

# SECURITIES LITIGATION

AMERICAN BAR ASSOCIATION SECTION OF LITIGATION



Winter 2014, Vol. 24 No. 2

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## The Puzzle and Promise of Bitcoin

By Alexander Aganin, Julia Brighton, George Gigounas, Victoria Lazear, and Isabelle Ord

Bitcoin as a payment system is still in its infancy. It reached a maximum of only 102,000 transactions per day in December 2013, compared with nearly 500 million transactions worldwide per day handled by payment card networks in 2012. But it has captured the public imagination and the investment attention of many smart, serious financial minds. Setting aside short-term speculators, these investors are betting that Bitcoin will achieve stability through long-term, mainstream acceptance. Why the excitement about an innovation that, on its face, offers consumers a transaction medium very similar to credit cards, checks, or cash, except far more volatile? The key answers appear to lie in Bitcoin's infrastructure efficiencies over traditional electronic banking (i.e., lower transaction costs and greater market reach), perceived anonymity, and reduced fraud and charge-backs to payees.

But Bitcoin faces a catch-22. The goal is mainstream acceptance through greater efficiencies and anonymity, but the cost of achieving that goal is mainstream regulation, reduced efficiencies, and reduced anonymity. We propose here that Bitcoin's success so far has ensured its mainstream regulation in the United States (as a currency, not as a security), that its current liquidity costs partially offset Bitcoin's advantages, and that structural factors in the Bitcoin market may have created a short-lived overvaluation. Whether Bitcoin eventually will adjust and find its place as a currency alternative will depend on the ability of the Bitcoin network to maximize its advantages over traditional payment methods.

### Bitcoin as an Alternative Payment Infrastructure

Traditional payment systems rely on the traditional banking infrastructure. A processor collects the transactions from the merchant or other entity and transmits the transaction to the relevant electronic network—the card network for payment cards, the Automated Clearing House (ACH) network for ACH payments and electronic checks. The network collects the money from the payer and transmits to the processor, who then pays the merchant.

This complex infrastructure is efficient for the rapid and secure transmittal of funds within the United States, but it has many costs, including costs of compliance with numerous state and federal laws regulating money services businesses (MSBs). Government regulations, designed to increase homeland security, reduce tax evasion, and allow easier tracking of criminal enterprises, developed a way of easily tracking most transactions within the existing infrastructure but at a cost. And the costs per transaction increase when transactions cross global borders due, in part, to even more government regulations to ease tracking.

The Financial Crimes Enforcement Network (FinCEN) defines MSBs depending on financial activity, imposing registration requirements and a range of anti-money-laundering, record-keeping, and reporting responsibilities. Under the [Bank Secrecy Act](#), MSBs must report

suspicious currency transactions of any size, and all transactions greater than \$10,000, to FinCEN. The USA PATRIOT Act prohibits MSBs from transacting with individuals who have funneled money to terrorist organizations. The U.S. Department of the Treasury's Office of Foreign Assets Control also prohibits MSBs from transacting with a monitored list of "Specially Designated Nationals" linked with terrorism, narcotics trafficking, and other crimes.

Credit card companies make substantial investments in payment systems globally to cover operating costs as well as innovations. To recoup, they charge the payees merchant fees, comprising processing fees to the acquiring bank (the processor) and an interchange fee to the card network and the issuing bank. According to industry estimates, merchants lose 1 percent of revenues to fraud, .59 percent is fraudulent card use, and the remainder is charge-backs. Innovative processors, by focusing on small-volume merchants, are able to charge lower rates to merchants. Large merchants have developed payment methods (e.g., electronic check acceptance) that do not require interchange fees.

Bitcoin infrastructure, in contrast, currently appears to cost less to develop and operate, and works seamlessly across borders. It offers greater perceived anonymity for the payer, fast (but not instantaneous) validation, and reduction in fraud and charge-backs to the payee (notably leaving no protection to the payer because the transaction is irrevocable). Increased anonymity arises from a purely digital currency, operating outside the existing infrastructure, except to use the ACH network to deposit a check after the bitcoin-to-currency conversion. Bitcoin code contains a mechanism to validate that the payer actually owns the Bitcoin and has not previously transmitted it to another payee. To facilitate the validation process, the payer financially motivates the "miners," who are responsible for validating the transactions. Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (May 24, 2009).

A Bitcoin intermediary such as Coinbase may provide merchants with software for Bitcoin transactions on their websites, which can include dynamic pricing tools. Currently, merchants incur no fees in accepting Bitcoin, except a Bitcoin-currency-exchange fee. Many Bitcoin intermediaries that provide exchange to and from dollars for U.S. customers currently charge 1 percent per exchange into dollars, collecting 2 percent in a transaction with conversion on each end (some of these intermediaries currently offer fee-reduction or fee-elimination incentives).

Finally, while perceived as anonymous, Bitcoin may be more transparent than other payment methods. The transfer of each bitcoin is traced back to its introduction into circulation, which is contained in a public ledger. Users can protect themselves by maintaining multiple Bitcoin wallets and guarding the information in the wallets, but users can become traceable when bitcoins are converted into currency because this requires delivery of the funds to a bank. Once the bitcoin is converted, the government (or a hacker who gains access to relevant information) can tie the bitcoin to the transfer recipient. Then, previous owners' wallets can be identified through the ledger. By comparing the transactions of the previous owners, one may acquire considerable information about the sender.

### **Regulatory Costs of the New Bitcoin Infrastructure**

While many Bitcoin users seek a widely accepted alternative exchange for goods and services and others want an investment, some want a medium for illegal activity. Bitcoin gained traction as a payment method for drug trafficking and other illegal activity because it was assumed to be anonymous. Since the closure of [Silk Road](#), most bitcoins reportedly are spent on off-shore gambling. Its use for illegal activities including money laundering and tax evasion causes anxiety for lawmakers and regulators. Bitcoin thus faces an existential question—can its legitimate function overcome its illicit uses? Several countries have banned Bitcoin transactions to prevent illegal activity. But even if Bitcoin survives for legitimate investment and exchange purposes, its potential for illegal activity will attract legal and regulatory scrutiny of Bitcoin users. Currency monitoring and reporting regulation of Bitcoin exchanges and intermediaries is inevitable, and it is already beginning.

Bitcoin proponents often rankle at this conclusion—much of the excitement over Bitcoin is around perceived anonymity and freedom from invasive government monitoring. But state and federal governments typically have their own agendas. They have prosecuted criminal activity through financial laws for centuries. In guidance issued on March 18, 2013, [Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies](#) (FIN-2013-G001), FinCEN labeled Bitcoin a “convertible virtual currency,” having “an equivalent value in real currency or act[ing] as a substitute for real currency,” but stated that it is not currency. Although it may not meet FinCEN’s formal definition, Bitcoin closely resembles a non-commodity-backed currency, i.e., a “fiat” currency backed by a sovereign government. While such currencies have no intrinsic value (unlike a gold-backed currency, for example), they are exchange media because market participants agree they have value, and they recognize transactions in these currencies. If the Bitcoin marketplace similarly develops, Bitcoin may be recognized as a de facto currency. High-profile arrests in California, New York, and Florida show that law enforcement already treats Bitcoin as a currency and prosecutes illicit users accordingly. Timothy B. Lee, “[Feds Arrest the Alleged Founder of Bitcoin’s Largest Drug Market](#),” *Wash. Post*, Oct. 2, 2013; Jose Pagliery, “[Bitcoin Exchange CEO Arrested for Money Laundering](#),” *CNN Money*, Jan. 28, 2014; Susannah Nesmith, “[Miami Bitcoin Arrests May Be First State Prosecution](#),” *Bloomberg Tech.*, Feb. 10, 2014.

Regulators are following enforcers’ lead in looking to existing currency law. New York State’s Department of Financial Services (NYDFS) recently held open hearings to collect information on regulating Bitcoin transactions, and NYDFS Superintendent Benjamin Lawsky announced he would employ existing regulations. California is contemplating the same issue, less publicly. The developing consensus among regulators is that existing regulatory frameworks for currency transactions can and should apply to Bitcoin, obviating the need for a separate set of rules. States are moving toward including Bitcoin entities under existing laws regulating MSBs. New York and California are both considering “BitLicenses” to regulate the MSBs. Carter Dougherty, “[New York Vying with California to Write Bitcoin Rules](#),” *Bloomberg Tech.*, Jan. 27, 2014. Federal regulators are working in the same vein. In its March 2013 guidance (discussed above),

FinCEN announced it will apply Bank Secrecy Act regulations (such as the requirement to report suspicious currency transactions of any size) to Bitcoin entities (but not miners or investors) under the rules for MSBs. At least two other anti-money-laundering regulatory projects will apply to Bitcoin MSBs: the PATRIOT Act and the Office of Foreign Assets Control [list](#) of prohibited transaction counterparties. State governments will likely crack down on attempts at sales tax evasion through Bitcoin transactions.

Regulation of criminal activity will increase transaction costs and decrease anonymity in the Bitcoin marketplace, reducing the key perceived value of Bitcoin transactions. Anticrime regulations are expensive to implement and monitor. Bitcoin intermediaries will absorb the costs and requirements of compliance, just as banks do, and will pass them to the customer. The touchstone of the above regulations is the [Bank Secrecy Act's "Know Your Customer"](#) imperative, requiring banks and other MSBs to provide the first line of defense in enforcing anti-money-laundering laws by gathering data on individuals with whom they conduct transactions. Already some banks are refusing to provide accounts to businesses that are involved with bitcoins.

Many bitcoins currently are held for investment, which raises the question of potential regulation of bitcoins as a security (as distinct from traditional investment vehicles such as the hedge funds, equity funds, or mutual funds that may choose to invest in bitcoins). There has been much debate about whether bitcoins will be subject to Securities and Exchange Commission (SEC) regulation as "securities" under the common tests, i.e., an investment of money in a common enterprise and an expectation of profits to come primarily from the efforts of others, or as an interest or instrument "commonly known" as a security. ([SEC v. W.J. Howey Co.](#), 328 U.S. 293 (1946); [SEC v. Turner Enterprises, Inc.](#), 474 F.2d 476 (9th Cir. 1973); [Securities Act of 1933 § 2\(a\)\(1\)](#); [Securities Exchange Act of 1934 § 3\(2\)\(10\)](#).) SEC Chairman Mary Jo White has so far left the question unanswered, suggesting that the SEC may be content to allow currency regulators to address Bitcoin.

Arguments on both sides largely address the issue as a series of answers to technical questions: whether Bitcoin acquisitions are "investment contracts" (while exchange-purchased bitcoins could be argued to be so, bitcoins acquired by mining cannot); whether Bitcoin value results from a "common enterprise" (only by the broadest definitions, arising in likely distinguished cases); and whether profit is expected from the efforts of others (again, only in the broadest sense—in reality, Bitcoin speculators are betting on the acceptance of Bitcoin as a transaction medium). Alternatively, when rejecting Bitcoin as a currency, government agencies sometimes classified it as a virtual commodity (like transferrable coins or points for use in video games). Some also suggested that Bitcoin could be regulated by the U.S. Commodity Futures Trading Commission as a commodity for future delivery.

Eminent scholars weigh in on both sides of this legal analysis, but we are skeptical that the SEC will regulate Bitcoin as a security, barring unforeseen developments in the Bitcoin ecosystem. Our skepticism arises more from the practical realities of Bitcoin's future. First, if and where

Bitcoin flourishes in the long term, it will likely be as a recognized medium for transactions in real goods and services, not as an investment contract. Speculative investments in Bitcoin are sustained specifically because of its promise as a currency or currency-like medium. To regulate Bitcoin acquisitions as securities transactions would turn this dynamic on its head. Second, the real-world risks that Bitcoin poses (criminal transactions, money laundering, tax evasion) are largely currency-like risks, not securities risks. Regulating those risks falls most naturally within the purview of currency regulators, who are already acting.

Derivative Bitcoin products (e.g., futures, options, swaps) exist in tiny markets and could become more prevalent, especially if market makers can short Bitcoin. But regulation of those derivatives would occur under existing rules and without remarkable differences. The real legal impact on Bitcoin as an investment will come from the effect of anticrime banking regulation on Bitcoin's transaction load and anonymity and, therefore, its perceived value and promise as a widely accepted medium for legitimate transactions.

### **Liquidity Cost of the New Bitcoin Infrastructure**

Many of the advantages that Bitcoin enthusiasts describe assume that Bitcoin is highly liquid. As an example of where bitcoin usage might dominate, there currently are few non-Bitcoin ways to make international transfers except for wire transfers. Alternative transfer methods are costly. Bitcoin could be an attractive method for these transactions, particularly if concerns about terrorist funding, tax evasion, and money laundering can be overcome. But the Bitcoin recipient (or local merchants accepting Bitcoin payments by the recipient) would need a way to convert bitcoins to local currency, and the cost of conversion will depend on the liquidity of Bitcoin, either through direct local currency exchanges or Bitcoin intermediaries that provide liquidity themselves or access exchanges for their users. Currently, Bitcoin intermediaries in the United States charge a commission of 1 percent for each exchange to and from dollars to bitcoins or 2 percent for the round-trip, but sometimes with limits on how much can be converted. An important concern is that much of the Bitcoin liquidity is concentrated in bitcoin/U.S. dollar transactions, thus the economics of bitcoin transactions in emerging markets is likely to be even less attractive than presented here.

An important consideration in assessing liquidity is to determine whether this commission charge of 2 percent round-trip offered by Bitcoin intermediaries could be arbitrated by trading directly on the Bitcoin exchanges. To assess this, we examine the economics of Bitcoin exchanges.

Bitcoin intermediaries must cover three types of costs: (1) *order processing costs*, related to business overhead, including regulatory compliance, computer infrastructure, and security; (2) *inventory costs*, largely generated by the necessity of selling and buying inventory without regard to fluctuating values to meet customer demands; and (3) *adverse selection costs*, incurred when users buy and sell bitcoins with advance knowledge of positive or adverse information.

The conversion rate for Bitcoin has been volatile. For example, when China barred its financial institutions from handling transactions in bitcoins, the price fell more than 20 percent in a single

day—and has yet to recover. (All Bitcoin-related data are from [Bitcoincharts](#).) There were four such days between January 1, 2013, and February 15, 2014, when the price of Bitcoin fell by more than 20 percent on a close-to-close basis. On the intraday basis, drops of this size relative to the prior day's close are even more numerous: There were 25 such drops on the BitStamp exchange and 21 on the BTC-e exchange during the same period. The standard deviation (a measure of volatility) of Bitcoin's close-to-close returns was 7.3 percent during this period. Even if we were to exclude days with a change of more than 20 percent (assuming, arguably, that they are not representative of volatility going forward), the volatility is still 5.4 percent. A financial intermediary trying to avoid this volatility would typically conduct offsetting transactions on exchanges simultaneously with transacting with its customers.

We analyzed the cost of instantaneous exchanges from U.S. dollars to bitcoin and back for a single day on [BitStamp](#) and [BTC-e](#). Following convention, we express the cost as a percentage of the midpoint between the cost of buying and selling. For example, a round-trip cost of 1 percent means that buyers and sellers pay an average of 0.5 percent each to the counterparty providing liquidity. Depending on the time of day and the exchange, the round-trip cost for buying or selling one bitcoin can be as low as 0.002 percent and as high as 0.42 percent. Liquidity is worse for larger trades. A round-trip cost for 100 bitcoins can be as low as 0.47 percent and as high as 1.40 percent. Bitcoin exchange users also must pay exchange transaction fees ranging between 0.2 percent and 0.5 percent, and currency withdrawal fees that may differ depending on the currency.

Thus, our analysis suggests the transaction costs of this activity for commercial quantities of bitcoins are high when compared with the maximum price of 2.75 percent that an innovative processor is charging its smallest merchants, and Bitcoin intermediaries currently cannot offer significantly better Bitcoin transaction economics than the 2 percent combined (“round-trip”) fees that they levy on consumers and merchants for exchanges to and from dollars today.

In discussing liquidity, it is useful to understand who provides the liquidity. Merchants are likely net sellers of bitcoin. The liquidity they rely on must then be supplied by consumers buying bitcoin for transaction purposes, by investors in Bitcoin, or potentially by exchange arbitrageurs. Thus, liquidity maybe adversely affected in the future should demand from consumers to buy bitcoin for transactional purposes decline or should investors currently using bitcoin for speculation move elsewhere.

### **Bitcoin as a Potentially Overvalued Investment**

Innovative people designed and built the Bitcoin infrastructure, and early adaptors are investing in the Bitcoin ecosystem. Will Bitcoin expand to mainstream consumers and merchants?

Setting aside illicit activities, Bitcoin faces serious challenges to acceptance as an alternative payment medium except, perhaps, for international transactions or maybe as an alternative to some credit card transactions or for its perceived anonymity. Because of the delay of 10 minutes to complete a transaction, Bitcoin transactions appear unacceptably slow for most commercial

applications. Consumers pay a conversion fee to exchange dollars to bitcoins, and a small transaction fee to make transactions in bitcoins (currently about .0001 BTC to .0005 BTC or \$.10 to \$.40). Yet, they generally do not receive a lower price than credit card users. They cannot finance purchases or receive fraud protection. Consumers also bear a volatility cost if they hold an inventory of bitcoins instead of immediately using them. On the other hand, credit card users pay some costs to issuing banks through annual fees and late fees, although they also receive reward points for card usage.

Bitcoin has key indications of an asset prone to overvaluation. Estimates are that only 4 million of the 12 million currently existing bitcoins are circulating, with the rest being held for investment. Bitcoin is mostly held by individuals, is the subject of high-profile news coverage, and is susceptible to being supplanted by other virtual currencies. Bearish investors currently cannot sell bitcoins short, thereby removing an important price-corrective force. Given research on prices of speculative assets that cannot be sold short and on aspects of investor psychology that can create a bias toward optimism, it is questionable whether the current Bitcoin conversion price is rational. Whether or not Bitcoin or another digital currency emerges as a new payment medium, its users and intermediaries will need to deal with regulatory and liquidity costs as well as with other payment market realities.

**Keywords:** litigation, securities, bitcoin, SEC, regulation

[Alexander Aganin](#) and [Vicki Lazear](#) are vice presidents at Cornerstone Research in its Menlo Park, California, office. [George Gigounas](#) and [Isabelle Ord](#) are partners and [Julia Brighton](#) is an associate at DLA Piper, LLP, in its San Francisco, California, office. The views expressed in this article are solely those of the authors, who are responsible for the content, and do not necessarily represent the views of Cornerstone Research or DLA Piper, LLP.

## Testing and Attacking Confidential Witness Allegations at an Early Stage

By John D. Pernick and Ryan D. Nassau

Almost every securities fraud complaint contains allegations supported by statements of confidential witnesses (CWs). CW statements may be inaccurate, but generally, on a motion to dismiss, the allegations of a complaint are taken as true. Recent cases involving false CW allegations have highlighted the potential for abuse as well as the procedural difficulties defendants face when seeking to attack the veracity of allegations based on CW statements. We review some of the recent cases addressing CW allegations and the procedural devices defendants have used to discredit CW allegations and obtain dismissals at an early stage.

### The Private Securities Litigation Reform Act and Plaintiffs' Use of CWs

In 1995, “prompted by significant evidence of abuse in private securities lawsuits,” Congress enacted the Private Securities Litigation Reform Act (PSLRA), [Pub. L. No. 104-67, 109 Stat. 737](#). One such abuse was the filing of suits alleging fraud against issuers following a drop in stock price “without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action.” See [H.R. Rep. No. 104-369](#), at 31 (1995) (Conf. Rep.). To combat these abuses, the PSLRA introduced a heightened standard for pleading, requiring that plaintiffs plead with particularity facts giving rise to a strong inference that defendants acted with scienter. [15 U.S.C. § 78u-4\(b\)\(2\)](#). The PSLRA also imposed a discovery stay while a motion to dismiss is pending, effectively eliminating plaintiffs’ ability to use discovery to uncover the facts necessary to meet the heightened pleading requirements. [15 U.S.C. § 78u-4\(b\)\(3\)\(B\)](#).

Those two aspects of the PSLRA have significantly changed how plaintiffs litigate securities fraud cases. Now plaintiffs’ counsel often conduct an investigation before filing their intended operative complaint, to try to uncover information supporting fraud allegations. The sources of this information are, primarily, current or former company employees or other company insiders. Because these insiders are, purportedly, concerned about retaliation or other consequences from their disclosure of internal company information, plaintiffs do not identify the sources by name. Instead, the sources are described as CWs.

In the use of allegations by CWs as anonymous sources, there is much room for misuse and abuse. A CW might have no foundation for the statements he or she makes, his or her statements might be misunderstood or misconstrued by the investigator or plaintiffs’ counsel, or the statements could be fabricated or misattributed altogether. Although defendants often have reason to doubt the veracity of allegations attributed to a CW, the general rule is that, on a motion to dismiss, allegations in a complaint are accepted as true. And the PSLRA bars discovery before a motion to dismiss. Therefore, there is no clear procedural means for a securities fraud defendant to attack the accuracy of CW allegations before the court rules on its motion to dismiss or, at least, before having to endure the expense of full-blown discovery.

Consequently, defendants have had to engineer their own procedures to bring evidence attacking the veracity of CW allegations before the courts. Defendants have sought pre-motion-to-dismiss discovery, have done their own independent investigations of CWs in connection with motions to dismiss, and have prioritized discovery relating to CWs following the denial of motions to dismiss for evidence supporting a motion for reconsideration. Below, we review how courts have responded to these defense efforts.

### Available Protections Against Misuse

**Limited discovery.** At its discretion, a court can lift the PSLRA's discovery stay "in order to prevent undue prejudice to a party." 15 USC § 78u-4(b)(3)(B). The leading case granting pre-motion-to-dismiss discovery relating to CWs is [\*Campo v. Sears Holding Corp.\*](#), 635 F. Supp. 2d 323 (S.D.N.Y. 2009), in which the court ordered and then considered deposition testimony of CWs in ruling on the motion. The *Campo* court denied the defendants' initial motion to dismiss, citing allegations of three CWs, but ordered the depositions of those CWs to test the allegations and determine whether dismissal should have been granted. In readdressing the motion after the CW depositions, the court stated that "[w]ith respect to allegations derived from confidential witnesses, the Court considers only those allegations that later were corroborated by those witnesses in depositions." The court granted dismissal, finding that a "reasonable person could not infer from the statements these CWs acknowledged in their depositions that [the individual defendants] acted with the requisite recklessness or intent. Two of [the three cited CWs] left the company before the Class Period and none had any contact with either [individual defendant]." On appeal, the Second Circuit found no error because the district court relied on the testimony "for the limited purpose of determining whether the CWs acknowledged the statements attributed to them," to test the good-faith basis of the plaintiffs' complaint.

Other courts have been reluctant to follow *Campo*. For example, in *In re Cell Therapeutics, Inc.*, 2010 U.S. Dist. LEXIS 125782, at \*5 (W.D. Wash. Nov. 18, 2010), the defendants submitted declarations from three CWs claiming their statements were taken out of context, misrepresented, or fabricated. Based on those declarations, and citing *Campo*, the defendants sought to depose two remaining CWs. The court denied the motion, stating "neither the Federal Rules nor the Private Security Litigation Reform Act (PSLRA) supports the practice" of allowing discovery during the pleading stage, except in limited circumstances not present. The court noted that *Campo* had not been followed elsewhere, that it was not binding, and that the language regarding CW depositions was dictum.

Some defendants, rather than seeking an order allowing pre-motion-to-dismiss discovery, have done their own investigation regarding CWs, and attempted to use evidence regarding CW allegations in a motion to dismiss. In *In re St. Jude Medical, Inc. Securities Litigation*, 836 F. Supp. 2d 878 (D. Minn. 2011), the defendants located one of

the CWs cited in the plaintiffs' complaint and submitted, with their motion to dismiss, the CW's affidavit asserting that the complaint misrepresented what she had told the plaintiffs. Although the court doubted "the propriety of addressing the factual accuracy of an affidavit" on a motion to dismiss, it did ignore the few allegations attributed solely to that witness. The court in *Local 703, I.B. of T. Grocery & Food Employees Welfare Fund v. Regions Financial Corp.*, 2011 U.S. Dist. LEXIS 93873 (N.D. Ala. Aug. 23, 2011), also allowed the defendants to submit CW affidavits with a motion to dismiss. The complaint cited the CWs for having personal knowledge that the individual defendants were aware of improper changes in loan classifications. Although the court did not discuss why it allowed the defense to submit the affidavits, it cited *Campo* in explaining that the investigator's notes were reviewed *in camera* to determine whether the CWs acknowledged statements attributed to them in the complaint.

Other courts have rejected evidentiary submissions on motions to dismiss. In *Belmont Holdings Corp. v. SunTrust Banks, Inc.*, 2011 U.S. Dist. LEXIS 156309 (N.D. Ga. Sept. 7, 2011), the complaint alleged that the defendants knew their statements regarding SunTrust's capital and reserves in 2007 were false. The complaint supported these allegations with statements from a CW described as the "Vice President of Risk Management" who "was employed by [SunTrust] from 2005 through 2007" and who, during his time at the company, told the defendants that reserves were inadequate. The defendants argued that the CW left SunTrust in August 2007 and therefore could not attest to matters after that date. The court declined to inquire into that factual assertion on the motion to dismiss, stating that it must view the allegations in the light most favorable to the plaintiffs and must therefore assume the CW did have personal knowledge. The court did say, however, that if it later surfaced that the CW did not have personal knowledge of events throughout 2007, it would consider whether the plaintiffs' actions had violated [Federal Rule of Civil Procedure 11\(b\)](#). The subsequent proceedings in *SunTrust* are discussed below.

**Motions for reconsideration.** If a court is unwilling to consider evidence contradicting CW allegations at the motion-to-dismiss stage, or if the defendants do not have such evidence at the time of the motion but obtain it later, the defendants may be able to raise the issue at a relatively early stage, through a motion for reconsideration.

That is what occurred in *SunTrust*, where, following the court's denial of their motion to dismiss, the defendants obtained several declarations from the CW who was the source of the allegations regarding the defendants' knowledge of inadequate reserves. [Belmont Holdings Corp. v. SunTrust Banks, Inc.](#), 896 F. Supp. 2d 1210, 1221–23 (N.D. Ga. 2012). In those declarations, the CW confirmed that he left the company in August 2007 and knew nothing about the defendants' knowledge after that time. In considering that evidence, the court noted:

In the securities litigation context, where there is a higher scienter pleading standard under the PSLRA, a district court may reconsider an order denying a motion to dismiss, even where the defendant relies upon extrinsic evidence outside the pleadings, when a manifest factual error was made by the court based on fraud [by the plaintiff], carelessness by [the plaintiff's] counsel [in making its factual allegations], or by the court's own misperception of the facts." The court granted defendants' motion for reconsideration and dismissed the case, noting that its initial denial was "based on its misperception of the facts due to Plaintiff's carelessness.

A similar situation arose in [\*City of Livonia Employees' Retirement System v. Boeing Co.\*](#), 711 F.3d 754 (7th Cir. 2013). There, the lower court had denied a motion to dismiss a second amended complaint after it had dismissed the prior complaint. The second amended complaint relied on a new CW allegation that certain officers made material misstatements, intentionally deceiving investors about tests of Boeing's 787-8 Dreamliner aircraft. The defendants deposed the CW, described as "a high-ranking Boeing engineer," and several other CWs during discovery. The alleged high-ranking engineer denied "virtually everything that the investigator had reported." The CW was actually a temporary contractor—not an employee—and did not work with Boeing when the tests at issue were conducted. He denied having any personal knowledge of the tests and was not in a position to obtain the information he was alleged to possess. Based on that testimony, the court granted the defendants' motion for reconsideration and dismissed the complaint. The Seventh Circuit affirmed the district court's dismissal.

In *City of Pontiac General Employees Retirement System v. Lockheed Martin Corp.*, 2013 U.S. Dist. LEXIS 96895 (S.D.N.Y. July 9, 2013), following an unsuccessful motion to dismiss, the defendants took depositions of CWs cited in the complaint, several of whom completely recanted or disputed the statements attributed to them. The defendants brought what they termed a "limited motion for summary judgment" based on the inconsistent CW testimony. The court directed five of the CWs implicated, as well as the investigator, to appear at a hearing to determine the veracity of the complaint. The hearing established that some of the CWs "had been lured by the investigator into stating as 'facts' what were often mere surmises, but then, when their indiscretions were revealed, felt pressured into denying outright statements they had actually made." Although the parties settled the case before the court issued an opinion, the judge, Hon. Jed Rakoff, issued a memorandum anyway "in light of certain issues presented by that motion that are likely to recur in future cases." The memorandum set out his views on the use of CWs in securities fraud cases, which he viewed as problematic for everyone involved—plaintiffs, defendants, and CWs themselves. But Judge Rakoff concluded that, because of the pleading requirements imposed on plaintiffs by the PSLRA and cases such as [\*Tellabs, Inc. v. Makor Issues & Rights\*](#), 551 U.S. 308 (2007), the problems were likely "endemic" to securities fraud actions.

**Sanctions.** Faulty or outright false CW allegations naturally raise the question of sanctions. A plaintiff's use of CWs in a complaint must comport with Rule 11, which requires certification that the claims are warranted and that the facts presented are supported by evidence. While Rule 11 applies to pleadings and motions in all cases, in enacting the PSLRA Congress unequivocally intended to "strengthen the application of Rule 11 in private securities actions." Accordingly, the PSLRA was designed to "impose upon courts the affirmative duty to scrutinize filings closely," mandating that the court make "specific findings regarding [each party's and attorney's] compliance" with Rule 11, and mandating sanctions for any violation thereof. See H.R. Rep. No. 104-369, at 39 (1995) (Conf. Rep.); 15 U.S.C. § 77z-1(c).

However, at least to date, even courts that have granted dismissals due to erroneous CW allegations have not imposed sanctions. The *SunTrust* court raised the potential for sanctions under Rule 11(b) in its initial denial of the defendants' motion to dismiss finding plaintiffs' counsel's conduct "troubling," but in a "close and reluctant call," no sanctions were issued. The court stated that "Plaintiff's counsel carelessly—or cleverly—led the Court to believe" that the CW had knowledge that was personal and current throughout 2007, when in fact it was not. The plaintiffs' counsel never met with or interviewed the CW to evaluate his credibility, and their "laundry list of explanations and excuses [was] itself disturbing." However, the court found that because the investigator had misleadingly reported the factual support the plaintiffs relied on for the complaint, the plaintiffs' conduct was merely careless and did not warrant sanctions.

The Seventh Circuit addressed the issue of sanctions in *Boeing*, discussing the plaintiffs' lack of diligence and noting that counsel's failure to inquire into a "red flag" raised by their investigator was akin to "ostrich tactics," "reveal[ing] stronger evidence of their scienter regarding the authenticity of the confidential source than the flimsy evidence of scienter they were able to marshal against Boeing." It stated "[r]epresentations in a filing in a federal district court that are not grounded in an 'inquiry reasonable under the circumstances' or that are unlikely to 'have evidentiary support after a reasonable opportunity for further investigation or discovery' violate" Rule 11. The court also noted that plaintiffs' counsel was the same law firm criticized for similar conduct in *SunTrust* and several other cases. Despite all this, the court found that whether to assess sanctions was more properly the province of the district court and thus remanded.

## Conclusion

A securities fraud defendant fighting a complaint with potentially false CW allegations faces a difficult, but not impossible, path to resolution. For the most part, courts are reluctant to consider disputes regarding the accuracy of CW allegations in the context of a motion to dismiss, although they seem to be more receptive to such evidence in the context of a motion for reconsideration. And, while courts do not seem eager to impose sanctions, even in the case of repeat offenders, if more examples of such misconduct arise, courts will, presumably, become more receptive to defense arguments on the issue and more willing to punish offenders.

**Keywords:** litigation, securities, confidential witness, securities class action, PSLRA, motion to dismiss

[John Pernick](#) is a partner and [Ryan Nassau](#) is an associate in the San Francisco, California, office of Bingham McCutchen, LLP.

## Foreign Law Securities Fraud Claims in U.S. Courts after *Morrison*

By Matthew L. Mustokoff and Margaret E. Onasch

The U.S. Supreme Court's 2010 decision in [\*Morrison v. National Australia Bank Ltd.\*](#), 130 S. Ct. 2869 (2010), dealt a landmark blow to investors who purchase securities on non-U.S. exchanges, holding that the antifraud provisions of the federal securities laws do not apply to losses suffered in overseas transactions. As a result, the U.S. courts have effectively been closed to these investors. Recently, however, one district court refused to cede its jurisdiction in a case involving foreign-listed securities given the case's other connections to the United States. [District Court Judge Keith Ellison](#) of the Southern District of Texas issued a milestone decision in the BP *Deepwater Horizon* oil spill litigation in which the court sustained common-law fraud claims premised on shareholder losses on the London Stock Exchange. [\*In re BP p.l.c. Secs. Litig.\*](#), MDL No. 10-md-2185, Civ. Act. No. 4:12-cv-1837 (S.D. Tex. Sept. 30, 2013). The decision illustrates that there is still a role for the common law in the vindication of investor rights after *Morrison*.

The plaintiffs, three public pension funds, alleged that BP made fraudulent representations regarding its implementation of process safety reforms following a 2005 incident at its Texas City refinery, which resulted in 15 deaths, as well as statements that falsely understated the flow rates of oil spewing into the Gulf of Mexico following the April 2010 explosion onboard the *Deepwater Horizon* rig. These plaintiffs, which purchased shares of BP abroad, were left without a remedy under federal securities law in the wake of *Morrison*. Judge Ellison sustained the large majority of the plaintiffs' claims, upholding allegations that BP plc (the U.K.-incorporated parent company of BP), BP Exploration & Production, Inc. (BP's U.S. subsidiary), and several senior BP executives made 27 false and misleading statements between 2007 and 2010. Many of these statements gave rise to so-called "foreign-squared" claims, i.e., claims against a foreign defendant and premised on foreign-traded or foreign-listed securities. The key aspects of the court's opinion are discussed below.

### The Court Applies English Law

As an initial matter, the court engaged in a choice-of-law analysis to determine whether Texas or English law should govern the plaintiffs' common-law claims. At BP's urging, Judge Ellison applied English law. The most significant factors swaying the court in this determination included the fact that the shares at issue were purchased in England (on the London Stock Exchange) and that the only face-to-face encounters between plaintiffs' investment advisors and BP executives occurred during a series of meetings in London. The court also identified the factors militating against application of Texas law, including that the various pension fund plaintiffs are based in three different states (but none in Texas) and that the alleged misstatements were not predominantly made in Texas (several were made in Massachusetts, Washington, D.C., and Louisiana, as well as England). The court thus determined that England had the most significant relationship to the plaintiffs' claims and applied English law.

### **Forum Non Conveniens Dismissal Not Warranted**

Notwithstanding the court's application of English law, Judge Ellison rejected BP's contention that the court should decline to exercise jurisdiction over the plaintiffs' claims under the doctrine of forum non conveniens, whereby courts may refuse to assert jurisdiction in cases where there is a more appropriate, available forum. BP contended that the case raised issues of first impression under English law and that it would therefore be more appropriate for the case to be heard by an English court. The court rejected BP's bid to send the case overseas, holding that it was "certainly capable of applying English law, which shares so many strong similarities with U.S. law due to a common heritage." The court further reasoned that because it also had jurisdiction over (1) some of the pension funds' federal securities claims based on purchases of BP American Depositary Receipts (ADRs) on the New York Stock Exchange—separate but related claims that were not barred by *Morrison*—and (2) the concurrently pending federal securities class action arising out of the *Deepwater Horizon* oil spill brought on behalf of ADR purchasers, it would be more practical to retain jurisdiction over *all* of the plaintiffs' claims, stating, "[i]t would be inefficient to send these claims to England, when nearly the same issues will be adjudicated here in the Class Action and in individual actions asserting [federal Securities] Exchange Act claims."

### **Departure from New York Appellate Decision**

Judge Ellison's ruling on forum non conveniens is significant given its departure from a New York state appellate decision issued one year earlier. In [\*Viking Global Equities, LP v. Porsche Automobil Holding SE\*](#), 101 A.D.3d 640 (N.Y. App. Div. 2012), the New York Appellate Division reversed New York County Supreme Court Justice Charles Ramos's 2012 decision to maintain jurisdiction over a fraud case against a German company involving German-traded securities but alleging misconduct in New York. The Appellate Division found that because the plaintiffs failed to plead a sufficient nexus with New York, the case did not belong in the U.S. courts; accordingly, the court dismissed the case. In reaching this decision, the court noted that the defendants and most of the plaintiffs were not New York residents, the stock at issue was traded only on foreign exchanges, and many of the witnesses and documents were located in Germany, which had "stated its interest in the underlying events" through the initiation of a regulatory enforcement action and "provides an adequate alternative forum." By contrast, in *BP*, Judge Ellison highlighted the "unquestionably local" nature of the conflict, emphasizing that "[t]he oil spill which prompted these claims occurred only 50 miles off the coast of Louisiana, in the Gulf of Mexico" and "[t]he majority of the misrepresentations alleged by Plaintiffs touch on the adequacy of, and the attention paid to, the safety of BP's U.S. operations, conducted largely by its U.S. subsidiaries based in this very district" (emphasis in original).

### **Constitutional Challenge and *Morrison* Arguments Mooted by Application of English Law**

Having determined to apply English law, the *BP* court held that it need not reach the defendants' argument that the plaintiffs' common-law claims (pled under Texas law) were barred by the dormant [Commerce Clause](#) of the U.S. Constitution. In its motion to dismiss, BP asserted that the dormant Commerce Clause bars the extraterritorial application of *state* law to claims based on securities transactions on foreign exchanges because such an application would create a

substantial risk of conflicts with foreign governments and undermine the ability of the federal government to “speak with one voice in regulating commercial affairs with foreign states.” BP further argued that even though *Morrison* (a case decided under federal law) does not technically apply to the plaintiffs’ common-law claims, the *Morrison* Court’s preclusion of recovery for investors on foreign stock exchanges under U.S. law demonstrates the policy imperative of deference to foreign governments in the regulation of overseas securities transactions and enhances the dormant Commerce Clause concerns presented by the plaintiffs’ suit.

Rejecting these arguments, Judge Ellison concluded that with the application of English law, there is no conflict between U.S. state and federal law, thus eliminating the federalism concerns that underlie the dormant Commerce Clause. By logical extension, the court did not address the policy implications of *Morrison*, as it had determined to apply foreign law to the foreign securities transactions at issue.

#### **Actual Reliance Required—No “Fraud on the Market” under English Law**

Applying English law, the court sustained the plaintiffs’ allegations on the merits. Of particular note, the court held that the plaintiffs adequately pled the common-law element of actual reliance. English common law has no analogue to the “fraud on the market” presumption of reliance for stocks purchased in an efficient market recognized under the federal securities laws. Therefore, Judge Ellison found, to satisfy the reliance element of their fraud claims under English common law, plaintiffs are required to plead that they actually relied to their detriment on defendants’ misstatements, or so-called eyeball reliance.

In addressing the plaintiffs’ reliance allegations, Judge Ellison recognized that the Court of Appeals for the Fifth Circuit, as well as other district courts within the Fifth Circuit, have held or strongly suggested that the heightened pleading requirements set forth in [Rule 9\(b\)](#) of the Federal Rules of Civil Procedure extend to allegations of actual reliance. Notwithstanding his personal skepticism as to whether the Rule 9(b) standard should apply to the reliance element, Judge Ellison followed Fifth Circuit precedent and applied Rule 9(b). Even under this more exacting standard, however, the court deemed sufficient the plaintiffs’ allegations of reliance on BP’s misstatements. Specifically, the court found that the plaintiffs’ identification of the months within which they purchased BP shares, among other allegations, was sufficient to satisfy this requirement at the pleading stage with respect to any misrepresentation made prior to each plaintiff’s final purchase. The court noted that the plaintiffs would not be relieved of their ultimate burden to *prove* actual reliance in order to recover damages at trial, stating that “any deficiency in the element of actual reliance is best tested on a full record, not on the pleadings.”

#### **Conclusion**

In *BP*, the Southern District of Texas permitted three investors in foreign-traded stocks to pursue common-law fraud claims—claims that are otherwise barred under federal securities law following *Morrison*. Although the *BP* ruling turned on the unique facts and circumstances of the case, not the least of which was the existence of a concurrent federal class action based on the same fraud and proceeding in the same court, it provides a notable post-*Morrison* precedent

establishing that where there is a significant nexus with the United States—including U.S.-based defendants and/or fraudulent statements touching on U.S. business operations—a U.S. court may exercise its jurisdiction over common-law claims premised on foreign securities purchases, even in cases governed by foreign law.

**Keywords:** litigation, securities, common law, fraud, reliance, BP *Deepwater Horizon*

[Matthew L. Mustokoff](#) is a partner and [Margaret Onasch](#) is an associate with Kessler Topaz Meltzer & Check LLP in Radnor, Pennsylvania. Mr. Mustokoff serves as cochair of the ABA Committee on Securities Litigation’s Class Actions and Derivative Suits Subcommittee.

## A Review of *Trados* and Its Impact

By Juan E. Monteverde

Six months ago, Delaware Vice Chancellor Laster issued a post-trial opinion in [\*In re Trados Inc. Shareholder Litigation\*](#), 73 A.3d 17 (Del. Ch. Aug. 16, 2013), which sparked a great deal of interest. In *Trados* the court held that management directors, the directors appointed by the venture capital (VC) investors, and one ostensibly independent director with strong ties to another VC were personally interested in a merger transaction that triggered payments on the preferred stock to VC investors while paying common stockholders nothing. Moreover, the court found the board had wrongfully considered only the interests of the preferred stockholders, to the exclusion of common stockholders, and failed to institute any procedural safeguards for common shareholders in approving the merger. These facts combined to require application of the entire fairness standard of review. Even though the court found the board's process was procedurally unfair, it nevertheless found the transaction satisfied the entire fairness standard based on price alone.

On these facts, *Trados* appeared to expand the application of the entire fairness standard of review in a typical VC start-up transaction, while simultaneously relaxing that application of that review. The *Trados* opinion was seen as presenting challenges and opportunities for both plaintiffs and defendants in Delaware merger-and-acquisition litigation. As a result, *Trados* sparked numerous articles and significant debate among both the plaintiff and defense bars. Now, six months later, it appears that Vice Chancellor Laster's opinion in *Trados* has had little application in subsequent opinions and has left many to wonder about the future of Delaware's entire fairness standard.

### The Factual Background

Trados, Inc., founded in 1984, began several rounds of VC financing through the issuance of preferred stock in 2000. The VC investors were issued convertible preferred shares with what has become "standard features of VC preferred stock:" (1) a liquidation preference payable upon a change-of-control transaction; (2) voting rights identical to common shares on an as-converted basis; (3) certain other customary VC control rights, including the veto right over change-in-control transactions; and (4) certain of the VC investors received the power to designate representatives to the Trados board. As a result of these features, the VC investors collectively controlled a majority of the voting power on an as-converted basis and held the power to elect the majority of the board.

In the years leading up to the merger, the company showed the ability to generate revenue but could not achieve meaningful profitability. Thus, by 2004, Trados was "neither a complete failure nor a stunning success." Consequently, the VC directors updated the partners at their respective VC firms throughout this period and advised them that although an exit was achievable, they were not likely to see significant returns on their investments.

Against this background, in July 2004 the board hired a new chief executive officer (CEO). The board also approved a management incentive plan that gave senior executives, including the newly appointed CEO, an incentive to pursue a sale of Trados by offering management an increasing percentage of the total sales proceeds as the sales price increased—*even if the ultimate sale paid nothing to common shareholders*. Also in 2004, the board rejected an initial \$40 million acquisition proposal from SDL plc, which it considered too low, because it was well below the VC investors' liquidation preference at that time.

The new CEO advised the board that the company had two options: Either Trados and its VC investors could invest additional capital (either debt or equity) to reposition its core business for growth in the enterprise sector, or the company could focus on a potential sale or merger transaction as an exit strategy for the VCs. Although additional investment in Trados as a stand-alone enterprise may have permitted the company to generate a modest return, it did not appear to offer a realistic opportunity for the “stunning success” sought by VC investors that would provide meaningful returns for both them and common shareholders. Thus, the board focused on an exit strategy for the VCs. However, as noted by Vice Chancellor Laster, because VC investors in “sales often exit as preferred shareholders with liquidation preferences that must be paid in full before common shareholders receive any payout, common shareholders may receive little (if any) payout. At the same time, the sale eliminates any ‘option value’ (upside potential) of the common stock.”

Ultimately, in June 2005, Trados agreed to be acquired by SDL for \$60 million in cash. Owing to the terms of the management incentive plan, the first \$7.8 million of proceeds went to the management directors and other employees. The remaining \$52.2 million went to the VC investors to satisfy their total combined liquidation preference of the preferred stock of \$57.9 million. Without the management incentive plan payments to management, the common stockholders would have been entitled to \$2.1 million in proceeds *but instead received nothing*. The merger agreement was approved by the required percentages of the preferred stock and the common stock, with the VC investors owning enough of the preferred stock to approve the merger on their own.

The plaintiff, a common stockholder, initially brought an action for appraisal of his shares but later brought a second action alleging a breach of the fiduciary duty of loyalty as a result of discovery during the appraisal action. The plaintiff alleged that the board ignored the interests of the common stock by focusing entirely on achieving an exit that would benefit the preferred stockholders, despite the fact that the company could have continued to operate profitably as a stand-alone entity and thereby generate value for common shareholders.

### **The Two Core Holdings**

**A majority of the board was interested in the outcome of the merger.** At the time of the merger with SDL, the board consisted of seven directors, including two management directors, three VC-appointed directors, and two ostensibly outside directors. The court

pointed out that “[t]here is nothing inherently pernicious” in the typical VC structure employed by many start-up businesses. Yet, following extensive discussion, it found that the three VC directors acted as “fiduciaries for VC funds that received disparate consideration in the Merger in the form of a liquidation preference.” Therefore, each of the VC directors “faced the dual fiduciary problem” or conflict inherent in conflicting fiduciary duties. *Trados*, 73 A.3d (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983)). Similarly, the court found the two management directors received material personal benefits in the merger that likewise rendered them “interested in the decision to approve the [m]erger.” *Id.* at 45.

Perhaps most notably, the court went on to review the independence and disinterestedness of the purportedly independent directors. After a discussion of the “web of interrelationships that characterizes the Silicon Valley startup community,” *id.* at 54, Vice Chancellor Laster found that one of the two ostensibly independent directors was likewise interested in the outcome of the merger by virtue of his business relationships with two of the VC directors and his beneficial ownership of preferred stock of Trados. Thus, the court found that six of the seven directors were interested in the merger, which required application of the “entire fairness” standard to the evaluation of the merger and the directors’ actions.

**The entire fairness standard applied to the merger.** Because a majority of the board was interested in the merger, the court applied “[e]ntire fairness, Delaware’s most onerous standard” for reviewing the transaction. The *Trados* court explained that once entire fairness applies, the defendants must establish “to the court’s satisfaction that the transaction was the product of both fair dealing *and* fair price.” *Id.* at 44 (quoting *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1163 (Del. 1995)) (emphasis in original, internal quotation marks omitted in original).

The court found that the defendants failed to establish that the merger was the product of fair dealing. Specifically, the court found that the board failed to recognize its inherent conflicts, consider the interests of the common shareholders, or implement any procedural protections whatsoever for common shareholders. Nevertheless, based on extensive expert testimony, the court ruled that the transaction ultimately passed review for entire fairness based on fair price alone, finding the common stock had zero value before the merger and that is exactly what the common shareholders received in the merger.

Vice Chancellor Laster explained that fair dealing “embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained,” while fair price “relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s

stock.” *Id.* at 56 (quoting *Weinberger*, 457 A.2d at 711). The court went on to conduct a holistic analysis stating “the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.” *Id.*

Thus, in the guise of a holistic analysis of entire fairness, the *Trados* court became the first Delaware court to find a transaction unfair because of the process by which it was negotiated, yet still hold that it satisfied the entire fairness standard based on price alone—even though the merger provided no value whatsoever to common shareholders.

### **Entire Fairness after *Trados***

The *Trados* opinion prompted immediate responses from practitioners, both from the plaintiff and defense bars. It raised concerns for VC investors that a typical VC start-up structure could subject VC investors to litigation and liability under the entire fairness standard of review. Likewise, for common shareholders, it generated concern that the entire fairness standard had been significantly weakened, where a merger with no procedural safeguards for common shareholders whatsoever can be approved on price alone—even where the entire sales price is divided between management and VC investors, leaving nothing for common shareholders.

In the six months following the issuance of *Trados*, Vice Chancellor Laster’s opinion has not yet demonstrated significant impact. Indeed, the opinion has been cited in only one published opinion, *Pfeiffer v. Leedle*, No. C.A. 7831-VCP (Del. Ch. Nov. 8, 2013), and only with respect to a general statement regarding the business judgment rule, and has been mentioned in passing in only two scholarly journals. See Brian Broughman & Jesse M. Fried, “[Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups](#),” 98 *Cornell L. Rev.* 1319, 1346 n.86 (2013); Michelle N. Harner, “[A More Realistic Approach to Directors’ Duties](#),” 15 *Transactions* 15, 17 n.8 (2013). Moreover, since the issuance of *Trados*, eight published Delaware opinions have discussed the entire fairness standard, none of which cited *Trados*. So far the *Trados* opinion has not had the impact some predicted, leaving investors and their counsel to wonder whether this decision will have a significant influence on Delaware transactional litigation or whether it is one more example of the age old adage that “bad facts can make bad law.”

**Keywords:** litigation, securities, entire fairness standard, *In re Trados*

[Juan E. Monteverde](#) is a partner in the New York City, New York, office of Faruqi & Faruqi, LLP.

**NEWS & DEVELOPMENTS**

## **FINRA Proposes Revisions to Definition of "Public Arbitrator"**

FINRA recently proposed new limitations regarding who can serve as a "public" arbitrator under the Customer and Industry Codes of Arbitration Procedure. The rule amendments would prohibit anyone who has worked in the securities industry at any time from ever being classified as a public arbitrator. FINRA's current rules allow individuals who have been out of the industry for at least five years to serve as public arbitrators.

In addition, professionals who represent investors or the financial industry as a "significant part of their business" would also be defined as non-public arbitrators. Current rules allow professionals whose firm has not derived 10 percent or more of its income over the past two years from the financial industry to serve as public arbitrators. Unlike those who worked directly in the industry, these professionals under the proposed amendments would be eligible to serve as public arbitrators after an unspecified "cooling off period." FINRA chairman and CEO Richard Ketchum called the amendments "a very balanced response to concerns on both sides" about how arbitrators are classified. The proposed amendments are being filed with the SEC for approval.

—[\*Joshua D. Jones\*](#) and [\*Joel M. Everest\*](#), *Bressler, Amery & Ross PC, Birmingham, AL*

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## **NERA Releases 2013 Securities Class Action Report**

On January 21, 2014, National Economic Research Associates (NERA) released its annual report, "[Recent Trends in Securities Class Action Litigation: 2013 Full-Year Review](#)," subtitled "Large Settlements get larger; small settlements get smaller." The subtitle is a reference to divergent settlement trends, with the average settlement amount reaching a record high while the median settlement amount decreased in comparison to 2012.

The report found a small increase in the number of complaints filed in 2013, both for securities class actions in general—which it defined broadly as "class actions filed in federal courts that involve securities"—and for Rule 10b-5 cases in particular. There was a 10 percent increase over securities cases filed in 2012, and a 15 percent increase in actions alleging violations of Rule 10b-5, Section 11, or Section 12. These "standard" filings were more numerous than in any year since 2008.

As in past years, the bulk of the filings were in the Second or Ninth Circuit, which together accounted for 53 percent of the total. No other circuits came close, but the Fifth Circuit did see twice as many filings in 2013 as in 2012—up from 12 to 25. The percentage of filings against

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foreign issuers dropped slightly from 2012, and remained roughly in proportion to the percentage of listings represented by foreign companies.

The breakdown of filings by industry remained roughly constant, with the finance sector as a primary defendant in 15 percent of cases. This number has fallen significantly since 2008, when that sector accounted for almost half of all securities class action filings. NERA reports that accounting firms were codefendants in only 2.1 percent of actions, which is consistent with the numbers from 2010 onward. The report hypothesizes that this may be due to the Supreme Court's decisions in *Stoneridge Inv. Partners, LLC v. Sci.-Atlanta, Inc.* in 2008 and *Janus Capital Group, Inc. v. First Derivative Traders* in 2011.

Forty-one percent of the complaints surveyed contained allegations regarding misleading earnings guidance, a sharp jump from the past few years. Another notable change from 2012 was the accelerated median filing time: half the cases were filed within 16 days of the end of the class period. Those cases not filed during that brief window were filed more slowly than in years past. The average time for filing—139 days—rose from 2012 numbers.

Motions to dismiss were filed in 95 percent of the cases. Where the court reached a decision, 48 percent were granted with prejudice, 6 percent were granted without prejudice, 25 percent were granted in part, and 21 percent were denied outright. Seventy-three percent of all cases were settled or dismissed before any motion for class certification was filed. For the remaining twenty-three percent of cases, the court reached a decision on class certification a little more than half of the time (56 percent), which equates to a class certification decision issued in approximately 15 percent of all securities class actions. Notably, courts deciding the issue granted certification 77 percent of the time. NERA cautioned that the vast majority of the decisions on a motion for class certification precede the Supreme Court's decisions in *Erica P. John Fund, Inc. v. Halliburton Co.* and *Amgen, Inc. v. Connecticut Retirement Plans and Trust Funds*, which are likely to have a significant impact. NERA reports the median time for a decision on class certification from the date of filing a complaint is almost two and a half years.

—[Mollie Kornreich](#) and [Patrick G. Rideout](#), *Skadden Arps, New York, NY*

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