

# INSIGHTS

*The Corporate & Securities Law Advisor*

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# INSIGHTS

*The Corporate & Securities Law Advisor*

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## ■ SECURITIES ENFORCEMENT

# Whistleblower Protection Actions by the SEC and Congress Impact Severance Agreements

*Two recent SEC enforcement actions highlight the possibility that severance agreements may violate whistleblower protections under the federal securities laws if not properly drafted. In a related development, Congress has provided protection to whistleblowers who disclose trade secrets to the government. Severance agreements can be drafted to address these concerns, yet protect privileged and confidential information.*

By Luis R. Mejia, Stewart M. Landefeld,  
Eric A. DeJong, and Ann Marie Painter

One year ago, the U.S. Securities and Exchange Commission (SEC) brought its first enforcement action pursuant to a whistleblower protection rule under the federal securities laws.<sup>1</sup> Rule 21F-17, adopted pursuant to Section 21F of the Securities Exchange Act of 1934 (Exchange Act), prohibits actions to impede individuals from communicating directly with the SEC staff about possible securities law violations.<sup>2</sup> Subject to certain exceptions, this prohibition explicitly extends to enforcing or threatening to enforce a confidentiality agreement to impede such communications.<sup>3</sup> In *KBR*, the SEC charged that a confidentiality agreement violated Rule 21F-17 because it threatened discipline if the employees discussed the particulars of an internal investigation with outside parties without the prior authorization of the company.<sup>4</sup> The case generated considerable discussion and led us to recommend protective language for confidentiality agreements.<sup>5</sup>

Recently, the SEC brought two enforcement actions against two companies charging that certain

severance agreements they entered into with employees violated Rule 21F-17 by requiring the employees to waive their ability to obtain monetary awards from the SEC's whistleblower program.<sup>6</sup> In a separate development to protect whistleblowers, on May 11, 2016, the Defend Trade Secret Acts of 2016 (DTSA) became effective, providing immunity and anti-retaliation provisions that protect whistleblowers who disclose trade secrets to the government.<sup>7</sup> These developments raise new concerns for companies, including whether severance agreements routinely used to protect sensitive or proprietary information, as well as to waive future rights to compensation or related payments to an employee, may violate federal securities laws.

In the "Practical Takeaways" section of this article below, we suggest steps companies can consider, including language that can be incorporated into severance agreements, to address the Rule 21F-17 issue. However, as we have noted in our prior article on Rule 21F-17 enforcement actions, our suggestions recognize the important fact that Rule 21F-17 expressly protects privileged communications from disclosure to the SEC.<sup>8</sup> Further, companies can continue to take steps to protect trade secrets and other proprietary information subject to two important limitations under the DTSA. Our language also reflects the authors' view that nothing in Rule 21F-17 or the DTSA requires employers to affirmatively encourage employees to communicate with the SEC about possible securities law violations.

### **Blue Linx and Health Net Enforcement Actions**

It has been common practice over the last decade for employers to include in severance agreements a broad waiver of the employee's right to receive

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future payments associated with their employment, often including payments from third parties (which could include government entities such as the SEC). However, the SEC believes the broad language of severance agreements, such as those described in *Blue Linx* and *Health Net*, go too far, and violate the SEC's whistleblower protection rule.

Health Net entered into voluntary severance agreements with employees who were leaving the company. The agreements specified that, while not prohibited from participating in a government investigation, the former employees were prohibited from accepting a whistleblower award directly from government agencies (which would include the SEC). For example, one version of the Waiver and Release of Claims provided:

While Employee may file a charge, provide information, or participate in any investigation or proceeding, by signing this Release, Employee, to the maximum extent permitted by law ... waives any right to any individual monetary recovery ... in any proceeding brought based on any communication by Employee to any federal, state, or local government agency or department.<sup>9</sup>

The company included this language in agreements with approximately 600 employees, even after the SEC adopted Rule 21F-17 on August 12, 2011.

Blue Linx included a similar provision in its severance agreements with approximately 160 employees:

Employee further acknowledges and agrees that nothing in this Agreement prevents Employee from filing a charge with ... the Equal Employment Opportunity Commission, the National Labor Relations Board, the Occupational Safety and Health Administration, *the Securities and Exchange Commission* or any other administrative agency if applicable law requires that Employee be permitted to do so; *however, Employee understands and agrees that Employee*

*is waiving the right to any monetary recovery in connection with any such complaint or charge that Employee may file with an administrative agency.* (Emphasis added.)<sup>10</sup>

The company also prohibited employees from disclosing confidential information or trade secrets unless "required to be disclosed by law, court, or other legal process," provided the employee gave notice to the company in time to permit the company to seek a protective order prior to any such disclosure.<sup>11</sup>

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### *The SEC alleged that the agreements removed important financial incentives that are intended to encourage persons to communicate with the SEC staff.*

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The SEC alleged that the agreements in *Health Net* and *Blue Linx* removed important financial incentives that are intended to encourage persons to communicate with the SEC staff about possible securities laws violations. The restrictions, wrote the SEC, therefore impeded communications between someone who signed the overly broad agreement and the SEC, and so violated Rule 21F-17.<sup>12</sup> With respect to the notice provision at issue in *Blue Linx*, the SEC stated employees were "forced to choose between identifying themselves to the company as whistleblowers or potentially losing their severance pay and benefits."<sup>13</sup>

Both cases were brought as settled administrative proceedings. Blue Linx agreed to pay a civil penalty of \$265,000 and Health Net agreed to pay a civil penalty of \$340,000. In both cases, the SEC found violations for all agreements that included the offending language going back to August 12, 2011, the date Rule 21F-17 was adopted. Thus, both companies were ordered to contact former employees who signed the agreements from August 12, 2011 forward and provide them with an Internet link to

the SEC's Order and a statement that the companies do not prohibit former employees from seeking and obtaining an SEC whistleblower award. Blue Linx was required to include an additional statement in the former employee notice stating that the company did not prohibit former employees from communicating with the SEC staff without advance notice to the company.

The SEC further required Blue Linx to include the following provision in all of its severance agreements and/or any other agreements that included prohibitions on the use or disclosure of confidential information:

Protected Rights. Employee understands that nothing contained in this Agreement limits Employee's ability to file a charge or complaint with the Equal Employment Opportunity Commission, the National Labor Relations Board, the Occupational Safety and Health Administration, the Securities and Exchange Commission or any other federal, state or local governmental agency or commission ("Government Agencies"). Employee further understands that this Agreement does not limit Employee's ability to communicate with any Government Agencies or otherwise participate in any investigation or proceeding that may be conducted by any Government Agency, including providing documents or other information, without notice to the Company. This Agreement does not limit Employee's right to receive an award for information provided to any Government Agencies.<sup>14</sup>

The SEC did not require a similar action by Health Net.<sup>15</sup>

As in *KBR*, the SEC charged *Health Net* even though the SEC was "unaware of any instances" where the company took action to enforce the offending provisions or otherwise prevent an employee from communicating with the SEC staff.<sup>16</sup> Similarly, there is no evidence in *Blue Linx* that the

company impeded any employee. However, these cases underscore the SEC's position that the restrictions cited may have an intimidating impact, and thereby violate Rule 21F-17.<sup>17</sup>

## Privileged Information Protected, Despite SEC's Omission in Orders

The SEC, as it had in *KBR*, made a curiously significant omission in its *Health Net* and *Blue Linx* orders in quoting the language of Rule 21F-17. In both cases, the SEC omitted the language in the rule that expressly permits companies to enforce confidentiality provisions relating to privileged communications.<sup>18</sup> This omission, and the SEC's mandated language in *Blue Linx*, may mislead employees by suggesting they are permitted to disclose privileged information to the SEC.

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*The SEC omitted the language in the rule that expressly permits companies to enforce confidentiality provisions relating to privileged communications.*

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Both recent cases were brought by the same SEC enforcement group, suggesting a broader SEC review of severance agreements at other public companies. In addition, plaintiffs' lawyers are scrutinizing the severance agreements of public companies, including Wells Fargo, Advanced Micro Devices, and Fifth Third Bank.<sup>19</sup>

## DTSA's Whistleblower Protection for Disclosure of Trade Secrets

As SEC Chair Mary Jo White has pointed out, Rule 21F-17 does not prohibit companies from enforcing confidentiality agreements to preserve trade secrets and similar proprietary information.<sup>20</sup> However, the DTSA strongly discourages employers

from seeking to enforce a confidentiality agreement prohibiting an employee from disclosing proprietary information to the government, if the disclosure is made in the context of reporting a suspected violation of law.

The primary purpose of the DTSA was to provide a federal cause of action for an employee's (or contractor's) theft of trade secrets. But the DTSA also provided immunity for whistleblowers, by shielding from criminal or civil liability an employee who discloses trade secrets to the government.<sup>21</sup> The DTSA requires the employer to provide notice of this immunity.<sup>22</sup> The notice requirement applies to "any contract or agreement with an employee that governs the use of a trade secret or other confidential information" and that is "entered into or updated after the date of enactment."<sup>23</sup> The DTSA does not appear to mandate the amendment of any pre-existing contracts or agreements (prior to the May 11, 2016, effective date). There is no statutory penalty for not providing the required notice. However, employers who do not provide notice cannot recover punitive damages or attorneys' fees in an action against an employee, alleging violations of the new law.<sup>24</sup>

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## Companies should take great care not to overreact to the SEC's recent cases.

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### Practical Takeaways

#### Addressing the SEC's Concerns

Companies should take great care not to overreact to the SEC's recent cases by taking steps that may encourage employees to disclose privileged information to the SEC. Companies are not required to educate employees about the SEC reward program or encourage whistleblowing at the expense of a company's right to protect privileged information or trade secrets. As we noted last year with respect to *KBR*, there are practical steps that companies

can take to protect confidential information without violating Rule 21F-17.<sup>25</sup> These steps include enhanced policies and procedures, a "savings clause" that is compliant with the rule, and considerations for the audit committee and board oversight.<sup>26</sup> These recommended steps are equally applicable to address the concerns raised by the SEC in its recent cases.

We recommend a two-part approach to severance agreements: a "savings clause" *and* a carefully drafted waiver designed to ensure that an employee waives future payments from the employer, but not payments from governmental agencies such as the SEC. The authors believe that the "savings clause" *Blue Linx* agreed to include in its severance agreements to resolve the SEC's charges is broader in its application than Rule 21F-17 requires. We continue to recommend the shorter version we previously suggested:

Nothing in this agreement is intended to or will be used in any way to limit employees' rights to communicate with a government agency, as provided for, protected under or warranted by applicable law.

Severance agreements containing the foregoing savings clause also should include waiver language that does not violate rule 21F-17's prohibition on interference with SEC whistleblower activity:

Employee agrees to waive the right to receive future monetary recovery directly from Employer, including Employer payments that result from any complaints or charges that Employee files with any governmental agency or that are filed on Employee's behalf.

So long as the agreement does not require an employee to waive the right to any future monetary recovery from the government in connection with any communication the employee may have with the SEC, Rule 21F-17 is not violated.

We do not believe that the severance agreement is required to call out Section 21F or Rule 21F-17.

Combining a carefully drafted severance agreement with the shorter “savings clause” and appropriate waiver language avoids two risks of the too-broad *Blue Linx* language:

- First, the *Blue Linx* language would allow employees to disclose to the SEC privileged attorney-client communications. Rule 21F-17 expressly permits companies to enforce agreements relating to privileged communications.
- Second, as in *KBR*, the *Blue Linx* language may prompt employees with internal audit and compliance responsibilities to make hasty disclosures to the SEC and avoid reporting issues internally. The *Blue Linx* language permits an employee to communicate with the SEC without notice to the company and does not limit an employee’s right to receive an award. However, under the applicable regulations, employees with internal audit and compliance functions are not eligible for a whistleblower award unless 120 days have elapsed since the employee provided the information to the responsible parties within the company.<sup>27</sup> Thus, the SEC rules contemplate that employees with internal audit and compliance functions will notify their company first, before the SEC, an important point not addressed in the *Blue Linx* language.

Because the SEC in *Health Net* and *Blue Linx* found violations in agreements going back to August 12, 2011, the date of the inception of the whistleblower rules, companies should review their severance agreements going back to that date as well as its current form of severance agreements. If any agreement contains provisions, such as confidentiality or non-disparagement covenants, limiting or restricting an individual’s ability to communicate with the SEC, or language requiring an employee to waive the right to any future monetary recovery from the government in connection with any communication the employee may have with the SEC, or provisions that could be interpreted to impose such limits or requirements, the company should revise its current forms accordingly and may need to take corrective steps as to past agreements. For example,

the company can notify the former employees in writing that this language is no longer valid.

### Compliance with the DTSA

In any severance or other agreement dated after May 11, 2016 that has terms governing the use of trade secrets, the company should include the following provision:

Employee may not be held criminally or civilly liable under any federal or state trade secret law for the disclosure of a trade secret that: (a) is made (i) in confidence to a federal, state, or local government official, either directly or indirectly, or to an attorney; and (ii) solely for the purpose of reporting or investigating a suspected violation of law; or (b) is made in a complaint or other document that is filed under seal in a lawsuit or other proceeding.

Alternatively, the company can provide a cross-reference in the agreement to a policy document provided to the employee that sets forth the company’s policy for reporting a suspected violation of the law, so long as the policy includes the information in the paragraph above.<sup>28</sup> Companies should continue to have policies and agreements in place to protect the disclosure of trade secrets and confidential information to all others except in the circumstances covered by the DTSA.

### Conclusion

The SEC’s *Blue Linx* and *Health Net* cases are useful reminders of the need to comply with Rule 21F-17 and to avoid impeding an employee from communicating with the SEC. The DTSA adds an additional risk that companies should be mindful of with respect to the protection of trade secrets. Following the practical suggestions that we outline above can help companies protect confidential information and preserve the attorney-client privilege while complying with applicable laws.

## Notes

1. *KBR, Inc.*, Exchange Act Release No. 74619 (Apr. 1, 2015) (KBR).
2. 17 C.F.R. § 240.21F-17 (2015).
3. *Id.*
4. *KBR*, at 2.
5. *Whistleblowers, NDAs and the SEC's KBR Enforcement Action*, INSIGHTS, Vol. 29, No. 8, Aug. 2015.
6. *Blue Linx Holdings, Inc.*, Exchange Act Release No. 78528 (August 10, 2016) (*Blue Linx*); *Health Net, Inc.*, Exchange Act Release No. 78590 (Aug. 16, 2016) (*Health Net*). See also, *Anheuser-Busch InBev SA/NV*, Exchange Act Release No. 78957 (Sept. 28, 2016) (SEC enforcement action focused largely on FCPA, but included Rule 21F-17 element).
7. *Defend Trade Secrets Act of 2016*, Pub. L. 114-153, May 11, 2016 (DTSA).
8. INSIGHTS, Vol. 29, No. 8, Aug. 2015. See 17 C.F.R. § 240.21F-17(a) (which permits enforcement of confidentiality agreements to protect privileged information described in Rule 21F-4(b)(4)). See also Sept. 14, 2016, speech by SEC Enforcement Director Andrew Ceresney reminding whistleblowers that providing privileged information or work product is “not helpful” to SEC. <https://www.sec.gov/news/speech/ceresney-sec-whistleblower-program.html>.
9. *Health Net*, at 3.
10. *Blue Linx*, at 4.
11. *Id.*
12. *Id.* at 4-5; *Health Net*, at 4.
13. *Blue Linx*, at 4.
14. *Blue Linx*, at 5.
15. The reasons why are unknown, including whether HealthNet’s agreement to merge with Centene was a factor. Centene Press Release, Mar. 24, 2016, [http://](http://phx.corporate-ir.net/phoenix.zhtml?c=130443&p=irol-newsArticle_Print&ID=2150756)
16. *Health Net*, at 3.
17. Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, SEC Release No. 34-64545, at 201 (eff. Aug.12, 2011).
18. *Blue Linx*, at 2; *Health Net*, at 2.
19. Reuters, “Exclusive: Companies made deals that could run afoul of U.S. whistleblower rules,” Aug. 25, 2016, <http://www.reuters.com/article/us-sec-whistleblower-settlements-exclusi-idUSKCN1100BU>.
20. See Mary Jo White, The SEC as the Whistleblower’s Advocate, Address at the Roy Garrett, Jr. Corporate and Securities Law Institute, Northwestern University School of Law (Apr. 30, 2015), available at <http://www.sec.gov/news/speech/chair-white-remarks-at-garrett-institute.html>.
21. Specifically, “in confidence” directly or indirectly to federal, state, and local government officials, or to a lawyer and “solely for the purpose of reporting or investigating a suspected violation of law” 18 U.S.C. § 1833(b)(1)(A)(i)–(ii). In addition, disclosure of trade secrets is specifically authorized in unlawful retaliation lawsuits, as long as the information is disclosed only to an individual’s lawyer, is filed under seal, and is not disclosed except by court order. The protections in this section will supersede any state law. 18 U.S.C. §1833(b).
22. Notice of other limited protections is also required, 18 U.S.C. §1833(b).
23. 18 U.S.C. §1833(b)(3)(D).
24. 18 U.S.C. §1833(b)(3)(C).
25. INSIGHTS, Vol. 29, No. 8, Aug. 2015, at 23-25.
26. *Id.*
27. 17 C.F.R. § 240.21F-4(b)(v)(C).
28. 18 U.S.C. §1833(b)(3)(B).



## ■ MERGERS AND ACQUISITIONS

# Three Days in August: Delaware's Evolving View of the Impact of Stockholder Approval on Post-Closing M&A Litigation

*Three members of Delaware's Court of Chancery—Chancellor Bouchard, Vice Chancellor Slight, and Vice Chancellor Laster—rendered decisions over three consecutive days in August 2016, all considering the impact of stockholder votes on challenged corporate transactions. All three cases involved a post-closing suit for money damages alleging that board members breached their fiduciary duties during the deal process, notwithstanding the fact that each transaction received stockholder approval. Each judge approached the question from a slightly different angle, leaving considerable uncertainty in their wake.*

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By C. Thomas Brown, Martin J. Crisp,  
and Gregory L. Demers

The Delaware Supreme Court's decision last year in *Corwin v. KKR Financial Holdings LLC*<sup>1</sup> was brief but important, addressing the question of whether, and when, stockholder approval can “cleanse” a corporate transaction that is the subject of post-closing litigation alleging fiduciary breaches in connection with the deal. Since *Corwin* was issued, almost every member of the Court of Chancery has been called upon to address its reach and determine whether stockholder approval had extinguished various plaintiffs' breach of fiduciary duty claims. Coincidentally, three of those rulings—by Chancellor Bouchard, Vice Chancellor Slight, and Vice Chancellor Laster—came over a

three-day stretch in August 2016. This closeness in time means that the three judges likely did not have the opportunity to review their colleagues' opinions before issuing their own, much less distinguish the other cases and reconcile any perceived inconsistencies. The result is that the impact of *Corwin* is perhaps even less clear than before, and the availability of the “cleansing” offered by *Corwin* remains—for now—a fact-specific question.

This is reflected in the three Court of Chancery cases. Specifically, Chancellor Bouchard's decision in *City of Miami General Employees' and Sanitation Employees' Retirement Trust v. Comstock (C&J)*<sup>2</sup> takes a narrow reading of *Corwin*, holding that even in the context of a fully informed, uncoerced stockholder vote, plaintiffs may rebut the business judgment presumption that the board acted loyally by adequately alleging that directors engaged in self-dealing or acted in bad faith.

In contrast, Vice Chancellor Slight's decision in *Larkin v. Shah (Auspex)*,<sup>3</sup> issued the day after the Chancellor's opinion in *C&J*, held that *Corwin* approval triggered an “irrebuttable” business judgment presumption and extinguished all breach of fiduciary duty claims except claims for waste.

The day after that, Vice Chancellor Laster ruled from the bench in *Basho Technologies Holdco B, LLC, et al. v. Georgetown Basho Investors, LLC, et al.*, addressing a similar issue but reaching a different result.<sup>4</sup> Unlike both *C&J* and *Auspex*, *Basho* denied the defendants' motion to dismiss without addressing *Corwin* at all. Instead, in light of the fact that the plaintiffs themselves had voted in favor of the challenged financing transaction, the *Basho* defendants argued both that the Court should apply the business judgment rule under *Corwin* and that the doctrines

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of waiver and acquiescence barred the plaintiffs' claims. Vice Chancellor Laster discussed only the latter in his decision, rejecting these arguments because the plaintiffs allegedly were strong-armed into voting for the transaction, and confirming that courts will not even consider *Corwin's* application where the plaintiff has adequately alleged that the stockholder vote was the product of coercion.

## Corwin and Its Progeny

In *Corwin v. KKR Financial Holdings LLC*, the Delaware Supreme Court analyzed a stockholder challenge to a stock-for-stock merger between KKR & Co. L.P. (KKR) and KKR Financial Holdings LLC (Financing Holdings), in which the plaintiffs alleged that the transaction was subject to entire fairness review because Financing Holdings's primary business involved financing KKR's leveraged buyout activities, managed by a KKR affiliate.<sup>5</sup> As a result, the plaintiffs contended that KKR effectively acted as a controlling stockholder of Financing Holdings, despite owning less than one percent of the company's stock.<sup>6</sup>

As an initial matter, the Court easily dispatched plaintiffs' claim that KKR was a controlling stockholder, agreeing with Chancellor Bouchard that plaintiffs had failed to allege "a combination of potent voting power and management control" that could support such a finding absent majority stock ownership.<sup>7</sup> The Court then considered the plaintiffs' claim that even if KKR was not a controlling stockholder, the Chancellor erred by dismissing the complaint because the plaintiffs adequately pled a *Revlon*<sup>8</sup> claim against the director defendants. But the Court concluded that "it does not matter" whether *Revlon* applied because "the Chancellor's analysis of the effect of the uncoerced, informed stockholder vote is outcome-determinative."<sup>9</sup>

The Court thus agreed with the Chancellor that "the business judgment rule is invoked as the appropriate standard of review for a post-closing damages action when a merger that is not subject to the entire fairness standard of review has been

approved by a fully informed, uncoerced majority of the disinterested stockholders."<sup>10</sup> Explaining the underlying policy rationale for this approach, the Court wrote:

When the real parties in interest—the disinterested equity owners—can easily protect themselves at the ballot box by simply voting no, the utility of a litigation-intrusive standard of review promises more costs to stockholders in the form of litigation rents and inhibitions on risk-taking than it promises in terms of benefits to them.<sup>11</sup>

While *Corwin* determined that the business judgment rule was the appropriate standard of review, it did not describe precisely what circumstances would trigger application of that rule. Stated differently, the Court made clear that its holding applied only to mergers that "are not subject to the entire fairness standard of review," but it did not provide express guidance as to how that rule should be applied in the context of a fully informed, uncoerced stockholder vote.

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### Corwin determined that the business judgment rule was the appropriate standard of review.

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Shortly after the Delaware Supreme Court issued its decision, Vice Chancellor Parsons had occasion to consider the implications of *Corwin* when defendants moved for reargument in *In re Zale Corp. Stockholders Litigation*.<sup>12</sup> In *Zale*, the Vice Chancellor took a narrow view of *Corwin*, observing that

[w]hile the Court in *Corwin* quotes [*In re KKR Financial Holdings LLC Shareholder Litigation*<sup>13</sup>] and a law review article for the proposition that a fully informed majority vote of disinterested stockholders insulates

directors from all claims except waste in the explanatory parentheticals of two footnotes, the Court itself does not hold that anywhere in its opinion.<sup>14</sup>

Although the Court ultimately dismissed the plaintiffs' duty of care claims, *Zale* suggested that a stockholder vote did not have a complete cleansing effect on a transaction, but rather left open the possibility that, absent exculpation, directors could be held liable for a breach of the duty of care if they acted in a grossly negligent manner during the transaction process.<sup>15</sup>

On appeal, the Delaware Supreme Court seemingly put an end to this lingering uncertainty over *Corwin's* reach in *Singh v. Attenborough*.<sup>16</sup> Citing *Corwin*, *Singh* held that the Court of Chancery correctly invoked the business judgment rule following a fully informed, uncoerced vote of disinterested stockholders.<sup>17</sup> However, Chief Justice Strine opined that it was incorrect for the Vice Chancellor to consider post-closing whether the plaintiffs stated a claim for breach of the duty of care after invoking the business judgment rule, because "employing this same standard after an informed, uncoerced vote of the disinterested stockholders would give no standard-of-review-shifting effect to the vote."<sup>18</sup> The Court further observed that invocation of the business judgment rule after a stockholder vote "typically" results in dismissal, as plaintiffs are left with only the "vestigial waste exception," which is rarely successful in this context.<sup>19</sup> *Singh* thus appeared to directly rebut the notion that *Corwin* left open the door for plaintiffs to pursue non-waste claims for breach of fiduciary duty even after a fully informed, uncoerced stockholder vote.

One of the Court of Chancery's newest members, Vice Chancellor Montgomery-Reeves, weighed in on the issue shortly after *Singh* was decided. In *In re Volcano Corp. Stockholder Litigation*,<sup>20</sup> former public company stockholders brought an action against the company's board of directors and financial advisor alleging that the board breached its fiduciary duties in approving the merger, and was aided and abetted

by its financial advisor. Relying on *Singh*, the Vice Chancellor concluded that

upon a fully informed vote by a majority of a company's disinterested, uncoerced stockholders, the business judgment rule *irrebuttably* applies ... even when that vote is statutorily required and the transaction otherwise would be subject to the *Revlon* standard of review.<sup>21</sup>

She further held that such a transaction "only can be challenged on the basis that it constituted waste."<sup>22</sup> After concluding that *Corwin* applied with equal force in the tender offer context, the Court dismissed the plaintiffs' claims.<sup>23</sup>

By June 2016, then, the Delaware Supreme Court had clarified its holding in *Corwin*, and a member of the Court of Chancery had held that the "irrebuttable" business judgment rule required dismissal of a class action challenging a stockholder-approved merger, relying on *Corwin* and *Singh*. The issue appeared to be fairly well-settled—but it did not last long.

## C&J Reintroduces Uncertainty over *Corwin's* Reach

In *C&J*, a former stockholder of C&J Energy Services, Inc. filed suit seeking damages for breaches of fiduciary duty against C&J directors and officers following C&J's merger with a subsidiary of Nabors Industries Ltd.<sup>24</sup> This damages action came on the heels of a decision by the Delaware Supreme Court reversing an earlier decision by the Delaware Court of Chancery to enjoin the C&J merger.<sup>25</sup> In the post-closing damages litigation, the plaintiff alleged that the defendants were improperly influenced by the prospect of continued employment and significant compensation packages and thereby breached their duty of loyalty in approving the transaction.<sup>26</sup> The plaintiff also alleged that the company made inadequate disclosures about the proposed transaction, and asserted claims for aiding and abetting against Nabors and the financial advisor to C&J's special committee.<sup>27</sup>

After rejecting the plaintiff's disclosure claims, Chancellor Bouchard considered the impact of the C&J stockholder vote on the plaintiff's breach of fiduciary duty claim in light of *Corwin*.<sup>28</sup> The plaintiff had not alleged that the transaction amounted to waste or that the stockholder vote was coerced, and the Court found that the plaintiff had failed to allege that C&J's stockholders were not fully informed.<sup>29</sup> Presumably Chancellor Bouchard could have ended the analysis there, holding that the "irrebuttable" business judgment rule applied and dismissing the plaintiff's claims, as the Court did in *Volcano*. But he did not. Rather than finding that stockholder approval cleansed the C&J merger, Chancellor Bouchard considered whether the plaintiff adequately "rebut[ted] the business judgment presumption that the board acted loyally."<sup>30</sup> He presented a detailed analysis of the plaintiff's claim that the majority of the board was interested in the transaction because of their desire to obtain future board seats, and that C&J's CEO and Chairman intentionally had deceived the Board to further his own interests.<sup>31</sup> Ultimately, the Court rejected the plaintiff's attempt to trigger entire fairness review and granted the defendants' motion to dismiss.<sup>32</sup> Despite arriving at the same result, however, *C&J* appeared to depart from *Volcano* by suggesting that plaintiffs could still pursue breach of fiduciary duty claims, including but not limited to claims for corporate waste, following a fully informed, uncoerced stockholder vote.

### Vice Chancellor Slight Takes a Broader Reading of *Corwin* in *Auspex*

On August 25, the day after *C&J* was issued, Vice Chancellor Slight rendered a decision in *Auspex* also examining *Corwin*'s reach.<sup>33</sup> *Auspex* involved a challenge by former stockholders to the 2015 all-cash sale of Auspex Pharmaceuticals, Inc. to Teva Pharmaceuticals Industries, Inc. for \$3.5 billion. The plaintiffs alleged that two venture capital firms that collectively controlled 23.1 percent of Auspex's stock and three of nine board seats acted as a controlling stockholder block, and that a majority of directors who approved the deal had disabling conflicts of interest,

including affiliation with the venture capital firms and the enticement of post-merger employment offers.<sup>34</sup>

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### Stockholder approval thus "extinguishes all challenges to the merger except those predicated on waste."

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Vice Chancellor Slight first considered the threshold question: "what did *Corwin* mean by 'a transaction not subject to the entire fairness standard'?"<sup>35</sup> The plaintiffs urged "a rigorously literal reading of that text—that is, that *all* transactions subject to entire fairness for *any reason* cannot be cleansed under *Corwin*."<sup>36</sup> The Court rejected this view, instead considering "contextual cues and the authority undergirding *Corwin*, both of which strongly suggest that the only transactions that are subject to entire fairness that cannot be cleansed by proper stockholder approval are those involving a controlling stockholder."<sup>37</sup> Vice Chancellor Slight noted that *Corwin* approved the Court of Chancery's conclusion that "*even if the plaintiffs had pled facts from which it was reasonably inferable that a majority of... directors were not independent*, the business judgment standard of review still would apply to the merger...."<sup>38</sup>

Accordingly, the Court concluded that absent a controlling stockholder attempting to extract unique, personal benefits from the company or otherwise competing with other stockholders for consideration,

the effect of disinterested stockholder approval of the merger is review under the irrebuttable business judgment rule, even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts faced by individual directors.<sup>39</sup>

Stockholder approval thus "extinguishes all challenges to the merger except those predicated on waste."<sup>40</sup> As a result, unlike *C&J*, the Court in

*Auspex* concluded that it did not need to reach the plaintiffs' allegations about disabling board conflicts because stockholder approval triggered the "irrebuttable" business judgment rule and extinguished the plaintiffs' duty of loyalty claim.

### **Basho Technologies Underscores the Limitations of *Corwin***

A third ruling from the Court of Chancery just one day after *Auspex* was decided also considered the issue of stockholder approval on a challenged corporate transaction, but reached a different result. In *Basho Technologies Holdco B, LLC, et al. v. Georgetown Basho Investors, LLC, et al.*,<sup>41</sup> the former Chairman of Basho Technologies, Inc., along with several Basho investors, brought suit against certain directors and officers of the company for breach of fiduciary duty related to a 2014 preferred stock financing transaction, which had received Board and stockholder approval. The plaintiffs claimed that the financing transaction was facilitated by a cash crisis created by minority stockholder Georgetown Basho Investors, LLC (GBI), by intentionally withholding funding in violation of its obligations under a convertible promissory note and preventing Basho's board from considering other funding options.<sup>42</sup>

Ruling from the bench, Vice Chancellor Laster explained that "[t]he complaint has a problem ... the plaintiff, both as a director and as the managing member of the four stockholder entities, voted in favor of the transaction."<sup>43</sup> Given that the plaintiffs had approved the transaction, the defendants' motion to dismiss relied principally on the twin doctrines of waiver and acquiescence. But the Court did not find these arguments persuasive. Vice Chancellor Laster observed that approval by the plaintiffs "gives rise to what ordinarily would be very strong defense," but ultimately concluded that "this could be the case that is the exception that proves the rule."<sup>44</sup>

The Court's ruling turned on the fact that the complaint contained "specific detail about aggressive, self-interested, prolonged, abusive fiduciary misconduct [by Basho board members] ... where the

company is days from insolvency and has absolutely no alternatives to accepting the punitive financing."<sup>45</sup> This conduct included "a continuing stream of ... misrepresentations to fellow directors and to others," leading to two outside director resignations after the transaction was signed, which the Court described as "a pretty huge red flag."<sup>46</sup> The Court therefore denied the defendants' motion to dismiss.<sup>47</sup> In doing so, Vice Chancellor Laster did not conclude that the defendants effectively acted as controlling stockholders or that the transaction was subject to entire fairness review. In fact, the decision did not even address the application of *Corwin*, despite the fact that both parties had briefed the issue.

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### *The tension between C&J and Auspex is obvious and difficult to resolve.*

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*Basho*, then, is notable not because of what it says about "cleansing" votes in reliance on *Corwin*, but because of what it does not say. The plaintiffs had alleged that the stockholder vote was infected by coercive conduct by GBI—specifically, that the independent stockholders had provided an irrevocable proxy to vote their shares under extreme duress due to Basho's liquidity crisis. A long line of Delaware precedent holds that stockholder approval in such circumstances will not inoculate the transaction, and *Corwin* did not purport to change that rule.<sup>48</sup> Vice Chancellor Laster denied the motion to dismiss without addressing the question of whether *Corwin* applied, likely an implicit recognition of the fact that the doctrine has no application in circumstances involving allegations of coercive conduct that compromised the stockholder vote. Because the Court held that the nearly 200-page complaint contained "specific detail about aggressive, self-interested, prolonged, abusive fiduciary misconduct" that forced the company to act to avoid a liquidity crisis, it was unnecessary to consider *Corwin's* reach.

## Thoughts on *Corwin* in Future Cases

These three decisions offer important insights into the Court of Chancery's evolving view of the impact of stockholder approval on post-closing breach of fiduciary duty claims seeking money damages. As an initial matter, the tension between *C&J* and *Auspex* is obvious and difficult to resolve. Chancellor Bouchard's opinion suggested that even a fully informed, uncoerced stockholder vote does not have a complete "cleansing" effect on a transaction, as his analysis in *C&J* considered whether the plaintiffs had adequately rebutted the presumption that the board acted loyally—apparently diverging from the *Volcano* decision just a few months earlier. In contrast, Vice Chancellor Slight's ruling in *Auspex* agreed with *Volcano* that *Corwin* approval extinguishes all breach of fiduciary duty claims except claims for waste. In other words, *C&J* held that *Corwin* approval triggered a *rebuttable* presumption that could be overcome with well-pled allegations of the breach of the duty of loyalty, while *Auspex* concluded that the business judgment rule is "irrebuttable" upon a fully informed, uncoerced stockholder vote.

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### Often the decision to apply one standard or the other is outcome determinative.

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Although this divergence did not affect the outcome in these cases—both *C&J* and *Auspex* resulted in dismissals—it could have a significant impact on future cases. If, as *C&J* suggests, plaintiffs can still challenge the independence and disinterestedness of board members following a fully informed, uncoerced vote, without having to plead control, it creates a new pressure point for companies and their board members in the transactional context. As a result, the plaintiffs' bar likely will take a more aggressive approach to challenging corporate transactions by putting more time and resources into those that do not involve controlling stockholders, and defense counsel can therefore expect an uptick in

such litigation. If, on the other hand, the approach taken by the Court in *Auspex* (and *Volcano*) prevails, plaintiffs will have a much higher bar to overcome when asserting post-closing claims based on a stockholder-approved transaction.

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### What constitutes a "fully informed" vote will depend on how the Court views the materiality of the alleged misrepresentations or omissions in the company's disclosures.

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One point of common ground in these decisions is that none questions the fact that *Corwin* approval only applies in the absence of a controlling stockholder attempting to extract some unique benefit from the transaction, not common to all stockholders. The bright-line rule established in *Auspex*—that *Corwin* approval triggers the "irrebuttable" business judgment rule, notwithstanding allegations of self-dealing or other duty of loyalty violations by the board—likely will yield further discussion over the disparate treatment of alleged misconduct by controlling stockholders and misconduct by directors and officers. While the former generally would trigger entire fairness review, the latter would not.<sup>49</sup> Often the decision to apply one standard or the other is outcome determinative. This could lead Delaware Courts to reconsider their treatment of controlling stockholder transactions and possibly broaden the *MFW* exception,<sup>50</sup> which allows for application of the business judgment rule in certain narrowly defined circumstances. *C&J* observed that transactions involving a conflicted controller "remain subject to entire fairness review absent the robust suite of procedural protections listed in *M&F Worldwide*," which will remain the case unless *Corwin* and its progeny reveal a deep and growing divide between those transactions that involve well-pled allegations of control and those that do not.<sup>51</sup>

One area that will undoubtedly remain a key battleground for litigants is whether the stockholder vote properly can be characterized as “fully informed” and “uncoerced.” *Corwin* did not delve into this quagmire. What constitutes a “fully informed” vote will depend on how the Court views the materiality of the alleged misrepresentations or omissions in the company’s disclosures. *C&J* made clear that this is not an insignificant obstacle for plaintiffs to overcome, but it is difficult to anticipate how consistently that principle will be applied from case to case. The fact that this is an obvious area of attack for plaintiffs, and that a dispute over whether the vote was fully informed can determine if a board is subject to the business judgment rule or the heightened entire fairness standard, highlights the continuing importance of robust disclosure in the transactional context.

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### *Courts are likely to require more than nominal allegations of coercion to avoid dismissal.*

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Similarly, coercion, by its very nature, is easy to characterize as a fact-specific inquiry, and the plaintiffs’ bar may attempt to defeat motions to dismiss by arguing that allegations of coercion create a fact issue that cannot be resolved on the pleadings. In the context of a stockholder-approved vote, however, Courts are likely to require more than nominal allegations of coercion to avoid dismissal. *Basho* is instructive in this regard. Although the Court did not specifically address *Corwin*’s application, Vice Chancellor Laster indicated that that highly unusual situation in which the defendants received an irrevocably proxy to vote plaintiffs’ shares, under protest and “extreme duress,” was the “exception that proves the rule.”

If nothing else, *C&J*, *Auspex*, and *Basho* illustrate that notwithstanding two Delaware Supreme Court rulings within the last year, the issue of when, and to what extent, *Corwin* approval effectively immunizes a transaction from post-closing judicial scrutiny remains far from settled. Unless subsequent decisions

from the Court of Chancery are able to somehow resolve the apparent incongruity between *C&J* and *Auspex*, the Delaware Supreme Court likely will be called upon once again to enter this thicket. Indeed, the plaintiffs in *Volcano* have appealed that decision to the Delaware Supreme Court, so it may be a short time before we have some clarity on the issue. Until then, practitioners will shoulder the burden of trying to understand and reconcile these decisions, and persuade the Court of Chancery that they have the better reading of *Corwin*.

### Notes

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1. 125 A.3d 304 (Del. 2015).
2. C.A. No. 9980-CB, 2016 WL 4464156 (Del. Ch. Aug. 24, 2016).
3. C.A. No. 10918-VCS, 2016 WL 4485447 (Del. Ch. Aug. 25, 2016).
4. C.A. No. 11802-VCL (Aug. 26, 2016) (transcript).
5. 125 A.3d 304 (Del. 2015).
6. *Id.* at 305.
7. *Id.* at 307-08.
8. *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).
9. *Corwin*, 125 A.3d at 308.
10. *Id.* at 305-06.
11. *Id.* at 313. The Court further observed that “judges are poorly positioned to evaluate the wisdom of business decisions and there is little utility to having them second-guess the determination of impartial decision-makers.” *Id.* at 313-14.
12. No. CV 9388-VCP, 2015 WL 6551418, at \*5 (Del. Ch. Oct. 29, 2015).
13. 101 A.3d 980 (Del. Ch. 2014).
14. 2015 WL 6551418, at \*3.
15. *Id.*
16. 137 A.3d 151 (Del. 2016).
17. *Id.* at 151.
18. *Id.*
19. *Id.* at 151-52 (“[T]he vestigial waste exception has long had little real-world relevance, because it has been understood that stockholders would be unlikely to approve a transaction that is wasteful.”).
20. 2016 WL 3626521 (Del. Ch. June 30, 2016).

21. *Id.* at \*11 (emphasis added).
22. *Id.* (emphasis added).
23. *Id.* at \*12 (holding that the *Corwin* standard applies with equal force to tender offers under Section 251(h) and has “the same cleansing effect as a stockholder vote in favor of a transaction”).
24. C.A. No. 9980-CB, 2016 WL 4464156 (Del. Ch. Aug. 24, 2016).
25. See *C & J Energy Servs., Inc. v. City of Miami Gen. Employees*, 107 A.3d 1049, 1052 (Del. 2014). The Court of Chancery had determined that there was a plausible violation of the C&J board’s *Revlon* duties because the board did not affirmatively shop the company either before or after signing of the deal. However, the Delaware Supreme Court concluded that “the Court of Chancery did not rely on undisputed facts showing a reasonable probability that the board had breached its fiduciary duties when it imposed this mandatory, affirmative injunction.” *Id.* “Instead, it is undisputed that a deal with Nabors made strategic business sense and offered substantial benefits for C & J’s stockholders.” *Id.*
26. *Id.* at \*18.
27. *Id.*
28. *Id.*
29. *Id.* at \*17.
30. *Id.* at \*18.
31. *Id.* at \*18-\*23.
32. *Id.* at \*23. The Court also granted C&J’s motion to recover \$542,000 of the \$650,000 injunction bond posted to secure a preliminary injunction, which was later reversed by the Delaware Supreme Court. The Court concluded that C&J was presumptively entitled to recover those “foreseeable and eminently reasonable” costs associated with retaining legal and financial advisors to shop the company while litigation was ongoing. *Id.* at \*24. The Court reasoned that delay could have jeopardized the transaction, and concluded that the cost of shopping the company paled in comparison to the risk of losing a \$3 billion transaction. *Id.*
33. C.A. No. 10918-VCS, 2016 WL 4485447 (Del. Ch. Aug. 25, 2016).
34. *Id.* at \*1.
35. *Id.* at 10.
36. *Id.*
37. *Id.* at \*10. The Court later dispensed with the plaintiffs’ controlling stockholder allegation, holding that they failed to adequately allege that the venture capital board designees exercised any form of actual control over the rest of the board. *Id.* at \*14.
38. *Id.* at \*11 (quoting *In re KKR Fin. Holdings LLC S’holder Litig.*, 101 A.3d 980, 990 (Del. Ch. 2014), *aff’d sub nom. Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015) (emphasis in original)).
39. *Id.*
40. *Id.*
41. C.A. No. 11802-VCL (Aug. 26, 2016) (Laster, V.C.) (transcript).
42. *Id.* at 24-26.
43. *Id.* at 46.
44. *Id.* at 46, 51.
45. *Id.* at 46.
46. *Id.* at 50.
47. *Id.* at 51-52.
48. See *Corwin*, 125 A.3d at 312 n.27 (“[a]n otherwise valid stockholder vote may be nullified by a showing that the structure or circumstances of the vote were impermissibly coercive”) (quoting *Williams v. Geier*, 671 A.2d 1368, 1380-83 (Del. 1996)).
49. To be clear, not all controlling stockholder transactions trigger entire fairness review. Heightened review is only required where the controller engaged in a conflicted transaction, by, for example, standing on both sides of a transaction. *Larkin*, 2016 WL 4485447, at \*8.
50. See *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 644 (Del. 2014) (listing the following six conditions that, if met, reduce the standard of review in “controller buyout” contexts to business judgment: “(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 definitively; (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”).
51. *Larkin*, 2016 WL 4485447, at \*11 (citing *M&F Worldwide Corp.*, 88 A.3d at 644).



## ■ CORPORATE GOVERNANCE

# Guidance on Identifying “Officers” for Advancement and Indemnification

*Recent Delaware decisions demonstrate that the determination of who is an “officer” for various purposes under Delaware law, particularly advancement and indemnification, is a fact-specific inquiry. Nevertheless, the decision provide some insight into the analysis that will be performed in making this determination.*

By Nathan P. Emeritz

A recent decision by Vice Chancellor Travis Laster of the Delaware Court of Chancery suggests that boilerplate advancement and indemnification bylaws, which ambiguously define “officers,” may be construed to apply to a broad group of individuals within a corporate structure.<sup>1</sup> Although the actual ruling in this case was that a former vice president at a subsidiary of Goldman Sachs was not entitled to advancement, this holding turned on the unique procedural posture of the litigation. Counsel should focus on the detailed dicta that likely will apply to future advancement and indemnification claims brought by employees under contractual provisions that do not clearly delineate “officers.” This dicta also may provide useful guidance regarding determinations whether an employee is an “officer” and, therefore, owes traditional corporate fiduciary duties.

### The Federal Litigation

Sergey Aleynikov was a computer programmer at Goldman Sachs & Co. (GS Subsidiary), who held the title of “Vice President.” After his federal conviction for theft of computer source code was

overturned by the Third Circuit Court of Appeals, Aleynikov was indicted by a New York grand jury. Aleynikov then sued the parent of the GS Subsidiary, The Goldman Sachs Group, Inc. (Parent and, together with the GS Subsidiary, Goldman), in the District of New Jersey federal court seeking advancement and indemnification for legal expenses under the Parent’s bylaws (Bylaws).<sup>2</sup>

District Judge Kevin McNulty granted Aleynikov’s motion for summary judgment, holding that Aleynikov was an “officer . . . of a Subsidiary of the Corporation” and therefore entitled to advancement.<sup>3</sup> The Third Circuit reversed the district judge’s decision, holding that the term “officer” was ambiguous and that genuine issues of material fact existed, which precluded summary judgment.<sup>4</sup> On remand, District Judge McNulty denied Aleynikov’s motion for summary judgment on the basis of the Circuit Decision.<sup>5</sup> Aleynikov then turned to Delaware.

### The Delaware Chancery Decision

Aleynikov instituted a summary proceeding in the Delaware Court of Chancery, under Section 145(k) of the Delaware General Corporation Law (DGCL), for advancement of litigation expenses.<sup>6</sup> After a one-day trial, Vice Chancellor Laster ruled that Aleynikov had failed to prove by a preponderance of the evidence that he was an officer and that Aleynikov, therefore, was not entitled to advancement.<sup>7</sup>

The vice chancellor held that he was constrained by the New Jersey doctrine of issue preclusion and holdings that had been “essential” to the Circuit Decision.<sup>8</sup> The vice chancellor quoted the US Supreme Court for the proposition that “issue preclusion prevents relitigation

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of wrong decisions just as much as right ones.”<sup>9</sup> Accordingly, the vice chancellor held that he was precluded from reconsidering the Third Circuit’s holdings that (1) the definition of “officer” under the Bylaws is ambiguous<sup>10</sup> and (2) the doctrine of *contra proferentem* could not be used to resolve the ambiguity.<sup>11</sup>

Vice Chancellor Laster held that he was not precluded from considering whether Aleynikov subjectively had believed himself to be an officer, the Subsidiary had held out Aleynikov as an officer for regulatory (but not indemnification) purposes or the Subsidiary typically had exercised its discretion regarding advancement and indemnification of vice presidents’ expenses. The vice chancellor agreed with the Circuit’s holdings, however, that none of the evidence on these three issues was probative of the definition of “officer.”<sup>12</sup> It is worth noting that the vice chancellor also agreed with the Circuit that, had the Subsidiary had a practice of always advancing and indemnifying (or never advancing and indemnifying) its vice presidents’ expenses, then that practice would have supported Goldman’s (or Aleynikov’s) position.<sup>13</sup> Finally, the vice chancellor held that he was not precluded from considering whether there were an industry-wide meaning of the term “officer,” but found that the evidence in support of either position was unconvincing.<sup>14</sup> Because the vice chancellor found that the limited non-precluded evidence “stands in equipoise,” he ruled that Aleynikov had failed to carry his burden of proving by a preponderance of the evidence that he was an officer and that Aleynikov was therefore not entitled to advancement.<sup>15</sup>

### Commentary in *Dicta* from Vice Chancellor Laster

The Chancery Decision is arguably more important going forward for Vice Chancellor Laster’s detailed explanation in *dicta* that, if he had not been constrained by issue preclusion, he was “personally inclined to think” that *contra proferentem* applied to construction of “officers” in the Bylaws and that a

Goldman “vice president” is an “officer” entitled to advancement.<sup>16</sup> The vice chancellor stated that *contra proferentem* should have applied to construction of the term “officers” in the Bylaws for the following reasons:

- The Parent drafted the Bylaws unilaterally and, therefore, was best positioned to remove any ambiguity and “should be held responsible for the reasonable expectations created by its Bylaws.”<sup>17</sup>
- An individual with the title “vice president” could conclude that he was an “officer” who was entitled to advancement rights under the Bylaws.<sup>18</sup>
- “Officers” of the Parent were defined in the Bylaws to include “vice presidents,” and that provision could be read *in pari materia* with relevant provisions for non-corporate subsidiaries such as the Subsidiary.<sup>19</sup>
- The “widespread understanding” of the term “officers” typically includes “vice presidents.” In support of this proposition, the vice chancellor observed, “The Delaware General Corporation Law expressly treats the concept of an entity’s ‘officers’ as including a ‘vice president’ by identifying a ‘vice president’ as one of the officers who can execute a stock certificate.”<sup>20</sup> In addition, the vice chancellor noted that the 2016 amendments to the DGCL replace the list of officers (including a “vice-president”), who are authorized by Section 158 of the DGCL to sign stock certificates, with the phrase “any two authorized officers of the corporation.” Vice Chancellor Laster inferred from this amendment that “the former titles already fell within the broader category.”<sup>21</sup>
- Commercial and investment banks have historically—based on bank records dating back to 1929—included “vice presidents” among their “officers” who have authority to sign documents that bind the bank.<sup>22</sup>
- Federal securities laws, including “core New Deal legislation” that imposed disclosure

obligations on officers and regulations promulgated by the SEC, historically have included and currently include “vice president” in the definition of “officer.”<sup>23</sup>

- “Wall Street firms as a whole, and Goldman Parent in particular, have engaged in a practice of title inflation whereby impressive sounding titles that historically would have carried real-world responsibilities have been disseminated widely. The evidence supports an inference that these titles have been used in lieu of other employment benefits, such as greater compensation. Goldman Parent and its subsidiaries easily could have clarified whether or not the title of ‘Vice President’ was an officer title for purposes of advancement and indemnification. The doctrine of *contra proferentem* appropriately holds Goldman Parent to the promises it implicitly made ‘to parties who did not participate in negotiating’ the Bylaws.”<sup>24</sup>
- Reasonable individuals would not conclude they are not “officers” simply because—like Aleynikov—they are one of many employees with the title “vice president,” their hiring was not required to be approved by the board of directors and they did not have supervisory or managerial functions.<sup>25</sup>
- “Officers” were authorized under the Bylaws to appoint vice presidents, and Aleynikov received the vice president title in an offer letter that was signed by another vice president, who may be inferred to have been an “officer.”<sup>26</sup>
- Applying the doctrine of *contra proferentem* in an advancement proceeding is “all the more appropriate because of Delaware’s policy in favor of advancement and indemnification.”<sup>27</sup> And declining to apply the doctrine of *contra proferentem* “has the potential to create problems for advancement proceedings, which are supposed to be summary in nature.”<sup>28</sup> The vice chancellor stated that the Circuit Decision invited fact-intensive—not summary—dissection of whether “the individual’s actual

job responsibilities were not sufficiently akin to those captured by an external, common law concept of officer-ship to warrant the individual having advancement rights.”<sup>29</sup> Applying the doctrine of *contra proferentem* and holding an entity to the presumptive implications of the title it chooses to bestow facilitates the summary disposition of advancement proceedings.<sup>30</sup>

- Finally, the vice chancellor stated that even if *contra proferentem* only applies to the scope of rights under the Bylaws—and not to a determination whether Aleynikov was a party to a contract—then the doctrine should have been held to apply to the Bylaws.<sup>31</sup>

Notwithstanding Vice Chancellor Laster’s narrow legal holding, the stronger reading of the Chancery Decision is that boilerplate advancement or indemnification bylaws, which ambiguously define “officers,” may be construed to cover employees with a “vice president” title.<sup>32</sup> Large organizations with interlocking organizational documents, entities ostensibly engaging in “title inflation” and businesses subject to extensive regulation and laws that might impose external definitions of titles (e.g., “officer” or “vice president”) should be aware of the entire universe of factors that likely will be considered by Delaware courts in favor of advancement and indemnification rights.

## Additional Implications of the Chancery Decision

The dicta in the Chancery Decision also may warrant consideration with respect to other issues around officer liability. While keeping in mind its limited precedential weight, counsel might consider the impact of the vice chancellor’s guidance on a determination whether an employee owes traditional corporate fiduciary duties.

As noted in a previous article, corporate officers face increasing risk of fiduciary liability without exculpatory protection under Section 102(b)(7) of the DGCL.<sup>33</sup> The Chancery Decision may support an argument that an employee outside of the C-suite, such as a Goldman vice president, will be deemed to

be an officer who owes traditional corporate fiduciary duties. Vice Chancellor Laster observed that, under the federal securities laws that distinguished between officers and executive officers, “other officers were still officers; they were simply officers without policy-making responsibility.”<sup>34</sup> There also is some logical appeal to a rule that the protections of advancement and indemnification would correspond to obligations that might give rise to the need for such protection.

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### *Delaware law does not necessarily view the title “vice president” as conferring officer status.*

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The Chancery Decision also may be read, however, to support the position that non-executive officers, such as a Goldman vice president, will not owe traditional corporate fiduciary duties under Delaware law. As demonstrated in the chancellor’s *Computer Sciences* decision, Delaware law does not necessarily view the title “vice president” as conferring officer status.<sup>35</sup> As the vice chancellor noted, Delaware has a strong policy and related approach to contractual construction that favors finding advancement rights; this policy-based presumption would have less application in a determination whether an employee was an officer with traditional corporate fiduciary duties. In addition, it may be worth considering whether the putative “officer” would be subject to Delaware’s long-arm statute and, if not, whether a court would be inclined to hold that the employee is an officer, who owes corporate fiduciary duties, only to dismiss fiduciary claims against that defendant on jurisdictional grounds.<sup>36</sup>

### **Conclusion**

Far from presenting a clean answer to the question who is an “officer” for various purposes under Delaware law, the recent decisions discussed above

demonstrate the fact-intensive nature of that determination. The value of these cases is that they provide insight into the analysis that likely will be performed when this question next arises in litigation governed by Delaware law.

### **Notes**

1. *Aleynikov v. The Goldman Sachs Group, Inc.*, C.A. No. 10636-VCL (Del. Ch. July 13, 2016) (the “Chancery Decision”). N.B. Aleynikov has filed a notice of appeal from Chancery Decision, and that appeal is docketed with the Delaware Supreme Court under the caption *Aleynikov v. The Goldman Sachs Group, Inc.*, No. 366,2016 (Del. July 15, 2016).
2. Bylaws, § 6.4, which read:  
The Corporation shall indemnify to the full extent permitted by law any person made or threatened to be made a party to any action, suit or proceeding, whether civil, criminal, administrative or investigative, by reason of the fact that such person or such person’s testator or intestate is or was a director or officer of the Corporation, is or was a director, officer, trustee, member, stockholder, partner, incorporator or liquidator of a Subsidiary of the Corporation.... Expenses, including attorneys’ fees, incurred by any such person in defending any such action, suit or proceeding shall be paid or reimbursed by the Corporation promptly upon demand by such person and, if any such demand is made in advance of the final disposition of any such action, suit or proceeding, promptly upon receipt by the Corporation of an undertaking of such person to repay such expenses if it shall ultimately be determined that such person is not entitled to be indemnified by the Corporation. The rights provided to any person by this bylaw shall be enforceable against the Corporation by such person, who shall be presumed to have relied upon it in serving or continuing to serve as a director or officer or in such other capacity as provided above.
3. *Aleynikov v. The Goldman Sachs Group, Inc.*, 2013 WL 5739137 (D.N.J. Oct. 22, 2013).
4. *Aleynikov v. The Goldman Sachs Group, Inc.*, 765 F.3d 350 (3d Cir. 2014) (the “Circuit Decision”).

5. *Aleynikov v. The Goldman Sachs Group, Inc.*, 2015 WL 5739137 (D.N.J. Oct. 22, 2013).
6. 8 *Del. C.* § 145(k).
7. Chancery Decision, C.A. No. 10636-VCL (Del. Ch. July 13, 2016).
8. Chancery Decision, at ¶ 3.
9. Chancery Decision, at ¶ 5(d)(xvii) (quoting *B & B Hardware, Inc. v. Hargis Indus., Inc.*, 135 S. Ct. 1293, 1308 (2015)).
10. Chancery Decision, at ¶ 4.
11. Chancery Decision, at ¶ 5.
12. Chancery Decision, at ¶¶ 6-8.
13. Chancery Decision, at ¶ 8.
14. Chancery Decision, at ¶¶ 9-10.
15. Chancery Decision, at ¶ 10.
16. Chancery Decision, at ¶ 8.
17. Chancery Decision, at ¶ 5(d)(i).
18. Chancery Decision, at ¶ 5(d)(ii).
19. Chancery Decision, at ¶ 5(d)(iii).
20. Chancery Decision, at ¶ 5(d)(iv).
21. Chancery Decision, at ¶ 5(d)(iv) & n.1 (discussing 80 Del. Laws ch. 265 § 6 (effective Aug. 1, 2016)).
22. Chancery Decision, at ¶ 5(d)(v)-(vi).
23. Chancery Decision, at ¶ 5(d)(vii)-(ix) (discussing the Banking Act of 1933, the Securities Act of 1933, the Exchange Act of 1934 and SEC Rules 3b-2 and 16a-1(f)).
24. Chancery Decision, at ¶ 5(d)(x).
25. Chancery Decision, at ¶ 5(d)(xi)-(xiii).
26. Chancery Decision, at ¶ 5(d)(xii).
27. Chancery Decision, at ¶ 5(d)(xiv).
28. Chancery Decision, at ¶ 5(d)(xv).
29. Chancery Decision, at ¶ 5(d)(xv).
30. Chancery Decision, at ¶ 5(d)(xv).
31. Chancery Decision, at ¶ 5(d)(xvi).
32. In another recent decision from the Delaware Court of Chancery, Chancellor Andre Bouchard held that an employee with the title of ‘vice president’ was not an ‘officer’ entitled to advancement, because he had not been elected by the board of directors. In that case, however, the company’s bylaws unambiguously stated that officers, including vice presidents, were to be elected by the board of directors. *Pulier v. Computer Sciences Corp.*, C.A. No. 12005-CB, at 19 (Del. Ch. May 12, 2016).
33. Jeffrey R. Wolters and Nathan P. Emeritz, *The New Targets of Shareholder Litigation: Officer Liability Under Delaware Law*, Insights, Vol. 28, No. 10, at 17 (Oct. 2015).
34. Chancery Decision, at ¶ 5(d)(viii).
35. C.A. No. 12005-CB (Del. Ch. May 12, 2016).
36. 10 *Del. C.* § 3114(b) (defining “officer” for the long-arm statute as (1) “president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer or chief accounting officer,” (2) an individual identified in public filings as one of the most highly compensated officers of the company or (3) an individual who has “by written agreement with the corporation, consented to be identified as an officer for purposes of this section”).

## STATE CORNER

### Absence of Claim of Wrongdoing Can Defeat Books and Records Demands

By Catherine G. Dearlove, Rachel E. Horn, and Arun J. Mohan

In recent years, as potential stockholder plaintiffs have begun to heed the advice of the Delaware Supreme Court to use the “tools at hand” to investigate potential corporate wrongdoing before filing derivative litigation,<sup>1</sup> use of Section 220 books and records demands has become a routine precursor to derivative litigation. The announcement of an adverse corporate event now is frequently the trigger for one—and often many—Section 220 demands from potential stockholder plaintiffs seeking to inspect corporate books and records for the ostensible purpose of investigating whether to bring fiduciary duty claims against the directors and officers who permitted the adverse event to occur.

Although proper use of Section 220 can help to limit nuisance lawsuits, responding to Section 220 demands also places a significant burden on corporations. While past decisions have noted that the stockholders’ burden of establishing a proper purpose for inspection in this context is not an onerous one,<sup>2</sup> the Delaware Court of Chancery recently has issued a series of decisions that demonstrate that a corporation can validly deny inspection to stockholders where the allegations of the demand do not provide

a credible basis to infer that actionable wrongdoing may have occurred, or where the stockholder would be legally barred from asserting the claims it seeks to investigate.

#### Recent Cases

In *Wolst v. Monster Beverage Corp.*, the Court of Chancery concluded that an anticipated affirmative defense to potential litigation may negate the stockholder’s proper purpose.<sup>3</sup> Wolst, a Monster Beverage stockholder, sought to inspect documents for the purpose of determining “whether there [was] a basis to bring a derivative suit based on the wrongs alleged” in a derivative action brought in 2008 that was dismissed because the stockholders in that action failed to establish demand futility.<sup>4</sup> Monster argued that Wolst’s purpose was not proper because the derivative claims that Wolst sought to bring would be barred by laches.<sup>5</sup> While “[a] potentially viable affirmative defense to an anticipated derivative claim will not necessarily defeat a books and records effort,” the Court found that, “in a specific factual setting, a time bar defense would eviscerate any showing that might otherwise be made in an effort to establish a proper stockholder purpose.”<sup>6</sup>

In *Fuchs Family Trust v. Parker Drilling Co.*, the Court denied a request for books and records where issue preclusion barred the future derivative claim that the stockholder sought to investigate, admonishing that a Section 220 inspection is not “for the merely curious.”<sup>7</sup> The Fuchs Family Trust requested books and records to “seek[] to assess the options, with the aid of counsel, for potential litigation and/or to demand that the Company take action” regarding an alleged bribery scheme perpetrated by Parker Drilling Company’s freight forwarding and customs agent.<sup>8</sup> Before the demand, a Texas federal court had dismissed with prejudice a separate stockholder derivative action for failure to plead demand futility.<sup>9</sup> The Court found that the Trust

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was barred from re-litigating the derivative action under the doctrine of collateral estoppel; thus, no proper purpose existed.<sup>10</sup>

In *Southeastern Pennsylvania Transportation Authority v. AbbVie, Inc.*, the Court denied two stockholders' Section 220 requests, finding that without stating a specific objective, they failed to show a credible basis for their stated purpose.<sup>11</sup> AbbVie withdrew from a planned merger with Shire plc after changes to the tax code eliminated the tax advantages of the merger, and was obligated to pay a reverse termination fee to Shire.<sup>12</sup> Stockholders SEPTA and James Rizzolo sought books and records for the purpose of investigating potential breaches of fiduciary duties, mismanagement, wrongdoing, and waste by the members of AbbVie's board in connection with the withdrawal.<sup>13</sup> The Court rejected this demand, explaining that a conclusory statement of a proper purpose without an explanation of "an end to which that investigation will lead" is insufficient.<sup>14</sup> Furthermore, the Court found that even if SEPTA and Rizzolo were credited with the purpose of seeking information to support a potential derivative action, they had failed to plead any non-exculpated potential breach of the fiduciary duty of loyalty where AbbVie's directors were exculpated from personal liability pursuant to 8 *Del. C.* § 102(b)(7) and, as such, had failed to demonstrate a credible basis for the Court to infer that wrongdoing, waste, or mismanagement had occurred.<sup>15</sup>

Finally, in *Beatrice Corwin Living Irrevocable Trust v. Pfizer, Inc.*, the Court found that the plaintiffs, trustees of a trust, had not established a proper purpose to inspect Pfizer's books and records where they failed to provide any evidence suggesting a credible basis from which the Court could infer that possible waste, mismanagement, or wrongdoing had occurred.<sup>16</sup> The plaintiffs sought to evaluate potential litigation based on possible breaches of fiduciary duty by Pfizer's board of directors for failing to assure compliance with applicable accounting rules relating to Pfizer's treatment of deferred reparation tax liability.<sup>17</sup> The demand specified an intent to investigate board oversight, but did not offer any

evidence focused on the board's conduct or, more specifically, on Pfizer's reporting system or the presence of red flags supporting a possible *Caremark* claim.<sup>18</sup> Additionally, the directors who potentially would be subject to the suit were protected under 8 *Del. C.* § 141(e) based on their reliance on Pfizer's auditor and thus were exculpated, negating a proper purpose under *AbbVie*.<sup>19</sup> The Court also rejected the plaintiffs' post-trial efforts to expand their proper purpose to investigate undefined "others" in addition to the board.<sup>20</sup>

## Conclusion

In summary, where a stockholder seeks to inspect corporate books and records for the purpose of investigating potential corporate wrongdoing, the stockholder must articulate a specific objective for the investigation, supported by some evidence providing a credible basis to infer that *actionable* wrongdoing may have occurred. Where the demand fails to do so, or where the corporation can demonstrate that the stockholder would be barred from asserting the claims it seeks to investigate, a corporation's rejection of the books and records demand should be endorsed by the Court. The admonitions against aimless articulations of purpose illustrated in each of *Monster Beverage*, *Fuchs*, *AbbVie*, and *Corwin* thus may provide a basis to defend against some Section 220 demands.

## Notes

1. See, e.g., *Grimes v. Donald*, 673 A.2d 1207, 1216 (Del. Ch. 1996) (citing *Rales v. Blasband*, 634 A.2d 927, 934 n. 10 (Del. 1993), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000)).
2. See, e.g., *Seinfeld v. Verizon Commc'ns, Inc.*, 909 A.2d 117, 124 (Del. 2006).
3. *Wolst*, 2014 WL 4966139 (Del. Ch. Oct. 3, 2014).
4. *Id.* at \*1 (internal quotation marks omitted).
5. *Id.*
6. *Id.* at \*2 (quoting *Amalgamated Bank v. UICI*, 2005 WL 1377432, at \*2 (Del. Ch. June 2, 2005)); see also *Graulich v. Dell Inc.*, 2011 WL 1843813, at \*6 (Del. Ch. May 16, 2011)

“As this Court has held, in a factual setting, a time bar defense or a claim or issue preclusion defense would eviscerate any showing that might otherwise be made in an effort to establish a proper shareholder purpose.” (internal quotation marks omitted).

7. *Fuchs*, 2015 WL 1036106, at \*3 (Del. Ch. Mar. 4, 2015).
8. *Id.* (citation omitted).
9. *Id.* at \*5.
10. *Id.* at \*7.
11. *AbbVie*, 2015 WL 1753033 (Del. Ch. Apr. 15, 2015), *aff'd*, 132 A.3d 1 (Del. 2016) (TABLE).
12. *Id.* at \*9.
13. *Id.* at \*10.
14. *Id.* at \*11 (citing *Graulich*, 2011 WL 1843813, at \*5); see also *West Coast Mgmt. & Capital, LLC v. Carrier Access Corp.*, 914 A.2d 636, 646 (Del. Ch. 2006).
15. *AbbVie*, 2015 WL 1753033, at \*13.
16. *Corwin*, 2016 WL 4548101 (Del. Ch. Sept. 1, 2016).
17. *Id.* at \*2.
18. *Id.* at \*5.
19. *Id.* at \*6.
20. *Id.* at \*7.



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## IN THE COURTS

### In Vivendi Appeal, Second Circuit Rejects Challenge to “Price Maintenance” Theory of Price Impact

By Daniel J. Kramer, Audra J. Soloway, Andrew J. Ehrlich, and Susanna M. Buergel

On September 27, 2016, in related appeals arising from a long-pending securities fraud class action against Vivendi, the Second Circuit ruled on several important issues, including the proof necessary to both sustain and defeat the fraud-on-the-market presumption of reliance.

Most significantly, in *In re Vivendi, S.A. Securities Litigation*,<sup>1</sup> the Second Circuit rejected defendants’ *per se* challenge to the so-called “price maintenance” theory, which posits that confirmatory misstatements fraudulently can maintain an artificially high stock price by preventing the stock price from declining. The Second Circuit held that misstatements that do not cause stock price increases are, at least in some circumstances, actionable under the fraud-on-the-market presumption of reliance. The Second Circuit’s decision, however, was rendered in the context of a challenge to the admissibility of plaintiffs’ damages expert’s event study, and the full scope of this theory, which continues to be contested, remains to be decided.

Additionally, in *GAMCO Investors, Inc. v. Vivendi Universal*,<sup>2</sup> the Second Circuit affirmed the District Court’s finding that defendants successfully had rebutted the fraud-on-the-market presumption of reliance by showing that a group of opt-out plaintiffs—self-described “value investors”—would

have made the same purchasing decisions even if they had known about the fraud. Such fact-intensive rebuttals will remain important to the defense of securities fraud claims by sophisticated investors, including in the increasingly frequent opt-out cases that commonly proceed alongside many class actions.

#### Background

In 1998, *Compagnie Générale des Eaux*, a French water utility, changed its name to Vivendi S.A. and later Vivendi Universal S.A. (Vivendi) and began an “overnight transformation” into an entertainment and media conglomerate.<sup>3</sup> It achieved this profile by aggressively pursuing a strategy of growth and diversification through a series of leveraged mergers and acquisitions. Vivendi financed these acquisitions by issuing stock and/or debt.

By late 2001, Vivendi “was running critically low” on cash.<sup>4</sup> Notwithstanding, Vivendi “made numerous representations to the market suggesting that the course ahead for the company was smooth sailing.”<sup>5</sup> For example, while internal communications at Vivendi in December 2001 suggested that the Company was extremely concerned about a credit rating downgrade, it externally communicated in a press conference that its transactions were “not putting pressure” on it, and that it anticipated maintaining “a very comfortable . . . credit rating.”<sup>6</sup> In January 2002, Vivendi was forced to sell treasury shares to raise cash, and in May 2002, Moody’s downgraded Vivendi’s credit rating. In July 2002, Standard & Poor’s and Moody’s both downgraded Vivendi and signaled the possibility of further downgrades. Following each of these events, Vivendi’s stock price declined. This lawsuit followed.

#### District Court Proceedings

In mid-2002, consolidated class actions were filed in the Southern District of New York against

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Vivendi and its former CEO and CFO. The shareholder plaintiffs alleged that Vivendi violated Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 and that the CEO and CFO were liable under Section 20(a) of the Exchange Act.

The proceedings in the District Court spanned more than a decade before three different District Court judges.<sup>7</sup> A three-month jury trial was held in late 2009. The jury found Vivendi (but not the CEO or CFO) liable for all 57 statements listed on the verdict form and found daily stock-price inflation to be approximately half of what plaintiffs' expert had opined.

Post-trial motions subsequently were filed. Of particular relevance, the District Court rejected the argument that plaintiffs had not shown loss causation because Vivendi's stock price did not increase on the dates of most of the alleged misstatements. The District Court (Holwell, J.) ruled that the misstatements could have caused inflation either "by adding to the inflation or helping to maintain it."<sup>8</sup> In December 2014, the District Court (Scheidlin, J.) entered a partial final judgment of approximately \$50 million, inclusive of prejudgment interest, against Vivendi.

Several investment funds managed by Gabelli & Co. opted out of the class action. These opt-outs were "value investors," who invested in stocks that they believed had intrinsic values that exceeded their prevailing stock prices and had "catalysts" that might cause the stock prices to increase to those intrinsic values. After a bench trial, Judge Scheindlin held that defendants had rebutted the fraud-on-the-market presumption of reliance by showing that the opt-outs likely would have made the same purchasing decisions even if they had known about the fraud. Judge Scheindlin thus dismissed the Gabelli opt-outs' claims.<sup>9</sup>

## The Second Circuit's Decisions

Vivendi appealed from the class action partial final judgment, arguing, among other things, that

plaintiffs' expert, Dr. Nye, should have been precluded from testifying. The Gabelli opt-outs also appealed from the dismissal of their claims, arguing that defendants had failed to rebut the fraud-on-the-market presumption of reliance. In an opinion by Judge Livingston, joined by Judges Cabranes and Lynch, the Second Circuit affirmed the class action judgment. The same panel affirmed the Gabelli judgment.

## The "Price Maintenance" Theory

The Second Circuit next held that the District Court did not abuse its discretion in admitting expert testimony from plaintiffs' damages expert, Dr. Nye. In reaching this conclusion, it rejected Vivendi's argument that Dr. Nye's analysis was defective because it failed to connect most of Vivendi's misstatements with stock price movements, and instead relied on the proposition that some of the misstatements had "maintained" artificial inflation already in Vivendi's stock price.

Dr. Nye had performed an event study designed, first, to identify statistically significant stock price movements specific to Vivendi (and not the industry or market at large), and, second, to identify the statistically significant price movements on dates when news about Vivendi's liquidity risk became public. After calculating the total artificial inflation relating to Vivendi's unknown liquidity risk, Dr. Nye then calculated the inflation for each day of the class period by applying an "inflation trajectory" model that assumed that the inflation grew over the relevant period. Dr. Nye did not, however, measure the amount of inflation that the various alleged misstatements actually caused.<sup>10</sup> Further, for most of the misstatements presented to the jury, Dr. Nye did not identify any inflation at all that entered the stock price as a result of that misstatement. Vivendi argued that this rendered Dr. Nye's testimony unreliable and inadmissible.

The Second Circuit rejected Vivendi's argument. It held that statements that "maintain" inflation *can*, in certain circumstances, have a price impact. For

instance, pre-existing inflation may dissipate over time as the truth comes out on its own, or if a defendant remains silent in the face of escalating concerns. In this case, however, Vivendi did *not* remain silent, but made affirmative statements that prevented the inflation from dissipating from its stock. The Second Circuit noted the legal principle that once an issuer chooses to speak, it assumes the obligation to “tell the whole truth.”<sup>11</sup> In a footnote, the Second Circuit clarified that it was only rejecting Vivendi’s argument that statements unassociated with an increase in inflation “categorically” lack price impact.<sup>12</sup> The Second Circuit allowed that this principle will not hold true for every misstatement that does not cause the stock price to rise, saying “there may be other reasons . . . why some statements unassociated with an increase in inflation do not affect a company’s stock price.”<sup>13</sup> On these facts, however, the Second Circuit held that the District Court did not abuse its discretion in allowing Dr. Nye to testify.

## Rebuttal of the Fraud-on-the-Market Presumption

In the Gabelli opt-out appeal, the Second Circuit affirmed, as not clearly erroneous, the District Court’s finding that defendants successfully had rebutted the fraud-on-the-market presumption of reliance. While declining 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 Second Circuit affirmed on the “much narrower theory” that “Vivendi proved that GAMCO would have purchased Vivendi securities even had it known of Vivendi’s alleged fraud.”<sup>14</sup>

The Second Circuit left open the issue of whether such a *Halliburton II* rebuttal requires a showing that the plaintiff, had it been aware of the fraud, would have purchased “at the same price.”<sup>15</sup> The Second Circuit found that the record of the bench trial supported Judge Scheindlin’s finding that the opt-out plaintiffs would indeed have purchased at the same prices.<sup>16</sup>

## Analysis

The Second Circuit’s at least partial acceptance of the “price maintenance” theory is a significant development in this Circuit. It will allow plaintiffs greater flexibility to assert fraud claims premised on allegations that the stock price decreased after “bad news,” regardless of whether it can be shown the allegedly false “good news” previously caused a stock-price increase. That theory is arguably in tension with the Eighth Circuit’s holding that a “front end” showing—*i.e.*, a showing that alleged misstatements did not cause a statistically significant stock-price increase when made—is generally sufficient to rebut the fraud-on-the-market presumption of reliance.<sup>17</sup>

That said, the range of cases in which the Second Circuit will accept the price maintenance theory remains to be seen. As the Second Circuit acknowledged, on its facts, the *Vivendi* case was “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.”<sup>18</sup> Further, the *Vivendi* court was evaluating the expert evidence after trial under a very permissive abuse-of-discretion standard. In other, less-remarkable cases, there may be no reason to believe it likely that the stock price would have deflated but for the allegedly confirmatory misstatement. In the absence of evidence that an allegedly confirmatory misstatement actually counteracted an anticipated decline, courts may find the price maintenance theory to be unacceptably speculative.

The Second Circuit’s ruling with respect to the Gabelli opt-outs also leaves open the precise contours of a *Halliburton II* rebuttal based upon a particular plaintiff’s indifference to a fraud on the market. Regardless of the precise standard, the Second Circuit’s ruling makes clear that defendants successfully may rebut the fraud-on-the-market presumption by developing evidence that the alleged fraud likely would not have affected the plaintiffs’ investment decisions. This factual development will be important, in particular, in the opt-out cases filed by sophisticated investors that often accompany class action litigation.

## Notes

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1. *In re Vivendi, S.A. Securities Litigation*, Nos. 15-180-cv(L), 15-208-cv(XAP) (2d Cir.).
2. *GAMCO Investors, Inc. v. Vivendi Universal, S.A.*, Nos. 13-1194(L), 13-1377(XAP) (2d Cir.).
3. *Vivendi*, Slip Op. at 4.
4. *Id.* at 4-5.
5. *Id.* at 5.
6. *Id.* at 14.
7. Prior to a partial final judgment being entered in December 2014, the case was assigned to the late Judge Harold Baer, Jr., Judge Richard Holwell (ret. 2012), and Judge Shira Scheindlin (ret. 2016).
8. *In re Vivendi Universal, S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 562 (S.D.N.Y. 2011). After the Supreme Court's decision in *Halliburton Co. v. Erica P. John Fund, Inc. (Halliburton II)*, 134 S. Ct. 2398 (2014), Vivendi requested permission to file a new motion for judgment as a matter of law, arguing that plaintiffs had failed to show "price impact." Judge Scheindlin did not permit the motion, but noted that Vivendi had raised an "interesting" issue that it could pursue on appeal. *In re Vivendi Universal, S.A. Sec. Litig.*, 2014 WL 4080950, at \*2 (S.D.N.Y. Aug. 18, 2014).
9. *GAMCO Investors, Inc. v. Vivendi, S.A.*, 927 F. Supp. 2d 88 (S.D.N.Y. 2013).
10. Dr. Nye's model thus purported to measure "actual inflation" (the difference between the stock price and the stock price that would have prevailed if the truth had been known), and *not* "fraud-induced inflation" (the amount of inflation caused by the actionable misstatements). *Vivendi*, Slip Op. at 66-67, 76-78 & n.19. Actual inflation sets the "maximum amount" of fraud-induced inflation. *Id.* at 77. It remains for a jury to determine "how much, if any" of the actual inflation was fraud-induced. *Id.* at 66.
11. *Vivendi*, Slip Op. at 72.
12. *Id.* at 78, n.20.
13. *Id.*
14. *GAMCO*, Slip Op. at 8.
15. *Id.* at 8, n.4.
16. *Id.* at 16-18.
17. *IBEW Local 98 Pension Fund v. Best Buy Co., Inc.*, 818 F.3d 775 (8th Cir. 2016).
18. *Vivendi*, Slip Op. at 52.

## CLIENT MEMOS

*A summary of recent memoranda that law firms have provided to their clients and other interested persons concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of the listed memoranda should contact the firms directly.*

### **Cadwalder, Wickersham & Taft LLP New York, NY (212-504-6000)**

#### **Your 401(k) Plan “Brokerage Window” May Require S-8 Registration (September 28, 2016)**

A discussion of guidance from the SEC in the form of a Compliance and Disclosure Interpretation (C&DI) addressing registration requirements for 401(k) plans that allow investment through a self-directed “brokerage window.”

### **Chapman and Cutler LLP Chicago, IL (312-845-3000)**

#### **Consider a Shareholder Engagement Policy (Q3 2016)**

A discussion of the need for shareholder engagement, the design of a shareholder engagement policy, implementing such a policy, and disclosing such a policy.

### **Davis Polk & Wardwell LLP New York, NY (212-450-4000)**

#### **SEC Proposes T Plus 2 Settlement Cycle (September 30, 2016)**

A discussion of the SEC proposal to shorten the standard settlement cycle for most broker-dealer transactions to two business days after the trade date from the current three business day cycle.

### **Dechert LLP Philadelphia, PA (215-994-4000)**

#### **SEC Staff No Longer Requires “Tandy” Representations in Filing Reviews (October 2016)**

A discussion of the announcement by the staff of the SEC that it will no longer require companies to include “Tandy” representations in their disclosure filing review correspondence. Tandy language refers

to an affirmative representation, in writing, from the disclosing company “that the disclosure in the document was its responsibility” and that it will “not raise the SEC review process and acceleration of effectiveness as a defense in any legal proceeding.” In its announcement, the SEC staff stated that “it remains true that companies are responsible for the accuracy and adequacy of the disclosure in their filings.”

### **K&L Gates LLP Pittsburgh, PA (412-355-6500)**

#### **Making Sense of Auditor Independence Issues (October 17, 2016)**

A discussion of a number of actions by the SEC and its staff over the last several months that have focused on the complex way the auditor independence rules apply to registered investment companies and their auditors.

### **KattenMuchinRosenman LLP Chicago, IL (312-902-5200)**

#### **SEC Adopts Rules for Enhanced Regulatory Framework for Securities Clearing Agencies (September 30, 2016)**

A discussion of the SEC adoption of rules enhancing standards for securities clearing agencies deemed systematically important or engaged in certain complex transactions. The SEC also proposed a rule that would subject other types of clearing agencies to the same standards.

### **King & Spalding LLP Atlanta, GA (404-572-4600)**

#### **SEC Cracks Down on Charitable Contributions under the FCPA (October 3, 2016)**

A discussion of a SEC enforcement action against Nu-Skin Enterprises, Inc., premised on its

subsidiary's one-time contribution to a charity associated with a Chinese Communist Party Official. The SEC framed the conduct as a violation of the Foreign Corrupt Practices Act's (FCPA) internal controls and books and records provisions.

**Delaware Court of Chancery Dismisses Litigation Arising from Controller Buyout of Books-A-Million under "MFW" Framework (October 14, 2016)**

A discussion of Delaware Court of Chancery decision in *In re Books-A-Million, Inc. Stockholders Litigation*, which it applies the framework set forth in *In re MFW Shareholders Litigation* and *Kahn v. M & F Worldwide Corporation* for structuring controller buyouts so as to obtain business judgment review rather than entire fairness review, adding several important developments to the fledgling body of *MFW* case law.

**Morrison & Foerster LLP  
San Francisco, CA (415-268-7000)**

**SEC FY 2016: A Record Year for Enforcement Cases Against Funds and Advisers (October 12, 2016)**

A discussion of the SEC's announcement that it prosecuted a record number of enforcement cases against investment advisers and investment companies in the fiscal year ended September 30, 2016.

**Orrick, Herrington & Sutcliffe LLP  
San Francisco, CA (415-773-5700)**

**This Cold Bud Is For You: SEC Sanctions Anheuser-Busch for "Chilling" Employee from Communicating with SEC (September 30, 2016)**

A discussion of a SEC enforcement action against Anheuser-Busch for violations of the FCPA and Dodd-Frank whistleblower provisions arising from payments made by an Indian joint venture and an employee reporting of such potential violations and subsequent separation agreement.

**Paul Hastings LLP  
New York, NY (212-318-6000)**

**SEC Approves New Liquidity Risk Management Rules for Certain Open-End Funds and Rules to Modernize and Enhance Reporting By Registered Investment Companies (October 14, 2016)**

A discussion of the SEC adoption of a set of broad and sweeping rules mandating that certain open-end management investment companies, including mutual funds and exchange-traded funds, develop and implement formalized and written liquidity risk management programs and related disclosures. In addition, the SEC adopted rules to modernize and enhance reporting of information provided by registered investment companies.

**Pepper Hamilton LLP  
Philadelphia, PA (215-981-4000)**

**Blockchain and Public Securities: Shedding Light on "Going Dark" (September 27, 2016)**

A discussion of how the application of blockchain technology to the securities market could be a game changer by adding transparency, reducing costs and speeding up settlements. The memorandum also discusses the state of Delaware's blockchain initiative.

**Proskauer Rose LLP  
New York, NY (212-969-3000)**

**New California Law Increased Private Fund Fee and Expense Disclosure (September 27, 2016)**

A discussion of new Section 7514.7 to the California Government Code, which imposes significant new disclosure requirements for private funds with investments by California state and local public pension and/or retirement systems.

**Simpson, Thacher & Bartlett LLP  
New York, NY (212-455-2000)**

**SEC Staff Confirms Its Approach to "Substantial Implementation" in the Context of Proxy Access (October 13, 2016)**

A discussion of three no-action letters issued by the SEC staff on September 27, 2016, that confirm

and refine its view with regard to the application of the “substantial implementation” exclusion in its shareholder proposal rule to proxy access proposals.

**Skadden, Arps, Slate, Meagher & Flom LLP**  
**New York, NY (212-735-3000)**

**Recurring Issues in Accounting for Litigation Contingencies (September 27, 2016)**

A discussion of questions that recur in connection with outside counsel’s communications with a company’s auditors about potential exposure as a result of litigation or regulatory/enforcement matters and the underlying accounting for such matters.

**SEC Disclosure Brexit Trends (October 3, 2016)**

A discussion of the disclosures, as risk factors, provided by approximately 400 SEC-registered public companies in the two-month period following the Brexit referendum in the United Kingdom in quarterly reports and registration statements.

**Sutherland, Asbill & Brennan LLP**  
**Atlanta, GA (404-853-8000)**

**FINRA’s Projected 2016 Fines (October 4, 2016)**

A discussion of FINRA monthly disciplinary reports and news releases, which indicate a dramatic increase in the fines reported during the first half of 2016.

**Wachtell, Lipton, Rosen & Katz**  
**New York, NY (212-403-1000)**

**SEC Enforcement Inquiries Focus on Non-GAAP Financial Measures (September 28, 2016)**

A discussion of the SEC Division of Enforcement’s sending a number of public companies letters containing broadly worded requests for information focused on non-GAAP financial measure disclosures that were made prior to the May 2016 C&DIs issued by the Division of Corporation Finance addressing the use of non-GAAP financial measures.

**Delaware Court of Chancery Reaffirms that Merger Disclosure Claims Should Be Brought before, Not after, Closing (September 29, 2016)**

A discussion of a Delaware Court of Chancery decision, *An Nguyen v. Michael G. Barrett, et al.* (Sept. 28, 2016), holding that claims challenging merger disclosures should be pursued before the merger closes if they are to be pursued at all.

**ISS’s 2017 Policy Survey Results (October 4, 2016)**

A discussion of the result of Institutional Shareholder Services annual survey of investors and companies, which it uses to inform possible changes to its proxy voting rules.

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