discussed below) were not included in the Proxy Statement. The Proxy Statement did, however, disclose that, upon approval and filing of the Plan of Dissolution, each holder of common stock "will cease to have any rights in respect thereof other than to receive distributions (if any) in accordance with the Plan of Dissolution."[13]

In a letter to the Longview Board dated June 5, 2015, Huff Energy requested that the Board rescind its request for approval of the Plan of Dissolution since Longview's withholding of the net sale proceeds would negate any tax burden associated with a distribution. The letter also included a list of various potential harmful effects of adoption of the Plan of Dissolution, including:

> eliminat[ing] the transferability of Longview shares and render[ing] the stockholders unable to enter into private sales of their shares; limit[ing] the alternatives to a potential buyer of Longview's remaining assets to an asset sale; signal[ing] to any potential buyer of the Oklahoma properties the fact that those properties must be sold, thereby reducing the likelihood of [Longview] receiving true fair market value for those properties; eliminat[ing] the ability to sell the Company to a buyer who might want to try and benefit from Longview's extant net operating loss; and eliminate[ing] any possibility of a tender offer for the Longview shares.[14]

On June 8, without meeting, the Board, by email, denied Huff Energy's request.

[13] Compl. ¶ 53 (quoting the Proxy Statement).

[14] Compl. ¶ 57.

E. The Texas Litigation

On September 26, 2011, Longview brought an action against Huff Energy, 1776 Energy Partners, LLC ("1776," Huff's portfolio company) and certain 1776 affiliates including Huff and D'Angelo (the "Texas Defendants"), alleging that Huff and D'Angelo breached their fiduciary duties to Longview by usurping a corporate opportunity in connection with 1776's acquisition of certain oil and gas leases (the "Texas Litigation"). The litigation resulted in a jury finding Huff, D'Angelo, 1776 and Huff Energy liable for breaches of fiduciary duties to Longview with a damages verdict of $10.5 million. On December 14, 2012, however, the Texas trial court amended the judgment to increase the amount of the verdict to $95.5 million and required 1776 to turn over to Longview the assets subject to the judgment.

On September 20, 2012, Huff Energy, on behalf of all Texas Defendants, posted a $25 million supersedeas bond, the maximum required to be posted in Texas, to suspend enforcement of the judgment. The Texas Defendants then filed a notice of appeal, and on June 3, 2015, presented oral argument to the Texas Fourth Court of Appeals.

In the interim, Longview challenged the amount of the bond the Texas Defendants were required to post to suspend the judgment, arguing that the $25 million maximum applied per judgment debtor, not per judgment, and requesting

that the remaining four parties also post $25 million each. The trial judge approved Longview's request, the Texas Defendants appealed, and the Fourth Court agreed with the Texas Defendants and ruled that the $25 million cap applied per judgment. Longview appealed that determination to the Texas Supreme Court, and on May 8, 2016, the Texas Supreme Court issued its ruling. Rather than reaching the bond cap issue, however, the Texas Supreme Court held that the $95.5 million judgment had no basis in fact or law as a compensatory award and thus must have been largely comprised of punitive damages. Consequently, the court determined that the Texas Defendants were required to post a bond of only $66,000—a fact Longview refused to add to the Proxy Statement.

F. Ramifications of the Asset Sale, Plan of Dissolution and Texas Litigation

Two factors resulted in Longview's conclusion that it could not make an immediate distribution to stockholders following the asset sale: (1) the value and ultimate purchase price of the California Assets fell precipitously in 2014, and (2) the Texas Supreme Court weighed in on the Texas Litigation. The impact of the drop in sale price from $43.1 million to $28 million reduced any potential distribution by over $15 million, or nearly $2.50 per share. Even considering the reduced price, however, "the Proxy Statement calculated over $9 million in

proceeds remaining *before setting up a reserve for liabilities*."[15] The impact of the Texas Supreme Court's ruling affected the liability reserve. If the Texas Supreme Court reverses the Texas Litigation judgment against Huff and D'Angelo, both will contend they are entitled to indemnification from Longview for their legal fees and costs in connection with the Texas Litigation. "Huff Energy disclosed to the Board that any such amount could be in excess of [$10 million]."[16] The Texas Supreme Court's recent rejection of the amended judgment and reinstatement of the Jury's $10.5 million verdict heightened Longview's concerns regarding indemnification of the Huff Energy directors and potentially increased Longview's target post-sale reserve liabilities.

In addition, the Complaint alleges that the Plan of Dissolution frustrates any potential tender offer Huff Energy may have made for Longview, which could have resolved the Texas Litigation. According to Huff Energy, Defendants recognized the possibility that Huff Energy would offer to purchase the remainder of Longview's shares, and were concerned about a sale of Longview in which Defendants were not in control. Adopting the Plan of Dissolution eliminated Huff Energy's ability to purchase Longview shares.[17]

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[15] Compl. ¶ 72 (emphasis added).

[16] Compl. ¶ 73.

[17] Compl. ¶¶ 77–78.

The Complaint alleges that the Plan of Dissolution further harmed Huff Energy by (1) depriving Huff Energy of its right to transfer or pledge Longview shares and, concomitantly, foreclosing a potential financing opportunity for 1776; (2) precluding Huff Energy from appointing two directors to the Board; and (3) depriving Huff Energy of any ability to attain value for its Longview stock until a liquidating distribution, if any, is made pursuant to the Plan of Distribution.[18]

To address these harms Huff Energy seeks (1) an order enjoining Longview from paying bonuses to certain Defendants; (2) a declaration that issuance of the Proxy Statement and Plan of Dissolution violated Sections 9(a), 9(d) and 10(b)(iii) of the Shareholders Agreement; (3) a declaration that the Director Defendants breached the Shareholders Agreement and their fiduciary duties in connection with the Plan of Dissolution; (4) a grant of appropriate equitable relief; (5) an order directing Defendants to disgorge all profits as a result of their allegedly unlawful conduct; (6) an award of compensatory damages; and (7) an award of fees and expenses.[19]

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[18] Compl. ¶¶ 80–91.

[19] Huff Energy does not contest any aspect of the sale of the California Assets. Its claims for breaches of contract and fiduciary duty are directed only to the approval and adoption of the Plan of Dissolution. Compl. ¶¶ 80–91 (breach of contract); ¶¶ 92–98 (breach of fiduciary duty).

II. ANALYSIS

A. Motion to Dismiss Standard

"[T]he governing pleading standard in Delaware to survive a motion to dismiss is reasonable 'conceivability.'"[20] That is, "[t]he Court will grant the motion only if Plaintiff 'could not recover under any reasonably conceivable set of circumstances susceptible of proof.'"[21] In making this determination, the Court accepts as true all well-pled allegations in the Complaint, but "should not accept as true conclusory statements unsupported by fact nor should it draw unreasonable inferences in favor of plaintiffs."[22]

B. Defendants Did Not Breach the Shareholders Agreement

To plead a breach of contract claim sufficient to withstand a motion to dismiss, a plaintiff must allege facts from which the Court may reasonably infer the existence of: "1) a contractual obligation; 2) a breach of that obligation by the defendant; and 3) a resulting damage to the plaintiff."[23] In Delaware, the "interpretation of contractual language is a question of law; thus, where the terms

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[20] *Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Hldgs. LLC*, 27 A.3d 531, 537 (Del. 2011).

[21] *Shaev v. Adkerson*, 2015 WL 5882942, at *3 (Del. Ch. Oct. 5, 2015) (quoting *Cent. Mortg.*, 27 A.3d at 536).

[22] *Sample v. Morgan*, 914 A.2d 647, 662 (Del. Ch. 2007).

[23] *H-M Wexford LLC v. Encorp, Inc.*, 832 A.2d 129, 140 (Del. Ch. 2003).

of a contract are unambiguous, the meaning thereof is suitable for determination on a motion to dismiss."[24] In determining whether disputed terms are subject to more than one reasonable interpretation, "Delaware courts are obligated to confine themselves to the language of the document and [may] not to look to extrinsic evidence to find ambiguity."[25]

1. The Director Defendants Cannot be Liable for the Alleged Breach of Contract

"It is a general principle of contract law that only a party to a contract may be sued for breach of that contract."[26] Under Delaware law, "officers of a corporation are not liable on corporate contracts as long as they do not purport to bind themselves individually."[27] Huff Energy argues two bases upon which the Court can depart from this settled law and hold the Director Defendants individually liable for a breach of the Shareholders Agreement.

First, Huff Energy alleges that three of the Director Defendants were signatories to the Shareholders Agreement and may therefore be sued for breach of

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[24] *Travelers Cas. & Sur. Co. v. Sequa Corp.*, 2012 WL 1931322, at *4 (Del. Ch. May 29, 2012) *overruled on other grounds, Scion Breckenridge Managing Member, LLC v. ASB Allegiance Real Estate Fund*, 68 A.3d 665 (Del. 2013).

[25] *O'Brien v. Progressive N. Ins. Co.*, 785 A.2d 281, 289 (Del. 2001).

[26] *Wallace ex rel. Cencom Cable Income P'rs II, Inc., L.P. v. Wood*, 752 A.2d 1175, 1180 (Del. Ch. 1999).

[27] *Id.*

that contract. While it is true that Gershen Waesche, Vessel and Carter signed the Shareholders Agreement, it is clear on the face of the document that they did so in a representative, not individual, capacity. They are not parties to the contract and merely executing an agreement on behalf of a stockholder who is a party to the agreement does not create liability for that signatory in his or her capacity as an officer or director of the corporation.[28] The Director Defendants were not personally obligated to perform under the contract and cannot be held liable for breach of the contract.

Huff Energy's second argument is clearly an afterthought. Like the plaintiffs in *Wallace*, Huff Energy, in its Answering Brief, "abandon[ed its] breach of contract claim . . ., choosing instead to assert a tortious interference claim."[29] Specifically, Huff Energy argues that the Director Defendants may be held liable for tortious interference with contract for causing Longview to adopt the Plan of Dissolution in breach of the Shareholders Agreement. To plead a tortious interference claim, Huff Energy must properly allege the existence of "(1) a contract, (2) about which defendant knew and (3) an intentional act that is a

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[28] *See Ruggiero v. FuturaGene, plc.*, 948 A.2d 1124, 1133 (Del. Ch. 2008).

[29] *Wallace*, 752 A.2d at 1180.

significant factor in causing the breach of such contract (4) without justification (5) which causes injury."[30]

I note that Huff Energy failed to plead a tortious interference count in the Complaint and this Court does not countenance efforts to raise causes of action for the first time in a brief filed in opposition to a case dispositive motion.[31] Even if Huff Energy had expressly pled a tortious interference claim in a separate count, there are no facts pled in the Complaint that would support it. Notably, Huff Energy identifies no facts that would allow a reasonable inference that any Director Defendant intentionally caused Longview to breach the Shareholders Agreement or that any conduct by any Director Defendant was without justification. Instead, Huff Energy argues that "directors and officers can be held personally liable [for tortious interference] if it is alleged that these actors have 'exceed[ed] the scope' of their employment in taking such actions."[32] The Complaint's only specific allegations that even hint that the Director Defendants exceeded the scope of their employment, however, relate to Gershen's alleged "animosity" toward Huff Energy in response to Huff Energy's "continuous

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[30] *Irwin & Leighton, Inc. v. W.M. Anderson Co.*, 532 A.2d 983, 992 (Del. Ch. 1987).

[31] *See Fletcher Int'l, Ltd. V. Ion Geophysical Corp.*, 2011 WL 1167088, at *5 n.42 (Del. Ch. March 29, 2011); *see also Aspen Advisors LLC v. United Artists Theatre Co.*, 861 A.2d 1251, 1266 (Del. 2004) (noting that tortious interference with contract is a separate, free-standing cause of action that is not subsumed within a breach of contract claim).

[32] Pl.'s Answering Br. 37 (alteration in original).

recommendations . . . for [Longview] to . . . evaluate value-maximizing strategic alternatives" and the Director Defendants "personal, selfish and/or retaliatory motives."[33] These conclusory allegations hardly put the Director Defendants on notice that Huff Energy was alleging that they acted outside the "scope of their employment" with Longview or tortiously interfered with the Shareholders Agreement.

Huff Energy cites *Nye v. Univ. of Delaware*[34] to substantiate its contention that allegations of bad motives and animosity rise to the requisite level of interestedness that would support an inference that the Director Defendants acted outside the scope of their employment. In *Nye*, the court found that the plaintiff "sufficiently plead a claim for breach of the implied covenant of good faith and fair dealing" based on well-pled allegations that "the University [intentionally] falsified grounds to engineer the removal of Dean Nye."[35] No facts remotely approximating this degree of misbehavior have been pled here. Moreover, Huff Energy has made no effort to present argument that its Complaint contains allegations that would meet the remaining elements of tortious interference (including that the Defendants

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[33] *Id.*

[34] 2003 WL 22176412, at *4 (Del. Super. Sept. 17, 2003).

[35] *Id.*

acted without justification).[36] Instead, it argues summarily that the same facts that support its breach of contract claim support its tortious interference claim.[37] This is not sufficient to state a viable claim, particularly where the Complaint does not separately designate a tortious interference cause of action.

2. Plaintiff Has Failed to Plead Breach of Contract Against Any Defendant

Huff Energy alleges that the Board's adoption of the Plan of Dissolution violated the following provisions of the Shareholders Agreement: (a) Section 10(b)(iii), which required unanimous Board approval of "any action or omission that would have a material adverse effect on the rights of any Shareholder, as set forth in this Agreement" including, according to Huff Energy, its purported "right of transferability" of its Longview stock; (b) Section 9(d), which required Longview to "use reasonable efforts to ensure that the rights granted [under the Shareholders Agreement] are effective and that the Shareholders enjoy the benefits thereof"; (c) Section 9(a), which provided that Longview "shall continue to exist and shall remain in good standing under the laws

[36] *Wallace*, 752 A.2d at 1182–83 ("[E]mployees acting within the scope of their employment are identified with the defendant himself so that they may ordinarily advise the defendant to breach his own contract without themselves incurring liability in tort. This rationale is particularly compelling when applied to corporate officers as 'their freedom of action directed toward corporate purposes should not be curtailed by fear of personal liability.'" (alteration in original) (footnotes and internal quotation marks omitted)).

[37] Pl.'s Answering Br. 36.

of its state of incorporation and under the laws of any state in which [Longview] conducts business"; and (d) Section 2(b), which allowed Huff Energy to appoint two directors to the Board. I address these alleged breaches in turn.

a. The Shareholders Agreement did not "Set Forth" a Right of Transferability

As stated, Section 10(b)(iii) of the Shareholders Agreement requires unanimous Board approval of "any action or omission that would have a material adverse effect on the rights of any [Longview shareholder], *as set forth in*" the Shareholders Agreement (emphasis added). Huff Energy argues that the Shareholders Agreement "set[s] forth" a "right of transferability," and that the Board's adoption of the Plan of Dissolution materially and adversely affected that right. According to Huff Energy, the "right of transferability" is reflected in the following language in Section 6(a), entitled "Right of First Offer":

> If any Shareholder proposes to sell, assign, pledge or in any manner transfer any [Longview stock], . . . to any third party other than [a Longview] affiliate, then such Selling Shareholder shall first grant [Longview] the right to purchase the [offered shares] at the same price and on the same terms as . . . [offered] to [the] third party.

Huff Energy argues that because the Shareholders Agreement acknowledges that Longview stockholders can sell their shares, that "right" is "set forth" in the agreement and is therefore subject to Section 10(b)(iii)'s unanimity requirement. It concedes, however, that any "right" it might possess to transfer its Longview stock originates outside of and notwithstanding the Shareholders Agreement's

acknowledgement of that "right."[38] In other words, the "right to transfer" is not created by the Shareholders Agreement.

The claim of breach under Section 10(b)(iii), therefore, turns on the construction of the phrase "set forth": if "set forth" means "created," then the purported the "right of transferability" would escape Section 10(b)(iii)'s unanimity requirement because the right was not created by the contract; if, however, "set forth" means that the unanimity requirement applies to any act or omission that has a materially adverse effect on any right that is merely "referenced" in the contract, then Huff Energy's interpretation, at least at this stage of the proceedings, might prevail to the extent a right of transfer is referenced in Section 6(a).

Huff Energy's construction of Section 10(b)(iii), on several levels, contradicts common sense and the business realities of the parties' relationship as reflected in the Shareholders Agreement. First, to interpret Sections 6 and 10 as granting Huff Energy a veto power over any Board act that has a materially adverse effect on its right to transfer its stock contradicts the sole purpose of Section 6(a), which is to grant *Longview* a right of first offer. In fact, the phrase "[if] any Shareholder proposes to sell [its stock] . . . then such Selling Shareholder

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[38] Tr. of Oral Arg. of Defs.' Mot. to Dismiss ("Oral Arg. Tr.") 52. I note that Huff Energy has never identified the origin of its "right to transfer" so it is difficult to evaluate whether it has stated a claim that the Plan of Dissolution had a material adverse effect on that right. I need not dwell on this question, however, because I am satisfied that any right of transfer Huff Energy might possess is not subject to Section 10(b)(iii).

shall first [offer such stock to Longview on the same terms]" *restricts* any preexisting right to transfer—it in no way "sets forth" that right.

Second, adopting Huff Energy's interpretation of Sections 6 and 10 would result in an arbitrary distinction between rights falling within and without Section 10(b)(iii)'s purview. For example, the purpose of Section 6 of the Shareholders Agreement was to create a right of first offer for Longview. To describe the right of first offer precisely, the drafters saw fit to assume that Huff Energy could transfer its shares.[39] A finding that the phrase "set forth" in the Agreement means "referenced" in the agreement would therefore subject all extra-contractual "rights" to Section 10(b)(iii)'s unanimity requirement solely because the "right" was referenced in relation to another right actually created by the Shareholders Agreement. I cannot reasonably infer that the drafters intended such a result. Therefore, I conclude that the only reasonable construction of the phrase "set forth" within Section 10(b)(iii) is that it means "created by" the Shareholders Agreement.[40] Because the Shareholders Agreement did not create a "right of transferability," and because the parties expressed no intent to reference pre-

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[39] *Id.* (Huff Energy counsel stating that Section 6(a) "obviously assumes a right to transfer.").

[40] *Caspian Alpha Long Credit Fund, L.P. v. GS Mezzanine P'rs 2006, L.P.*, 93 A.3d 1203, 1205 (Del. 2014) (holding that where there is only one reasonable interpretation of a contract, claims based upon another interpretation should be dismissed as a matter of law).

existing rights within Section 10(b)(iii), I reject Huff Energy's argument that the less-than-unanimous Board adoption of the Plan of Dissolution violated Section 10(b)(iii) of the Shareholders Agreement.

b. The Plan of Dissolution Did Not Violate Section 9(a)

Huff Energy next argues that the Board's less-than-unanimous adoption of the Plan of Dissolution violated Section 9(a) of the Shareholders Agreement, which provided that Longview "shall continue to exist and shall remain in good standing under the laws of its state of incorporation and under the laws of any state in which [it] conducts business." This argument attempts to meld Section 10(b)(iii)'s unanimity requirement with Section 9(a)'s purported "covenant that [Longview] will continue to exist."[41] Counsel for Huff Energy acknowledged as much in prior proceedings in this Court.[42] Once again, Huff Energy has offered an unreasonable construction of the Shareholders Agreement that contradicts its clear terms.

I start by noting that Section 9(a) appears to be nothing more than a recognition by Longview that it will remain in good standing as a Delaware corporation. It speaks to a commitment to make necessary filings and pay required

[41] Pl.'s Answering Br. 22.

[42] *See* Defs. Opening Br. in Supp. of their Mot. To Dismiss the Verified Am. Compl. Ex. C, at 9–10 ("THE COURT: . . . Is it your view that there can never be a plan of dissolution implemented as long as Huff Energy is a shareholder and it continues to oppose the plan of dissolution? MR. KRINER: Yes, Your Honor.")

fees and expenses. It is a stretch to read more into the provision, particularly the commitment to exist "come what may" that Huff Energy ascribes to it.

A more rigorous analysis of Huff Energy's construction of Section 9(a)—that the provision requires Longview to exist eternally unless Huff Energy agrees otherwise—reveals that it is inconsistent with and would render meaningless other provisions within the Shareholders Agreement. For example, Section 10(a) of the Shareholders Agreement requires a vote of two-thirds of the Board to engage in a merger or sale of substantially all of Longview's assets.[43] A merger in certain forms would have the same effect on Section 9(a) as the Plan of Dissolution (Longview would cease to exist), yet the Shareholders Agreement explicitly provides for a two-thirds vote. Indeed, since "dissolution" is not listed under the Shareholders Agreement's supermajority provisions, and is not referenced in Section 10(b), it is reasonable to read the Shareholders Agreement to allow the Board to approve a plan of dissolution by majority vote.

Finally, if the Court adopted Huff Energy's interpretation of Section 9(a), any dissolution, even a dissolution that is patently in the best interests of the corporation and its stockholders, would in all events violate the Shareholders

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[43] Shareholders Agreement § 10(a)(iv).

Agreement absent Huff Energy's endorsement.[44] The drafters of the Shareholders Agreement could not have intended to place this kind of restriction on the Board without expressly saying so in the contract.[45] Therefore, the Complaint fails to plead facts from which I can reasonably infer that the Plan of Dissolution breached Section 9(a) of the Shareholders Agreement.

c. The Plan of Dissolution Did Not Violate Sections 2(b) or 9(d)

The Complaint alleges that the Plan of Dissolution violates Section 2(b), when read in conjunction with Section 10(b)(iii), because it materially and adversely denies Huff Energy's right to appoint two directors to the Board. Defendants moved to dismiss this claim but Huff Energy has not pressed it since raising it in its Complaint—it did not address the claim in its Answering Brief or at oral argument. Consequently, the motion to dismiss this claim stands unopposed.

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[44] In response to the Court's question whether dissolution would always amount to a breach of Section 9(a), Huff Energy stated "[t]he way this is written, that's correct, Your Honor, always." Oral Arg. Tr. 67.

[45] *Osborn v. Kemp,* 991 A.2d 1153, 1160–61 (Del. 2010) (the court will avoid interpretations of contracts that produce "absurd" results); *Delta & Pine Land Co. v. Monsanto Co.*, 2006 WL 1510417, at *4 (Del. Ch. May 24, 2006) ("[C]ontracts must be interpreted in a manner that does not render any provision 'illusory or meaningless.'"); *Council of Dorset Condo. Apartments v. Gordon*, 801 A.2d 1, 7 (Del. 2002) ("A court must interpret contractual provisions in a way that gives effect to every term of the instrument, and that, if possible, reconciles all of the provisions of the instrument when read as a whole."); *Warner Commc'ns Inc. v. Chris-Craft Indus., Inc.*, 583 A.2d 962, 971 (Del. Ch.) ("An interpretation that gives an effect to each term of an agreement, instrument or statute is to be preferred to an interpretation that accounts for some terms as redundant."), *aff'd*, 567 A.2d 419 (Del. 1989).

In any event, Huff Energy's right to appoint two directors continues without infringement throughout the winding up process. The Board's adoption of the Plan of Dissolution had no effect on Huff Energy's rights under Section 2(b), and therefore this claim of breach must be dismissed.

Section 9(d) of the Shareholders Agreement provides that Longview "agrees to use reasonable efforts to ensure that the rights granted hereunder are effective and that the Shareholders enjoy the benefits thereof." Having determined that Huff Energy has not well-pled that the Board's adoption of the Plan of Dissolution adversely affected any "right" set forth in the Shareholders Agreement, Huff Energy's claim of breach under Section 9(d) must also be dismissed.

C. The Director Defendants Did Not Breach their Fiduciary Duties

Count II of the Complaint alleges that the Director Defendants breached their fiduciary duties by approving and implementing the Plan of Dissolution. Specifically, Huff Energy argues that: (1) by adopting the Plan of Dissolution, the Director Defendants acted to "advance their own special interests at the expense of Plaintiff and Longview's other stockholders";[46] or (2) the Plan of Dissolution must be reviewed with *Revlon* enhanced scrutiny as a "final stage" transaction because the Director Defendants failed to take reasonable measures to maximize

[46] Pl.'s Answering Br. 40.

shareholder value;[47] or (3) it must be reviewed with *Unocal* enhanced scrutiny as an unreasonable defensive measure. Each of these arguments fails, and Count II of the Complaint must be dismissed.

1. The Director Defendants were Disinterested and Independent

Under Delaware law, "a breach of fiduciary duty analysis begins with the rebuttable presumption that a board of directors acted with loyalty and care."[48] "To rebut the [presumption], a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision," breached their duty of loyalty or care.[49] And to plead a breach of the duty of loyalty, a plaintiff must normally plead facts demonstrating "that a *majority* of the director defendants have a financial interest in the transaction or were dominated or controlled by a materially interested director."[50] Failing to rebut the presumption results in the business judgment rule protecting the directors' challenged decisions, so long as they can be attributed to any rational business purpose.[51]

Huff Energy has failed to rebut the business judgment presumption. The Complaint's only allegations that any individual Board member acted other than in

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[47] *Id.* 46.

[48] *Crescent/Mach I P'rs, L.P. v. Turner*, 846 A.2d 963, 979 (Del. Ch. 2000).

[49] *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

[50] *Orman v. Cullman*, 794 A.2d 5, 22 (Del. Ch. 2002) (internal quotation marks omitted).

[51] *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1374 (Del. 1995).

the best interests of Longview are that, upon dissolution, Gershen was to receive a severance payment equal to one year's salary plus bonuses, Pearce was to receive a severance payment equal to two years' salary plus bonuses, Gershen had prior business relationships with other members of the Board (presumably of a nature that would allow him to control their decision making) and Gershen had sought an exit from Longview for years due to his growing animosity toward Huff and Huff Energy. For several reasons, these allegations fall well short of what is required to strip the Director Defendants of the protections of the business judgment rule.

First, "the possibility of receiving change-in-control benefits pursuant to pre-existing employment agreements does not create a disqualifying interest as a matter of law."[52] In fact, this Court has sanctioned director change-in-control benefits larger than those at issue here.[53] Moreover, although the gravamen of Huff Energy's complaint against the Board is its adoption of the Plan of Dissolution, the severance payments that are alleged to have motivated certain of the Director Defendants to act out of self-interest were actually triggered by the

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[52] *In re Novell, Inc. S'holder Litig.*, 2013 WL 322560, at *11 (Del. Ch. Jan. 3, 2013).

[53] *In re W. Nat. Corp. S'holders Litig.*, 2000 WL 710192, at *12 (Del. Ch. May 22, 2000) ("[A] $4.5 million cash severance payment coupled with accelerated vesting of certain options to an executive chairman of a large corporation does not strike me as so far beyond the pale that it would give rise to an improper motive to accomplish a merger."); *Nebenzahl v. Miller*, 1993 WL 488284, at *3 (Del. Ch. Nov. 8, 1993) (finding that employment agreements ensuring that "three executives will receive lump sum payments equal to their salaries for the remainder of the terms of their contracts" upon a change in control did not render such executives "interested").

sale of the California Assets.[54] Huff Energy does not challenge that transaction. Simply stated, the severance provisions in Gershen's and Pearce's respective employment agreements fail to render either director/officer interested in any relevant transaction to a degree that would rebut the business judgment rule.

Second, allegations regarding Gershen's former and then-current business relationships with other Board members, in the absence of any allegation that Gershen either controlled or was controlled by any other member, fail to create a reasonable inference of a disqualifying conflict. Our law is clear that "personal friendships, without more; outside business relationships, without more; and approving of or acquiescing in the challenged transactions, without more, are each insufficient to raise a reasonable doubt of a director's ability to exercise independent business judgment."[55]

Third, Huff Energy's argument that Gershen's animosity towards Huff drove Gershen to act out of self-interest does not square with the well-pled allegations in the Complaint and does not, in any event, rise to the level of any legal significance

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[54] Compl. ¶¶ 31, 74.

[55] *Cal. Pub. Empls.' Ret. Sys. v. Coulter*, 2002 WL 31888343, at *9 (Del. Ch. Dec. 18, 2002) (footnotes omitted); *accord Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1050 (Del. 2004); *Litt v. Wycoff*, 2003 WL 1794724, at *4 (Del. Ch. Mar. 28, 2003); *Goldman v. Pogo.com, Inc.*, 2002 WL 1358760, at *3 (Del. Ch. June 14, 2002).

when considering the appropriate standard of review.[56] The only allegations in the Complaint cited in support of this theory involve Gershen's alleged pursuit, since 2008, of a liquidity event to counter Huff Energy's growing stake in Longview. Why Gershen would seek to relinquish all control and dissolve Longview as a solution to Huff Energy's increasing influence over Longview is unclear. Absent any additional, non-conclusory allegations regarding Gershen's alleged self-interested motivation to adopt the Plan of Dissolution, I am unable to draw a reasonable inference that Gershen was in any way personally interested in the Board's decision to adopt the Plan of Dissolution. Having determined that Gershen was not subject to a disqualifying conflict of interest, it follows that Huff Energy's argument that Gershen's alleged animosity "infected the other [Director] Defendants, who [had] also developed a pattern of animosity in their course of dealings with [Huff Energy] and its Board designees" would also ring hollow.[57]

Finally, apart from Huff Energy's conclusory allegation that Gershen's interest "infected" the remaining Director Defendants, the Complaint makes no loyalty allegations with respect to any of the four remaining Director Defendants. Therefore, even accepting Huff Energy's allegations regarding Gershen's interest

[56] Pl.'s Answering Br. 49 n.39.

[57] *Id.* 42.

as true, a majority of the indisputably independent and disinterested Board members properly approved the Plan of Dissolution.

To rebut the business judgment rule, Huff Energy must allege facts allowing for a reasonable inference that a majority of the Board acted in the midst of a disqualifying conflict of interest with respect to the decision to adopt the Plan of Dissolution.[58] It has failed to do so, and for that reason, the business judgment rule shields the Board from allegations other than waste.

While not explicitly alleging that the Board's adoption of the Plan of Dissolution amounts to waste, Huff Energy does argue that because the approved transaction resulted in no immediate distribution to Longview's stockholders, the Plan of Dissolution was "no longer advisable or indeed rational."[59] To the extent this conclusory argument in the Answering Brief is intended as a substitute for well-pled allegations of waste, it is rejected as inadequate. The Plan of Dissolution was adopted in the first instance at the urging of Huff Energy in connection with the first proposed sale of the California Assets. The Board determined to maintain that deal structure when it agreed to sell the California Assets in 2015. At the risk of repeating what has already been repeated, Huff Energy is not challenging the sale of the California Assets. In any event, the allegations that the Plan of

[58] *Orman*, 794 A.2d at 24.

[59] Pl.'s Answering Br. 41.

Dissolution eliminated the chance of an illusory tender offer from Huff Energy, rendered Longview's remaining assets less marketable, and rendered Longview shares less transferable are conclusory and fall well short of pleading that the Plan of Dissolution lacked "any rational business purpose."[60]

The Complaint fails to plead facts from which I may reasonably infer that the entire fairness standard of review applies to the Board's adoption of the Plan of Dissolution. I suspect this holding will come as no surprise to Huff Energy. As its arguments evolved in the course of briefing and arguing the motion to dismiss, it became clear that Huff Energy's focus had turned to its *Revlon* and *Unocal* claims. I address those claims next.[61]

2. *Revlon* Does Not Apply

Revlon enhanced scrutiny applies to "final stage" transactions, including a "cash sale, a break-up, or a transaction like a change of control that fundamentally alters ownership rights."[62] Inherent in such situations, even absent allegations challenging a board's interestedness or independence, "are subtle structural and

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[60] *Calma ex rel. Citrix Sys., Inc. v. Templeton*, 114 A.3d 563, 590 (Del. Ch. 2015).

[61] Because I conclude that neither *Revlon* nor *Unocal* apply here, I need not address the Defendants' argument that *Revlon* and *Unocal* claims are "not tools designed with post-closing money damages in mind . . . ." *Corwin v. KKR Fin. Hldgs. LLC.*, 126 A.3d 304, 312 (Del. 2015).

[62] *Lonergan v. EPE Hldgs., LLC*, 5 A.3d 1008, 1019 (Del. Ch. 2010); *accord Mendel v. Carroll*, 651 A.2d 297, 306 (Del. Ch. 1994).

situational conflicts that do not rise to a level sufficient to trigger entire fairness review, but also do not comfortably permit expansive judicial deference."[63] Therefore, where *Revlon* concerns are present, "the defendant fiduciaries bear the burden of proving that they 'act[ed] reasonably to seek the transaction offering the best value reasonably available to the stockholders,' which could be remaining independent and not engaging in any transaction at all."[64] Indeed, "directors are generally free to select the path to value maximization,"[65] so long as that path, and the decisions made along the way, "on balance, [fall] within a range of reasonableness."[66]

The Board's adoption of the Plan of Dissolution in no way implicates the policy concerns expressed in *Revlon* that trigger this Court's enhanced scrutiny. Huff Energy argues that the Plan of Dissolution constitutes a "'final stage' transaction."[67] To the contrary, following board and stockholder approval of a plan of dissolution and the filing of a certificate of dissolution, a corporation's "existence continues for a period of three years 'or for such longer period as the

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[63] *In re Rural Metro Corp.*, 88 A.3d 54, 82 (Del. Ch. 2014), *aff'd sub nom. RBC Capital Markets, LLC v. Jervis*, 129 A.3d 816 (Del. 2015).

[64] *Id.* at 83 (alteration in original).

[65] *In re Dollar Thrifty S'holder Litig.*, 14 A.3d 573, 595 (Del. Ch. 2010).

[66] *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994).

[67] Pl.'s Answering Br. 46.

Court of Chancery shall in its discretion direct' for the purpose of prosecuting and defending suits and to enable the corporation gradually to sell its properties and to wind up its affairs and discharge its liabilities."[68] As such, "the formal act of dissolution does not disturb the directors' authority to determine the means by which winding up is to be accomplished," and the directors of a dissolved corporation have "as much authority after dissolution as they had before dissolution."[69] Consequently, "[o]nce a corporation dissolves, . . . fiduciary obligations [are] imposed on its director[s] . . . not only to the former stockholders of the corporation, but also to the creditors of the corporation."[70]

Therefore, while the Board's adoption of the Plan of Dissolution began the winding up process, the Board maintained control over Longview's non-California Assets and retained its duty to act in the best interests of Longview's stockholders and creditors. For that reason, I cannot accept Huff Energy's argument that the Board's adoption of the Plan of Dissolution constituted a "final stage" transaction or implicated *Revlon* concerns—*i.e.*, "the potential conflicts of interest that fiduciaries face when considering whether to sell the corporation, to whom, and on

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[68] 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 10.16 (2016 Supp.).

[69] *Lone Star Indus., Inc. v. Redwine*, 757 F.2d 1544, 1550, n.7 (5th Cir. 1985).

[70] *Gans v. MDR Liquidating Corp.*, 1990 WL 2851, at *9 (Del. Ch. Jan. 10, 1990).

what terms"[71]—to the same extent as a "cash sale, a break-up, or a transaction like a change of control that fundamentally alters ownership rights."[72]

Nor did the Plan of Dissolution effect a "change of control."[73] The best Huff Energy can muster on this front is that Longview agreed to pay Gershen, Pearce and others "'change of control' payments based on the Dissolution."[74] Of course, the Complaint acknowledges and pleads that the "change of control" payments were actually triggered by the sale of the California Assets, not the Dissolution.[75] No well pled facts allow an inference that the Plan of Dissolution effected a change of control. *Revlon* does not apply.

3. *Unocal* Does Not Apply

As an alternative (or perhaps accent) to its *Revlon* argument, Huff Energy contends that the Plan of Dissolution invokes *Unocal* enhanced scrutiny because it was adopted as "an unreasonable poison pill."[76] "The Delaware Supreme Court created the intermediate standard of review in its iconic *Unocal* decision, which declined to apply either the business judgment rule or the entire fairness test to

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[71] *Rural Metro*, 88 A.3d at 82–83.

[72] *Lonergan*, 5 A.3d at 1019.

[73] *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 242 (Del. 2009).

[74] Pl.'s Answering Br. 45.

[75] Compl. ¶¶ 31, 74–75.

[76] Compl. ¶ 93.

actions taken by directors to resist a hostile takeover."[77] In *Unocal*, the Court recognized that "[w]hen a board addresses a pending takeover bid," there is an "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."[78] Thus, notwithstanding the absence of allegations that the board or board members were motivated by conflicts of interest, this Court recognizes that in the context of a board's resistance to a hostile offer, a level of scrutiny more exacting than the business judgment rule but less rigorous than entire fairness is necessary to protect stockholders from entrenchment concerns inherent in such circumstances.[79]

Huff Energy argues that the Board's adoption of the Plan of Dissolution implicates *Unocal* entrenchment concerns because it constituted a "defensive measure[] in response to a perceived threat to corporate policy that 'touche[d] upon issues of control.'"[80] The Complaint's only allegations supporting this contention, however, are (1) that the Plan of Dissolution was designed to "wrest any control from Plaintiff and its Board designees over a sale of the Company," and (2) that Gershen and the other Director Defendants perceived Huff Energy "as a threat to

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[77] *Rural Metro*, 88 A.3d at 82.

[78] *Unocal*, 493 A.2d at 954.

[79] *See Obeid v. Hogan*, 2016 WL 3356851, at *13 (Del. Ch. June 10, 2016).

[80] Pl.'s Answering Br. 48 (quoting *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59, 71 (Del. 1995)).

[Gershen's] power over Longview."[81] Huff Energy cites no cases, however, indicating either that (1) the adoption or filing of a certificate of dissolution or (2) the board's "perception" that a shareholder posed a threat to any individual director's "power" over the corporation implicates the "omnipresent specter" lingering in those instances where *Unocal* scrutiny has been invoked.[82] Indeed, the adoption and filing of a certificate of dissolution avoids any specter of entrenchment given that such action invariably results in winding up of the company's operations, payments of its debts and liquidation of its assets. Not only did the Board not adopt a defensive measure in the *Unocal* sense or otherwise, it faced no cognizable threat that would have motivated it to do so (for entrenchment purposes or any other purpose for that matter).[83]

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[81] *Id.* 48–49. In fact, the Complaint refers only to a "potential tender offer" that Huff Energy "might have made" for the remaining Longview shares. Compl. ¶ 77. It contains no allegations that any such offer was forthcoming or, more importantly, that the Board knew a tender offer was in the works.

[82] *Kahn ex rel. DeKalb Genetics Corp. v. Roberts*, 679 A.2d 460, 466 (Del. 1996) (finding that "the factual circumstances do not warrant the application of *Unocal*" because "[n]othing in the record indicates that there was a real probability of any hostile acquir[er] emerging or that the corporation was 'in play'").

[83] Even if the Plan of Dissolution was to be characterized as a "defensive measure," in the absence of a real or perceived threat, its adoption likely would be subject to business judgment review. *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1079 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985); *Goggin v. Vermillion, Inc.*, 2011 WL 2347704, at *4 (Del. Ch. June 3, 2011); *eBay Domestic Hldgs, Inc. v. Newmark*, 16 A.3d 1, 27–28 (Del. Ch. 2010).

4. The Cleansing Effect of the Longview Stockholders' Vote

Even if the Court agreed with Huff Energy that it has pled facts that would allow an inference that the Board's adoption of the Plan of Dissolution invoked some form of enhanced scrutiny, the Longview stockholders' approval cleansed the transaction thereby irrebuttably reinstating the business judgment rule. As recently reiterated by our Supreme Court in *Corwin v. KKR Financial Holdings LLC*,[84] "Delaware corporate law has long been reluctant to second-guess the judgment of a disinterested stockholder majority that determines that a transaction with a party other than a controlling stockholder is in their best interests."[85]

Huff Energy attempts to circumvent *Corwin*'s cleansing effect by contending that the Longview stockholders' vote was not fully informed. To succeed on this argument, Huff Energy must plead facts from which the Court may reasonably infer that the Proxy Statement omitted material information, that is, information that, if disclosed, had a "substantial likelihood" of being "viewed by the reasonable stockholder as having significantly altered the 'total mix' of information made available."[86] Huff Energy's only allegation to that end,

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[84] 125 A.3d 304 (Del. 2015).

[85] *Id.* at 306–08 (holding that business judgment rule applies when a transaction is approved by a fully informed and uncoerced vote of disinterested stockholders).

[86] *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170, 1172 (Del. 2000). *See also Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985) ("An omitted fact is material if there is a

however, is that the Proxy Statement failed to disclose that D'Angelo, the only Huff Energy-appointed director present during the Board's approval of the Plan of Dissolution, abstained from the vote and the reason(s) for his abstention.[87] The argument is essentially that the Proxy Statement's disclosure that "the Board" recommended the Plan of Dissolution misleadingly suggests that the vote to approve the Plan of Dissolution was unanimous when, in fact, one director abstained.

With respect to Huff Energy's concerns that the Proxy Statement omitted the rationale underlying D'Angelo's abstention, Delaware law is clear that while "all material *facts* must be disclosed . . . individual directors need not state 'the grounds of their judgment for or against a proposed shareholder action.'"[88] With respect to the abstention itself, my determination that the adoption of the Plan of Dissolution did not require unanimous Board approval dispenses with any argument that it is "[substantially likely] that a reasonable shareholder would consider" a disclosure

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substantial likelihood that a reasonable shareholder would consider it important in deciding [whether to approve the challenged transaction]") (citations omitted).

[87] Pl.'s Answering Br. 51–52.

[88] *Dias v. Purches*, 2012 WL 4503174, at *9 (Del. Ch. Oct. 1, 2012) (quoting *In re Sauer-Danfoss Inc. S'holders Litig.*, 65 A.3d 1116, 1131 (Del. 2011)).

that D'Angelo's abstained from voting to be "important in deciding" whether to vote to approve the plan.[89]

To the extent Huff Energy argues, separate and apart from its unanimity argument, that the omission of a disclosure that D'Angelo abstained materially misled the stockholders because the Proxy Statement's "generalized use of the term 'Board' in the Proxy Statement . . . indicates that the full Board [was] in support of"[90] the Plan of Dissolution, I must again disagree. Neither party cited a case, and I am aware of none, that stands for the proposition that a proxy statement's omission of the fact that a board's approval of a transaction was other than unanimous, much less that the only dissent was one director's abstention, is a material omission. I can discern no basis to set that precedent.

Having determined that Huff Energy has failed to plead that the stockholder vote was uninformed, absent any allegations regarding potential interestedness or coercion of Longview's stockholders, *Corwin* and its progeny provide that, even if the Court determined that *Revlon* or *Unocal* enhanced scrutiny might otherwise apply, given the cleansing vote of the stockholders, "the business judgment rule irrebuttably applies" to the Board's adoption of the Plan of Dissolution.[91] And

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[89] *Rosenblatt,* 493 A.2d at 944.

[90] Pl.'s Answering Br. 52.

[91] *In re Volcano Corp. S'holder Litig.*, 2016 WL 3626521, at *9 (Del. Ch. June 30, 2016). *See also Singh v. Attenborough*, 137A.3d 151 (Del. 2016) (holding that "a fully informed

having determined that the Complaint fails to state a claim for waste, Huff Energy has no remaining ground on which to stake a breach of fiduciary duty claim.[92]

III. CONCLUSION

For the reasons stated above, the Board's approval of the Plan of Dissolution and subsequent filing of a certificate of dissolution in no way violated the Shareholders Agreement or the Director Defendants' fiduciary duties. Accordingly, Defendants' Motion to Dismiss must be granted in full.

IT IS SO ORDERED.

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uncoerced vote of the disinterested stockholders invoke the business judgment standard of review" and noting that "[w]hen the business judgment standard of review is involved because of a vote, dismissal is typically the result").

[92] *Id.*

**UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT**

August Term 2015

(Argued: March 3, 2016 Decided: September 27, 2016)

Nos. 15-180-cv(L), 15-208-cv(XAP)

IN RE VIVENDI, S.A. SECURITIES LITIGATION[1]

MIAMI GROUP, CONSISTING OF THE RETIREMENT SYSTEM FOR GENERAL EMPLOYEES OF THE CITY OF MIAMI BEACH, FRANCOIS R. GERARD, PRIGEST S.A. AND TOCQUEVILLE FINANCE S.A., PEARSON-DONIGER FAMILY, CONSISTING OF TWO SISTERS AND THEIR RESPECTIVE FAMILY MEMBERS BEATRICE DONIGER, GRANDCHILDREN'S TRUST BY BRUCE DONIGER TRUSTEE, ALISON DONIGER, MICHAEL DONIGER, EDWARD B. BRUNSWICK AND RUTH PEARSON TRUST PEARSON TRUSTEE, GAMCO INVESTORS, INCORPORATED, OPPENHEIM KAPITALANLAGEGESELLSCHAFT MBH, PLAINTIFF KBC ASSET MANAGEMENT N.V., CAPITALIA ASSET MANAGEMENT SGR, S.P.A., CAPITALIA INVESTMENT MANAGEMENT S.A., EURIZON CAPITAL SGR S.P.A., BADEN-WURTTEMBERGISCHE INVESTMENTGESELLSCHAFT MBH, BARCLAYS GLOBAL INVESTORS (DEUTSCHLAND), COMINVEST ASSET MANAGEMENT GMBH, DEUTSCHE ASSET MANAGEMENT INVESTMENTGESELLSCHAFT MBH, DWS (AUSTRIA) INVESTMENTGESELLSCHAFT MBH, DWS INVESTMENT GMBH, ERSTE-SPARINVEST KAPITALANLAGEGESELLSCHAFT M.B.H., FORSTA AP-FONDEN, FORTIS INVESTMENT MANAGEMENT SA, KBC ASSET MANAGEMENT S.A., LANDESBANK BERLIN INVESTMENT GMBH, LBBW LUXEMBURG S.A., OPPENHEIM ASSET MANAGEMENT SERVICES S.A.R.L., PIONEER INVESTMENT MANAGEMENT LIMITED, PIONEER INVESTMENT MANAGEMENT SGRPA, PIONEER INVESTMENTS AUSTRIA GMBH, PIONEER INVESTMENTS

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[1] The Clerk of the Court is directed to amend the caption of the case.

KAPITALANLAGEGESELLSCHAFT MBH, RAIFFEISEN KAPITALANLAGE-GESELLSCHAFT M.B.H., SEB INVESTMENT MANAGEMENT AB, SKANDIA INSURANCE COMPANY LTD., UNION ASSET MANAGEMENT HOLDING AG, UNIVERSAL-INVESTMENT-GESELLSCHAFT MBH, SEB INVESTMENT GMBH, ANDRA AP-FONDEN, BAYERN-INVEST KAPITALANLAGEGESELLSCHAFT MBH, DEKA INVESTMENT GMBH, PRIGEST, S.A., TOCQUEVILLE FINANCE, S.A., ROSENBAUM PARTNERS, L.P., ON BEHALF OF THEMSELVES AND ALL OTHERS SIMILARLY SITUATED, RUTH PEARSON TRUST, DEKA INTERNATIONAL (IRELAND) LIMITED, DEKA INTERNATIONAL S.A. LUXEMBURG, DEKA FUNDMASTER INVESTMENTGESELLSCHAFT MBH, FIDEURAM INVESTIMENTI S.G.R., FIDEURAM GESTIONS S.A., INTERFUND SICA V., FRANKFURT-TRUST INVESTMENT-GESELLSCHAFT MBH, FRANKFURT-TRUST INVEST LUXEMBURG AG, HELABA INVEST KAPITALANLAGEGESELLSCHAFT MBH, HSBC TRINKAUS & BURKHARDT AG, INTERNATIONALE KAPITALANLAGEGESELLSCHAFT MBH, MEAG MUNICH ERGO KAPITALANLAGEGESELLSCFHAFT MBH, MEAG MUNICH ERGO ASSET MANAGEMENT GMBH, METZLER INVESTMENT GMBH, METZLER IRELAND LTD, NORDCON INVESTMENT MANAGEMENT AG, NORGES BANK, SWISS LIFE HOLDING AG, SWISS LIFE INVESTMENT MANAGEMENT HOLDING AG, SWISS LIFE ASSET MANAGEMENT AG, SWISS LIFE FUNDS AG, SWISS LIFE (BELGIUM) S.A., SWISS LIFE ASSET MANAGEMENT GMBH, SWISS LIFE ASSET MANAGEMENT (NEDERLAN) B.V., TREDJE AP-FONDEN, WESTLB MELLON ASSET MANAGEMENT KAPITALANLAGEGESELLSCHAFT MBH, ALECTA PENSIONSFORSAKRING, OMSESIDIGT, SJUNDE AP-FONDEN, VARMA MUTUAL PENSION INSURANCE COMPANY, DANSKE INVEST ADMINISTRATION A/S, AFA LIVFORSAKRINGSAKTIEBOLAG, AFA TRYGGHETSFORSAKRINGSAKTIEBOLAG, AFA SJUKFORSAKRINGSAKTIEBOLAG, AMF PENSION FONDFORVALTNING AB, ARBETSMARKNADSFORSAKRINGAR, PENSIONSFORSAKRINGSAKTIEBOLAG, PENSIONSKASSERNES ADMINISTRATION A/S, ARBEJDSMARKEDETS TILLAEGSPENSION, INDUSTRIENS PENSIONSSFORIKRING A/S, ARCA SGR, S.P.A., ILMARINEN MUTUAL PENSION INSURANCE COMPANY, PRIMA SOCIETA' DI GESTIONE DEL RISPARMIO S.P.A., NORDEA INVEST FUND MANAGEMENT A/S, NORDEA FONDER AB, NORDEA INVESTMENT FUNDS COMPANY I.S.A., NORDEA FONDENE NORGE AS, NORDEA FONDBOLAG FINLAND AB, SWEDBANK ROBUR FONDER AB, FJARDE AP-FONDEN, OLIVIER CHASTAN, REED S. CLARK, DAHA DAVIS, COLLEN DODI, RUTH PEARSON TRUST PEARSON TRUSTEE, EDWARD B. BRUNSWICK, MICHAEL DONIGER, ALISON DONIGER, GRANDCHILDREN'S TRUST BY BRUCE DONIGER TRUSTEE, BRUCE DONIGER, BEATRICE DONIGER, JEFFREY KURTZ, PRICE HAL, W. SCOTT POLLAND, JR., NICHOLAS A. RADOSEVICH, CAISSE DE DEPOT ET

PLACEMENT DU QUEBEC, AGF ASSET MANAGEMENT, S.A., IRISH LIFE INVESTMENT MANAGERS LIMITED,

Plaintiffs-Appellees,

BRUCE DONIGER, GERARD MOREL, OLIVER M. GERARD, THE RETIREMENT SYSTEM FOR GENERAL EMPLOYEES OF THE CITY OF MIAMI BEACH,

Plaintiffs-Appellees-Cross-Appellants,

WILLIAM CAVANAGH,

Cross-Appellant,

-v.-

VIVENDI, S.A.,

Defendant-Appellant-Cross-Appellee,

JEAN-MARIE MESSIER, GUILLAUME HANNEZO, VIVENDI UNIVERSAL,

Defendants.

Before: CABRANES, LIVINGSTON, AND LYNCH, *Circuit Judges.*

JEFFREY A. LAMKEN, Molo Lamken LLP, Washington, D.C. (Robert K. Kry, Lauren M. Weinstein, Molo Lamken LLP, Washington, D.C.; Arthur N. Abbey, Stephen T. Rodd, Jeremy Nash, Abbey Spanier, LLP, New York, N.Y.; Matthew Gluck, Michael C. Spencer, Milberg LLP, New York, N.Y.; Brian C. Kerr, Brower Piven, P.C., New York, N.Y., *on the brief*), *for Plaintiffs-Appellees-Cross-Appellants*

MIGUEL A. ESTRADA, Gibson, Dunn & Crutcher, LLP (Mark A. Perry, Lucas C. Townsend, Gibson, Dunn & Crutcher LLP, Washington, D.C.; Caitlin J. Halligan, Gibson, Dunn & Crutcher LLP, New York, N.Y.; Daniel Slifkin, Timothy G. Cameron, Cravath, Swaine & Moore LLP, New York, N.Y.; James W. Quinn, Gregory Silbert, Weil, Gotshal & Manges LLP, New York, N.Y., *on the brief*), *for Defendant-Appellant-Cross-Appellee*.

DEBRA ANN LIVINGSTON, *Circuit Judge*:

Prior to 1998, *Compagnie Générale des Eaux* was a French utilities company, best known for supplying water to households across France. By the close of 2000, that same company, now touting the name Vivendi Universal, S.A. ("Vivendi"), was a global media conglomerate with extensive dealings in the film, music, telecommunications, publishing, and Internet industries, among related others. What followed on the heels of Defendant-Appellant-Cross-Appellee Vivendi's seemingly overnight transformation gives rise to the securities-fraud allegations now at issue.

To pull off its transformation and buttress its position as a mover-and-shaker in the global media-and-telecommunications market, Vivendi spent much of 2000 and 2001 acquiring a diverse array of media and communications businesses in the United States and abroad. Naturally, these acquisitions required money, and Vivendi did not have an unlimited supply. By 2001 and

especially by 2002, Vivendi was running critically low. Indeed, Vivendi was in danger of not being able to meet all of its various payment obligations, including payments on loans it had taken out for the very purpose of financing its buying spree. In the worst case scenario, which inquiries later revealed was not an altogether unlikely one, Vivendi was months away from bankruptcy or insolvency. Yet, up until approximately July 2002, Vivendi made numerous representations to the market suggesting that the course ahead for the company was smooth sailing. That all came to a halt when Vivendi's stock price came tumbling down in the middle of 2002, after a series of credit downgrades and revelations that Vivendi was strapped for cash.

In a class-action suit they initiated against Vivendi in 2002, Plaintiffs-Appellees and Plaintiffs-Appellees-Cross-Appellants (collectively, "Plaintiffs"), investors in Vivendi's stock during the relevant time period, alleged that Vivendi's persistently optimistic representations during the period from October 30, 2000 to August 14, 2002, constituted securities fraud under § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), as well as the Securities Exchange Commission's ("SEC") Rule 10b–5 ("Rule 10b–5") promulgated thereunder, 17 C.F.R. § 240.10b–5. Vivendi now appeals from a

December 22, 2014 partial final judgment of the United States District Court for the Southern District of New York (Scheindlin, *J.*),[2] following a three-month jury trial that started in late 2009 and resulted in a jury verdict finding Vivendi liable for securities fraud under § 10(b) and Rule 10b–5.

We affirm as to Vivendi's claims on appeal, concluding as follows:

(1) Plaintiffs relied on specifically identified false or misleading statements at trial and thus, contrary to Vivendi's argument on appeal, did not fail to present an actionable claim of securities fraud by "eliminat[ing] the foundational element of . . . a specific false or misleading statement," Vivendi Br. 41;

(2) Vivendi's claim that certain statements constituted non-actionable statements of opinion is not preserved for appellate review;

(3) Vivendi's claims that certain statements constituted non-actionable puffery and that others fall under the Private Securities Law Reform Act's ("PSLRA") safe harbor provision for "forward-looking statements," see 15 U.S.C. § 78u-5(c), is without merit;

[2] Judge Richard J. Holwell presided over the trial. After he stepped down from the bench in 2012, the case was assigned to Judge Shira Scheindlin, who entered the order of partial final judgment from which Vivendi appeals.

(4) the evidence was sufficient to support the jury's determination that the fifty-six statements at issue here were materially false or misleading with respect to Vivendi's liquidity risk;

(5) the district court did not abuse its discretion in admitting the testimony of Plaintiffs' expert, Dr. Blaine Nye ("Nye"); and

(6) the evidence was sufficient to support the jury's finding as to loss causation.

As to the Plaintiffs' cross-appeal, we likewise affirm, concluding that the district court:

(1) did not abuse its discretion in excluding certain foreign shareholders from the class at the class certification stage; and

(2) did not err in dismissing claims by American purchasers of ordinary shares under *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247 (2010).

I. Background

At the helm of Vivendi's transition from a centuries-old French utilities conglomerate into a modern global media powerhouse was a man named Jean-Marie Messier, who had been the chief executive and chairman of the executive committee since 1994, and chairman of the company since 1996. Messier was not,

by trade, an expert in French utilities, but rather a former investment-banker at the firm Lazard Frères & Co. LLC. Soon after becoming chairman of the company's executive committee, Messier formulated an ambitious plan to transform the company completely. In broad strokes, Messier's plan was to merge the company with two other large companies that had significant media dealings; steadily supplement this new company's core media operations with various additional media acquisitions; and gradually divest the new company of its utilities and environment divisions.

The plan largely got underway in May 1998, when the shareholders of *Compagnie Générale des Eaux* approved the company's name change to Vivendi, S.A. Over the course of the following year, Vivendi, S.A., contributed or sold its interests in certain water-related holdings to a subsidiary, Vivendi Environnement, and acquired scattered interests in various media and telecommunications firms.

The most aggressive foray in Messier's plan came on June 20, 2000, when Vivendi, S.A., formally announced its intent to enter into a three-way merger with Canal Plus, S.A. ("Canal+"), a French film and television production company; and The Seagram Company Ltd. ("Seagram"), a Canadian

entertainment and beverage company that owned, among other things, Universal Studios and Universal Music Group. Shortly after the announcement of the merger, credit-rating agencies Moody's and Standard & Poor's ("S&P") undertook to reevaluate the creditworthiness of Vivendi, S.A. On July 4, 2000, Moody's noted a "possible downgrade" of a particular senior class of Vivendi, S.A.'s debt might be on the horizon, on account of, *inter alia*, concerns about the considerable amount of debt Vivendi, S.A., would carry after the merger (including extensive prior debts already incurred). S&P also expressed some concern, but tempered its forecast with the expectation that the company would be able to dispose of several assets and thereby alleviate its debt. Neither Moody's nor S&P downgraded Vivendi, S.A., at the time. The three-way merger was complete on December 8, 2000, with the surviving entity being Vivendi, formerly a subsidiary of Vivendi, S.A. With the three-way merger, Vivendi became one of the world's leading media and communications companies, second only to AOL-Time Warner. Among Vivendi's assets were the world's largest recorded music company, one of the world's largest motion picture studios, and businesses in the global telecommunications, television, theme park, publishing, and Internet industries.

Still, Vivendi pressed forth with additional acquisitions. Over the course of the next eighteen months, Vivendi acquired significant stakes, or added to its existing interests, in a number of media and telecommunications companies across the world. To start, within just a few days of the three-way merger's completion in December 2000, Vivendi announced its acquisition of a 35% interest in Maroc Telecom, the Kingdom of Morocco's state-owned telecommunications company, for approximately €2.3 billion. In Summer 2001, Vivendi acquired publishing company Houghton Mifflin Company ("Houghton Mifflin"), along with its $500 million in net debt, for approximately $2.2 billion. Several months later, on December 17, 2001, Vivendi announced that it would acquire full control of television company USA Networks Corporation ("USA Networks") for $10.3 billion, approximately $1.6 billion of which Vivendi would finance in cash. That same day, Vivendi announced that it would invest $1.5 billion in satellite television company EchoStar Communications Corporation ("EchoStar"), which was expected to gain access to approximately 15 million homes in the United States when EchoStar acquired DirecTV.

These multi-billion-dollar transactions merely scratched the surface of Vivendi's buying frenzy. Vivendi also acquired, in whole or in part, MP3.com,

GetMusic LLC, RMM Records & Video, MUSIDISC, Koch Group Recorded Music, Uproar Inc. and EMusic.com Inc., among other media or telecommunications companies. In total, Vivendi reportedly spent approximately $77 billion on its acquisition spree, with Seagram alone costing roughly $34 billion. According to Plaintiffs, Vivendi's debts associated with its media and communications operations ballooned from approximately €3 billion in early 2000 to over €21 billion in 2002.

Meanwhile, Vivendi repeatedly expressed its aggressive growth prospects and its secure financial footing. Many of Vivendi's public statements during its acquisition period focused on EBITDA ("Earnings Before Interest, Tax, Depreciation, and Amortization"), an earnings measure that is typically considered a "good example of [a company's] cash income" and ability to service debt. J.A. 2833. On October 30, 2000, the company announced its "objective" to "grow *pro forma* adjusted EBITDA at an approximate 35% compound annual growth rate through 2002." Special App'x 315. Over the next year, Vivendi repeatedly underscored its "confidenc[e] that [it] w[ould] meet [its] very aggressive [EBITDA] growth targets," *id.* at 316, and emphasized that its fiscal year 2001 quarterly results met or exceeded its EBITDA growth targets, *e.g.*, *id.* at

320 (“With three quarters of the ‘aggressive’ incremental EBITDA target for the full year 2001 already achieved in the first half of the year, I can only re-emphasiz[e] our confidence. We will at least meet our stated targets.”); *id.* at 322 (“EBITDA organic growth is very strong, reaching 36% in the third quarter and 52% year-to-date. It represents the achievement in nine months of close to 100% of the full year 2001 incremental EBITDA growth target.”). Vivendi supplemented these statements with representations that it had “very strong . . . results with outstanding growth,” *id.* at 316, “the highest growth rates in the industry,” *id.* at 320, “strong operating results,” *id.*, “free operational cash flow [that was] far above [its] objectives,” *id.* at 328, and “strong free cash flow,” *id.* at 330.

But the tableau painted by Vivendi’s public statements did not match the tenor of the discussions inside the company. With each acquisition, Vivendi “had to borrow some money from the banks,” J.A. 2485, and it became “more and more difficult to raise the cash” Vivendi needed to pay for its acquisitions and its accumulating debts, J.A. 2487. Vivendi’s liquidity, or its ability to pay its fixed obligations, became increasingly strained. According to one member of Vivendi’s finance department, members of that department believed Vivendi’s

liquidity situation was "tense" by the middle of 2001, "dangerous" by late 2001, and "more than dangerous [throughout 2002]." J.A. 2488. The USA Networks and EchoStar transactions at the close of 2001 were particularly alarming to one member of Vivendi's finance department, who testified that the two deals "would create havoc with the debt level of Vivendi," whose "cash situation" was already "extremely tense" at the time. Special App'x 366 n.21.

Starting in June 2001, Vivendi's Treasurer, Hubert Dupont-L'Hôtelain, "clearly raised the issue of a cash problem inside Vivendi" at each one of Vivendi's Finance Committee meetings. J.A. 2512. According to a Vivendi employee present at the meetings, Dupont-L'Hôtelain repeatedly "expressed concerns over . . . the liquidity situation" and discussed Vivendi's "shortage in cash." *Id.* These discussions prompted Vivendi's Chief Financial Officer, Guillaume Hannezo, to comment on multiple occasions that Vivendi appeared to be "running out of cash" and "nearing bankruptcy." *Id.* at 2513.

Hannezo also warned Messier of these conditions. For example, after credit-rating agencies raised concerns with Hannezo in early December 2001 about Vivendi's contemplated USA Networks and EchoStar transactions, Hannezo wrote Messier warning of the "danger" of a downgrade. J.A. 4072. He

later penned a memorandum to Messier recounting the "painful and humiliating meetings with the ratings agencies." *Id.* at 3794. In that note, he explained that he did "not want to put up with[] a downgrade, which [he believed] would [lead] to a liquidity crisis." *Id.* Hannezo also told Messier that he had "the unpleasant feeling of being in a car whose driver is accelerating in a sharp turn while [he was] the one in the death seat." *Id.* "The only thing that I am asking," Hannezo continued, "is that it doesn't all end in shame." *Id.* at 3794–95. Four days after Hannezo alerted Messier to the "danger" of a downgrade, Vivendi publicly announced its $10.3 billion USA Networks transaction and $1.5 billion EchoStar transaction. In a press conference shortly after the announcement, Vivendi stated that the transactions were "not putting pressure on Vivendi Universal," and that it anticipated maintaining "a very comfortable . . . credit rating." *Id.* at 4158, 4162.

Around the same time, however, fissures began to appear in Vivendi's public façade. Despite Vivendi's assurances about the financial soundness of the USA Networks and EchoStar deals, the two transactions prompted Moody's to change its rating outlook on Vivendi to "negative." J.A. 4164. The decision, Moody's explained, came as a result of its concerns over the additional debt

incurred by the transactions, in conjunction with other debts previously incurred by Vivendi and uncertainty about Vivendi's ability to take steps to reduce its debt. A few weeks later, on January 7, 2002, Vivendi announced the sale of 55 million treasury shares for a total of €3.3 billion. "The proceeds of the sale," Vivendi explained in a press release, "w[ould] be used mostly to reduce the company's debt." J.A. 4117. Vivendi's stock prices dipped following the announcement of the treasury-share sale.

Despite raising €3.3 billion for Vivendi, the substantial treasury-share sale in January 2002 did not prevent Vivendi's problems from coming to a head several months later. On May 3, 2002, Moody's downgraded Vivendi's long-term senior debt rating from Baa2 to Baa3, citing concerns about Vivendi's ability to reduce debt and return its leverage to a point that would justify a Baa2 rating.[3] In response to Moody's decision, Vivendi stated that the downgrade "ha[d] no impact on Vivendi['s] . . . cash situation," and that Vivendi "ha[d] every confidence in its ability to meet its operating targets for 2002." J.A. 4667.

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[3] Credit ratings are generally divided into "investment-grade" and "non-investment-grade," the latter of which is sometimes referred to as "speculative-grade" or "junk." Moody's credit rating of Baa3 is its lowest rating in the investment-grade category, which is to say its lowest rating above junk status. *See generally* Moody's Investment Service, *Rating Symbols and Definitions* (2016), https://www.moodys.com/sites/products/AboutMoodysRatingsAttachments/MoodysRatingSymbolsandDefinitions.pdf.

Nonetheless, S&P followed Moody's suit on May 6, 2002, downgrading Vivendi's short-term debt from A-2 to A-3.[4] Shortly afterwards, Vivendi issued a press release stating that it "ha[d] no reason to fear any further deterioration [in its credit rating]." J.A. 4623. Vivendi's "cash flow situation," according to the press release, was "comfortable." *Id.* "[E]ven assuming an extremely pessimistic market," Vivendi would be able to "continue its debt reduction program in all serenity." *Id.*

Quietly, Vivendi attempted to slough off some of its less critical holdings for cash. On June 12, 2002, unbeknownst to the public, Vivendi and Deutsche Bank entered into a private sale-and-repurchase agreement, under which Vivendi sold a 12.7% stake in its 63%-owned subsidiary Vivendi Environnement and agreed to repurchase those shares from Deutsche Bank at a later point. On June 17, 2002, while the public remained unaware of Vivendi's deal with Deutsche Bank, Vivendi announced it was considering selling a significant stake in Vivendi Environnement when market conditions were appropriate. Vivendi's stock price took a hit on June 21, 2002, after the market learned that Vivendi had already entered a sale-and-repurchase agreement with respect to some of its

[4] For short-term debt, S&P's A-3 rating is its lowest rating in the investment-grade category. *See generally* S&P Global, *S&P Global Ratings Definitions* (2016), https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352.

shares in Vivendi Environnement. Press reports questioned why Vivendi could not wait until market conditions were appropriate to go through with the sale.

Three days later, on June 24, 2002, Vivendi announced the immediate sale of a 15.6% stake in Vivendi Environnement shares, including the 12.7% stake that was the subject of its repurchase-and-sale agreement with Deutsche Bank. That day alone, Vivendi's stock price dropped 23%. Financial commentators remarked that the quick succession of the two Vivendi Environnement transactions suggested that Vivendi "needed a quick cash injection" and "w[as] in a big rush to get that cash." J.A. 2792. Vivendi parried back on June 26, 2002, stating in a press release that "[o]wing to its strong free cash flow," combined with other factors, Vivendi was "confident of its capacity to meets its anticipated obligations over the next [year]." Special App'x 330. Two days later, however, Vivendi negotiated a new €275 million credit line from Société Générale.

After the market closed on July 1, 2002, Moody's downgraded Vivendi's long-term senior debt rating again, this time from Baa3 to Ba1, landing Vivendi's long-term senior debt in junk territory. In a press release announcing the downgrade, Moody's explained that its decision primarily reflected growing doubts about Vivendi's ability to achieve the level of debt reduction befitting of a

Baa3 rating and concerns over Vivendi's ability to refinance liabilities that would become due over the course of the next 12 months. When the market opened the following day, on July 2, 2002, S&P downgraded Vivendi's long-term debt from BBB to BBB–, just a notch above junk status, and warned that liquidity concerns could prompt further downgrades.[5] Like Moody's, S&P cited Vivendi's lack of transparency about large debt obligations that were fast approaching repayment deadlines, among other things, as a reason for the downgrade. After news of both downgrades hit the market on July 2, 2002, Vivendi's stock price slid approximately 26%. Financial analysts speculated that Vivendi could face a cash shortfall by the end of 2002 because it did not have the means to cover its debt repayments.

Vivendi's board of directors, meanwhile, hired Goldman Sachs to assess the severity of Vivendi's financial difficulties. In late June 2002, Goldman Sachs presented its findings to the board and noted that one of four possible scenarios for Vivendi was bankruptcy, as early as September or October 2002. The board of directors then zeroed in on Messier as the source of Vivendi's troubles and sought to oust him from his position as CEO. On July 2, 2002, Messier

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[5] For long-term debt, S&P's BBB rating is its second-lowest rating in the investment-grade category. *See* S&P Global, *supra* note 4.

announced his resignation, and the next day Vivendi's stock prices tumbled 22%. Now under new management, Vivendi issued a press release acknowledging that the company faced a "short-term liquidity issue." J.A. 2049. The press release also revealed that by the end of July, Vivendi would have to repay creditors €1.8 billion, and €3.8 billion in credit lines would be up for renegotiation. The following week, French regulators began a probe into Vivendi's financial affairs, while Moody's and S&P warned of further downgrades.

Additional damaging revelations surfaced on August 14, 2002, when Vivendi's new management announced that the company faced refinancing needs of €5.6 billion, had €10 billion more in debt than is typical of a company with a BBB credit rating by S&P, and planned to sell €5 billion worth of assets over the next nine months. That day, S&P further downgraded Vivendi's long-term debt, and Vivendi's stock price dropped more than 25%.

II. Procedural History

On January 7, 2003, Plaintiffs filed a Consolidated Class Action Complaint against Vivendi, Messier, and Hannezo (collectively, "Defendants") in the United States District Court for the Southern District of New York (Baer, *J.*), principally

alleging that between October 30, 2000 and August 14, 2002 (the "Class Period"), Defendants made material misstatements that artificially inflated Vivendi's stock price, in violation of § 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and SEC Rule 10b–5 promulgated thereunder, 17 C.F.R. § 240.10b–5, as well as § 20(a) of the Exchange Act, 15 U.S.C. § 78t(a).[6] In February 2003, Defendants moved to dismiss, arguing, *inter alia*, that Plaintiffs had failed to specify with sufficient particularity the statements Plaintiffs alleged to be false or misleading. By opinion dated November 4, 2003, Judge Baer denied in part and granted in part Defendants' motion to dismiss, and granted Plaintiffs leave to amend its Consolidated Class Action Complaint. On November 24, 2003, Plaintiffs filed a First Amended Consolidated Class Action Complaint.

After several years of discovery, during which time the case was transferred from Judge Baer to Judge Holwell, Defendants moved for summary judgment on August 15, 2008. Judge Holwell denied that motion on March 31, 2009. On June 2, 2009, Defendants filed a motion *in limine* to exclude the testimony of Plaintiffs' expert, Dr. Blaine Nye. On August 18, 2009, Judge

[6] Section 20(a) of the Exchange Act imposes "derivative liability on parties controlling persons who commit Exchange Act violations." *Tongue v. Sanofi*, 816 F.3d 199, 209 n.12. Accordingly, Plaintiffs only alleged § 20(a) claims against Messier and Hannezo.

Holwell denied Defendants' motion, with one narrow exception not at issue on appeal. Trial was scheduled to begin in the fall of 2009.

On October 5, 2009, a jury trial commenced on Plaintiffs' § 10(b) claims against Vivendi, Messier, and Hannezo, as well as Plaintiffs' § 20(a) control-person claims against Messier and Hannezo. At trial, Plaintiffs introduced into evidence the "Book of Warnings," a compendium of internal communications and memoranda that Hannezo had written to Messier and other Vivendi employees during the period from 2000 to 2002, warning them of financial difficulties Vivendi was facing at the time. Special App'x 364. As Plaintiffs pointed out to the jury, Hannezo's communications about Vivendi's deteriorating financial health stood in sharp contrast to Vivendi's rosy public statements. Plaintiffs also presented the testimony of former Vivendi employees, who generally corroborated the bleak internal view presented by the Book of Warnings. Defendants, meanwhile, called Messier and Hannezo to testify that Vivendi's optimistic public statements regarding earnings and growth were in fact accurate at the time they were made. Defendants also emphasized that Vivendi never actually experienced a full-blown liquidity crisis or defaulted on a loan. According to Defendants, the events that occurred in the summer of 2002

merely reflected a transient hitch, from which the company ultimately rebounded.

The jury began its deliberations in early January 2010. The seventy-two-page final jury verdict form identified fifty-seven alleged misstatements, some of which were alleged against Vivendi only, and others of which were alleged against Vivendi and Messier and/or Hannezo. Among other things, the final jury verdict form asked the jury to determine whether Plaintiffs had proven the elements of their § 10(b) claim with respect to each of the fifty-seven statements for each Defendant against whom that false statement was alleged. It also asked the jury to determine whether Messier and Hannezo had violated § 20(a).

After fourteen days of deliberation, the jury reached a verdict. The jury found that neither Messier nor Hannezo was liable under § 10(b) or § 20(a) for any of the alleged misstatements. However, it found Vivendi liable under § 10(b) for all fifty-seven alleged misstatements. The district court denied Vivendi's motions for judgment as a matter of law and for a new trial on February 17, 2011, with one exception: it awarded Vivendi judgment as a matter of law with respect to one statement.[7] *See In re Vivendi Universal, S.A. Secs. Litig.*, 765 F. Supp. 2d 512, 545 (S.D.N.Y. 2011). This appeal followed.

[7] Plaintiffs do not appeal this determination.

DISCUSSION

I. Plaintiffs' Theory of the Case

Vivendi first challenges Plaintiffs' theory of the case as well as the way that Plaintiffs presented that theory at trial. According to Vivendi, Plaintiffs were required to prove their case "statement-by-statement." Vivendi Br. 2. Vivendi suggests that throughout the trial, Plaintiffs did not focus on specifically alleged fraudulent statements, but rather, argued generally that the company failed to disclose a liquidity risk (an approach Vivendi refers to as the theory of "unitary omission"). *Id.* at 35. Vivendi contends that Plaintiffs thus sought to prove that it committed securities fraud with respect to no particular statement at all. Only at the eleventh hour and after the close of evidence at trial, Vivendi continues, did Plaintiffs in fact identify the fifty-seven alleged misstatements for which they sought to hold Vivendi liable. The result, according to Vivendi, was that Plaintiffs presented no actionable claim of securities fraud.

Vivendi thus argues that Plaintiffs' supposed failure to define a specific set of alleged misstatements earlier in the trial had the effect of "eliminat[ing] the foundational element of a claim for securities fraud" under § 10(b) and Rule 10b–5: "a specific false or misleading statement." Vivendi Br. 41. Under Rule 10b–5,

it is unlawful to (1) "make any untrue statement of a material fact," or (2) "omit to state a material fact necessary in order to make the statements made . . . not misleading." 17 C.F.R. § 240.10b–5(b). Thus, to support a finding of liability, Rule 10b–5 expressly requires an actual *statement*, one that is either "untrue" outright or "misleading" by virtue of what it omits to state. Absent an actual statement, a complete failure to make a statement — in other words, a "pure omission," *Litwin v. Blackstone Grp., L.P.*, 634 F.3d 706, 719 (2d Cir. 2011) — "is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts," *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 101 (2d Cir. 2015) (quoting *In re Time Warner Inc. Secs. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993)); *see also Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988).[8] And in and of themselves, "§ 10(b) and Rule 10b–5 do not create an affirmative duty to disclose any and all material information." *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 44 (2011). No such duty arises "merely because a reasonable investor would very much like to know" that information. *In re Time Warner*, 9 F.3d at 267.

[8] For instance, "a duty to disclose under [§] 10(b) [or Rule 10b–5] can derive from statutes or regulations that obligate a party to speak." *Stratte-McClure*, 776 F.3d at 102.

"Pure omissions," of course, must be distinguished from "half-truths" — statements that are misleading under the second prong of Rule 10b–5 by virtue of what they omit to disclose.[9] *See S.E.C. v. Gabelli*, 653 F.3d 49, 57 (2d Cir. 2011), *rev'd on other grounds*, *Gabelli v. S.E.C.*, 133 S. Ct. 1216 (2013) ("The law is well settled . . . that so-called half-truths — literally true statements that create a materially misleading impression — will support claims for securities fraud." (internal quotation marks omitted)); *see also Universal Health Servs., Inc. v. United States*, 136 S. Ct. 1989, 2000 & n.3 (2016) (noting that the principle that "half-truths — representations that state the truth only so far as it goes, while omitting critical qualifying information — can be actionable misrepresentations" applies in the "securities law" context (citing *Matrixx*, 563 U.S. at 44)). The rule against half-truths, or statements that are misleading by omission, comports with the common-law tort of fraudulent misrepresentation, according to which "a statement that contains only favorable matters and omits all reference to

[9] Because a "pure omission" theory is relatively uncommon in securities litigation, and also not strictly within the letter of Rule 10b–5, courts often, to some confusion, use the term "omission" when referring to statements that fall under the second prong of Rule 10b–5. *See, e.g., Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 161 (2d Cir. 2000).

unfavorable matters is as much a false representation as if all the facts stated were untrue." Restatement (Second) of Torts, § 529, cmt. *a* (1977).

It is undisputed that Vivendi had no legal duty to disclose its liquidity risk, such that Plaintiffs could not hold Vivendi liable simply for its silence on the subject. Vivendi therefore contends that Plaintiffs' presentation of the case effectively vitiated the requirement that the Plaintiffs prove Vivendi made a false or misleading statement. As a result, Vivendi argues, the jury necessarily held Vivendi liable for failing to disclose something that it had no legal duty to disclose. Simply put, we disagree.

The record does not support Vivendi's suggestion that Plaintiffs presented their case to the jury on the theory that Vivendi violated § 10(b) by remaining completely silent on the subject of its liquidity risk. To be sure, over the course of the litigation below, Plaintiffs were at times less than precise in articulating their theory of liability. In Plaintiffs' opening statements, for example, counsel for Plaintiffs remarked at points that Plaintiffs were "going to prove . . . that the defendant *failed to tell the truth* about the growing problems about its liquidity." Trial Tr. 128 (emphasis added). In isolation, this statement could be taken to suggest that Plaintiffs would attempt to prove that Vivendi was liable *merely* for

failing to disclose the company's liquidity risk, although, even in isolation, it is at least as easy to understand the statement as an accusation that Vivendi had lied about the subject. In context, however, Plaintiffs' opening statements made clear that the *way* in which they alleged that Vivendi "failed to tell the truth" was by making affirmative statements that were either outright lies or misleading half-truths. *See, e.g.*, *id.* at 128–29 (noting, two lines later, that Vivendi "gave reports about how great the company was doing and, in doing so, . . . completely disregarded alarms that Vivendi's own employees . . . were sounding inside Vivendi").

Indeed, counsel for Plaintiffs went on in that opening statement to ask the jury to "take a look at some examples" of alleged misstatements by Vivendi, Trial Tr. 141, and consider how those statements compared to the actual situation inside Vivendi at the time Vivendi made the statements, *see* Trial Tr. 142–79. Essentially all of the examples provided were ultimately submitted to the jury for consideration. *Compare* Trial Tr. 142, *with* Special App'x 315 (Statement 3); *compare* Trial Tr. 152–53, *with* Special App'x 316 (Statement 5); *compare* Trial Tr. 154–55, *with* Special App'x 316 (Statement 6); *compare* Trial Tr. 162, *with* Special App'x 320 (Statement 18); *compare* Trial Tr. 167, *with* Special App'x 324

(Statement 32); *compare* Trial Tr. 167–68, *with* Special App'x 324 (Statement 33); *compare* Trial Tr. 169, *with* Special App'x 324 (Statement 34); *compare* Trial Tr. 169–70, *with* Special App'x 324–25 (Statement 35); *compare* Trial Tr. 171, *with* Special App'x 326 (Statement 40); *compare* Trial Tr. 172, *with* Special App'x 327 (Statement 42); *compare* Trial Tr. 173, *with* Special App'x 329 (Statement 51); *compare* Trial Tr. 177, *with* Special App'x 330 (Statement 55).

It is true that Plaintiffs initially proposed to Judge Holwell a jury verdict form that did not include a list of specific alleged misstatements.[10] *In re Vivendi*, 765 F. Supp. 2d at 577. It is also true that at oral argument on Vivendi's renewed motion for judgment as a matter of law, which took place after trial, Plaintiffs suggested that their initial proposed jury verdict form embodied the theory that Vivendi had made "a single unitary omission . . . concerning Vivendi's true liquidity risk" that the Plaintiffs believed "manifested in many different ways

[10] Specifically, when Judge Holwell solicited proposed verdict forms from both sides towards the close of evidence but before closing statements, Plaintiffs requested that the proposed verdict form not list specific statements, on the ground that including "numerous alleged subsidiary statements" would "break[] up" and "[f]ragment[] [P]laintiffs' claim in [a] way [that] risks confusing and misleading the jury." J.A. 1686. Plaintiffs wanted, instead, a straightforward verdict form that asked the jury simply to determine, with respect to each Defendant (Vivendi, Messier, and Hannezo), whether that Defendant "knowingly or recklessly ma[d]e materially misleading statements or omissions that concealed liquidity risks at the company during the Class Period." *E.g.*, J.A. 1690.

and with respect to many different statements," and thus that might not easily boil down into a discrete set of specific alleged misstatements. J.A. 3693.

At trial, however, Judge Holwell insisted on a more specific approach. After "review[ing] the verdict forms used in several [then-]recent securities class actions tried before a jury," Judge Holwell concluded that Plaintiffs' proposed jury verdict form was inadequate because "[u]nder the plain language of Rule 10b–5, an 'omission' is not a violation unless plaintiffs can point to statements that were made misleading by the omitted facts." *In re Vivendi*, 765 F. Supp. 2d at 578. Because failing to identify a discrete set of statements in the verdict form might thus invite a verdict that would be inconsistent with this language, Judge Holwell "asked [P]laintiffs to propose a[] . . . verdict form that identified specific misstatements." *Id.* The final jury verdict form thus asked, with respect to *each* statement and in regard to each Defendant, whether "plaintiffs [have] proven *each element* of their Section 10(b) claim." *E.g.*, Special App'x 243 (emphasis added).

At closing argument after the district court finalized the jury verdict form, counsel for Plaintiffs walked through the fifty-seven alleged misstatements, highlighting with respect to each one the evidence that Plaintiffs believed

supported a finding of securities fraud. Repeatedly, counsel for Plaintiffs asked the jury to consider the disparity between Vivendi's "inside reality" and its "outside message." *See* Trial Tr. 7294–365. From opening statements to closing arguments, then, Plaintiffs presented to the jury a theory of securities-fraud liability predicated on Vivendi's statements, not its silence.

In any event, "we review the proof at trial only by reference to th[e] charged theory." *United States ex rel. O'Donnell v. Countrywide Home Loans, Inc.*, 822 F.3d 650, 663 (2d Cir. 2016). As in *O'Donnell*, the record here "shows that the jury was charged only as to a theory of fraud through an affirmative misstatement." *Id.* In keeping with the final jury verdict form, Judge Holwell instructed the jury that Plaintiffs had to "prove by a preponderance of the evidence that during the class period . . . [Vivendi] made a false or misleading statement or omitted to state a fact which made what was said under the circumstances misleading." Trial Tr. 7512. Far from charging the jury on what Vivendi terms a "'pure-omission' theory," Vivendi Br. 2, Judge Holwell informed the jury that Vivendi was "not required to disclose every piece of material information" it possessed, Trial Tr. 7513. He further expressly distinguished between so-called "pure omissions" and statements that are misleading by virtue

of what they omit to disclose. *See id.* It is simply incorrect, then, to say that Plaintiffs "secured a jury verdict based on 'proof' [of the six elements of a private 10b–5 action] *as to no particular statement*." Vivendi Br. 41. In light of the Plaintiffs' own presentation of their case, it does not appear that they in fact presented a "pure omission" theory, as Vivendi argues. And reviewing the proof at trial with reference to the *charged* theory, we discern no basis for concluding that the jury verdict was based on a theory other than the one on which the jury was, in fact, instructed.

In short, Plaintiffs presented a case to the jury based on Vivendi's alleged misstatements, and the jury entered a verdict against Vivendi based on fifty-seven of them. We thus reject Vivendi's contention that the way in which Plaintiffs tried and proved their case had the effect of vitiating an essential element of their § 10(b) claim: proving that Vivendi made materially false or misleading statements.[11]

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[11] Vivendi also argues that Plaintiffs' supposedly belated identification of a specific set of statements violated the PSLRA's requirement that "securities-fraud plaintiffs . . . 'specify *each* statement alleged to have been misleading' and 'why the statement is misleading.'" Vivendi Br. 38 (emphasis in quoting source) (quoting 15 U.S.C. § 78u-4(b)(1)). This argument appears to assume what it seeks to prove: that the PSLRA's so-called "specificity requirement," as Vivendi terms it, Vivendi Br. 40, confines securities-fraud plaintiffs to the particular alleged misstatements identified in their complaint. We identify no such requirement in the PSLRA, which sets out certain

II. Materially False or Misleading Statements

Having identified no reversible error stemming from the manner in which Plaintiffs presented and identified statements at trial, we turn to the statements themselves. Vivendi contests liability for certain statements on the ground that they were non-actionable opinion, puffery, or forward-looking statements. Separately, Vivendi also contests liability for *all* of the statements on the ground

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pleading standards so as to prevent securities-fraud plaintiffs from filing costly securities class-action suits on the basis of a barely formed hunch, but nowhere binds such plaintiffs to the precise set of alleged misstatements identified in their complaint throughout the entire course of litigation.

Further, many, if not most, of the fifty-seven alleged misstatements *were* identified in Plaintiffs' First Amended Consolidated Class Action Complaint, which Plaintiffs filed in November 2003. As for the remaining alleged misstatements included on the final jury verdict form, when the parties were engaged in discovery in 2007, Defendants submitted multiple sets of interrogatories asking Plaintiffs to "[i]dentify and describe each false statement, misleading statement and/or omission of material fact on which you are suing in this Consolidated Action." *E.g.*, J.A. 1944; J.A. 2055. Defendants described Plaintiffs' interrogatory responses as "enormously detailed" documents that reflected the "great care" with which Plaintiffs "identif[ied] . . . statements that they even conceivably thought that they m[ight] intend to pursue." Trial Tr. 6673. And although a small handful of the alleged misstatements on the final jury verdict form did not appear in the First Amended Consolidated Class Action Complaint or Plaintiffs' interrogatory responses, they were nonetheless detailed in Plaintiffs' expert reports, which Vivendi received during discovery. *See id.* at 6737–38. We thus agree with the district court that Vivendi was "aware long before trial" both "that [P]laintiffs believed the fifty-seven [alleged mis]statements . . . were misleading" and "why [P]laintiffs believed each of [those] statements was misleading." *In re Vivendi*, 765 F. Supp. 2d at 579.

that they all rested on an impermissible "liquidity risk theory" of liability. We address these arguments in turn.

1. Opinion Statements

Vivendi first argues that certain statements (or sub-statements) are non-actionable statements of opinion. This argument is not preserved for appellate review, as Vivendi failed to contend that certain statements were non-actionable as opinions in its motions for judgment as a matter of law, even after the parties agreed upon the set of statements the jury would consider. *See Kirsch v. Fleet Street, Ltd.*, 148 F.3d 149, 164 (2d Cir. 1998). Recognizing this, Vivendi now tries to excuse its failure to raise this argument below in several ways.

Vivendi first points out that it objected to statements as opinions in its motion to dismiss, which it filed in 2003. This argument can be rejected easily. Raising this argument in a motion to dismiss did not sufficiently alert the district court to the existence of the argument more than six years later, when Vivendi was required to raise it in its Federal Rule of Civil Procedure 50 motions at trial. *See id.*

Second, Vivendi suggests that the late submission of the actual statements to the jury prevented Vivendi from challenging certain statements as opinion

statements. Even assuming this argument to be otherwise colorable, Vivendi's own submissions to the district court belie this claim. Specifically, Vivendi's post-trial Rule 50(b) renewed motion for judgment as a matter of law clearly challenged specific statements on the ground that they were non-actionable *forward-looking* statements; it also (in a footnote) challenged certain statements on the ground that they were inactionable *puffery*. Given these challenges, Vivendi cannot now argue that the timing of Plaintiffs' identification of a specific set of statements prevented it from *also* challenging specific statements on the ground that they were non-actionable *opinion*.

Finally, Vivendi contends that intervening authority — by way of *Fait v. Regions Fin. Corp.*, 655 F.3d 105 (2d Cir. 2011), and *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318 (2015) — excuses its failure to raise the argument below. This argument, too, lacks merit. To excuse waiver on the grounds of intervening authority, it is not enough to argue that the intervening authority may have sharpened or otherwise elaborated upon an argument. Rather, the intervening authority must have established an argument that was "not known to be available" to the party seeking to excuse waiver at the first opportunity that the party had to raise the argument. *Gucci Am., Inc. v.*

Weixing Li, 768 F.3d 122, 135 (2d Cir. 2014) (quoting *Hawknet, Ltd. v. Overseas Shipping Agencies*, 590 F.3d 87, 92 (2d Cir. 2009)); *see also Holzsager v. Valley Hosp.*, 646 F.2d 792, 796 (2d Cir. 1981). Not so with the decisions Vivendi claims constitute intervening authority.

For purposes of the claim Vivendi makes on appeal, neither *Fait* nor *Omnicare* established an argument regarding the actionability of opinion statements that was previously unknown. As both *Fait* and *Omnicare* acknowledge, *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1090–98 (1991), addressed the circumstances under which liability may extend to statements of opinion or belief expressed in proxy solicitations. *See Fait*, 655 F.3d at 110; *Omnicare*, 135 S. Ct. at 1326–27 & n.2. *Fait* and *Omnicare* merely expanded upon an uncontroversial point already made clear by *Virginia Bankshares*: that although statements expressing opinions may not be grounds for liability when they are not false or misleading in context to a reasonable investor, such statements are "not beyond the purview" of the federal securities statutes. *Fait*, 655 F.3d at 110; *see also Omnicare*, 135 S. Ct. at 1329 ("[I]f a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take

from the statement itself, then § 11[] . . . creates liability. An opinion statement, however, is not necessarily misleading when an issuer knows, but fails to disclose, some fact cutting the other way."). Indeed, we made similar observations even before *Fait* or *Omnicare*. *See, e.g.*, *In re Int'l Bus. Machs. Corp. Secs. Litig.*, 163 F.3d 102, 107 (2d Cir. 1998) ("Statements that are opinions . . . are not *per se* inactionable under the securities laws."); *In re Time Warner*, 9 F.3d at 266 (2d Cir. 1993) (noting that "expressions of opinion" are "not beyond the reach of the securities laws" (citing, *inter alia*, *Virginia Bankshares*, 501 U.S. at 1088–97)).

The argument that certain statements are not materially false or misleading because they contain only opinions was therefore known to be available prior to *Fait* and *Omnicare*. *Cf. Gucci Am., Inc.*, 768 F.3d at 135–36 (concluding that a defendant did not "waive its personal jurisdiction objection" when, prior to an intervening decision, "controlling precedent in this Circuit made it clear that [the defendant] . . . *was* properly subject to general personal jurisdiction" (emphasis in original)); *Hawknet*, 590 F.3d at 91–92 (concluding that a defendant could raise an argument on appeal that the defendant did not raise before the district court because intervening authority "provided [the] defendant with a new objection"

that, prior to the intervening decision, "would have been *directly contrary* to controlling precedent in this Circuit" (emphasis added)). Although *Fait* and *Omnicare* may have provided a stronger basis for such an objection, having a better argument on appeal is not tantamount to having a previously unknown argument. As it required not "clairvoyance" but "conscientiousness" on Vivendi's part to object to certain statements on the basis that they were non-actionable opinion statements, Vivendi's reliance on *Fait* and *Omnicare* as intervening authority is unavailing. *See id.* at 92 ("[T]he doctrine of waiver demands conscientiousness, not clairvoyance, from parties."). Finding none of Vivendi's reasons for excusing its failure to raise the opinion argument below convincing, we decline to consider the argument on its merits.

2. Puffery

Vivendi next contends that several statements are non-actionable puffery. Vivendi raised this argument only in a footnote in its Rule 50(b) renewed motion for judgment as a matter of law, though the district court considered, and rejected, the argument on the merits. *Cf. Fortress Bible Church v. Feiner*, 694 F.3d 208, 216 n.3 (2d Cir. 2012). Assuming this footnote was sufficient to present the

argument to the district court and thus preserve it for appellate review, the statements of which Vivendi complains are simply not puffery.

Puffery encompasses "statements [that] are too general to cause a reasonable investor to rely upon them," *ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 206 (2d Cir. 2009), and thus "cannot have misled a reasonable investor," *San Leandro Emergency Med. Grp. Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 811 (2d Cir. 1996). They are statements that "lack the sort of definite positive projections that might require later correction." *Id.* (quoting *In re Time Warner*, 9 F.3d at 259, 267 (2d Cir. 1993)).

The jury reasonably concluded that the statements identified by Vivendi as puffery were actionable.[12] Consider, for example, Vivendi's June 26, 2001 statement that it "posted RECORD-HIGH NET INCOME, and ha[d] cash available for investing," Special App'x 318, or its July 23, 2001 representation that "[t]he results produced by Vivendi Universal in the second quarter are well

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[12] Vivendi argues that these statements should not have been submitted to the jury, but does not contend on appeal that the district court was wrong to view the question whether a given statement was inactionable puffery as a fact one. Thus, we assume this to be the case, and we review the jury's verdict in this regard for sufficiency of the evidence. *See Gronowski v. Spencer*, 424 F.3d 285, 291 (2d Cir. 2005) ("In reviewing the sufficiency of the evidence in support of a jury's verdict, we examine the evidence in the light most favorable to the party in whose favor the jury decided, drawing all reasonable inferences in the winning party's favor.").

ahead of market consensus," *id.* at 319. There was sufficient evidence for the jury to conclude that such statements were not so general that a reasonable investor could not have relied upon them in evaluating whether to purchase Vivendi's stock. *Cf. ECA, Local 134*, 553 F.3d at 205–06 (concluding that "statements such as the assertion[s] that [the defendant company] had 'risk management processes [that] are highly disciplined and designed to preserve the integrity of the risk management process'; that [the company] 'set the standard for integrity'; and that [the company] would 'continue to reposition and strengthen [its] franchises with a focus on financial discipline'" constituted puffery (citations omitted)); *San Leandro*, 75 F.3d at 806, 811 (concluding that "general announcements," such as the defendant company's statement that it "'should deliver income growth consistent with [its] historically superior performance'" and was "'optimistic about 1993'" constituted puffery). We thus reject Vivendi's argument that certain statements found actionable by the jury are statements of puffery that are non-actionable as a matter of law.

3. Forward-Looking Statements

Vivendi next argues that certain statements fall under the safe-harbor provision for "forward-looking statements" under the PSLRA. *See* 15 U.S.C.

§ 78u–5(c). Under that provision a defendant is not liable if (1) "the forward-looking statement is identified and accompanied by meaningful cautionary language," (2) the forward-looking statement "is immaterial," or (3) "the plaintiff fails to prove that [the forward-looking statement] was made with actual knowledge that it was false or misleading." *Slayton v. Am. Express Co.*, 604 F.3d 758, 766 (2d Cir. 2010). Because "[t]he safe harbor is written in the disjunctive," a forward-looking statement is protected under the safe harbor if any of the three prongs applies. *Id.*

As an initial matter, Vivendi disputes the district court's conclusion that "[P]laintiffs challenge the non-forward looking elements of Vivendi's statements regarding its EBITDA growth, rather than the [forward-looking] elements." *In re Vivendi*, 765 F. Supp. 2d at 569. "The PSLRA includes several definitions of a forward-looking statement, including 'a statement containing a projection of . . . income (including income loss), earnings (including earnings loss) per share, . . . or other financial items' and 'a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management.'" *Slayton*, 605 F.3d at 766–67 (quoting 15 U.S.C. § 78u–5(i)(1)(A) & (C)). However, "[a] statement may contain

some elements that look forward and others that do not," and "forward-looking elements" may be "severable" from "non-forward-looking" elements. *Iowa Pub. Emps.' Ret. Sys. v. MF Glob., Ltd.*, 620 F.3d 137, 144 (2d Cir. 2010); *see also Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 705 (7th Cir. 2008) ("[A] mixed present/future statement is not entitled to the safe harbor with respect to the part of the statement that refers to the present.").

It is clear that at least some of the statements that Vivendi identifies as forward-looking contain present representations, and that it is these non-forward-looking elements of those statements that Plaintiffs alleged were false or misleading. Consider the February 14, 2001 alleged misstatement, which Vivendi labels as forward-looking: "Vivendi Universal enters its first full year of operations with strong growth prospects and a very strong balance sheet. This new company is off to a fast start and we are very confident that we will meet the very aggressive growth targets we have set for ourselves both at the revenues and EBITDA levels." Special App'x 316. Although some aspects of this statement could conceivably be characterized as forward-looking, there is nothing prospective about the representation that Vivendi entered 2001 with a "very strong balance sheet," which Plaintiffs argued at trial was part of what

made Vivendi's February 14, 2001 statement misleading. *See* Trial Tr. 7297. The safe-harbor provision does not protect this and other present representations — about "very strong 2000 results," Special App'x 316, or achievement of "'aggressive' incremental EBITDA targets," Special App'x 320 — embedded within statements that Vivendi deems forward-looking.

To the extent that other statements identified by Vivendi as forward-looking are arguably false or misleading with respect to their forward-looking elements, we need not decide whether those statements, or elements thereof, are indeed forward-looking. Even assuming, *arguendo*, that they are, there was sufficient evidence for a reasonable jury to conclude that none of the prongs of the PSLRA safe-harbor provision applies to them.[13]

Contrary to Vivendi's argument, there was sufficient evidence to support the jury in concluding that any forward-looking statements were not

[13] We consider here only Vivendi's arguments that: (1) any forward-looking statements were accompanied by meaningful cautionary language, and (2) Plaintiffs failed to show that Vivendi made such statements with actual knowledge that they were false or misleading. To the extent that Vivendi contends that the statements are not material because they did not increase price inflation, we address that argument *infra*, in Part III.

accompanied by meaningful cautionary language.[14] "To avail themselves of safe harbor protection under the meaningful cautionary language prong, defendants must demonstrate that their cautionary language was not boilerplate and conveyed substantive information." *Slayton*, 604 F.3d at 772. "Vague" disclaimers are inadequate. *Id.*

Although Vivendi points to a miscellany of disclaimers peppered throughout its required SEC filings in 2001 and 2002, there is sufficient evidence to support the jury's conclusion that none of them was meaningful. To start, several of the disclaimers highlighted by Vivendi are quite irrelevant to the alleged misstatements at issue. In one, for example, Vivendi warned that factors that "could cause actual results to differ materially from those described in the forward-looking statements" included "inability to identify, develop and achieve success for new products, services and technologies; increased competition and

[14] The district court instructed the jury to determine whether any forward-looking statements were accompanied by meaningful cautionary language. It further noted in its opinion denying Vivendi's renewed motion for judgment as a matter of law that "it was for the jury to determine whether the cautionary language accompanying any of the statements . . . was sufficiently 'meaningful.'" *In re Vivendi*, 765 F. Supp. 2d at 567 n.45. Vivendi does not argue on appeal that the meaningfulness of the cautionary language in question was not a factual question (whether or not the district court could have or should have resolved it as a matter of law). As with puffery, we therefore treat the meaningfulness of the cautionary language here as a question of fact that the district court appropriately put to the jury to consider, and review the sufficiency of the evidence in support of the jury's determination.

its effect on pricing, spending, third-party relationships and revenue; [and] inability to establish and maintain relationships with commerce, advertising, marketing, technology, and content providers." J.A. 4167. The considerations mentioned in this disclaimer — success with new products and services, relationships with competitors and third parties, and marketing and advertising efforts — do not bear even tangentially on Vivendi's liquidity risk. The jury reasonably could have found that this kitchen-sink disclaimer, listing garden-variety business concerns that could affect *any* company's financial well-being, was not meaningful cautionary language.

Vivendi's disclaimers with respect to the use of EBITDA were no less oblique. In Vivendi's October 30, 2000 Form F–4 registration statement filing with the SEC, Vivendi stated that it "considers operating income to be the key indicator of the operational strength and performance of its business." J.A. 4681. Vivendi continued to state, however, that while "[a]djusted EBITDA should not be considered an *alternative* to operating or net income as an indicator of Vivendi's performance," or "an alternative to cash flows from operating activities as a measure of liquidity," adjusted EBITDA was nevertheless a "pertinent comparative measure" to "operating income." *Id.* (emphasis added).

Given the arguable endorsement of the EBITDA measure inherent in this language, sufficient evidence supported the jury's conclusion that such language did not meaningfully caution against reliance on EBITDA figures as a measure of Vivendi's performance.

Turning to the "actual knowledge" prong of the PSLRA safe-harbor provision, we conclude that there was sufficient evidence for the jury to find that Vivendi made the statements with actual knowledge that the statements were false or misleading.[15] To take an example, Plaintiffs presented evidence that

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[15] Vivendi suggests in its reply brief that, in assessing whether there was sufficient evidence for any reasonable jury to find liability as to these purportedly forward-looking statements, we must defer to the impaneled jury's answers, in special interrogatories, that Vivendi acted recklessly in making each of the fifty-seven statements. Our hands tied by these interrogatory responses, the argument goes, we should limit our inquiry to whether there was sufficient evidence to find the statements not to be forward-looking, as plainly they cannot have been made with actual knowledge.

As an initial matter, Vivendi does not clearly make such an argument, predicated on the special interrogatories, in its opening brief. *See* Vivendi Br. 56. Thus, the argument is waived. *See JP Morgan Chase Bank v. Altos Hornos de Mexico, S.A. de C.V.*, 412 F.3d 418, 428 (2d Cir. 2005) ("[A]rguments not made in an appellant's opening brief are waived even if the appellant pursued those arguments in the district court . . . .").

It is also without merit. As the Eleventh Circuit has observed, there is a fundamental distinction between an argument that the actual jury's verdict is internally inconsistent (and thus that the court should order a new trial), and an argument that the district court should grant a party judgment as a matter of law on the basis that there is insufficient evidence in the record to support *any* reasonable jury's verdict against the movant. *See Hubbard v. BankAtlantic Bancorp, Inc.*, 688 F.3d 713, 716 (11th Cir. 2012) ("When a court considers a motion for judgment as a matter of law — even after the jury has rendered a verdict — only the sufficiency of the evidence matters. The jury's

Vivendi actually knew that its October 30, 2000 announcement of a 35% EBITDA growth-rate objective was misleading to a reasonable investor. On September 15,

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findings are irrelevant." (citation omitted)); *cf. United States v. Jespersen*, 65 F.3d 993, 998 (2d Cir. 1995) ("[W]hen reviewing the sufficiency of the evidence, the Supreme Court has made it clear that jury verdicts are not to be reviewed for consistency.").

A consistency challenge argues that the jury verdict itself is flawed — and we generally ask in assessing such a claim whether the jury's findings are "ineluctably inconsistent," an inquiry that may require some examination of the record. *Cash v. County of Erie*, 654 F.3d 324, 343 (2d Cir. 2011) (quoting *Munafo v. Metro. Transp. Auth.*, 381 F.3d 99, 105 (2d Cir. 2004)). Since the jury itself is capable of correcting such an inconsistency at the judge's behest, a party must raise a consistency challenge before the district court discharges the jury. *See id.* at 342. Because success as to such a claim does not suggest that no reasonable jury *could have* found for the prevailing party, only that the verdict itself could not be reconciled internally, the remedy is not a directed verdict, but a new trial. *See id.* at 342.

In contrast, a motion for judgment as a matter of law is not based on the jury's verdict, but on the record established at trial. Such a motion must be made *before* the jury even renders a verdict (and can be granted at such a time in rare circumstances), and then renewed thereafter. *See Chaney v. City of Orlando*, 483 F.3d 1221, 1228 (11th Cir. 2007) ("The fact that Rule 50(b) uses the word 'renew[ed]' makes clear that a Rule 50(b) motion should be decided in the same way it would have been decided prior to the jury's verdict, and that the jury's particular findings are not germane to the legal analysis."). And success on such a motion results not in a new trial, but in a directed verdict in favor of the movant — and thus reflects the court's assessment not that the *jury* has erred, but that the evidence could not support *any* jury in reaching a verdict against the movant. For these reasons, a judge, assessing a motion for judgment as a matter of law, looks only to the evidence in the record; she is not bound by a jury's answers in special interrogatories.

To the degree that Vivendi indeed means to make a consistency (rather than a sufficiency) challenge, that argument (as well as Vivendi's argument that the findings of liability as to Vivendi, Messier, and Hannezo were inconsistent) was not timely made. *See In re Vivendi*, 765 F. Supp. 2d at 550–52 (finding Vivendi waived any challenge to the verdict on consistency grounds by failing to timely object to the verdict); *see also Anderson Grp., LLC v. City of Saratoga Springs*, 805 F.3d 34, 46–47 (2d Cir. 2015). As to the sufficiency argument that *is* before us, we consider all the evidence in the record, and are not bound by the jury's determination in special interrogatories that Vivendi acted recklessly in making the statements.

2000, Hannezo circulated an e-mail informing others at Vivendi that "the analysts will not have it easy to track the purchase accounting benefits" in EBITDA figures. J.A. 4169. Much less would a reasonable investor, who is not as well-versed at making sense of Vivendi's disclosures as a financial analyst, be able to discern the impact of purchase accounting.

To take another example, Vivendi highlights as forward-looking the December 19, 2000 statement that Vivendi would be "free of debt in its communications businesses" as of January 1, 2001 and have "free cash flow of more than 2 billion euros for the two coming years." Special App'x 315. Plaintiffs presented sufficient evidence at trial, however, for a jury to find that Vivendi actually knew that this statement conflicted with internal forecasts of debt and free cash flow and thus was misleading. In December 2000, Vivendi was planning to restructure Seagram's debt, a process that it knew would incur additional short-term debt and require it to pay substantial premiums on that debt. *See* Trial Tr. 1305–06, 7295. And just two weeks after Vivendi issued the statement, Hannezo stated in an internal communication that he "believe[d] that it [was] wrong to reason in terms of . . . free cash flow" because "there [wouldn't]

be any this year."[16] J.A. 4059. Assuming, *arguendo*, that some of the statements Vivendi claims are purely forward-looking are indeed so, such evidence was sufficient for a jury to find that Vivendi actually knew that its forward-looking statements were false or misleading.

4. Liquidity Risk Theory

In addition to objecting that certain alleged misstatements are non-actionable opinion, puffery, or forward-looking statements, Vivendi lodges a broader attack against the entire set of alleged misstatements. To wit, Vivendi repeatedly protests what it terms to be Plaintiffs' impermissible "liquidity risk theory," under which all of the fifty-seven statements were allegedly false or misleading with respect to Vivendi's liquidity risk. The nub of Vivendi's argument appears to be that "liquidity risk" is too "amorphous" and "ephemeral" a concept for *any* statement to be false or misleading with respect to it, much less all fifty-seven statements at issue here. Vivendi Br. 51, 88.

But, even assuming that this argument has separate purchase from the more specific arguments Vivendi makes as to the actionability of the

[16] Hannezo qualified this statement at trial, testifying that it referred to his view that Vivendi would not have enough free cash flow "when it comes to buying things like Direct TV or Echostar or Yahoo." J.A. 2540–41.

statements,[17] "liquidity risk" is not so "amorphous" or "ephemeral" a concept as Vivendi would lead us to believe. As Plaintiffs defined it at trial, liquidity is "the ease or difficulty with which a company can timely meet its financial obligations and fund its operations." Trial Tr. 128; *see also* Trial Tr. 3481 (Nye testifying that liquidity is "the ability to pay fixed obligations"). Liquidity *risk*, then, is simply a financial-accounting term for the concept of being "debt rich and cash poor." Trial Tr. 141. Further, to the extent that liquidity risk is not a *perfectly* defined concept with rigid outer bounds, that does not necessarily preclude liability for securities fraud. The federal securities laws do not protect against only those false and misleading statements that are false or misleading with respect to very specific material facts. *See, e.g.*, *Suez Equity Inv'rs, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 97–99 (2d Cir. 2001) (concluding that plaintiffs' allegations were sufficient to state a claim that certain statements fraudulently concealed a company executive's "financial and business problems," "lack of skill," and "inability to run the [company]"). The jury found that knowledge of Vivendi's true liquidity risk at any given time would have been material to a reasonable

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[17] Indeed, this broader attack echoes specific points made throughout the other challenges in this section. For instance, Vivendi argues that the amorphousness of "liquidity risk" necessarily rendered statements regarding or concealing such a risk inactionable opinions. *See* Vivendi Br. 51.

investor and that the fifty-seven statements were individually false or misleading with respect to this risk. Without opining on whether there are indeed concepts so amorphous or broad that their concealment cannot support an actionable theory under § 10(b) as a matter of law, liquidity risk as defined in this case was not such a concept.

The question, then, is whether there was sufficient evidence to support the jury's finding that all of the fifty-six statements (excluding the statement on which the district court granted Vivendi judgment as a matter of law) were materially false or misleading with respect to liquidity risk. "The test for whether a statement is materially misleading under Section 10(b)" is not whether the statement is misleading in and of itself, but "whether the defendants' representations, *taken together and in context*, would have misled a reasonable investor." *Rombach v. Chang*, 355 F.3d 164, 172 n.7 (2d Cir. 2004) (emphasis added) (quoting *I. Meyer Pincus & Assocs. v. Oppenheimer & Co.*, 936 F.2d 759, 761 (2d Cir. 1991)); *see also Meyer v. Jinkosolar Holdings Co., Ltd.*, 761 F.3d 245, 250 (2d Cir. 2014) ("The literal truth of an isolated statement is insufficient; the proper inquiry requires an examination of defendants' representations, taken together and in context." (quoting *In re Morgan Stanley Info. Fund Secs. Litig.*, 592 F.3d 347,

366 (2d Cir. 2010))). Whether a misrepresentation is material is "judged according to an objective standard" that turns on "the significance of an omitted or misrepresented fact to a reasonable investor." *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1187, 1191, 1195 (2013) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976)).

We conclude that there was sufficient evidence for the jury to find the fifty-six relevant statements materially false or misleading in regards to Vivendi's true liquidity risk. To be sure, the statements do not each repeat the precise same refrain. Some speak directly to liquidity risk, while others concern components that contributed to Vivendi's liquidity risk. That individual alleged misstatements may relate to different aspects of a larger problem does not necessarily subvert a finding of fraud, however. It would be perverse if companies could escape liability for securities fraud simply by disseminating a network of interrelated lies, each one slightly distinct from the other, but all collectively aimed at perpetuating a broader, material lie. Where a company seeks fraudulently to hide a particularly large problem with multiple contributing factors, it is quite probable that the company will have to lie about a number of related topics in order successfully to conceal the larger issue.

Just so here. Vivendi's alleged fraud (in the jury's reasonable estimation) is remarkable in part because the problem that Vivendi sought to conceal from the public was so vast, and touched upon so many aspects of its business, that a few scattered misstatements would not have sufficed to mask it. Vivendi needed both to systematically misrepresent its ability to satisfy its liquidity demands, and also to assiduously conceal any material facts (of which there were many) that would call into question its ability to meet its liquidity demands.

Consider, for instance, Vivendi's statements about its self-described "aggressive" EBITDA growth rates, which Vivendi consistently advertised as a point of strength. *E.g.*, Special App'x 317 (Statement 9: "[F]or first quarter of 2001, the Company generated very strong EBITDA . . . growth with 900 million euros, an increase of 112% or an incremental 475 million euros over the first quarter of the prior year." (first alteration in original)); *id.* at 320 (Statement 18: "With three quarters of the 'aggressive' incremental EBITDA target for the full year 2001 already achieved in the first half of the year, I can only re-emphasiz[e] our confidence"). As Plaintiffs' expert testified, high EBTIDA suggests high profitability — and by implication, ample cash flow available to service debt. But Vivendi's high EBITDA targets derived in large part from purchase

accounting effects (which are just one-time paper adjustments that cannot readily translate into free cash flow) rather than profits from a company's business operations (which reflect actual earnings that may translate into free cash flow). And although purchase accounting was the required accounting technique at the time, Plaintiffs submitted evidence that Vivendi emphasized EBITDA growth to the public because financial analysts, to say nothing of the average investor, "w[ould] not have it easy to track the purchase accounting benefits" and the degree to which they contributed to Vivendi's EBITDA figures. J.A. 4169. Hannezo at one point referred to purchase accounting benefits as "accounting magic" and acknowledged that Vivendi met its EBITDA growth targets thanks to purchase accounting benefits. J.A. 4119; *see* Trial Tr. 1348-50.

Further, investors did not digest Vivendi's statements about EBITDA growth in a vacuum. During the Class Period, Vivendi also made numerous statements about, for example, its cash flow and its debt. Whether misleading or not when made, such statements strongly suggested that Vivendi faced no liquidity risk at the time. Given that Vivendi was in a phase of intense buying, moreover, any investor attuned to Vivendi's pattern of behavior would be keen to know whether and how Vivendi was making sufficient profits to translate into

cash flow that would cover all of Vivendi's sundry debt obligations. We find the evidence introduced at trial sufficient to support the jury's conclusion that a reasonable investor could find Vivendi's statements about high EBITDA growth misleading for omission to disclose Vivendi's liquidity risk.

We need not detail the evidence in support of the jury's verdict with respect to each of the remaining alleged misstatements. It suffices to highlight a representative sample of statements:

- On December 19, 2000, Vivendi stated in a press release that, on a January 1, 2001 pro forma basis, Vivendi would "be free of debt in its communications businesses, yet . . . have a free cash flow of more than 2 billion euros for the two coming years." Special App'x 315 (Statement 2). Two weeks later, Hannezo expressed to Messier his "belie[f] that it is wrong to reason . . . in terms of free cash flow (there won't be any this year)." J.A. 3952.
- On January 12, 2001, Vivendi stated in a 6–K SEC filing that "[t]hanks to our free net cash flow and the opportunities to dispose of some holdings, such as our stake in BSkyB, we will have an additional war chest of 10 billion euros for 2001–2002

before the first euro of debt, and without the creation of new shares. That means we will have the resources to pursue the growth of our businesses in an especially healthy and efficient way." Special App'x 315 (Statement 3). Two days earlier, however, Hannezo had informed Messier that it was "wrong to reason . . . in terms of free cash flow." J.A. 3952.

- On June 26, 2001, Vivendi stated in a 6–K SEC filing that it "posted record-high net income" and had "cash available for investing." Special App'x 318 (Statement 12) (emphasis omitted). In the same filing, Vivendi also emphasized "the strength of [its] cash flow." *Id.* (Statement 13) (emphasis omitted). In contrast, a Vivendi employee testified that "beginning in June 2001," Dupont-L'Hôtelain "expressed concerns over the cash situation, the liquidity situation," and noted "the shortage in cash inside Vivendi." J.A. 2512.

- On September 25, 2001, Vivendi stated that "[f]or the first half [of] 2001, operating free cash flow was more than 500 million euros (excluding environment)," meaning that "[f]or the first

time, cash flow is breaking even after financial costs, taxes and restricting costs." Special App'x 321 (Statement 19). According to a Vivendi employee, during this time ("between June and October of 2001"), Dupont-L'Hôtelain "often" discussed "the shortage in cash inside Vivendi," and Hannezo even noted "two or three times" that if Vivendi's "path . . . continue[d], [Vivendi would] be near bankruptcy." J.A. 2512–13.

- On February 6, 2002, a Reuters article indicated that Vivendi (through Messier) stated the following: "*Is there any major uncertainty about our level of debt? No. *Are there any hidden off-balance sheet transactions that could cause any particular fears or risks? No. . . . There are no hidden risks . . . ." Special App'x 324–25 (Statement 35); *see also* J.A. 4719. Two days later, however, Hannezo informed Messier that "[c]ompared to its peers[,] and particularly if the market begins to disregard EBITDA," Vivendi "has a big problem," including "free cash flow" difficulties and "overleverage." Trial Tr. 7346. Hannezo

also stated that "although Vivendi's rival, AOL Time Warner, had impressive cash flows, Vivendi's was around zero." *Id.*

- On June 26, 2002, Vivendi issued a press release stating that "[o]wing to its strong free cash flow, combined with the execution of the disposals program and potential bond issues, [Vivendi] is confident of its capacity to meet its anticipated obligations over the next 12 months." Special App'x 330 (Statement 56). Two days earlier, on June 24, 2002, Goldman Sachs, in response to a request by Vivendi's board to analyze Vivendi's liquidity situation, explained to Vivendi's board that one of four possible scenarios is that Vivendi would have to file for bankruptcy protection as early as September. Soon thereafter, Edgar Bronfman, Jr., whose family was one of Vivendi's largest shareholders at the time, wrote that Vivendi's situation was a "matter of the gravest concern" and that Vivendi "must install . . . new management right away to take charge of convincing the banks to extend some credit while we sell some of our assets to avoid bankruptcy. We have no time. Our board

must act tomorrow without fail. Our company may fail, and we have not one minute more to waste." Trial Tr. 7361.

The jury's finding that these (and all of the fifty-six relevant) alleged misstatements were materially false or misleading was supported by sufficient evidence. To be clear, we do not foreclose the possibility that in a different case, a set of alleged misstatements will cover such varied and sundry territory that a single theory of fraud will not adequately encompass all of the statements. We merely conclude that, on the facts of this case, there is sufficient evidence to support the jury's finding that a reasonable investor could find each of the alleged misstatements false or misleading in context with respect to Vivendi's liquidity risk, and that this risk was not so amorphous, in this case, to be categorically inactionable for purposes of a theory of liability.

III. Expert Testimony

Vivendi next asserts that the district court abused its discretion in admitting the testimony of Plaintiffs' expert, Dr. Nye, on loss causation and damages.[18] Under Federal Rule of Evidence 702, which governs the admissibility of expert testimony, an expert with "specialized knowledge [that] will help the

[18] Nye holds an M.B.A. and a Ph.D in finance from Stanford University. He also owns an economic consulting group that frequently provides expert reports in securities litigation.

trier of fact" may testify so long as that testimony is "based on sufficient facts or data" and "is the product of reliable principles and methods" that the witness has "reliably applied . . . to the facts of the case." The proponent of the expert testimony bears the burden of establishing these admissibility requirements, and the district court acts as a "gatekeeper" to ensure that the "expert's testimony both rests on a reliable foundation and is relevant to the task at hand." *United States v. Williams*, 506 F.3d 151, 160 (2d Cir. 2007) (quoting *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579, 597 (1993)).

"The district court has broad discretion to carry out this gatekeeping function," and "[i]ts inquiry is necessarily a 'flexible one.'" *In re Pfizer Inc. Secs. Litig.*, 819 F.3d 642, 658 (2d Cir. 2016) (quoting *Daubert*, 509 U.S. at 594). "We therefore review both the district court's 'ultimate reliability determination' and its decision about '*how* to determine reliability' for abuse of discretion." *Id.* (quoting *Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 142 (1999)).

Consistent with what has now become "standard operating procedure in federal securities litigation," Nye performed an event study to determine whether, and the extent to which, Vivendi's stock price was artificially high (*i.e.*, inflated) during the Class Period due to the market's misapprehension of

Vivendi's true liquidity risk. *United States v. Gushlak*, 728 F.3d 184, 201 (2d Cir. 2013); *see also FindWhat Inv'r Grp. v. FindWhat.com*, 658 F.3d 1282, 1313 n.31 (11th Cir. 2011) ("The methodology of event studies has been sustained by many circuits."). In a typical event study, an expert "disentangle[s] the effects of two types of information on stock prices — information that is specific to the firm under question . . . and information that is likely to affect stock prices marketwide." Mark L. Mitchell & Jeffry M. Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities & Exchange Commission*, 49 Bus. Law. 545, 556–57 (1994). The expert then identifies which "information . . . caused notable changes in the price of [a company's] securit[ies]" and the magnitude of those changes. J.A. 853; *see also In re Pfizer Inc.*, 819 F.3d at 649. Thus, an event study can help an expert determine whether, and the extent to which, the release of certain information caused a stock price to fall. *See id.* at 649-50. This, in turn, allows an expert to make inferences about the degree to which the company's stock price may have been artificially inflated on the basis of the market's misconception as to the truth prior to the release of that information. *See id.*

The first step for Nye was to identify changes in Vivendi's stock price during the Class Period that could not be attributed to general market dynamics, but were unique to Vivendi, called "residual returns." J.A. 856. Nye began by analyzing the normally observed correlation between Vivendi's stock price and market- and industry-wide trends over the course of a benchmark "control period." Identifying this correlation made it "possible [for Nye] to predict," for each day of the Class Period, the "predicted return" on Vivendi's stock, *i.e.*, "what the return of [Vivendi's] security should [have] be[en]" on the basis of the normally observed correlation. *In re Pfizer*, 819 F.3d at 649 (quoting Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law. 1, 18 (1982)); *see also* J.A. 856. Nye then calculated, for each day of the Class Period, the "actual return" on Vivendi's stock, *i.e.*, the amount that the company's stock price actually changed. *Id.* The residual return on any given day, then, was simply the difference between the actual return and the predicted return.

Thus, because the residual returns equal the predicted returns subtracted from the actual returns, they factored out the market- and industry-wide effects captured by predicted returns. In other words, the residual returns Nye

calculated, as he explained it, isolated the variations in Vivendi's stock price that were specific to Vivendi, rather than reflective of fluctuations affecting the entire market or the industry in which Vivendi operated. A positive residual return on any given day generally implied that good news about Vivendi emerged, and that the stock price went up accordingly. On the flipside, a negative residual return on any given day generally implied that negative information about Vivendi issued that day.

After identifying the residual returns that were statistically significant, Nye then attempted to isolate the residual returns that could be attributed to information related to Vivendi's liquidity risk, rather than other information related to Vivendi but unrelated to liquidity. To do this, Nye reviewed more than 16,000 documents to determine whether the information released in the market about Vivendi on any particular day had to do with Vivendi's liquidity risk. His analysis yielded a list of days on which there was either a positive or negative residual return associated with information bearing on Vivendi's liquidity risk.

The final relevant list included nine "negative" residual return days and one "positive" residual return day. As Nye testified, the nine negative-return

days were days on which negative news about Vivendi's liquidity risk came out and resulted in inflation dissipating from Vivendi's stock price. The one positive-return day, meanwhile, was a day on which positive news pertaining to Vivendi's liquidity came out and inflation in Vivendi's stock price increased. The sum of the nine negative-return days, offset by the one positive-return day, came to €22.52. This amount, Nye concluded, was the maximum loss that investors suffered due to the market's lack of knowledge about Vivendi's true liquidity risk, which is to say the maximum artificial inflation that entered Vivendi's stock price and subsequently dissipated as the market found out about the truth.

Inflation reached its highest point, Nye believed, around December 13, 2001. As far as the market knew at that time, Vivendi had doubled down on statements about Vivendi's growth projections, but inside the company, Vivendi employees viewed the company's liquidity situation as dangerous and Hannezo was telling Messier that a credit-downgrade would lead to a liquidity crisis. Thus, in Nye's opinion, December 13, 2001 was when "the discrepancy between what the market knew and what Vivendi knew was at its widest." Trial Tr. 3577.

If what goes up must come down, as the saying goes, then (Nye assumed) what came down must have gone up. In other words, the artificial inflation that dissipated from Vivendi's stock price must have entered into the price in the first place. *See Glickenhaus & Co. v. Household Int'l, Inc.*, 787 F.3d 408, 415 (2d Cir. 2015) ("The best way to determine the impact of a false statement is to observe what happens when the truth is finally disclosed and use that to work backward, on the assumption that the lie's positive effect on the share price is equal to the additive inverse of the truth's negative effect.").

A key question was how that inflation entered the stock or, more aptly, *when*. Given that the maximum amount of inflation in the stock was €22.52, one approach to determining how inflated the stock price was throughout the Class Period would have been to say that all €22.52 of inflation entered into Vivendi's stock price from the very beginning of that period, on October 30, 2000, and remained at that level until the date of the first negative residual return, January 7, 2002. There is an obvious downside to this approach, however. Namely, the full amount of the inflation reflects the value of the truth about Vivendi's liquidity problem at the *apex* of that problem. But the magnitude of Vivendi's liquidity risk — and by extension, the amount of liquidity-related inflation in

Vivendi's stock — presumably had not reached its peak at the start of the Class Period. Rather, it grew over time as Vivendi's liquidity situation worsened, and as the distance between the truth and the deception thus widened. Ascribing the full value amount of loss to the very first alleged misstatement would therefore tend to overstate the degree to which Vivendi's stock was inflated due to the market's lack of knowledge about Vivendi's true liquidity risk, at least toward the beginning of the Class Period. Such an approach might thus lead to an inflated recovery for class members who purchased the stock earlier in the Class Period.

A better method, Nye reasoned, would be to model inflation as increasing over time — that is, as the magnitude of Vivendi's liquidity risk grew — and reaching its maximum point on December 13. But precisely because the market was not privy to the full extent of Vivendi's liquidity risk, or so Plaintiffs alleged, the scope of that liquidity risk had no direct measure. Without a direct measure, Nye turned to potential proxy measures. He examined three quantitative proxies for the magnitude of Vivendi's true liquidity risk at any given time and considered how well each one might approximate the inflation trajectory over the relevant period. Observing that all three "followed similar paths over time,

and matched qualitative descriptions of [Vivendi's] accelerating debt and liquidity problems over time," Nye selected as a proxy the most conservative of the proxy candidates: the increasing degree to which purchase accounting benefits contributed to Vivendi's EBITDA figures. J.A. 864–65. Because Vivendi reported EBITDA figures on a quarterly basis, Nye's model of inflation showed inflation increasing step-wise on such a basis.

It is important to emphasize that, although Nye calculated the artificial inflation in Vivendi's stock that was due to the market's misapprehension about Vivendi's true liquidity risk, his analysis did not purport to *prove* that that misapprehension was caused by Vivendi's alleged fraud. Artificial inflation is not necessarily fraud-induced, for a falsehood can exist in the market (and thereby cause artificial inflation) for reasons unrelated to fraudulent conduct. *See Glickenhaus*, 787 F.3d at 418. Nye did not measure inflation actually *caused* by Vivendi's alleged fraud nor "assume[] that [Vivendi's] share price was inflated *due to misrepresentations*." *Id.*

It was up to the *jury* to determine how much, if any, of the artificial inflation identified by Nye was caused by Vivendi's alleged fraud (and thus by the various statements Vivendi released in the relevant period), by assessing the

alleged misstatements and their connection to the misconception in question. Nye's analysis merely operated on the assumption that Plaintiffs would be able to prove at trial all the necessary elements to succeed on their private 10b–5 action.

Because Nye determined the amount of artificial inflation due to the market's lack of information about Vivendi's true liquidity risk, without reference to whether that inflation was a result of Vivendi's alleged misstatements, Nye's testimony did not depend on the specific identification of the fifty-seven alleged misstatements that Plaintiffs later identified at the close of trial. By design, then, Nye's testimony did not exhibit any obvious correlation between the inflation increases identified by Nye and the timing of the fifty-seven statements. Though fifteen of the fifty-seven statements issued on days where, under Nye's model, inflation increased, such correlation was not something Nye himself sought to prove. And to the degree that the remaining forty-two statements were not associated with an immediate increase in inflation under Nye's model, that would not obviously affect Nye's own testimony.

Nevertheless, according to Vivendi, the fact that these forty-two statements did not directly correlate with specific increases in inflation made

Nye's testimony unreliable. Vivendi asserts that the securities laws require an alleged misstatement to have a "price impact," and that no such impact exists with respect to these forty-two statements. Vivendi Br. 72. To salvage Nye's testimony from this supposed legal deficiency, Vivendi continues, the district court had to fabricate an erroneous inflation "maintenance" theory. That theory, as Vivendi frames it, posits that statements that merely maintain inflation already extant in a company's stock price, but do not add to that inflation, nonetheless affect a company's stock price. Vivendi urges us to hold that this purportedly newfangled theory violates the securities laws, and that because Nye's testimony necessarily rests on the theory, the district court abused its discretion in admitting it.

We begin with an assessment of Vivendi's argument that a statement must be associated with an increase in inflation to be actionable, before turning to what relevance, if any, such an argument had to the district court's decision to admit Nye's testimony. The "price impact" requirement to which Vivendi refers arises in the context of "transaction causation," or "reliance," the element of a private § 10(b) action that asks whether there is "a proper 'connection between a defendant's misrepresentation and a plaintiff's injury,'" or, framed more

specifically, whether the fraud affected "the investor's decision to engage in the transaction." *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 805, 810-12 (2011) ("*Halliburton I*") (quoting *Basic*, 485 U.S. at 243). "The traditional (and most direct) way a plaintiff can demonstrate reliance is by showing that he was aware of a company's statement and engaged in a relevant transaction — *e.g.*, purchasing a common stock — based on that specific misrepresentation." *Id.* at 810. But because "limiting proof of reliance [to the traditional method] 'would place an unnecessarily unrealistic evidentiary burden on the Rule 10b–5 plaintiff who has traded on an impersonal market,'" *id.* (quoting *Basic*, 485 U.S. at 245), the Supreme Court has established a rebuttable presumption of reliance under which courts may "assume . . . that an investor relies on public misstatements whenever he 'buys or sells stock at the price set by the market,'" *id.* (quoting *Basic*, 485 U.S. at 244, 247).

"Price impact" simply concerns "whether the alleged misrepresentations affected the market price in the first place." *Id.* at 814. If they do not affect the stock price, then there is "no grounding for any contention that investors indirectly relied on those misrepresentations through their reliance on the integrity of the market price." *Amgen*, 133 S. Ct. at 1199. Defendants can

therefore attempt to rebut the presumption of reliance by introducing "evidence that the misrepresentation did not in fact affect the stock price." *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2414 (2014) ("*Halliburton II*").

In distinguishing between inflation introduction and inflation maintenance, Vivendi contends that statements that introduce new inflation actually affect a company's stock price, while statements that merely maintain inflation have no impact. And the reason they have no "price impact" is because the "preexisting inflation would have persisted" had the defendant who made those inflation-maintaining statements "simply remained silent" as was the defendant's right in the absence of a duty to disclose. Vivendi Reply Br. 33. Thus, Vivendi's objection to the idea that a statement may cause inflation by maintaining it (rather than by increasing it) rests on two premises: that the maintained inflation would have remained if Vivendi had simply remained silent; and that Vivendi had the option of remaining silent even though it in fact chose to speak. Both premises are problematic.

First, contrary to Vivendi's implication to the contrary, it is not necessarily the case that preexisting inflation indeed remains in a company's stock price in the face of that company's silence, either in a circumstance where the stock is

inflated because the market arrived at a misconception on its own or a case in which inflation may itself be traced to a prior fraudulent statement. Perhaps, in the face of silence, inflation *could* have remained unchanged. But it also could have plummeted rapidly, or gradually, as the truth came out on its own, no longer hidden by a misstatement's perpetuation of the misconception. Alternately, inflation (or, really, the market's continued belief in the misconception) could have dissipated gradually because the defendant's silence in the face of escalating concerns on a particular subject would have all but amounted to an admission. The important point is that the defendant's alleged misstatement, in a scenario where, as here, the defendant does *not* remain silent, prevents the market from discovering which of these scenarios, among other relevant scenarios, would have materialized had the defendant said nothing at all. In light of the dubiousness of the premise that inflation would have continued in the face of silence, it becomes evident that Vivendi has framed the effect of a given *affirmative* material misstatement in the context of preexisting inflation improperly. It is far more coherent to conclude that such a misstatement does not simply *maintain* the inflation, but indeed "*prevents* [the] preexisting inflation in a stock price from dissipating." *FindWhat*, 658 F.3d at

1317 (holding that "[d]efendants whose fraud *prevents* preexisting inflation in a stock price from dissipating are just as liable as defendants whose fraud introduces inflation into the stock price in the first instance").

In short, it is hardly obvious that had Vivendi remained silent, the market would indeed have maintained its rosy perception of Vivendi's liquidity state. Even were that not so, however, Vivendi's attack on the so-called inflation-maintenance theory suffers from a greater deficiency: in suggesting that, had it remained silent, the misconception-induced (whether or not fraud-induced) inflation would have persisted in the market price, Vivendi assumes it is even *relevant* what would have happened had it chosen not to speak. Yet in framing the argument this way, Vivendi misunderstands the nature of the obligations a company takes upon itself at the moment it *chooses*, even without obligation, to speak. It is well-established precedent in this Circuit that "once a company speaks on an issue or topic, there is a duty to tell the whole truth," "[e]ven when there is no existing independent duty to disclose information" on the issue or topic. *Meyer v. Jinkosolar Holdings Co., Ltd.*, 761 F.3d 245, 250 (2d Cir. 2014); *see also Caiola v. Citibank, N.A., N.Y.*, 295 F.3d 312, 331 (2d Cir. 2002) ("[T]he lack of an independent duty [to disclose] is not . . . a defense to . . . liability[,] because

upon choosing to speak, one must speak truthfully about material issues."). That is because, at the moment the company chooses to speak, it takes upon itself the obligation to *speak truthfully*, and it is the breach of *that* obligation which forms the basis for the §10(b) claim. Framed as such, it becomes clear that, once a company chooses to speak, the proper question for purposes of our inquiry into price impact is not what might have happened had a company remained silent, but what would have happened if it had spoken *truthfully*. And there is little need to speculate what would have happened to the inflation in Vivendi's stock price had it released to the public not a rosy picture of its liquidity state, but the misgivings its executives were sharing behind the scenes.

Vivendi's argument thus rests on erroneous principles that, once dispelled, make clear that it is hardly illogical or inconsistent with precedent to find that a statement may cause inflation not simply by *adding* it to a stock, but by maintaining it. Were this not the case, companies could eschew securities-fraud liability whenever they actively perpetuate (*i.e.*, though affirmative misstatements) inflation that is already extant in their stock price, as long as they cannot be found liable for whatever originally introduced the inflation. Indeed, under Vivendi's approach, companies (like Vivendi) would have every incentive

to maintain inflation that already exists in their stock price by making false or misleading statements. After all, the alternatives would only operate to the company's detriment: remaining silent, as already noted, could allow the inflation to dissipate, and making true statements on the issue would *ensure* that the inflation dissipates immediately.

A hypothetical helps illustrate the point. Suppose an automobile manufacturer widely praised for selling the world's safest cars plans to release a new model ("Model V") in the near future. The market believes that Model V, like all of the company's previous models, is safe, or has no reason to think otherwise. In fact, the automobile manufacturer knows that Model V has failed crash test after crash test; it is, in short, simply unfit to be on the road. To protect its stock price, however, the automobile manufacturer informs the market, as per routine industry practice, that Model V has passed all safety tests. When the truth eventually reaches the market, the automobile manufacturer's stock price bottoms out.

In addition to potentially being liable for any number of things if Model V indeed makes it to the market, the automobile manufacturer has almost certainly committed securities fraud. And the question of the automobile manufacturer's

liability for securities fraud does not turn on whether inflation moved incrementally upwards when the company represented to the market that the new model passed all safety tests. Nor does it rest on whether the market originally arrived at a misconception about the model's safety on its own, or whether the company led the market to that misconception in the first place. "We decline to erect a *per se* rule that, once a market is already misinformed about a particular truth, corporations are free to knowingly and intentionally reinforce material misconceptions by repeating falsehoods with impunity." *FindWhat*, 658 F.3d at 1317. "Defendants who commit fraud to prop up an already inflated stock price do not get an automatic free pass under the securities laws." *Id.*

In rejecting Vivendi's position that an alleged misstatement must be associated with an increase in inflation to have a "price impact," we join in the Seventh and Eleventh Circuits' conclusion that "theories of 'inflation maintenance' and 'inflation introduction' are not separate legal categories." *Glickenhaus*, 787 F.3d at 418; *FindWhat*, 658 F.3d at 1316 ("There is no reason to draw any legal distinction between fraudulent statements that wrongfully *prolong* the presence of inflation in a stock price and fraudulent statements that

initially *introduce* that inflation." (emphases added)). Put differently, we agree with the Seventh and Eleventh Circuits that securities-fraud defendants cannot avoid liability for an alleged misstatement merely because the misstatement is not associated with an uptick in inflation.

All of that said, it is unclear how Vivendi's "price impact" argument, even were it valid, bears on the question here: whether the district court abused its discretion in concluding that Nye's testimony "rest[ed] on a reliable foundation and [was] relevant to the task at hand." *Williams*, 506 F.3d at 160 (quoting *Daubert*, 509 U.S. at 597). Nye's model measured "'actual inflation' — inflation due to investors not knowing the truth" about Vivendi's liquidity risk.[19] *Glickenhaus*, 787 F.3d at 418. And it identified the amount of inflation due to

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[19] As the Seventh Circuit has explained:

> [T]here are two senses of "inflation." One is "actual inflation" — just the difference between the stock price and what the price would have been if the truth had been known; this is what the expert's model measures. The other is "fraud-induced inflation" — the difference between the stock price and what the price would have been if the defendants had spoken truthfully; this is what the jury determined using the model *plus* its findings regarding false statements. Before the first false statement is made, there is "actual inflation" in the stock price but no "fraud-induced inflation" because although the stock is overpriced, misrepresentations are not the cause.

Glickenhaus, 787 F.3d at 418.

investors not knowing the truth "*even if no false statement* [*was*] *ever made*[,] because investors might not know the truth for reasons other than false statements." *Id.* at 417. This method of measuring actual inflation, without reference to the timing or nature of a defendant's alleged misstatements, is commonly employed by experts who provide testimony on loss causation and/or damages in securities-fraud cases. *See, e.g.*, *In re Pfizer*, 819 F.3d at 649–52; *Glickenhaus*, 787 F.3d at 415–19; *FindWhat*, 658 F.3d at 1313–14.

Here, Nye's testimony is relevant as to loss causation because the total amount of actual inflation that Nye identified is the maximum amount of loss potentially caused by Vivendi's alleged misstatements. Nye's testimony is also relevant as to damages because Nye's model of inflation over the course of the Class Period provides a means for calculating each Plaintiff's damages. *See* *Gushlak*, 728 F.3d at 197 (explaining that an investor's damages are generally "equal to 'the artificial inflation when the shares were purchased minus the artificial inflation when the shares were sold.'" (quoting Michael Barclay & Frank C. Torchio, *A Comparison of Trading Models Used for Calculating Aggregate Damages in Securities Litigation*, 64 L. & Contemp. Probs. 105, 106 (2001))).

Vivendi's "price impact" argument, if successful, would at most imply that Plaintiffs could not establish reliance with respect to *some* of the fifty-six relevant misstatements. But that would not render Nye's testimony wholly irrelevant to loss causation or damages; nor would it transform Nye's calculation of actual inflation into the product of unreliable principles or methods. *See In re Pfizer*, 819 F.3d at 661 ("The dispositive question [under Rule 702] is whether the testimony will assist the trier of fact . . . not whether the testimony satisfies the plaintiff's burden on the ultimate issue at trial." (quoting *Ambrosini v. Labarraque*, 101 F.3d 129, 135 (D.C. Cir. 1996)). Thus, even if Vivendi's "price impact" argument were correct, it would not justify concluding that Nye's testimony is sufficiently unreliable or unhelpful to the jury that the district court's admission of that testimony constituted an abuse of discretion.

In any event, we do not accept Vivendi's position that the "price impact" requirement inherent in the reliance element of a private § 10(b) action means that an alleged misstatement must be associated with an increase in inflation to have any effect on a company's stock price.[20] *A fortiori* Nye's testimony did not

[20] To be clear, we do not hold that all statements unassociated with an increase in inflation necessarily have a "price impact." We merely hold that such statements do not, as Vivendi argues, categorically *lack* a "price impact." Thus, we do not address

have to show such an association for each alleged misstatement in order to "rest[] on a reliable foundation and [be] relevant to the task at hand." *Williams*, 506 F.3d at 160 (quoting *Daubert*, 509 U.S. at 597). As Vivendi has identified no other convincing reason why Nye's testimony fails to satisfy these basic requirements, we conclude that the district court did not abuse its discretion in admitting it.

IV. Loss Causation

Finally, we address Vivendi's challenge to the sufficiency of the evidence to support loss causation. "Loss causation 'is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff.'" *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 172 (2d Cir. 2005) (quoting *Emergent Capital Inv. Mgmt., LLC v. Stonepath Grp., Inc.*, 343 F.3d 189, 197 (2d Cir. 2003)). In some respects, loss causation resembles the tort-law concept of proximate cause, which generally requires that a plaintiff's injury be the "'foreseeable consequence'" of the defendant's conduct. *Emergent Capital*, 343 F.3d at 197 (quoting *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 186 (2d Cir. 2001)). But this traditional foreseeability test is "imperfect" in the § 10(b) context, for "it cannot ordinarily

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whether there may be other reasons, not raised by Vivendi here, why some statements unassociated with an increase in inflation do not affect a company's stock price.

be said" that the alleged misstatements themselves, "as opposed to the underlying circumstance that is concealed or misstated" "cause[]" investors' loss. *See Lentell*, 396 F.3d at 173. We thus clarified in *Lentell* that to establish loss causation, a plaintiff must show that "the loss [was a] foreseeable" result of the defendant's conduct (*i.e.*, the fraud), "*and* that the loss [was] caused by the materialization of the . . . risk" concealed by the defendant's alleged fraud. *Id.*

Put more simply, proof of loss causation requires demonstrating that "the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered." *Suez Equity*, 250 F.3d at 95 (emphasis added). If "the relationship between the plaintiff's investment loss and the information misstated or concealed by the defendant . . . is sufficiently direct, loss causation is established." *Lentell*, 396 F.3d at 174. "[B]ut if the connection is attenuated, or if the plaintiff fails to 'demonstrate a causal connection between the content of the alleged misstatements or omissions and the harm actually suffered,' a fraud claim will not lie." *Id.* (quoting *Emergent Capital*, 343 F.3d at 199)).

Homing in on the phrase "materialization of risk" from *Lentell*, Vivendi contends that the loss that Plaintiffs sought to establish here was not a materialization of the risk concealed by Vivendi's alleged misstatements.

According to Vivendi, the risk that it allegedly concealed (*i.e.*, the risk of a liquidity crisis) must have materialized into a more significant problem (*i.e.*, an actual liquidity crisis) in order for Plaintiffs to show that Vivendi's alleged fraud caused them loss. Since it is undisputed that Vivendi's liquidity risk "never materialized" into "an objective event such as bankruptcy, default, or insolvency," Vivendi asserts that Plaintiffs cannot establish loss causation. *See* Vivendi Br. 83–84 (emphasis omitted). We disagree.

Vivendi fails to appreciate that to show loss causation, it is enough that the loss caused by the alleged fraud results from the "relevant truth . . . leak[ing] out." *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 342 (2005); *cf. also id.* at 344 ("[T]he Restatement of Torts, in setting forth the judicial consensus [on what a party must show to demonstrate loss], says that a person who 'misrepresents the financial condition of a corporation in order to sell its stock' becomes liable to a relying purchaser 'for the loss' the purchaser sustains '*when the facts . . . become generally known*' and 'as a result' share value 'depreciate[s].'" (emphasis added and all but first alteration in original) (quoting Restatement. (Second) of Torts § 548A, cmt. *b* (1977))). Although we have previously stated that a plaintiff can establish loss causation either by showing a "materialization of risk" or by

identifying a "corrective disclosure" that reveals the truth behind the alleged fraud, *see Carpenters Pension Trust Fund of St. Louis v. Barclays PLC*, 750 F.3d 227, 233 (2d Cir. 2014); *Omnicom*, 597 F.3d at 513, our past holdings do not suggest that "corrective disclosure" and "materialization of risk" create fundamentally different pathways for proving loss causation, such that a specific corrective disclosure is the only method by which a plaintiff may prove losses resulting from the revelation of the truth. Indeed, *Lentell* itself understood "materialization of risk" as reflective of the principle that "to establish loss causation, [plaintiffs must show that a] . . . misstatement or omission concealed *something* from the market that, *when disclosed*, negatively affected the value of the security." *Lentell*, 396 F.3d at 173 (emphases added). Whether the truth comes out by way of a corrective disclosure describing the precise fraud inherent in the alleged misstatements, or through events constructively disclosing the fraud, does not alter the basic loss-causation calculus.

That "corrective disclosure" and "materialization of risk" are not wholly distinct theories of loss causation highlights the flaws of Vivendi's position. Vivendi's conception of loss causation would have the effect of insulating companies from securities-fraud liability whenever the thing concealed in a

material misstatement never ripens from a mere risk to an out-and-out disaster — unless a specific corrective disclosure issues.

A simple hypothetical helps bring into stark relief why Vivendi cannot be right that the Plaintiffs, short of pointing to explicit corrective disclosures, had to point to an event, such as a bankruptcy, to demonstrate loss causation in this case. Suppose that a company knows that it faces tremendous risk of bankruptcy, yet fraudulently informs the market that there is no risk of bankruptcy. Soon, the risk becomes too great to ignore, and a series of events indicating that the company is on the verge of bankruptcy takes place: a major bank backs out of a potential loan agreement with the company; a large deal with another firm falls through after the other firm does due diligence into the company; the company rapidly sells off an abnormally large amount of its assets in an effort to raise capital; and so on. The company's stock price sinks, indeed becomes all but valueless.

The company in this hypothetical lied about its *risk* of bankruptcy — a lie that was separate and distinct from any lie about whether the company actually filed for bankruptcy — and events revealing the truth about the company's *risk* of bankruptcy caused investors to lose money. Yet, Vivendi would have us

believe that, absent a specific corrective disclosure, the actual filing of bankruptcy is the *necessary* "materialization of risk" that must occur in order for the company to have caused investors any loss under § 10(b). But whether the company caused loss to investors under § 10(b) does not turn on whether the company actually files Chapter 11 at some point or manages to steer clear of bankruptcy at the last minute. "Fraud depends on the state of events when a statement is made, not on what happens later." *Schleicher v. Wendt*, 618 F.3d 679, 684 (7th Cir. 2010); *see also Pommer v. Medtest Corp.*, 961 F.2d 620 (7th Cir. 1992) ("The securities laws approach matters from an *ex ante* perspective: just as a statement true when made does not become fraudulent because things unexpectedly go wrong, so a statement materially false when made does not become acceptable because it happens to come true. Good fortune . . . does not make the falsehood any the less material." (citations omitted)).

Here, although no specific corrective disclosure ever exposed the precise extent of Vivendi's alleged fraud, Plaintiffs' theory of loss causation nevertheless rested on the revelation of the truth. According to Plaintiffs, Vivendi's alleged misstatements concealed its liquidity risk, and a series of events in the first half of 2002 made the truth about that liquidity risk come to light. According to

Nye's testimony on loss causation and damages, those events took place on nine days, when the following news reached the market: (1) January 7, 2002 news that Vivendi sold 55 million of its treasury shares; (2) May 3, 2002 news that Moody's downgraded Vivendi's long-term senior debt to a notch above junk status; (3) June 21, 2002 news that Vivendi sold a stake in its subsidiary Vivendi Environnement, despite earlier statements that it would wait to sell; (4) June 24, 2002 news just three days later that Vivendi sold an even larger stake in Vivendi Environnement; (5) July 2, 2002 news that Moody's downgraded Vivendi's long-term senior debt to junk status, followed by S&P's downgrade of Vivendi's short-term senior debt; (6) July 3, 2002 news that Vivendi acknowledged its short-term liquidity problems and its €1.8 billion in obligations that were due that very month; (7) July 10, 2002 news that rating agencies cautioned that further downgrades were possible, and that French authorities had raided Vivendi's Paris headquarters to investigate possible securities fraud; (8) July 15, 2002 news that a member of Vivendi's board of directors was urging Vivendi quickly to sell Canal+, which was not generating earnings as expected; and (9) August 14, 2002 news that Vivendi planned to sell €10 billion in assets over the following two years, €5 billion of which it hoped to sell within just nine months.

There was ample evidence to support the jury's finding of a "sufficiently direct" "relationship between the . . . loss [that Plaintiffs suffered on these nine days] and the information misstated or concealed by [Vivendi]." *Lentell*, 396 F.3d at 174. To take just one example — Vivendi's January 7, 2002 sale of 55 million treasury shares — Nye testified at trial that a treasury-share sale of such magnitude indicated to the market that Vivendi "need[ed] cash badly," and that "academic economic literature . . . inform[ed] [this] view." J.A. 2768. Vivendi's own witness, the company's credit-rating liaison at the time of the transaction, testified to the effect that there was "no question" that the sale implied to the market that Vivendi needed cash. J.A. 2770–71. This and other evidence presented at trial were sufficient for the jury to conclude that the nine events identified by Nye revealed the truth about Vivendi's liquidity risk, and that concealment of "the *subject*" of Vivendi's alleged misstatements — its liquidity risk — was therefore "the cause of the actual loss suffered" by Plaintiffs. *Suez Equity*, 250 F.3d at 95 (emphasis added).

V. Plaintiffs' Cross-Appeal

Plaintiffs set forth two additional contentions on cross-appeal, challenging prior judgments of the district court. Neither has merit.

Plaintiffs first maintain that, at the class certification stage, the district court improperly excluded certain foreign shareholders from the class based on a concern that some foreign courts may not give preclusive effect to a class judgment. We review a district court's conclusions as to whether the requirements of Federal Rule of Civil Procedure 23 were met, and in turn whether class certification was appropriate, for abuse of discretion. *Gallego v. Northland Grp. Inc.*, 814 F.3d 123, 129 (2d Cir. 2016); *In re Initial Public Offerings Secs. Litig.*, 471 F.3d 24, 31-32 (2d Cir. 2006). "That standard of review is deferential: the district court is empowered to make a decision — of its choosing — that falls within a range of permissible decisions, and we will only find 'abuse' when the district court's decision rests on an error of law or a clearly erroneous factual finding, or its decision cannot be located within the range of permissible decisions." *Gallego*, 814 F.3d at 129 (internal quotation marks omitted).

As an initial matter, the district court did not abuse its discretion when, in assessing whether the class action would be "superior to other available methods for fairly and efficiently adjudicating [a] controversy," Fed. R. Civ. P. 23(b)(3), it considered whether a class judgment would be given preclusive effect in foreign courts. Concerns about foreign recognition of our judgments are reasonably

related to superiority. As Judge Friendly recognized in *Bersch v. Drexel Firestone, Inc.*, "if defendants prevail against a class[,] they are entitled to a victory no less broad than a defeat would have been," and so the risk that a foreign court will not grant preclusive effect to a class judgment may, as it did in *Bersch*, counsel against the inclusion of some foreign claimants. 519 F.2d 974, 996–97 (2d Cir. 1975), *abrogated in part on other grounds*, *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247 (2010). It was therefore within the district court's discretion to take that risk into account.

With respect to the district court's ultimate determination to exclude some foreign shareholders on superiority grounds, it was Plaintiffs' burden to establish, by a preponderance of the evidence, that its proposed class met the requirements of Rule 23. *See In re Am. Int'l Grp., Inc. Secs. Litig.*, 689 F.3d 229, 237–38 (2d Cir. 2012); *Myers v. Hertz Corp.*, 624 F.3d 537, 547 (2d Cir. 2010). We recognize that assessing superiority is a fact-specific inquiry, and we do not opine on how likely it must be that a foreign court will recognize a class judgment in order for Rule 23's superiority requirement to be met. Here, however, Plaintiffs do not identify *any* evidence that they presented to the district court which suggested that foreign courts in the countries at issue would

grant preclusive effect to a class judgment.[21] The district court accordingly did not abuse its discretion in concluding that, except for shareholders from a few countries, Plaintiffs had not demonstrated superiority.

Plaintiffs' second contention is that, after trial, the district court incorrectly dismissed claims by American purchasers of ordinary shares under *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247 (2010). Plaintiffs contend that (1) Vivendi forfeited any *Morrison*-based defense because it did not bring its motion to dismiss the claims until after trial, and (2) in any event, the district court should not have dismissed these claims because the purchasers incurred "irrevocable liability" within the United States, and thus were covered by § 10(b). We review the district court's decision *de novo*. *In re Air Cargo Shipping Servs. Antitrust Litig.*, 697 F.3d 154, 157 (2d Cir. 2012).

Vivendi did not forfeit its *Morrison* argument because, prior to *Morrison*, its motion was foreclosed by controlling precedent in this Circuit, and parties are not required to raise arguments "directly contrary to controlling precedent" to avoid waiving them. *Hawknet*, 590 F.3d at 92 (2d Cir. 2009); *see also Holzsager*, 646

[21] The only evidence that Plaintiffs identify is Vivendi's suggestion in a prior brief that Canada typically grants preclusive effect to class judgments when there are a significant number of Canadian class members. Plaintiffs do not contend that they informed the district court of this alleged admission, however, nor was the district court obligated to search the record for evidence that it was Plaintiffs' burden to produce.

F.2d at 796 ("[A] party cannot be deemed to have waived objections or defenses which were not known to be available at the time they could have first been made, especially when it does raise the objections as soon as their cognizability is made apparent."). Here, before the Supreme Court decided *Morrison* in June 2010 (less than a month before Vivendi filed its motion), this Circuit's conduct and effects tests were the "north star of [its] § 10(b) jurisprudence." *Morrison*, 561 U.S. at 257. In *Morrison*, the Supreme Court struck down those tests and made clear that § 10(b) applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities," *id.* at 267, thereby providing, for the first time, a legal basis for Vivendi's argument that the claims of American purchasers of ordinary shares were not covered by § 10(b). Vivendi accordingly did not forfeit its right to seek dismissal of those claims under *Morrison*.

Plaintiffs also maintain that under this Court's decision in *Absolute Activist Value Master Fund Ltd. v. Ficeto*, American purchasers of ordinary shares, and specifically those who acquired shares in the course of the three-way merger between Vivendi, S.A., Canal+, and Seagram, are protected by § 10(b) because they incurred "irrevocable liability" while present in the United States, 677 F.3d

60, 67 (2d Cir. 2012). We disagree. In *Absolute Activist*, we used the concept of "irrevocable liability" to determine what constitutes a "domestic purchase or sale" under *Morrison*. *Id.* at 67–68. We reasoned that when the "parties" to a transaction incur irrevocable liability in the United States, defined as "becom[ing] bound to effectuate the transaction" or "entering into a binding contract to purchase or sell securities," the transaction is domestic and § 10(b) applies. *Id*. at 67. To the extent that Plaintiffs rely on the merger as the transaction at issue, the location of the Americans who acquired ordinary shares as a result of the merger, who Plaintiffs admit were not parties to it, is not relevant to the question of whether the merger qualifies as a "domestic purchase or sale." Plaintiffs do not otherwise point to any evidence that the parties to the merger incurred irrevocable liability in the United States. The district court therefore appropriately determined that American purchasers of ordinary shares were not protected by § 10(b) under *Morrison*.

CONCLUSION

We have considered Vivendi's remaining arguments, as well as Plaintiffs' remaining cross-appeal arguments, and find them to be without merit. The partial judgment of the district court is therefore **AFFIRMED**.