Securities Litigation
American Bar Association Section of Litigation

Spring 2016, Vol. 26 No. 3

## TABLE OF CONTENTS

### Articles »



### Practice Points »

**ARTICLES**

# Did the Supreme Court's *Omnicare* Decision Create a Distinction Without a Difference?

By Aaron T. Morris

In the year following the Supreme Court's decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S. Ct. 1318 (2015), which clarified the circumstances under which an opinion may give rise to liability under the Securities Act, much has been written about the "new" standards for such claims. In the decision, the Court confirmed that a mistaken opinion cannot be considered a misstatement so long as it was honestly held (as multiple circuits had already held), but the Court also held that an opinion might create liability (under an omission theory) if a company fails to disclose facts about the *basis* for the opinion that conflict with a reasonable investor's expectations. The latter part of the decision received attention for seemingly creating a second avenue of opinion liability (some even suggested that this second avenue would create fact issues precluding dismissal at the pleading stage).

Yet, in this context, the Court's distinction between a misstatement claim and an omission claim is tenuous, even in theory; in practice, this article argues that *Omnicare* will have (and has had) little effect on the outcome of securities litigation. Here's why: both theories will ultimately turn on the strength of the same allegations—facts alleged to demonstrate some problem with the opinion. Before *Omnicare*, courts considered those facts with an eye toward whether they created doubt about the speaker's true belief. Now, *Omnicare* instructs courts to also consider whether the facts would conflict with a reasonable investor's understanding of the opinion if read "fairly and in context." Both are especially difficult standards, susceptible only to circumstantial evidence, and the underlying allegations are likely to be the same. In other words, the allegations tending to show that a speaker could not have believed an opinion are likely to be the same that a plaintiff will use to show that a hypothetical investor would have been misled. For that reason, we should not expect to see an omission theory prevail where a misstatement theory could not, nor a change in the scope of liability for an opinion.

**The Supreme Court's Decision**

The *Omnicare* case arose from a company's opinion (in a registration statement) that its customer and supplier contracts were "legally and economically valid" and "in compliance" with applicable law. The plaintiffs brought claims under section 11 of the Securities Act, which provides that an issuer (and certain employees and advisors) may be liable for a registration statement that contains "an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

The Court began its decision by distinguishing opinion from fact:

> [A] statement of fact ("the coffee is hot") expresses certainty about a thing, whereas a statement of opinion ("I think the coffee is hot") does not. . . . And Congress effectively

> incorporated just that distinction in [section] 11's first part by exposing issuers to liability not for untrue statements full stop (which would have included ones of opinion), *but only for untrue statements of fact*.

Applying that principle, the Court held that a "sincere statement of pure opinion is not an untrue statement of material fact, regardless whether an investor can ultimately prove the belief wrong." But the Court noted that an opinion does convey one ancillary fact: "that the speaker actually holds the stated belief." Thus, the Court held that an issuer may be liable for a pure opinion as a misstatement only if it was not sincerely held.

In contrast to the first part of the Court's decision—which narrowly defined when an opinion qualifies as a *misstatement*—the second part considered whether an honest opinion may nonetheless be misleading in light of what the company *did not say*. In that regard, the Court held that an issuer may be liable under section 11's omission provision if it concealed facts that conflict with a reasonable investor's understanding about the opinion:

> [A] reasonable investor may, depending on the circumstances, understand an opinion statement to convey facts about how the speaker has formed the opinion—or, otherwise put, about the speaker's basis for holding that view. And if the real facts are otherwise, but not provided, the opinion statement will mislead its audience. . . . Thus, *if a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself,* then §11's omissions clause creates liability.

While the Court acknowledged a theory of liability based on the failure to disclose facts about an opinion, it raised the pleading bar substantially with several limitations:

- First, the Court made clear that liability for an opinion requires more than an allegation that the company concealed "some fact cutting the other way." In the Court's view, a "reasonable investor does not expect *every* fact known to an issuer supports its opinion."
- Second, the Court stated that whether an opinion is misleading "always depends on context," including any "hedges, disclaimers, and apparently conflicting information."
- Third, the Court cautioned that a plaintiff "cannot just say that the issuer failed to reveal its basis"; rather, a plaintiff "must identify particular (and material) facts going to the basis for the issuer's opinion . . . whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context."

### Why *Omnicare* Will Not Increase the Scope of Liability for Opinions

Despite the attention garnered by *Omnicare*, we should not expect much change in the outcome of securities litigation. Although the Court articulated two seemingly independent theories of liability, both will be based on the same circumstantial evidence and will be exceptionally difficult to plead and prove. In understanding why, a good place to start is the Court's own hypothetical intended to illuminate the role of an omission claim:

> Suppose [a] CEO, in claiming that her company's TV had the highest resolution available on the market, had failed to review any of her competitors' product specifications. Or suppose she had recently received information from industry analysts indicating that a new product had surpassed her company's on this metric. The CEO may still honestly believe in her TV's superiority. But under [section] 11's omission provision, that subjective belief, in the absence of the expected inquiry or in the face of known contradictory evidence, would not insulate her from liability.

But this fact pattern is not new to securities litigators. Before *Omnicare*, plaintiffs were already trying to plead misstatement claims with circumstantial evidence of the kind the Court imagines above. While the CEO in the Court's example "may" honestly believe her opinion, a plaintiff will almost certainly allege that she did not by pointing to the specifications she "failed to review" or the contradictory information she "recently received." Although plaintiffs may well craft omission claims after *Omnicare* with these same facts, the Court's hypo begs the question of how defendants were "insulated" before (at least from litigation). For example, in a pre-*Omnicare* case arising from Facebook's initial public offering (IPO), the plaintiffs alleged that the company did not believe its opinion that an increase in mobile usage among customers "may negatively affect [Facebook's] revenue" because it allegedly "discovered that mobile usage was impacting its revenues *before* its IPO" and had already "cut its revenue projections." *In re Facebook, Inc. IPO Sec. & Derivative Litig.*, 986 F. Supp. 2d 487 (S.D.N.Y. 2013). In light of those allegations, Judge Sweet of the Southern District of New York upheld the claims on the basis that the company could not have believed that revenues "may" decrease if they, in fact, already had.

However, while it is true that plaintiffs were bringing misstatement claims before *Omnicare* based on circumstantial allegations about an opinion, they were never easy claims to plead. The *Facebook* case is perhaps an exceptional circumstance: There, the court acknowledged that the opinion at issue was perhaps "more" than an opinion because it warned of something that "may occur when that event had already occurred." In a typical opinion case pre-*Omnicare*, plaintiffs were limited to mustering enough purely circumstantial allegations to cast doubt on the speaker's veracity—a task that proved easier said than done. For example, in one case, the plaintiffs tried to show that an analyst's opinions were dishonest by alleging that he was pressured by his firm into issuing overly optimistic reports. *In re Salomon Analyst Level 3 Litig.*, 350 F. Supp. 2d 477 (S.D.N.Y. 2004). The court noted that the allegations painted a "disturbing picture" of the atmosphere at the firm that—if true—could demonstrate a "motive for analysts to issue research reports that were more positive than their truly held opinions." Such evidence, the court reasoned, could be introduced "at trial or in a summary judgment motion" to support a claim that the opinions were dishonest. Nonetheless, the court dismissed the case, finding that allegations about "undisclosed motivations that might lead someone to misrepresent his true opinion" were insufficient to pass the pleading stage, without additional allegations focused on the particular speaker.

Against this backdrop, this article suggests that *Omnicare* effects little change in the scope of liability for an opinion. Courts were already assessing—in connection with misstatement claims—the kind of circumstantial allegations that *Omnicare* envisioned supporting an omission theory. And while *Omnicare* may have repurposed those allegations into a theory with different analytical underpinnings, the new framework is equally dependent on context and, ultimately, the strength of circumstantial evidence (after all, there will never be direct evidence of a "reasonable investor's" expectations). It's no surprise that the Supreme Court described an omission theory as "no small task for an investor." These claims were not easy to win before *Omnicare*, and with the same underlying allegations, we should not expect omission claims to gain any more traction than misstatement claims did.

The early decisions applying *Omnicare* support this prediction. For example, Judge Kaplan of the Southern District of New York dismissed claims under both theories based on an insurer's opinion that its reserves were sufficient. *City of Westland Police & Fire Ret. Sys. v. MetLife, Inc.*, No. 12-CV-0256 LAK, 2015 WL 5311196 (S.D.N.Y. Sept. 11, 2015). The plaintiff alleged that the company must have discovered a problem with its reserves after a cross-check of its records against a government database, but the court discredited those allegations because the plaintiffs could not explain how the cross-check would have revealed a shortfall. Accordingly, as to the misstatement claim, the court found that the cross-check allegations did not plausibly suggest that the company disbelieved its opinion about reserves. Likewise, as to the omission claim, Judge Kaplan held that the company had not improperly concealed facts about the cross-check because it would not have revealed a shortfall in reserves, and the plaintiff failed to allege any other facts that "did not fairly align" with the company's opinion.

In another case, Judge Nathan of the Southern District of New York upheld claims under both theories involving an opinion that the company was in compliance with all laws and regulations. *In re BioScrip, Inc. Securities Litig.*, 95 F. Supp. 3d 711 (S.D.N.Y. 2015). The plaintiffs claimed that the opinion was inconsistent with a civil investigative demand (CID) received by the company, which suggested wrongdoing within the company at the time the opinions were expressed. As to the misstatement claim, the court held that the company's knowledge of the CID created an "inference" that the company "could not have believed the veracity of its legal compliance statements." Likewise, as to the omission claim, the court held that the opinions "could have led a reasonable investor to conclude that [the company] was not presently involved in a wide-ranging investigation into its sales practices"—an inference that was contradicted by the CID.

Most recently, the Second Circuit considered a case that had been dismissed under a misstatement theory before *Omnicare* was decided. *Tongue v. Sanofi*, No. 15-588-CV, 2016 WL 851797 (2d Cir. Mar. 4, 2016). In that case, the plaintiffs based their claims on an opinion about the company's high likelihood of obtaining Food and Drug Administration (FDA) approval for a new drug, despite alleged concerns regarding the use of single-blind rather than double-blind studies. The district court had previously determined that the allegations did "not come close" to demonstrating that the company did not believe its opinion because the company's "substantial investment of money and personnel" in the single-blind study was "hard to square with the premise that defendants understood that the study design was fatally flawed." *In re Sanofi Sec. Litig.*, 87 F. Supp. 3d 510 (S.D.N.Y. 2015). Following the *Omnicare* decision, the Second Circuit considered the plaintiffs' allegations under an omission theory and affirmed dismissal. Although the FDA had expressed "interim, albeit repeated" concerns that were not fully disclosed to investors, the court noted that a reasonable investor would have expected such a dialogue to take place between the company and the FDA. The court determined that the company's opinion "fairly aligned" with the information available at the time and that investors were not entitled to "so much information as might have been desired to make their own determination about the likelihood of FDA approval." Thus, under either theory, circumstantial allegations about the FDA's displeasure with the single-blind study were not enough to state a claim based on the opinion.

**Conclusion**

*Omnicare*'s confirmation of the already high bar to plead a misstatement based on an opinion was a welcome development for the defense bar; the other part of the decision received mixed reviews from both sides. Yet, in practice, both theories will turn on the same circumstantial allegations about the opinion at issue and will be equally difficult to plead and prove. For that reason, we should not expect a significant change in the outcome of securities litigation after *Omnicare*, and we have not seen much change in the cases decided thus far. While plaintiffs are likely to formulate claims under both theories—which courts will continue to analyze separately—the net effect of *Omnicare*'s omission theory on the scope of liability for an opinion under the federal securities laws appears to be nil.

**Keywords:** litigation, securities, *Omnicare*, misstatement, omission

Aaron T. Morris is an associate in the Boston, Massachusetts, office of Skadden, Arps, Slate, Meagher & Flom.

# Will Securities Antitrust Cases Invite More Objections Because of the Complexity of Their Distribution Plans?

By Terry McMahon, Joel D. Rothman, and Peter M. Saparoff

The number of antitrust claims being brought in securities cases, especially class actions, in on the increase. *See* Peter M. Saparoff et al., "The Increasing Application of Antitrust Claims to Securities Transactions," *Securities Litigation*, Winter 2016. Antitrust claims have appeared in several recent high-profile class action securities cases, including the litigations covering the LIBOR manipulation scandal [log-in required], the market for U.S. Treasuries, the foreign currency exchanges, and the precious metals markets [log-in required]. In one such class action, *In re Credit Default Swaps Antitrust Litigation*, No. 1:2013-md-02476 (S.D.N.Y.) (registration required), several institutional class members recently objected to a proposed settlement, criticizing, among other issues, the pricing models and methodology used to allocate settlement funds among the class plaintiffs. Although the court has now rejected those objections and approved the settlement, it is worth examining the objections in more detail. Traditionally, objections to class action settlements focus on attorney fees. But the objections in the credit default swap (CDS) litigation could signify that class members will start to examine distribution plans more closely, especially as part of these highly complex hybrid cases that address antitrust issues in the context of securities class action litigation.

**Background on the Proposed Settlement**

On October 16, 2015, class plaintiffs in the CDS litigation moved for the preliminary approval of a $1.865 billion settlement of the litigation. Memorandum in Support of Plaintiffs' Motion for Preliminary Approval of Settlement, *In re Credit Default Swaps Antitrust Litig.*, No. 1:2013-md-02476 (Oct. 16, 2015). The plaintiffs alleged that, in and around 2008 and 2009, a number of financial institutions conspired to prevent new entrants to the market from introducing exchange trading venues and electronic platforms that would have increased competition and transparency in the CDS market.

The proposed settlement class in the CDS case includes "[a]ll Persons who, during the period of January 1, 2008 through September 25, 2015, purchased CDS from or sold CDS to the Dealer Defendants, a Released Party, or any purported co-conspirator, in any Covered Transaction." The settlement defines "CDS" to include "any and all types of credit default swap(s) and CDS-based products, including, without limitation, single-name CDS, CDS on corporate, sovereign and municipal reference entities, tranche CDS, basket CDS, index CDS, and CDS futures." Under the settlement agreement, a purchase or sale of a CDS was deemed to be a "Covered Transaction" if the transaction was made by (or on behalf of) a person domiciled or located in the United States at the time of transaction, if the transaction was in United States commerce, or if the transaction otherwise fell within the scope of the U.S. antitrust laws. The "Dealer Defendants" in this case were BNP Paribas, Bank of America Corporation, Bank of America, N.A., Barclays Bank PLC, Citibank, N.A., Citigroup Global Markets Inc., Citigroup, Inc., Credit Suisse AG, Deutsche Bank AG, Goldman, Sachs & Co., HSBC Bank PLC, HSBC Bank USA N.A., JP Morgan Chase &

Co., JPMorgan Chase Bank, N.A., Morgan Stanley & Co. L.L.C., Royal Bank of Scotland N.V., Royal Bank of Scotland PLC, UBS AG, and UBS Securities LLC.

One important way that the recovery process for antitrust settlements can differ from securities law settlements is in how settlement proceeds are distributed. In most class action settlements, class members must file claims and attach data to prove their entitlement to participate in the recovery. However, in antitrust settlements, the process of measuring and allocating damages based on the records of the defendants is so complex that this question alone often necessitates expert advice, and class members cannot simply assume that they will receive a distribution. In those cases, defendants and class plaintiffs typically jointly determine who is eligible and notify those parties. In some cases, such as the Forex settlement, class members who receive the notice of eligibility can only receive their distribution once they register on an online portal. The process in the CDS litigation is even more detailed: Class members must still file a proof of claim form on an online portal, but they can only do so once provided a claim number. Those claim numbers, however, were contained in notices that were randomly mailed out to only a subset of class members. Class members who did not receive this notice have had to do some digging to find their claim number in order to file their proof of claim.

The deadline for parties to object to the settlement was on February 29, 2016, and on that date several parties leapt to make their objections to the settlement, or at least to the plan for distributing the recovered funds among the plaintiffs. While in most cases parties typically object to settlements only in terms of how much they allocate to attorney fees, several potential settlement class members in the CDS litigation made specific, substantive objections to the potential distribution of settlement funds among the class members. In their memo of law in support of approval of the settlement, the class plaintiffs responded forcefully to these objections. Judge Denise Cote approved the settlement, denying the objections in one short paragraph. *In re Credit Default Swaps Antitrust Litig.*, No. 1:2013-md-02476 (S.D.N.Y. Apr. 18, 2016). However, the types of objections made may signal a trend in class action settlement objections—at least in the antitrust context. In addition, the plaintiffs' heavy reliance on experts to create a settlement model may reflect another trend worth watching.

**Common Objections**

Although each objector had its own set of criticisms about the proposed settlement, there were a few common themes throughout the group.

> **Inadequate time for analysis.** In some cases, the February 29 deadline was itself the problem. Some class members were unable to have their questions fully answered concerning the settlement plan and methodology of apportioning the settlement funds in time, despite being in communication with co-lead counsel to the class plaintiffs. Because they still had questions as of the deadline to object, these class members objected to the settlement out of an abundance of caution. Similarly, another group of class members expressed concerns that information regarding the covered transactions "was not available on the website until on or about January 29, 2016," 30 days before the opt-out

deadline. According to these objectors, "[t]his is an extremely complicated case, and many of the key documents at issue are under seal. … Allowing Settlement Class Members a mere 30 days to assess their rights and the adequacy of the settlement agreements is unreasonable, unfair, and inadequate." Objections of Silver Point Capital, L.P., and Related Entities at 1–2, *In re Credit Default Swaps Antitrust Litig.*, No. 1:2013-md-02476 (Mar. 1, 2016), ECF No. 496. Thus, the objectors "request[ed] that the Court deny approval of the settlement agreements unless the date to opt out is extended at least four weeks, to March 27, 2016." *Id.* at 2.

**Exclusion of certain trades.** Several institutional class members objected to the proposed settlement because they believed that the proposed distribution plan failed to take into account many of their CDS trades that should have been included. The primary concern of these funds was that "[t]he settlement website fails to include many of [the funds'] transactions that should be included as Covered Transactions," and "neither the Settlement Administrator nor Class Counsel has provided assurance that the missing transactions will be included before claims are paid and that [the funds] will be compensated based on those transactions." Objections of the Anchorage Funds at 2, *In re Credit Default Swaps Antitrust Litig.*, No. 1:2013-md-02476 (Mar. 1, 2016), ECF No. 494. Thus, these funds "request[ed] that they be allowed to opt out of the Settlement Agreement once the Settlement Administrator finally determines which of [the funds'] CDS transactions are included in the Covered Transactions." *Id.*

**Critique of methodology used to determine the settlement plan.** Many of the objections concerned, as one set of objectors argued, "the methodology utilized" in the settlement distribution plan "for determining bid-ask spreads for the various types" of covered transactions, "and thus whether certain types of transactions received more favorable treatment than others." Letter to Clerk of Court from Counsel for FFI Fund Ltd., FYI Fund Ltd., Olifant Fund, Ltd., and Asset-Backed Recovery Fund, Ltd. (Feb. 29, 2016), at 1–2, ECF No. 489. For example, one institutional class member argued that "[t]he proposed plan of distribution includes settlement terms which discriminate against a majority of class members and prevent a fair recovery for those who suffered the greatest harm." Objections of MF Global Capital LLC at 1, *In re Credit Default Swaps Antitrust Litig.*, No. 1:2013-md-02476 (Mar. 1, 2016), ECF No. 491. According to this institution, the proposed settlement defines relevant terms in such a way that applying "the plan's allocation methodology . . . unfairly results in the award of damages for a great number of covered transactions which in fact incurred a zero or a de minimis bid-ask spread."*Id.* As a result, "class members who bought or sold such CDS contracts unfairly benefit from the application of an anticompetitive inflation amount to trades that had zero or de minimis spread damages," and "the vast majority of class members, including institutional traders and others who did not employ these strategies, are being very substantially under-compensated." *Id.* at 1–2. According to this objector, "the plan for distribution of settlement funds could be readily adjusted so that the anticompetitive spread is not applied unfairly to all legs of packaged transactions, even those with a zero or de minimis spread," by identifying certain types of transactions and adjusting their treatment in the settlement. *Id.* at 5.

More specifically, some class members objected that the distribution plan unfairly awarded damages regarding multi-leg CDS index related trades. As one objector put it, these trades "generally involve payment of the bid-ask spread on a single leg, or one side of the trade, or a significantly reduced bid-ask spread on both legs of the trade with the net effect being similar to paying the bid-ask spread on only one leg of the trade." Objections of the Anchorage Funds, *supra*, at 3. The distribution plan, however, "awards full damages as though the full bid-ask spread had actually been paid on each leg of Multi-Leg CDS Index Related Trades. Therefore, class members that employed such trades were unfairly over-allocated settlement proceeds to the detriment of other class members." *Id.* One objector even suggested a nefarious purpose to this alleged error, arguing that the distribution plan

> seems to be the result of a process whereby the Defendants' most active clients in CDS (who likely received discounted bid-ask spreads simply by virtue of their frequent use of the product) are disproportionately benefiting from the settlement at the expense of smaller consumers of CDS (who, in reality, would have been the proportionately larger beneficiaries of a transparent and liquid exchange).

Objections of Silver Point Capital, L.P., and Related Entities, *supra*, at 3.

In addition, another institutional class member filed an objection arguing that bid-ask spreads had also been miscalculated for package transactions. Specifically, this institution identified two types of trades, index arbitrage packages and correlation trade packages, which could create issues with calculating bid-ask spreads similar to those described above. According to the objector,

> [t]rading an index arbitrage package requires simultaneously buying or selling a credit index and buying or selling all of the underlying single names that make up the index. . . . Due to the packaged nature of these trades and volume of activity, it is common market practice for dealer defendants to significantly mark down or reduce heavily the bid/ask spread.

Letter to Clerk of the Court from Counsel for Saba Capital (Feb. 29, 2016), at 1, ECF No. 497.

This objector asked the court to consider implementing, "on a best efforts basis, a procedure for identifying and either discounting or removing the (i) index arbitrage package trades and (ii) correlation trade packages." *Id.* at 2.

**Class Plaintiffs' Counterarguments**

Because the court did not go into detail as to why it denied these objections, it is worth reviewing the class plaintiffs' response to these objections, made in a memo of law filed on April 1, 2016. Memorandum in Support of Plaintiffs' Motion for Final Approval of Settlement, *In re Credit Default Swaps Antitrust Litig.*, No. 1:2013-md-02476 (Apr. 1, 2016), ECF. No. 503. First, according to the class plaintiffs, the objections "disregard the applicable legal standard." *Id.* at 25. The plaintiffs acknowledge that "[n]o damages model or distribution plan in a case where damages are this complex could ever be perfect," but "[t]he only question, at this stage, is whether the plan has a reasonable, rational basis." *Id.* (internal quotations omitted). Second, the plaintiffs call the objections "wholly impracticable." *Id.* at 26. According to the plaintiffs, "[t]o the limited extent they offer 'solutions' to the problems they purport to identify, those solutions are either unworkable given the limitations of the available class-wide data, obviously subjective, or they even contradict each other, which powerfully illustrates that these solutions are not themselves objective or practicable." *Id.* Pointedly, the plaintiffs argue that

> [n]either in their written comments nor otherwise have these Objectors expressed any understanding of the practical limitations of what can be done with the available class-wide datasets or of the inherent challenges of building a claims model that works objectively on a class-wide basis. Their narrow focus on maximizing the value of their own claims has simply blinded them to any other considerations.

*Id.*

Next, the plaintiffs argue that "the objections are speculative."

> While objectors assert that other class members may have engaged in trades or trading strategies that could have resulted in tighter bid-ask spreads and thus may have been overvalued by the Plan, they offer no citation to any objective evidence or source establishing how exactly such trades were performed, what the volume of such trades were during the relevant time period, or what impact there would be on spreads for such trades and why.

*Id.*

Perhaps more to the point, the plaintiffs argue that the volume of such transactions is small: "having gone back (at the expense of the Class) to evaluate these types of transactions, Co-Lead Counsel and their consulting experts have not been able to identify anything other than potentially (using subjective and arbitrary criteria) a de minimis number of such transactions in the available dataset." *Id.* at 27. The plaintiffs observe that "if these entities truly feel that they have a superior way of proving their own individual damages, they were free to opt out. . . . But they should not be permitted to stay in the Class and hold up a widely embraced distribution plan in the process." (*Id.* at 27–28.)

As for the class members who raised objections because the settlement website did not include certain of their transactions, the plaintiffs argue that "because Objectors have successfully availed themselves of the 'challenge' process available to every class member on the settlement website, . . . the vast majority of these trades will now be included in Objectors' claims." *Id.* at 29. In addition, "[i]t is well accepted that often the details of allocation and distribution are not established until after the settlement is approved," and "[i]t is impracticable for each class member to know with mathematical precision what its payment will be prior to making a decision about whether to remain a class member." *Id.* at 36 (internal citations omitted).

In regard to the claim that objectors "did not have 'sufficient opportunity' to assess [their] rights prior to the opt-out deadline," the plaintiffs respond that "notice and description of the Settlement were sent to class members on January 11, 2016, and individual claimants were provided a tremendous amount of additional information about their transactions on January 29, 2016," which they argue was an ample amount of time to decide whether to object. *Id.* at 40.

Finally, as an interesting corollary, although several objectors requested that more work be done to analyze the trades at issue, the plaintiffs also made several observations in their briefing as to the amount of work performed already by their expert. The plaintiffs noted that "[t]he expert work alone in this complex financial market case was extremely costly, exceeding $7 million as of January 29, 2016." *Id.* at 7. More specifically, "[t]he expert work required to build a viable damages model was tremendous. Plaintiffs' experts processed over 100 million individual CDS transaction records in less than a year, and provided Defendants with a functioning (and defensible) damages model months before class certification." *Id.* at 12.

> To develop a class-wide damages model, Co-Lead Counsel first worked with their consulting experts to model the spreads paid by class members in the actual world. This was a herculean task for many reasons—including because there was no available source of class-wide data on the spreads paid by class members in the OTC market.
>
> . . . .
>
> To provide class members with a great deal of information early in the process, Co-Lead Counsel and their consulting experts took the initiative to identify the Covered Transactions applicable to each class member that could be identified in the DTCC Trade Dataset. This, too, took an enormous amount of work—work that, arguably, Co-Lead Counsel could have left for each class member to do itself as part of the claims process."

*Id.* at 18, 20.

**Conclusion**

Because the court summarily rejected the objections made to the proposed settlement and distribution plan in the CDS litigation, the objections will not have a significant impact on this litigation. Still, the fact that these objections are even being made is an indication that substantive objections to plans of distribution may become the norm for future proposed class action settlements, especially in the antitrust context.

**Keywords:** litigation, securities, antitrust, settlement, distribution, objection, objector

Terry McMahon is an associate at Mintz Levin Cohn Ferris Glovsky & Popeo, P.C., in the firm's New York City, New York, office. Joel D. Rothman is an associate and Peter M. Saparoff is a member in the firm's Boston, Massachusetts, office.

# Securities Fraud Class Actions: A Practical Approach to Your Initial Case Assessment

By Jessie M. Gabriel and Sumon Mazumdar

Your first securities fraud class action can feel overwhelming. The substantive law is expansive, confusing, and constantly in flux. You are dealing with multiple acts of Congress and a variety of regulations, not to mention the unique challenges associated with class action litigation of any kind. But there are a number of practical considerations that should also factor into your initial case assessment. Below are four issues that may be more important to your client than your knowledge of *Basic v. Levinson* and *Halliburton I* and *II*.

**Insurance: Is There Any and What Does It Cover?**

One of the good things about securities litigation is that defense costs are often covered by insurance. If you are a defense attorney, this is one of the first conversations you need to have with your client. This is not only relevant to getting your bills paid, but it is one of most important considerations for clients who are trying to estimate their anticipated legal spend.

The first thing you need to ask is whether your client has coverage. Many companies carry director’s and officer’s liability insurance (often called “D&O”), which may cover not only these executives but the company as well. Next, ensure the company has provided notice of the claim to the carrier. Most insurance policies will only cover fees incurred after notice has been provided.

The second step is to confirm your representation with the carrier. Many insurance carriers have lists of preapproved law firms with whom they have negotiated reduced rates. If your firm is not on the approved list, all hope is not lost. Depending on the terms of the policy, your client may have the right to choose its own counsel. Even if the policy does not explicitly allow for that, your client may be able to argue that you are the best firm for the job if you have a preexisting relationship with the client and the client lobbies strongly for you.

Finally, you need to review the terms of the policy to determine the scope of the coverage. Most policies will cover attorney fees. Policies vary more significantly, however, regarding the extent to which the insurer will cover settlement payments or a judgment. You also need to understand the coverage cap. These terms directly affect the potential cost to the company of the litigation and may affect your litigation strategy depending on the allocation between insurer and insured.

This information is equally important to plaintiffs’ counsel as they assess the value of their case. While plaintiffs are entitled to this information as part of initial disclosures under Federal Rule of Civil Procedure 26(a)(1)(A)(ii), because discovery is automatically stayed in securities class actions until after the court rules on any motions to dismiss, plaintiffs’ counsel may only get their copy if they can withstand a challenge on the pleadings.

**Document Preservation and Review: Is There a Litigation Hold in Place and How Are We Going to Efficiently Produce and Review This Information?**
The single biggest cost in securities class actions that get past the motion to dismiss and class action phases is discovery. Plaintiffs often request massive quantities of data, justified by a long class period and the expansive notion of scienter. This leaves defendants with huge costs for preservation, collection, and pre-production review, and plaintiffs with the burden of reviewing all the materials they requested.

One of the first topics of discussion after your client is served with a lawsuit, or is considering filing a lawsuit, is how to preserve documents. All federal circuits recognize a duty to preserve that arises when litigation is reasonably anticipated. This can generally be accomplished by issuing a litigation hold to all potentially relevant parties, as well as by suspending any automatic deletion protocols for electronically stored information. The recent revisions to the Federal Rules of Civil Procedure address the consequences of neglecting your preservation obligations. Fed. R. Civ. P. 37(e).

The production and review of this information is delayed in securities fraud class actions by the Private Securities Litigation Reform Act. However, the stay provides a good time to get your discovery strategy in order, to find an effective and cost-conscious vendor, and to provide a reasonable cost estimate to your client. In addition, under the new rules, you need to be ready to discuss discovery and to start producing much earlier. *See, e.g.*, Fed. R. Civ. P. 26(d), (f). Remember also that collecting data is not just about production; it's also about learning about the strength of your own case. A basic understanding of the case and a good vendor can help you formulate an efficient plan for culling the most relevant documents well before you start producing.

**Related Actions: Are There Any and Where Do They Stand?**
Events that trigger securities fraud class actions often trigger other proceedings as well. Companies and executives will be best served if you provide a consistent strategy across all actions, even if this means coordinating with other firms. This approach is even more important to counsel for the plaintiff because he or she may lose the status of lead plaintiff to another plaintiff in a related action.

Many complaints under the Securities Exchange Act of 1934 are preceded or accompanied by investigations and claims by government agencies, such as the Securities and Exchange Commission, and nongovernmental organizations, such as the Financial Industry Regulatory Authority. These actions can directly affect a private party securities class action because plaintiffs may strengthen their claims if one of these entities has already obtained discovery and found fault with the company.

There may also be other private party actions filed against the company either before or after your particular lawsuit. Just because your case is a class action does not mean that all shareholders have to fall into line. Any shareholder can file his or her own, separate action on behalf of a class. Even though these suits are then consolidated and one plaintiff selected to lead the class, it is important to anticipate this process. The plaintiffs' lawyers have a direct stake in their particular plaintiff being appointed lead plaintiff and, thus, their firm being appointed to lead the litigation.

Derivative actions are often coupled with securities fraud class actions. These claims are not brought on behalf of a class; rather, theoretically, they are brought on behalf of the company itself. Derivative plaintiffs typically allege breach of fiduciary duty by officers and directors who were involved in the company activity that prompted the class action. These actions are sometimes consolidated with the class actions.

**Damages: What Is the Estimated Value of This Lawsuit?**
Finally, your client will want to know the value of the claims alleged in the complaint and the likely settlement amount. This will obviously affect the client's assessment of the total cost to defend the litigation and the case strategy. If your client is a public company, the valuation may also affect the extent to which your client must disclose details about the lawsuit to its shareholders.

In a typical Rule 10b-5 securities class action, plaintiffs allege that defendants' misrepresentations or omissions artificially "inflated" the company's stock price above its true value until one or more "corrective disclosures" revealed the truth about the alleged fraud and the stock price dropped as inflation dissipated. If the stock traded in an efficient market in which its price quickly impounded new information, then investors claim that they were harmed because they bought the stock during the class period when the price was inflated, relying on the integrity of its market price.

To understand some of the nuances of a damage analysis, let us consider a hypothetical example in which the alleged class period starts January 1 and ends on February 1. Plaintiffs allege that a single corrective disclosure on February 1 removed all prior inflation in the stock price. Suppose the stock traded at $12 per share on January 1 and fell to $9 after the disclosure on February 1. To obtain a very rough estimate of damages, one could start by multiplying the stock price drop over the class period ($3 per share in this example) by shares outstanding. But such an estimate ignores several issues that must be considered to determine the harm *attributable to the alleged fraud*, e.g., investors' trading pattern during the class period and the level of alleged inflation at different points in time.

A better approach is to base the calculation on the change of *inflation* per share rather than on changes in the stock price per se. Suppose, in this example, the February 1 corrective disclosure is estimated to have removed 60 cents per share of artificial inflation and such inflation is reasonably estimated to have been constant at 60 cents per share over the entire class period. (Later we discuss how inflation may be estimated.) The damage per share for each individual investor is then typically calculated by comparing the change in the artificial inflation per share over the period the investor held the stock. Thus, damages *for shares bought and resold during* *the class period* equal inflation at the purchase date less inflation at the sale date. In this example, inflation on any date during the class period was estimated to be 60 cents. So damages on resold shares would be zero. Damages *for shares bought and held till the end of the class period* are simply the inflation at the purchase date (or 60 cents in this example) because, by then, all inflation has been removed from the stock price. In contrast, an investor's *actual* gain or loss on his or her stock investment would depend on the change in the stock price over the holding period, which will likely be very different from estimated *damages*.

As the above example suggests, the class's aggregate damages depend on each individual plaintiff's trading records and the daily artificial inflation per share over the class period. Because these records are generally unavailable, simulation models ("trading" models) are often used to estimate the class's trading behavior. However, such models are frequently subjected to *Daubert* challenges as they rely on restrictive assumptions, e.g., the propensity of shares bought during the class period being resold.

Estimating daily artificial inflation also involves statistical analysis and rests on various assumptions. First, every event related to the alleged fraud that introduced or removed artificial inflation must be identified. Second, the impact of each event on the stock price must be estimated, typically using a statistical procedure known as an "event study," which calculates the price impact adjusted for market and industry factors. This "residual" price impact may be attributed to the identified event provided it is "statistically significant" (i.e., the residual return is sufficiently large compared with its normal variability so that the likelihood it was due to chance alone is reasonably low) and cannot be attributed to any confounding news unrelated to the alleged fraud.

In general, material misrepresentations are expected to introduce inflation (or have a positive price impact). The price impacts of alleged corrective disclosures are then used to estimate the inflation previously present in the stock price. For instance, returning to our hypothetical example, suppose the stock price fell by 10 percent from $10 to $9 on February 1, the final corrective disclosure date, and the expected return that day based on an event study was −4 percent, i.e., the stock's residual return that day was −6 percent or −60 cents, which could arguably be considered a measure of *all* the artificial inflation previously present that the single corrective disclosure on February 1 removed, as we discussed previously. (Note there are others ways of calculating the daily artificial inflation during the class period. Alternative artificial inflation estimates would result in different damage conclusions.)

Finally, it may be helpful to gauge the likely settlement. To do so one could preliminarily consider publicly available studies that report settlements as a ratio of estimated damages in particular samples of cases. But estimates may vary depending on the manner in which these studies calculate damages and the facts and circumstances of each case. So, to obtain a more precise estimate of the likely settlement range, various other qualitative issues may have to be considered.

In short, any damage conclusion rests on several critical assumptions. Therefore, rather than relying on a single number to gauge the value of the claims alleged in the complaint, it may be useful to consider a range of outcomes by varying particular assumptions. Considering alternative damage scenarios may also help identify the strengths and weaknesses of your own case and assist you in devising your case strategy.

**Conclusion**
Considering each of these topics at the outset of a securities fraud class action will provide real value to your client, who will have to make decisions about the case based on more than just its legal merit. Once you have these issues resolved, you can turn your attention to the substance of the case knowing that you have already addressed the questions most important to your client.

**Keywords:** litigation, securities, securities fraud class action, insurance, litigation hold, related action, damages

Jessie M. Gabriel is a partner at Baker & Hostetler LLP in New York City, New York. Sumon Mazumdar, PhD, is a lead director at Navigant Economics in Oakland, California.

# From *Aeroflex* to *Trulia*: A Seismic Shift

By Peter Adams, Jeffrey Kaban, and Jeffrey Walker

On January 22, 2016, Chancellor Bouchard rejected a proposed disclosure-only settlement in *In re Trulia, Inc. Stockholder Litigation*, 129 A.3d 884 (Del. Ch. 2016), marking the culmination of what has been a seismic shift over the past several months in the Delaware Chancery Court's treatment of disclosure-only settlements in lawsuits challenging mergers. While the Chancery Court had expressed increasing skepticism of the value of disclosure-only settlements with broad, "intergalactic" releases over the past couple years, the recent change in the court's jurisprudence on this issue gained critical momentum on July 8, 2015, after Vice Chancellor Laster rejected the proposed disclosure-only settlement in *Acevedo v. Aeroflex Holding Corp.* Since *Aeroflex*, the pressure for change within the Delaware Chancery Court has only increased as the other members of the court signaled their desire to reconsider how the court treats disclosure-only settlements going forward. And Chancellor Bouchard's *Trulia* opinionat the beginning of this year appears to confirm that the likelihood of approval for most disclosure-only settlements in the future is bleak. We briefly discuss the Delaware Chancery Court's recent shift in jurisprudence on disclosure-only settlements and what this might mean for deal litigation in the future.

**Increased Scrutiny for "Disclosure-Only" Settlements with Broad Releases in *Aeroflex***

In *Aeroflex*, Vice Chancellor Laster began the "seismic" shift in the Chancery Court's jurisprudence by expressly rejecting the parties' stipulated settlement of a class action challenging the 2014 acquisition of Aeroflex by Cobham PLC for about $1.5 billion. The proposed settlement included additional disclosures to Aeroflex's shareholders plus two modifications to the deal protections: (1) a 40 percent reduction in the termination fee and (2) a reduction in the matching rights period from four days to three days. The settlement also included a broad release of class claims against the defendants. The defendants agreed not to oppose the plaintiffs' request for an award of attorney fees of up to $825,000.

During the settlement hearing, Vice Chancellor Laster began by acknowledging "that this is the type of settlement which courts have long approved on a relatively routine basis."Transcript of the Court's Rulings at 62, *Acevedo v. Aeroflex Holding Corp.*, No. 7930-VCL (Del. Ch. July 8, 2015). The court held, however, that the "relief" obtained by the plaintiffs—i.e., the supplemental "disclosures plus two tweaks to the merger agreement"—was not "sufficient to support an intergalactic release." *Id.* at 63, 73. He found the supplemental disclosures to be "precisely the type of nonsubstantive disclosures that routinely show up in these types of settlements." *Id.* at 73. And he considered the reductions in the termination fee and matching right period to be merely "cosmetic." *Id.* at 22. Ultimately, the court concluded:

> I don't think this relief is sufficient to support an intergalactic release. I don't know what's covered by an intergalactic release and I don't think the plaintiffs know either. I think what they know is that there was essentially, once they got in there, no merit to

> their Delaware breach of fiduciary duty claims. I don't think we know anything else beyond that.

*Id.* at 73.

In rejecting the settlement, the court identified three options going forward: (1) the parties could reframe the settlement as a mootness settlement; (2) the parties could seek approval of the settlement in exchange for a release limited to only those claims that the plaintiffs actually investigated; or (3) the defendants could move to dismiss, given the plaintiffs' concession that the merger was approved by a fully informed vote. The parties chose the third option, opting to file a joint motion to dismiss, and the court granted their motion on August 10, 2015.

**Aftershocks from *Aeroflex***

The impact of Vice Chancellor Laster's *Aeroflex* opinion was evident in the Chancery Court's other decisions issued throughout the remainder of 2015. *See, e.g.*, Transcript of Settlement Hearing and Rulings of the Court at 65, *In re Aruba Networks, Inc. S'holder Litig.*, No. 10765-VCL (Del. Ch. Oct. 9, 2015) (Laster, V.C.) (rejecting proposed disclosure-only settlement and stating that "we have reached a point where we have to acknowledge that settling for disclosure only and giving the type of expansive release that has been given has created a real systemic problem"); Letter from Settling Parties in *In re Conversant, Inc. Stockholder Litig.*, No. 10174-VCL (consol.) (Del. Ch. Aug. 25, 2015) (Laster, V.C.) (settling parties requested the court vacate the currently scheduled settlement hearing and permit withdrawal of the parties' previously submitted stipulated settlement in light of *Aeroflex*). For example, on July 27, 2015, Vice Chancellor Glasscock heard argument in *In re Riverbed Technology, Inc. Stockholders Litigation* concerning the approval of a settlement in which a class of shareholders challenging a private party's \$3.6 billion acquisition of the company granted broad litigation releases in exchange for supplemental disclosures that an objector argued were "worthless." Transcript of Hearing at 65, *In re Riverbed Tech., Inc. Stockholders Litig.*, No. 10484-VCG (Del. Ch. July 27, 2015). On the day of the hearing, the vice chancellor advised the parties that "[t]ypically, my practice is to resolve settlement motions from the bench" but that he would take the current motion under consideration because "at least certain members of the Court have been thinking in some depth about what the value of disclosure-only settlements is." *Id.* at 93. While Vice Chancellor Glasscock subsequently issued a memorandum opinion on September 17, 2015, approving the proposed settlement, he emphasized that he did so because in "the past practice of this Court in examining settlements of this type, the parties in good faith negotiated a remedy—additional disclosures—that has been consummated, with reasonable expectation that the very broad, but hardly unprecedented, release negotiated in return would be approved by this Court." *In re Riverbed Tech., Inc. Stockholders Litig.*, No. 10484-VCG, slip op. at 14 (Del. Ch. Sept. 17, 2015). However, he warned the parties that "this factor, while it bears some equitable weight here, will be diminished or eliminated going forward in light of this Memorandum Opinion and other decisions of this Court." *Id.*

Similarly, the other members of the Chancery Court who approved disclosure-only settlements with broad releases in the second half of 2015 warned that disclosure-only settlements entered into after July 2015 would receive greater scrutiny. *See, e.g.*, Transcript at 26, *In re CareFusion Corp. Stockholders Litig.*, No. 10214-VCN (Del. Ch. Sept. 17, 2015) (Noble, V.C.) ("[W]e need to be careful about imposing a whole new set of rules on folks who don't have advance knowledge or notice. . . ." But "[t]he times they are a-changing."); Transcript at 54–55, *In re Silicon Image, Inc. Stockholder Litig.*, No. 10601-VCG (Del. Ch. Dec. 9, 2015) (Glasscock, V.C.) ("This is, I think, something of a dying breed of cases. And it's a dying breed of cases because the bench in the Court of Chancery and other courts around the country have expressed concern at broad releases given up for disclosure-only settlements. . . . If this were a post-July case, I suspect strongly my decision here would be different."); Transcript of Settlement Hearing and Rulings of the Court at 38, 40, *Assad v. World Energy Sols., Inc.*, No. 10324-CB (Del. Ch. Aug. 20, 2015) (Bouchard, C.) ("[I]t should be pretty clear from some of the questions that I'm asking and some of the recent hearings . . . that there is a lot of concern in this court about nonmonetary settlements" and "there is going to be more scrutiny on some of the give and the get of these things. . . .").

**Chancellor Bouchard Confirms in *Trulia* That It Is No Longer Business as Usual for Disclosure-Only Settlements**

On January 22, 2016, Chancellor Bouchard rejected a proposed "disclosure-only" settlement of a shareholder suit challenging a merger in which Zillow acquired Trulia for about $3.5 billion in stock. *In re Trulia Stockholder Litig.*, 129 A.3d 884 (Del. Ch. Jan. 22, 2016). Under the proposed settlement, Trulia agreed to provide supplemental disclosures in its proxy materials, the plaintiffs agreed to drop their motion to preliminarily enjoin the merger and to provide a broad release of claims on behalf of a proposed class of Trulia's shareholders, and Trulia later agreed to pay the plaintiffs' counsel $325,000 in attorney fees. At the fairness hearing in September 2015, Chancellor Bouchard took the proposed "disclosure-only" settlement under advisement and asked the parties to provide additional briefing about (1) what standard applied when determining the value of supplemental disclosures and (2) "why does it make sense that the Court would be endorsing releases with unknown claims included in them?" Transcript at 43–44, *In re Trulia Stockholder Litig.*, No. 10020-CB (Del. Ch. Sept. 16, 2015). Following the supplemental briefing, the chancellor issued a memorandum opinion in which he rejected the proposed settlement. In the opinion, the chancellor explained:

> Given the rapid proliferation and current ubiquity of deal litigation, the mounting evidence that supplemental disclosures rarely yield genuine benefits for stockholders, the risk of stockholders losing potentially valuable claims that have not been investigated with rigor, and the challenges of assessing disclosure claims in a non-adversarial settlement process, the Court's historical predisposition toward approving disclosure settlements needs to be reexamined.

*In re Trulia Stockholder Litig.*, 129 A.3d at 896.

The chancellor went on to clarify that

> the optimal means by which disclosure claims in deal litigation should be adjudicated is outside the context of a proposed settlement so that the Court's consideration of the merits of the disclosure claims can occur in an adversarial process where the defendants' desire to obtain a release does not hang in the balance.

*Id.*

The court identified two alternative ways for courts to assess disclosure claims outside the settlement context: (1) as part of a preliminary injunction motion and (2) as part of the adjudication of "mootness" fee applications. *Id.* at 896–97. Under the second scenario, plaintiffs can apply for a fee award after "defendants voluntarily supplement . . . their proxy materials by making one or more of the disclosures sought by plaintiffs, thereby mooting some or all of [plaintiff's] claims." *Id.* In this situation, because there is no release, "defendants are incentivized to oppose fee requests they view as excessive." *Id.* at 897.

Chancellor Bouchard further warned that

> practitioners should expect that disclosure settlements are likely to be met with continued disfavor in the future unless the supplemental disclosures address a plainly material misrepresentation or omission, and the subject matter of the proposed release is narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process, if the record shows that such claims have been investigated sufficiently.

*Id.* at 898.

The court clarified that for a misrepresentation or omission to be "plainly material," "it should not be a close call that the information is material as that term is defined under Delaware law." *Id.* In applying these standards, the court found that "none of plaintiffs' Supplemental Disclosures were material or even helpful to Trulia's stockholders" and the scope of the release was too broad to support a fair and reasonable settlement because it "was not limited to disclosure claims and fiduciary duty claims concerning the decision to enter the merger." *Id.* at 907 n.89. Ultimately, "it is the Court's opinion, based on its extensive experience in adjudicating cases of this nature that the historical predisposition that has been shown towards approving disclosure settlements must evolve for the reasons explained above." *Id.* at 899.

**What Does This Mean for Deal Litigation Going Forward?**

In lawsuits challenging mergers, litigants should no longer expect quick and easy settlements featuring only supplemental disclosures and broad releases. What is less clear, however, is what impact this shift will have on future deal litigation in the long term. There are several potential results going forward.

**Fewer deal cases being filed.** The end of routine "disclosure-only" settlements could result in plaintiffs challenging fewer deals. A recent review by the *Wall Street Journal* found that this may be happening. Liz Hoffman, "The Judge Who Shoots Down Merger Lawsuits," [log-in required] *Wall. St. J.*, Jan. 10, 2016. While 78 percent of Delaware companies that sold themselves during the first nine months of 2015 faced at least one lawsuit in Delaware, only 34 percent of mergers have been challenged since October 1, 2015. *Id*. Another recent study found that the lawsuit rate for the fourth quarter of 2015 dropped even lower, to 21.4 percent. Matthew D. Cain & Steven Davidoff Solomon, *Takeover Litigation in 2015*, at 1 (Jan. 14, 2016). This same study also found that dismissals—voluntary or otherwise—are up from 32 percent in 2014 to 46 percent in 2015. *Id*. at 5. While these numbers suggest a downward trend in deal litigation being filed and litigated in Delaware, it is still too early to know for sure if this trend will continue in the long term.

**Companies should be prepared for more discovery and motion practice.** While fewer deals may be challenged, those that are challenged may be more expensive to litigate. With no quick and easy settlement route, plaintiffs may seek more discovery before the transaction closes and companies may need to more aggressively fight plaintiffs' applications for expedited proceedings and motions for preliminary injunction.

**Uptick in post-close litigation.** Plaintiffs may also more aggressively pursue damage claims, which would result in plaintiffs opting to litigate more merger cases post-close. There is little data to date on whether any trends have developed on this front. However, should this trend develop, it may be most prudent for defendants to provide supplemental disclosures, thereby mooting any disclosure claim and potentially invoking the business judgment rule. *See* *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304, 308 (Del. 2015) (holding that business judgment standard of review applies when a merger, not subject to entire fairness, has been approved by fully informed, uncoerced majority of disinterested stockholders).

**Increased adjudication of "mootness" fee awards or disclosure-only settlements with limited releases.** To the extent parties still seek to negotiate a pre-close resolution, such resolutions will likely involve voluntary supplemental disclosures by defendants with either no release and plaintiffs' application for a mootness fee award, or a much more limited release, provided that plaintiffs can show a "plainly material" disclosure and that they have adequately investigated the released claims.

**More suits against Delaware corporations in other jurisdictions.** As Chancellor Bouchard highlighted, "some have expressed concern that enhanced judicial scrutiny of disclosure settlements could lead plaintiffs to sue fiduciaries of Delaware corporations in other jurisdictions in the hope of finding a forum more hospitable to signing off on settlements of no genuine value." *In re Trulia Stockholder Litig.*, 129 A.3d at 899. However, Delaware corporations can mitigate this concern by adopting a forum selection provision requiring that fiduciary duty cases be litigated exclusively in Delaware. Indeed, since the Chancery Court's decision in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934, 955 (Del. Ch. 2013) (upholding the validity of an exclusive forum bylaw provision), hundreds of Delaware corporations have adopted such a provision.

**Keywords:** litigation, securities, Delaware Chancery Court, disclosure-only settlement

Peter Adams is a partner in the San Diego, California, office of Cooley LLP. Jeffrey Kaban is a partner and Jeffrey Walker is an associate in the firm's Palo Alto, California, office.

**PRACTICE POINTS**

# Pro-Defense Post-*Halliburton II* Circuit Court of Appeals Ruling: *IBEW Local 98 Pension Fund v. Best Buy*

The *Best Buy* decision out of the Eighth Circuit Court of Appeals, issued on April 12, 2016, is the first appellate court opinion interpreting and applying the rebuttable presumption of reliance standard at the class certification stage following the Supreme Court's decision in *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014) (*Halliburton II*). And it is a definite win for defendants seeking to defeat rule 10b-5 class actions. In a 2-to-1 decision, with Judge Murphy dissenting, the court reversed the trial court's decision certifying a class of purchasers of Best Buy stock between September and December of 2010. The trial court held that Defendants had failed to rebut the *Basic v. Levinson* presumption by "establishing that the challenged statements did not impact Best Buy's publicly-traded stock price." On appeal, the Eighth Circuit concluded that the trial court misapplied the price-impact analysis mandated by *Halliburton II*.

Before the court on appeal was the district court's finding of predominance under rule 23 and the question of whether the defendants had adequately rebutted the fraud-on-the-market presumption of reliance such that certification of the class was improper. The court noted that, as the Supreme Court held in *Halliburton II*, if a defendant rebuts the presumption, the class should not be certified because individual questions of reliance will predominate over common questions of law and fact. Therefore, establishment of the presumption "is critical to a Rule 10b-5 plaintiff's burden to establish that a class action should be certified."

In support of their motion for class certification, the plaintiffs submitted an expert report and event study concluding that the company's stock price increased in reaction to three allegedly misleading statements (one in a press release and two on an earnings call two hours later), without distinguishing the effects that occurred for each. Not surprisingly, the defendants rebutted the plaintiffs' report with their own expert's event study and report, which found that the rise in Best Buy's stock price occurred after the first statement (in the press release, which contained appropriate safe-harbor cautionary language about forward-looking statements, and therefore, was not actionable) but before the guidance call in which the additional alleged misstatements were made. Because the price of the stock was virtually identical right before and after the call, the defendants' expert concluded that the statements on the call had no discernable impact on the stock price. In response, the plaintiffs' expert issued a revised report acknowledging that the statements on the call did not "immediately increase the stock price," but claiming that they "fraudulently maintained" the price until the corrective disclosure was made in December, when another press release was issued reporting a decline in the preceding quarter's sales (contrary to the statements made in September about earnings being on track and in line with expectations).

The court stated that, while it was clear the plaintiffs had made a prima facie showing of the presumption of reliance for purposes of class certification, per *Halliburton II*, an additional question must be answered at the class certification stage. That is, whether the defendants had rebutted the presumption with evidence showing an absence of price impact, which "severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price." The district court found that the defendants did not adequately rebut the presumption. Instead, it found the plaintiff's expert's revised opinion persuasive, agreeing with him that the defendant's alleged misstatements on the call could have "further inflated the price, prolonged the inflation of the price, or slowed the rate of fall." The Eighth Circuit disagreed, stating that the district court ignored the defendants' "strong evidence" showing a lack of price impact—i.e., '*the opinion of Plaintiffs' own expert.*'" (emphasis in original). Most notably, the plaintiffs' expert's event study showed that the statements in the press release had an immediate impact on the stock price, whereas "the confirming statements in the conference call two hours later had no additional price impact." Additionally, the court rejected the plaintiffs' contention that the conference call statements effected a gradual increase in the stock price, finding such theory directly contrary to the efficient market hypothesis on which the *Basic* presumption is founded. The problem for the plaintiffs, in essence, was that any price inflation was admittedly (by the plaintiffs' own expert) attributable to the first statements made in the press release, which were not actionable, and not to the statements made in the conference call. Accordingly, any "correction" to the stock price following the December press release was logically linked to the non-fraudulent statements from the first press release and not to the earnings call. Thus the court reversed certification and remanded for further proceedings.

The dissent strenuously disagreed with the majority opinion, arguing that the majority misapplied the presumption of reliance standard at the certification stage. The dissent made three key points in taking issue with the majority opinion: (1) that the defendants could have rebutted the presumption (to the plaintiffs' price maintenance theory) by showing that "the alleged misrepresentations had not counteracted a price decline that would otherwise have occurred, but they failed to do so; (2) that the majority focused on the "gradual increase" theory over the price maintenance theory, which was ignored, causing the Eighth Circuit to diverge from other circuit courts that have recognized the theory; and (3) that the court's finding that the statements in the press release and earnings call were nearly identical was factually inaccurate and an improper finding as to materiality (of the statements on the call), which is not permitted at the class certification stage.

The impact of the *Best Buy* decision on pending and new securities class actions remains to be determined. Undoubtedly, the defendants will rely on the court's reasoning rejecting the gradual price increase theory as well as its implicit rejection of the more accepted (in other circuits) price maintenance theory and seek to defeat class certification following the template of the Best Buy expert where applicable and possible. On the other side, the plaintiffs will seek to distinguish the opinion and encourage courts in other circuits to disregard it as a poorly reasoned anomaly. Regardless, in the post-*Halliburton II* class certification era, the score stands at defendants one, plaintiffs zero. Stay tuned.

—*Laura J. O'Rourke, Baker McKenzie, Dallas, TX*

# Who's That Peeking in My Window?: SEC Scrutiny of Private Companies

One contributing factor as to why companies stay (or go) private is to avoid the costs, burdens, and regulatory and legal risks associated with being a public company. But private companies are not as insulated from SEC scrutiny as they may think—a fact underscored by two recent events: (1) a speech by SEC Chair Mary Jo White on March 31, 2016 and (2)news reports that Theranos—a private company estimated to be worth more than $1 billion—is the subject of a current SEC investigation.

On one hand, the SEC's expressed interest in scrutinizing private companies may not seem so convincing. The SEC has only a few tools to police the conduct of private companies, although the SEC's most powerful anti-fraud tool—Section 10(b) and Rule 10b-5promulgated thereunder—are applicable when private companies buy or sell their securities (with that term being defined quite broadly). The SEC also lacks the same type of visibility into the operations of private companies as it has with public companies. Private companies also tend to have larger and more sophisticated investors who can understand the risks, spot red flags, and have the financial ability to seek their own legal remedies for any harm they suffer as a result of their investment (a fact that White acknowledged in her speech).

But all that aside, it does make sense to take White at her word that the SEC is "monitoring and responding to developments in the private markets"? Here are a few key areas where private companies can expect to see the most vigilance:

> **Pre-IPO stage**. White emphasized the importance of complying with the federal securities laws for any company anticipating or planning for an initial public offering (IPO). She also explained the importance of incorporating many of the obligations arising under those laws, such as maintaining proper books and records and having adequate internal controls. This is not particularly surprising as companies planning for an IPO already anticipate the scrutiny from the SEC that that process will bring. But pre-IPO private companies should be aware of two other tools that the SEC can utilize. First, if a company seeks to withdraw its registration statement for any reason, the SEC can refuse the withdrawal request, thereby precluding—for all practical purposes—the company from doing a private placement with a similar structure as the proposed IPO. Second, the SEC can administratively issue a "stop order" if it determines that the registration statement contains an untrue or misleading statement. Of even more consequence, the SEC can initiate an investigation into whether the registration statement contains any untrue or misleading statements, and the registration statement will not be effective while that investigation is proceeding.
>
> **Employees paid with private company stock.** While investors in private companies tend to have sufficient sophistication to look out for themselves, the SEC views employees of private companies as among the more potentially vulnerable victims of any potential fraud. Accordingly, White articulated that the SEC would be vigilant with

respect to private companies that issue employees stock as part of their compensation. In fact, one of the more recent and high-profile enforcement actions involving a private company focused on this issue.

**Unicorns and valuation issues.** White, perhaps unsurprisingly, expressed potential concern with respect to "unicorns"—private companies with valuations over $1 billion. She questioned whether the prestige and status associated with becoming (or remaining) a unicorn could lead to inflation or distortion of a company's true value, especially given her perception that private companies do not have the same level of internal accounting resources and controls as most public companies.

**Monitoring of issuances under new regulations.** In passing Regulation A+ andRegulation Crowdfunding, the SEC sought to make the capital markets more accessible to smaller companies by creating more ways to sell securities without being subject to registration requirements. While the practical impact of these regulations remains open to debate, White emphasized that she has directed staff from across the SEC to monitor these issuances for potential problems or abuses.

**Secondary market trading.** White noted the increase in secondary markets for pre-IPO shares of private companies, and emphasized how these markets raise issues with respect to valuation and liquidity, and that the SEC would "scrutinize these emerging platforms to ensure they provide a functioning market that operates within the parameters disclosed to investors."

In closing, the limited toolbox the SEC has to work with in regard to regulation of private companies, coupled with the lack of visibility it has into their operations, suggests that there will not be a significant uptick in the number of enforcement actions against private companies. This possibility, however, will be cold comfort to any private company that does find itself in the SEC's crosshairs, and so private companies operating in the areas outlined above should be particularly conscious of this heightened scrutiny.

**Keywords:** securities litigation, SEC regulations, initial public offerings

—*Bret Leone-Quick, Mintz, Levin, Cohn, Ferris, Glovsky and Popeo P.C., Boston, MA*

The views expressed herein are those of the author(s) and do not necessarily reflect the positions or policies of the American Bar Association, the Section of Litigation, this committee, or the employer(s) of the author(s).

ABA Section of Litigation Securities Committee
http://apps.americanbar.org/litigation/committees/securities/home.html