SIMPSON THACHER

SECURITIES LAW ALERT

OCTOBER 2010

This month's edition of the Securities Law Alert addresses: the Fifth Circuit's reinstatement of insider trading charges against Mark Cuban; the two securities cases on the Supreme Court's docket for October Term 2010, one addressing the scope of secondary actor liability under Section 10(b) and the other concerning the disclosure obligations of pharmaceutical companies with respect to non-statistically significant adverse events; the Southern District of New York's denial of a motion to dismiss in a major subprime-related class action against Sallie Mae; a Delaware Chancery Court decision considering the reasonableness of a merger termination fee; and the most recent jurisprudence applying the Supreme Court's ruling in *Morrison v. National Bank*.

## The Fifth Circuit Revives the SEC's Insider Trading Charges Against Mark Cuban

In a headline-making decision this past September, the Fifth Circuit reinstated the Securities & Exchange Commission's ("SEC's") insider trading case against Mark Cuban, owner of the Dallas Mavericks and a well-known entrepreneur. The ruling reversed the August 2009 Northern District of Texas decision dismissing the charges.

At issue in the case is Cuban's 2004 sale of a six percent stake in Mamma.com, a web search engine. Cuban's only relationship with the company was as an investor; he had no role in Mamma.com's management, governance or operations. Given Cuban's substantial investment in the company, Mamma.com's Chief Executive Officer ("CEO") provided Cuban with advance notice of the company's confidential plans to raise capital through a private investment in public equity ("PIPE") offering. Within a day of this conversation and prior to the public announcement of the offering, Cuban sold his entire equity stake in Mamma.com. The sale enabled Cuban to avoid more than $750,000 in losses.

### The SEC Brings Insider Trading Charges Against Cuban Under the Misappropriation Theory

The SEC charged Cuban with insider trading under the misappropriation theory of liability articulated in *United States v. O'Hagan*, 521 U.S. 642 (1997) and SEC Rule 10b5-2(b)(1). While the classical theory of insider trading governs cases where "a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information," the misappropriation theory extends the scope of insider trading liability to situations where a person "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." *U.S. v. O'Hagan*, 521 U.S. at 651-52. "[T]he misappropriation

This edition of the Securities Law Alert was edited by Peter E. Kazanoff (pkazanoff@stblaw.com/212-455-3525) and Jonathan K. Youngwood (jyoungwood@stblaw.com/212-455-3539).

theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." *Id*. at 652.

Three years after the Court's ruling in *O'Hagan*, the SEC adopted Rule 10b5-2, entitled "Duties of Trust or Confidence in Insider Trading Misappropriation Cases." Subsection (b)(1) of this rule provides that a "duty of trust or confidence" exists for purposes of the misappropriation theory of insider trading liability "[w]henever a person agrees to maintain information in confidence." 17 C.F.R. § 240.10b5-2 (b)(1).

In *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009) ("*Cuban I*"), the SEC contended that Cuban was "liable under the misappropriation theory based on a duty created by his agreement to keep confidential the information that Mamma.com's CEO provided him about the impending PIPE offering." *Id*. at 721. According to the SEC, "Cuban breached this duty when, without disclosing to Mamma.com his intent to trade in its stock based on the information, he sold his shares in the company." *Id*.

## The Northern District of Texas Limits the Reach of the Misappropriation Theory

The SEC's action against Cuban raised the broader question of when a company outsider may be held liable under the misappropriation theory of insider trading liability. What triggers an outsider's duty to refrain from using confidential information for trading purposes? The Northern District of Texas concluded that "a duty sufficient to support liability under the misappropriation theory can arise by agreement absent a preexisting fiduciary or fiduciary-like relationship." *Id*. at 725. However, the court determined that an agreement to keep information confidential—standing alone—is insufficient to give rise to such a duty. Rather, the relevant agreement "must also impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain." *Id*.

Under *Cuban I*, "a person must undertake, either expressly or implicitly, both obligations. He must agree to maintain the confidentiality of the information *and* not to trade on or otherwise use it." *Id*. Unless an outsider has agreed to both nondisclosure *and* non-use, the outsider has no duty to refrain from trading on the confidential information shared. "Absent a duty not to use the information for personal benefit, there is no deception in doing so." *Id*.

Based on this analysis, the court found that the SEC had exceeded its authority under Section 10(b) in enacting Rule 10b5-2(b)(1). *Id*. at 730-31. "Because Rule 10b5-2(b)(1) attempts to predicate misappropriation theory liability on a mere confidentiality agreement lacking a non-use component," the court held that the SEC "cannot rely on it to establish Cuban's liability." *Id*. at 730-31.

## The Court Dismisses the SEC's Charges Against Cuban

Reviewing the complaint against the standards articulated in the decision, the Northern District of Texas determined that the SEC had failed to state a claim because there was no allegation that Cuban undertook an obligation of non-use with respect to news of Mamma.com's planned PIPE offering. The

court found that "while the SEC adequately pleads that Cuban entered into a confidentiality agreement," the complaint "does not allege that he agreed, expressly or implicitly, to refrain from trading or otherwise using for his own benefit the information the CEO was about to share." *Id*. at 728.

The complaint alleged that during Cuban's phone call with the CEO regarding the offering, Cuban stated: "Well, now I'm screwed, I can't sell." *Id*. The Northern District of Texas found that this simply "express[ed] [Cuban's] *belief* … that it would be illegal for him to sell his Mamma.com shares based on the information the CEO had provided." *Id*. (emphasis added). "This statement … cannot reasonably be understood as an *agreement* not to sell based on the information" shared during the call. *Id*. (emphasis added).

The complaint also alleged that the CEO believed that Cuban did not intend to sell his shares until after a public announcement of the PIPE offering. *Id*. For example, the complaint quoted an email from the CEO to the Mamma.com board stating that "'[Cuban] said he would sell his shares (recognizing that he was not able to do anything until we announce the equity).'" *Id*. The court found these allegations similarly insufficient to evidence the existence of an agreement of non-use: "Outside a fiduciary or fiduciary-like relationship, a mere unilateral expectation on the part of the information source—one that is not based on the other party's agreement to refrain from trading on the information—cannot create the predicate duty for misappropriation theory liability." *Id*.

## The Fifth Circuit Reverses on Narrow Grounds

The Fifth Circuit vacated the original judgment of dismissal and remanded the Cuban case to the Northern District of Texas for discovery and further proceedings. *SEC v. Cuban*, No. 09-10996, 2010 WL 3633059 (5th Cir. Sept. 21, 2010) ("*Cuban II*"). In reversing the dismissal, the Fifth Circuit took a far more expansive view of the allegations in the SEC's complaint against Cuban than the court in *Cuban I*: "The allegations, taken in their entirety, provide more than a plausible basis to find that the understanding between the CEO and Cuban was that he was not to trade, that it was more than a simple confidentiality agreement." *Id*. at *5.

The Fifth Circuit emphasized the fact that after Cuban's conversation with Mamma.com's CEO regarding the PIPE offering, Cuban requested pricing information: "It is at least plausible that each of the parties understood, if only implicitly, that Mamma.com would only provide the terms and conditions of the offering to Cuban for the purpose of evaluating whether he would participate in the offering, and that Cuban could not use the information for his own personal benefit." *Id*.

Significantly, the Fifth Circuit limited its review to the face of the complaint. The *Cuban II* court expressly declined to address the larger questions of when a duty to refrain from using confidential information for trading purposes arises under the misappropriation theory of liability or whether Rule 10b5-2(b)(1) exceeds the scope of the SEC's rulemaking authority:

> Given the paucity of jurisprudence on the question of what constitutes a relationship of 'trust and confidence' and the inherently fact-bound nature of determining whether such a duty exists, we decline to first determine or place our thumb on the scale in the district court's determination of its presence or to now draw the contours of any liability that it might bring, including the force of Rule 10b5-2(b)(1).

*Id*.

While the Fifth Circuit's decision marks a victory for the SEC in its dispute with Cuban, there remains limited appellate guidance on the type of duty that triggers insider trading liability under the misappropriation theory, or the validity of Rule 10b5-2(b)(1).

# The Supreme Court Will Consider Two Securities Cases in October Term 2010

The Court has demonstrated a heightened interest in securities cases in recent years, and the upcoming term proves no exception. On the docket are two securities cases of interest: *Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525, (U.S. petition for cert. filed Oct. 30, 2009) ("*Janus II*") and *Matrixx Initiatives Inc. v. Siracusano*, No. 09-1156, (U.S. petition for cert. filed Mar. 23, 2010) ("*Matrixx III*").

*Janus II* addresses the scope of secondary actor liability under Section 10(b). As discussed in further detail below, the Fourth Circuit decision appealed from in *Janus II* found that an investment adviser to a family of mutual funds could be primarily liable under Section 10(b) for helping to prepare the mutual fund prospectuses, even though the prospectuses were not actually attributed to the investment adviser. The Court's decision in *Janus II* may have far-reaching ramifications not only for investment advisers to mutual funds, but also for other secondary actors—such as lawyers and accountants—who play a role in preparing an issuer's offering materials.

*Matrixx III* concerns the question of whether a pharmaceutical company can be held liable under Section 10(b) for failing to disclose adverse event reports that are not alleged to be statistically significant. The decision will likely provide guidance to pharmaceutical companies, who often face thousands of such reports each year. (In 2008 alone, for example, consumers filed more than 525,000 adverse event reports with the Food and Drug Administration.)

## The Court May Clarify the Boundaries of Secondary Actor Liability Under Section 10(b)

In *In re Mutual Funds Investment Litigation*, 566 F.3d 111 (4th Cir. 2009) ("*Janus I*"), the Fourth Circuit considered the question of when an investment adviser to a family of mutual funds can be held liable under Section 10(b) for alleged misstatements and omissions in the mutual fund prospectuses.

Class members in the action had purchased shares of Janus Capital Group Inc. ("JCG") common stock. JCG is the parent company for the Janus family of mutual funds; JCG's wholly-owned subsidiary, Janus Capital Management LLC ("JCM"), is the investment adviser to the Janus funds. JCG, JCM and the Janus mutual funds are distinct legal entities. Consistent with standard practice in the mutual fund industry, JCM handles the day-to-day management and supervises the operations of the Janus mutual funds.

The case concerns the accuracy of disclosures regarding market timing practices at the Janus funds. According to the plaintiffs, "statements about market timing appearing in the various Janus fund prospectuses were misleading because they falsely represented that the Janus funds had policies of preventing market timing when, in fact, fund managers explicitly permitted significant market timing and late trading to occur." *Id.* at 116. While the plaintiffs did not purchase shares of the Janus funds, the plaintiffs claimed that misstatements in the Janus fund prospectuses artificially impacted the value of JCG shares. The plaintiffs alleged that they "bought JCG shares at inflated prices and thereafter lost money

when market timing practices authorized by JCG and JCM became known to the public." *Id*. at 115.

Neither JCG nor JCM is specifically listed as the author of any of the Janus fund prospectuses at issue. The Fourth Circuit acknowledged that "the individual fund prospectuses are unattributed on their face." *Id*. However, the court found that "the clear essence of plaintiffs' complaint is that JCG and JCM *helped draft* the misleading prospectuses." *Id*. (emphasis added). The court further determined that the statements in the complaint, viewed as a whole, alleged that JCG and JCM "*participat[ed] in* the writing and dissemination of the prospectuses." *Id*. (emphasis added). Based on these claims, the Fourth Circuit concluded that the complaint adequately alleged that JCG and JCM had "*made* the misleading statements" in the prospectuses for purposes of Section 10(b) liability. *Id*.

The court then turned to the question of attribution: were the statements in the Janus fund prospectuses "sufficiently attributable to JCG and JCM" under Section 10(b)? *Id*. at 121. Declining to adopt a clear-cut rule, the court held that "the attribution determination is properly made on a case-by-case basis by considering whether interested investors would attribute to the defendant a substantial role in preparing or approving the allegedly misleading statement." *Id*. at 124. The *Janus I* court concluded that this standard was met with respect to JCM:

> [G]iven the publicly disclosed responsibilities of JCM [as the funds' investment adviser], interested investors would infer that JCM played a role in preparing or approving the content of the Janus fund prospectuses, particularly the content pertaining to the funds' policies affecting the purchase or sale of shares.

*Id*. at 127. However, the court determined that the attribution analysis failed with respect to JCG, because it would not necessarily be "apparent to the investing public that the investment adviser's parent company, which sponsors a family of funds, participates in the drafting or approving of prospectuses issued by the individual funds." *Id*. at 127-28.

The Janus defendants successfully petitioned the Supreme Court for a writ of certiorari on two key questions raised by the Fourth Circuit's decision in *Janus I*: First, can a service provider be held primarily liable in a private securities fraud action for "helping" or "participating in" another company's misstatements? *See* Petition for a Writ of Certiorari at i, *Janus II* (No. 09-525). Second, can a service provider face primary liability for statements that were not "directly and contemporaneously attributed to the service provider"? *Id*.

### 1. Can a Service Provider Be Liable for Participating in Another Company's Misstatements?

In their petition for certiorari, the Janus entities challenged the Fourth's Circuit's decision as tantamount to resurrecting private aiding-and-abetting claims foreclosed by the Court's holdings in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) and *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008). *See* Petition for a Writ of Certiorari at 8, *Janus II* (No. 09-525) (contending that the Fourth Circuit contravened the Supreme Court's pronouncements that there is no private right of action under Rule 10b-5 for aiding and abetting or "helping" securities fraud). The Janus entities asserted that the ruling threatens to open the floodgates for securities suits against a wide range of secondary actors—including banks, lawyers and accountants—based on their roles in "helping" or "participating in" an issuer's preparation of its offering materials. *See id*. at 19-20. Even limiting the decision to the specific facts of the case, the Janus entities contended that the Fourth Circuit's ruling stands for the proposition that *every* investment adviser could be held primarily

liable for statements in the prospectuses of the funds it advises—a "breathtaking expansion of liability in an industry that manages more than $10 trillion in assets." Reply Brief for Petitioners at 10, *Janus II* (No. 09-525).

The United States Government, as amicus curiae in the action, argued that the Fourth Circuit's decision "properly took account of the unique and close relationship between a mutual fund and its investment adviser" in determining whether JCM itself made the misstatements in the Janus fund prospectuses. Brief for the United States as Amicus Curiae at 8, *Janus II* (No. 09-525). In contrast to typical service providers (such as lawyers and accountants), the Government argued that "an investment adviser's unique and close relationship with the fund makes it essentially a corporate insider." *Id*. at 9.

The Government took the position that "a defendant who has participated to a sufficient degree in the drafting or dissemination of misleading statements can be primarily liable under Section 10(b)." *Id*. at 11. The Government contended that because the defendants in *Stoneridge* "had no role in preparing or disseminating the allegedly false financial statements [at issue], the Court had no occasion to decide what type or degree of participation in the drafting or dissemination of such statements would be necessary to support primary liability." *Id*. (internal quotations and citations omitted). Both the SEC and the Solicitor General signed the Government's brief.

The Lead Plaintiff-Respondent, First Derivative Traders, responded to the petition for certiorari by downplaying the potential implications of the Fourth Circuit's decision. Emphasizing the "considerable overlap in the management structure of JCM and the Funds," the Lead Plaintiff-Respondent argued that the Fourth Circuit's ruling has no bearing on "the existing body of authority that holds that in most ordinary situations, outside professionals and service providers are not responsible to investors for misleading statements in an issuers' public filings." Brief in Opposition to Petition for Writ of Certiorari at 22, *Janus II* (No. 09-525).

## 2. Is Attribution a Requirement of Secondary Actor Liability?

The Fourth Circuit in *Janus I* acknowledged a disagreement among the circuits as to the "degree of attribution required to plead reliance." *Janus I*, 566 F.3d at 122. Both the Second and Eleventh Circuits have held that Section 10(b) "requires direct attribution of the allegedly misleading statement to the defendant." *Id.; see, e.g., Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) (finding that "in order for the defendant to be primarily liable under § 10(b) and Rule 10b-5, the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at the time that the plaintiff's investment decision was made"); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d. Cir. 1998) (holding that "a secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination").

The Ninth Circuit has reached the opposite conclusion, finding that "public attribution is not required to plead reliance; substantial participation

or intricate involvement in preparing the misleading statement is sufficient to state a primary violation of § 10(b)." *Janus I*, 566 F.3d at 123 (citing *In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615, 628-29 & n. 3 (9th Cir. 1994) and *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n. 5 (9th Cir. 2000)). And while the Tenth Circuit initially took what it perceived to be a middle ground approach, recent authority indicates support for the attribution rule. *See SEC v. Wolfson*, 539 F.3d 1249, 1258-60 (10th Cir. 2008) (explaining that "the attribution requirement … stems directly from the need for private litigants to prove reliance on an alleged fraud to succeed on a private cause of action") (emphases omitted).

A year and a half after the Fourth Circuit's decision in *Janus I*, while the petition for certiorari was pending, the Second Circuit in *PIMCO v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010) addressed the question of whether a corporation's outside counsel can be liable under Section 10(b) for "false statements that those attorneys allegedly create[d], but which were not attributed to the law firm or its attorneys at the time the statements were disseminated." *PIMCO v. Mayer Brown LLP*, 609 F.3d at 148. The Second Circuit rejected the argument—advanced by the SEC and the plaintiffs—that "a defendant can be liable for creating a false statement that investors rely on, regardless of whether that statement is attributed to the defendant at the time of dissemination." *Id.* at 151. Instead, the Second Circuit reaffirmed the validity of the bright-line attribution rule:

> [S]econdary actors can be liable in a private action under Rule 10b-5 for only those statements that are explicitly attributed to them. The mere identification of a secondary actor as being involved in a transaction, or the public's understanding that a secondary actor "is at work behind the scenes" are alone insufficient.

*Id*. at 155.

How the Supreme Court ultimately rules in *Janus II* will likely have significant implications not only for mutual fund investment advisers but also for the full range of secondary actors who play a role in the preparation of a company's offering materials and other public statements. We are following the case closely and will report further developments in future editions of the Securities Law Alert.

## The Court Will Consider Whether Pharmaceutical Companies Must Disclose Non-Statistically Significant Adverse Event Reports

The *Matrixx III* case raises the question of "whether drug companies have a duty to disclose 'adverse event' reports—i.e., reports by users of a drug that they experienced an adverse event after using the drug—where the reports do not reflect statistically significant evidence that the adverse event may be caused by use of the drug." Petition for Writ of Certiorari at 1-2, *Matrixx III* (No. 09-1156).

In *Siracusano v. Matrixx Initiatives, Inc.*, 585 F.3d 1167 (9th Cir. 2009) ("*Matrixx II*"), the Ninth Circuit reversed the dismissal of a Section 10(b) complaint alleging that the defendants had failed to disclose a potential link between Zicam—an over-the-counter cold remedy—and the loss of sense of smell (a condition known as "anosmia"). Physicians reported treating more than 150 patients allegedly suffering from Zicam-related anosmia, and multiple Zicam/anosmia-related product liability lawsuits were filed against Matrixx Initiatives. However, there was no statistically significant evidence that Zicam caused anosmia.

The district court dismissed the complaint on the grounds that the plaintiffs "failed to present evidence of a statistically significant correlation between the use of Zicam and anosmia so as to make the failure to publicly disclose complaints … a material omission." *Siracusano v. Matrixx Initiatives, Inc.*, No. CV040886(PHX MHM), 2005 WL 3970117, at *7 (D. Ariz. Dec. 15, 2005)

("*Matrixx I*"). The *Matrixx I* court relied on the Second Circuit's ruling in *In re Carter-Wallace, Inc. Securities Litigation*, 220 F.3d 36 (2d. Cir. 2000) ("*Carter-Wallace II*") to find that "adverse information related to the safety of a product is not material unless such reports provide reliable statistically significant evidence that a drug is unsafe." *Matrixx I*, 2005 WL 3970117, at *5. In an earlier decision in the Carter-Wallace litigation, the Second Circuit held:

> Drug companies need not disclose isolated reports of illnesses suffered by users of their drugs until those reports provide *statistically significant* evidence that the ill effects may be caused by—rather than randomly associated with—use of the drugs and are sufficiently serious and frequent to affect future earnings.

150 F.3d 153, 157 (2d Cir. 1998) ("*Carter-Wallace I*") (emphasis added).

In reversing the district court's decision, the Ninth Circuit found that the *Matrixx I* court had "erred in relying on the statistical significance standard to conclude that Appellants failed adequately to allege materiality." *Matrixx II*, 585 F.3d at 1178. The *Matrixx II* court determined that under *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the question of materiality cannot be resolved by bright-line rules. *Matrixx II*, 585 F.3d at 1178. Rather, the "determination of materiality requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him." *Id.* (*quoting Basic*, 485 U.S. at 236) (internal quotations and alterations omitted). Reviewing the complaint against this standard, the Ninth Circuit concluded that the plaintiffs' allegations supporting a possible (but not statistically significant) link between Zicam use and anosmia were "sufficient to meet the pleading requirement under the [Private Securities Litigation Reform Act]." *Id.* at 1179.

The defendants successfully petitioned the Supreme Court for certiorari, arguing that the Ninth Circuit's ruling conflicts with the decisions of three other circuits addressing the question of whether pharmaceutical companies can face securities fraud liability for the failure to disclose adverse event reports that are not alleged to be statistically significant. Petition for Writ of Certiorari at 2, *Matrixx III* (No. 09-1156). In *Avon Pension Fund v. GlaxoSmithKline PLC*, No. 08-4363-cv, 2009 WL 2591173 (2d Cir. Aug. 24, 2009), the Second Circuit relied on *Carter-Wallace I* to hold that GlaxoSmithKline PLC's failure to disclose "alleged cardiovascular risks associated with the drug Avandia" was neither misleading nor material because the test results demonstrating potential adverse effects were not "even statistically significant." *Avon v. GlaxoSmithKline*, 2009 WL 2591173 at *1. In *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000), the Third Circuit found that because there was no allegation of a "statistically significant relationship" between the pharmaceuticals at issue and valvular heart disease, American Home Products Corporation's failure to disclose the relevant data was not "materially misleading." *Id.* at 283-84. And in *New Jersey Carpenters*

*Pension & Annuity Funds v. Biogen IDEC Inc.*, 537 F.3d 35 (1st Cir. 2008), the First Circuit upheld the dismissal of the plaintiffs' Section 10(b) claims stemming from the nondisclosure of adverse event reports, finding that there was "no basis to conclude that [the] results [at issue] … were statistically significant." *Id.* at 50.

In addition to citing a circuit split, the *Matrixx III* Petitioner-Defendants contended that the question of when the obligation to disclose adverse events arises has "immense consequences for pharmaceutical companies." Petition for Writ of Certiorari at 2, *Matrixx III* (No. 09-1156). The Petitioner-Defendants argued that under the Ninth Circuit's decision in *Matrixx* II, the "only safe course for a company would be to provide investors with *every* adverse event report even though the company has no reason to believe that the report casts the slightest doubt on the safety of the drug." *Id.* (emphasis added).

The Supreme Court's ruling in *Matrixx III* will likely clarify the scope of a pharmaceutical company's disclosure obligations under Section 10(b). In addition, the ruling may offer more generally applicable guidance on how courts should approach the question of materiality. We will report on further developments in the case in future editions of the Securities Law Alert.

## The Southern District of New York Finds That "Suspicious" Stock Trades by Sallie Mae's CEO Support a Finding of Scienter

In late September, the Southern District of New York permitted a securities fraud class action to go forward against Sallie Mae Corporation and its CEO and Vice Chairman of its Board of Directors, Albert Lord. *See In re SLM Corp. Sec. Litig.*, No. 08 Civ. 1029 (WHP), 2010 WL 3783749 (S.D.N.Y. Sept. 24, 2010) ("*Sallie Mae*"). However, the court dismissed all claims against Sallie Mae's former Chief Financial Officer ("CFO"), Charles Andrews, for lack of scienter. The action was brought by SLM Venture, a joint venture established by several families for the purpose of investing in Sallie Mae stock, on behalf of all

purchasers of Sallie Mae common stock between January 18, 2007 and January 23, 2008. The court also dismissed a related ERISA suit, finding that Sallie Mae had sufficiently warned plan participants of the risks of their investments and determining that the drop in Sallie Mae's stock price was not sufficiently severe to warrant a finding of "imminent corporate collapse." *In re SLM Corp. ERISA Litig.*, No. 08 Civ. 4334 (WHP), 2010 WL 3910566, at *9 (S.D.N.Y. Sept. 24, 2010).

According to the plaintiff, the Sallie Mae defendants "misled the market about Sallie Mae's financial performance" by "lower[ing] its borrowing criteria to increase its portfolio of private loans, hid[ing] defaults by changing its forbearance policy, and inflat[ing] profits through inadequate loan loss reserves." *Sallie Mae*, 2010 WL 3783749, at *2.

The plaintiff alleged that Sallie Mae began offering private loans "directly to … individuals enrolled in career training courses or for-profit institutions of higher education." *Id.* The federal government neither guarantees private loans nor caps the interest rates for these loans; accordingly, private loans offer both greater risk and greater potential reward than loans offered to students through the Federal Family Education Loan Program. "[T]o increase its market share of potentially lucrative Private Loans," Sallie Mae allegedly "significantly reduced the credit score that a borrower needed to obtain a [private] loan and issued

more loans to students who were attending schools with low graduation rates." *Id*. (internal quotations and alterations omitted). The plaintiffs contended that Sallie Mae affirmatively "concealed this sea change in underwriting practices." *Id*.

The plaintiff further alleged that "Sallie Mae changed its forbearance policy to hide [private loan] defaults." *Id*. at *4. Forbearance permits a borrower to postpone payments for a set period of time. "[B]y shifting delinquent loans into forbearance, Sallie Mae avoided accounting for them as delinquent or in default." *Id*.

Finally, the plaintiff claimed that Sallie Mae did not adequately adjust its loan loss allowances to reflect the heightened risk presented by private loans. "Loan loss allowances are used to calculate the present value of a loan portfolio by accounting for the percentage of loans that will ultimately be deemed uncollectible and charged off." *Sallie Mae*, 2010 WL 3783749, at *3. According to the plaintiff, Sallie Mae "materially misstated the adequacy of the [company's] loan loss reserves," allowing defendants to overstate Sallie Mae's earnings. *Id*. at *3-*4.

## The Defendants Were Allegedly Incentivized to Keep the Stock Price High

The Sallie Mae defendants were allegedly incentivized to "show continued growth and favorable financial trends during the Class Period." *Id*. at *4. First, Sallie Mae had entered into equity forward contracts to raise capital without incurring debt. Pursuant to these contracts, Sallie Mae sold shares "at a set price and agreed to repurchase them later at a higher strike price." *Id*. (internal quotations omitted). The contracts provided that if Sallie Mae's shares fell below specified "trigger prices," the company would have to repurchase the shares immediately at the contractual strike price. The plaintiffs alleged that these contracts placed "enormous pressure on Sallie Mae to keep its stock price as high as possible." *Id*. (internal quotations omitted).

Second, Sallie Mae began merger negotiations with a consortium led by J.C. Flowers & Co. (the "Flowers Group") in November 2006. The plan of merger—signed in April 2007—called for the Flowers Group to acquire Sallie Mae's shares for $60 per share, a 50% premium over the trading price at the time. Upon the consummation of the merger, Sallie Mae CEO Albert Lord was to receive "a cash payment in the amount of approximately $225 million and could exercise stock options tied to exercise prices above the market price of [Sallie Mae] stock at that time." *Id*. at *11 (internal quotations omitted). Sallie Mae's "continued satisfactory performance" was a condition of the merger. *Sallie Mae*, 2010 WL 3783749, at *5.

Just a few months after the plan of merger was finalized, the Flowers Group determined that "legislation limiting the interest rate on federally-guaranteed student loans could doom the merger." *Id*. In December 2007, Sallie Mae publicly announced that the Flowers Group was not going forward with the merger.

## The Complaint Alleged "Suspicious" Stock Sales by Sallie Mae CEO Albert Lord

The plaintiff claimed that CEO Albert Lord "sold Sallie Mae stock at three points during the Class

Period in unusual amounts and at suspicious times." *Id*. (internal quotations omitted). In February 2007, he sold 400,000 shares of Sallie Mae stock just days before the White House released a budget proposal cutting federal subsidies for student lenders and increasing lender risk. The sale allegedly reflected Lord's knowledge that the proposal would "adversely affect profitability of [federally-guaranteed student] loans and make [riskier private] loans critical to Sallie Mae's success." *Id*.

Several months later, in August 2007, Lord exercised options to purchase more than 1.5 million shares of Sallie Mae for between $18.33 and $26.62 per share, and then tendered the vast majority of those shares back to Sallie Mae at their fair market value of $49.33 per share. Lord allegedly "chose to sell as many shares as he could … because he knew that the Flowers Group would not continue with the planned merger in view of the significant reductions in [federal student loan] guarantees and concomitant increase in lender risk." *Id*.

Finally, two days after Sallie Mae's announcement that the Flowers Group would not be proceeding with the planned merger, Lord liquidated 97% of his Sallie Mae holdings.

In contrast to Lord's trades, former CFO Charles Andrews increased his Sallie Mae holdings during the Class Period. The complaint contains no allegations of "suspicious stock sales" by Andrews. *Id*. at *6.

## The Court Finds That the Plaintiffs Adequately Alleged Scienter as to Lord and Sallie Mae

The crux of the Southern District's ruling was the court's finding that the plaintiff had alleged facts to show that Lord and Sallie Mae had both motive and opportunity to commit fraud. *See Sallie Mae*, 2010 WL 3783749, at *9, *12. As a preliminary matter, the court found that it was "not disputed" that both Lord and Andrews had the "opportunity to commit fraud" as they "held the highest positions of power and authority within the company." *Id*. at *10 (internal quotations omitted).

With respective to motive, the court found that the "allegations regarding the Flowers Group merger transcend a generic corporate desire to negotiate favorable terms" to specify a "concrete and personal benefit for Lord"—namely, the $225 million payout and the possibility of exercising lucrative stock options. *Id*. at *11 (internal quotations omitted). The court also pointed to the existence of the equity forward contracts as further evidence of motive:

> Lord had an incentive to avoid the possibility that Sallie Mae's share price would fall below the trigger price in its equity forward contracts. If that occurred, Sallie Mae would have been required to repurchase approximately $2 billion in shares, an event that would have torpedoed the merger and Lord's payout.

*Id*. Lord's "unusual" stock trades in February, August, and December 2007 also weighed heavily in favor of the court's finding of sufficient motive to overstate Sallie Mae's financial performance. *Id*.

Based on these allegations, the court found that the plaintiff had adequately alleged scienter as to both Lord and Sallie Mae. The court explained that "'a corporate defendant's scienter is necessarily derived from its employees … [and] courts have readily attributed the scienter of management-level employees to corporate defendants.'" *Id*. at *10 (quoting *In re Marsh & Mclennan Cos., Inc. Sec. Litig.*, 501 F. Supp. 2d 452, 481 (S.D.N.Y. 2006) (alteration in original)). However, the court determined that the plaintiff had failed to state a claim as to Andrews, who neither "engage[d] in unusual trading activity during the Class Period" nor made any reckless statements during that time. *Id*. at *12.

# The Delaware Chancery Court Considers the Reasonableness of a Merger Termination Fee

In a decision dated October 5th, the Delaware Court of Chancery addressed a shareholder challenge to the termination fee in connection with Cogent, Inc.'s acquisition by 3M Company and its wholly-owned subsidiary, Ventura Acquisition Corporation (the "Cogent-3M merger"). *See In re Cogent, Inc. S'holder Litig.*, Civil Action No. 5780-VCP, 2010 WL 3894991 (Del. Ch. Oct. 5, 2010). At issue was whether Cogent's substantial cash holdings should be included in the deal value for purposes of assessing the reasonableness of the merger termination fee.

The Cogent-3M merger agreement provided for a termination fee of $28.3 million. This sum represented 3% of the deal's $943 million equity value, a metric "defined as the cost necessary to purchase the equity of [the acquired corporation] in the market." *Id.* at *10 n. 41. Under Delaware precedents, "[a] termination fee of 3% [of equity value] is generally considered reasonable." *Id*, at *10 & n. 47 (citing *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, 1015-21 (Del. Ch. 2005) (approving a termination fee of 3.75% of equity value); *In re the MONY Group Inc. S'holder Litig.*, 852 A.2d 9, 24 (Del. Ch. 2004) (approving a termination fee of 3.3% of equity value); and *McMillan v. Intercargo Corp.*, 768 A.2d 492, 505-06 (Del. Ch. 2000) (approving a fee of 3.5% of equity value)).

The plaintiffs contended that in view of Cogent's sizeable cash holdings, "the enterprise value, and not the equity value, is the proper metric against which to measure the reasonableness of the [t]ermination [f]ee." *Cogent*, 2010 WL 3894991, at *10. "'Enterprise value' is defined as the equity value, plus the value of debt, *minus the cash on the company's balance sheet*." *Id.* at *10 n. 41 (emphasis added). Because Cogent had a substantial amount of cash on its balance sheet, and virtually no debt, Cogent's enterprise value was $430 million—less than half of its $943 million equity value. The termination fee represented 6.6% of Cogent's enterprise value, a percentage the plaintiffs challenged as "unreasonably high." *Id.* at *10.

In support of their argument for using Cogent's enterprise value as the appropriate metric for assessing the reasonableness of the termination fee, the plaintiffs argued that "any acquirer will be able to use the cash on Cogent's balance sheet to defray the effective cost of its bid and, therefore, would only need to kick in $430 million of 'new' money." *Id.* The plaintiffs cited to the Delaware Chancery Court's decisions in *In re Lear Corp. Shareholder Litigation*, 926 A.2d 94 (Del. Ch. 2007) and *In re Dollar Thrifty Shareholder Litigation*, Cons. C.A. No. 5458-VCS, 2010 WL 3503471 (Del. Ch. Sept. 8, 2010) as precedents for using enterprise value rather than equity value to evaluate the reasonableness of a merger termination fee.

*Lear* involved the acquisition of a company with substantial debt on its balance sheet. The court in *Lear* observed that "[f]or purposes of considering the preclusive effect of a termination fee on a rival bidder, it is arguably more important to look at the enterprise value metric because … most acquisitions require the buyer to pay for the company's equity and refinance all of its debt." *Lear*, 926 A.2d at 120. Since the termination fee at issue in *Lear* amounted to 3.5% of the equity value and 2.4% of the enterprise value, the court found that the fee was not unreasonable under either metric.

*Id*. (finding that "the percentage of either measure [of] the termination fee … is hardly of the magnitude that should deter a serious rival bid").

The *Cogent* court acknowledged *Lear's* holding that "enterprise value … might sometimes (within the context of a highly leveraged transaction, for example) be [the] appropriate [metric]" for evaluating the reasonableness of a termination fee. *Cogent*, 2010 WL 3894991, at *10. However, the *Cogent* court distinguished *Lear*, explaining that "[h]ere … the facts are quite different in that Cogent essentially has no debt." *Id*. The court rejected the notion that the cash on Cogent's balance sheet should be subtracted when determining the company's value for purposes of evaluating the reasonableness of the termination fee:

> [T]here is no dispute that in this case, 3M is purchasing $943 million worth of assets. The fact that a sizeable part of those assets are especially liquid, like cash, does not change the fact that a buyer still must come up with the cash to purchase it, even if the buyer may be able to obtain very favourable financing (by using the cash of the target as security).

*Id*.

As to the *Dollar Thrifty* decision, the *Cogent* court found that the case "seems to support" the defendants' position that the company's cash assets should be included when calculating the relevant deal value. The merger agreement at issue in *Dollar Thrifty* provided for a special dividend of $200 million, to be paid from the target corporation's treasury to the stockholders upon closing of the merger. In their challenge to the merger termination fee, the *Dollar Thrifty* plaintiffs urged the court to subtract the $200 million special dividend from the deal value used to assess the reasonableness of the fee. The *Dollar Thrifty* court rejected the plaintiffs' argument, explaining that "the relevant transaction value is 'logically quantified as the amount of consideration flowing into [stockholders'] pockets—not the amount coming exclusively from [bidder and bidder] alone.'" *Cogent*, 2010 WL 3894991, at *11 (quoting *Dollar Thrifty*, 2010 WL 3503471, at *29). Because "the $200 million [dividend], regardless of the fact that it will be paid from Dollar Thrifty's own assets, must be matched in any topping bid," the *Dollar Thrifty* court held that this sum should be included in calculating the deal value for purposes of assessing the reasonableness of the termination fee. 2010 WL 3503471, at *29.

The *Cogent* court found that the $200 million dividend at issue in *Dollar Thrifty* was analogous to the cash on Cogent's books. In both cases, the plaintiffs argued that "because cash on the acquired company's balance sheet would … or could … be paid out to stockholders, it should be excluded for purposes of calculating the break-up fee." *Cogent*, 2010 WL 3894991, at *11. "Just as the court in *Dollar Thrifty* held that the cash used to pay the special dividend should be included for purposes of calculating the break-up fee there," the *Cogent* court determined that "cash on Cogent's balance sheet should be included for purposes of evaluating the reasonableness of the Termination Fee in this case." *Id*.

## Post-*Morrison* Jurisprudence Continues to Follow Early Trends

In last month's edition of the Securities Law Alert, we reported on the lower courts' implementation of the Supreme Court's ruling in *Morrison v. National Australia Bank Ltd.*, 130 S.Ct. 2869 (2010). (Please click here to read the complete article.) Recent decisions have followed the trends discussed in our prior report. Courts have maintained that Section 10(b) does not apply to transactions involving securities listed on a foreign exchange. Notably, a September ruling from the Southern District of New York went even further to find that *Morrison* also precludes Section 10(b)

claims involving American Depositary Receipts ("ADRs") traded over-the-counter in the United States.

Outside of the securities arena, courts have looked to *Morrison* for guidance on the extraterritorial application of federal statutes. The Second Circuit recently relied on *Morrison* to hold that the federal Racketeer Influenced and Corrupt Organizations Act ("RICO") does not apply extraterritorially.

## Courts Hold That *Morrison* Precludes Section 10(b) Liability in Cases Involving Securities Listed on a Foreign Exchange

Courts continue to hold that *Morrison* forecloses Section 10(b) liability in cases involving securities sold on foreign exchanges. *See, e.g., In re Société Générale Sec. Litig.*, No. 08 Civ. 2495 (RMB), 2010 WL 3910286, at *5 (S.D.N.Y. Sept. 29, 2010) (holding that "[w]here, as here, domestic plaintiffs purchased shares of a foreign bank traded on a foreign exchange, the Exchange Act is inapplicable"); *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, No. 08 Civ. 1958 (JGK), 2010 WL 3860397, at *7-*10 (S.D.N.Y. Oct. 4, 2010) (finding that Section 10(b) does not reach the claims of plaintiffs who purchased stock in a Swiss corporation on a Swiss stock exchange).

Under these decisions, neither the purchaser's residence in the United States nor the domestic execution of a foreign securities purchase is relevant to the "transactional" test outlined in *Morrison*. *See, e.g., Plumbers' Union*, 2010 WL 3860397, at *9-*10 (explaining that "[a] purchaser's citizenship or residency does not affect where a transaction occurs" and holding that "the country in which an investor happened to be located at the time that it placed its purchase order is immaterial"); *Société Générale*, 2010 WL 3910286, at *6 (finding that "[b]y asking the Court to look to the location of 'the act of placing a buy order,' and to 'the place of the wrong,' Plaintiffs are asking the Court to apply the conduct test specifically rejected in

*Morrison*."). However, at least one court has left open the possibility that "[t]here may be unique circumstances in which an issuer's conduct takes a sale or purchase outside [the general] rule" that "a purchase order in the United States for a security that is sold on a foreign exchange is insufficient to subject the purchase to the coverage of section 10(b)." *Plumbers' Union*, 2010 WL 3860397, at *9.

## The Southern District of New York Holds That Section 10(b) Does Not Apply to ADRs

In late September, the Southern District of New York applied *Morrison* to dismiss—*sua sponte*—claims involving ADRs issued by a French company but traded on the over-the counter market in the United States. *See Société Générale*, 2010 WL 3910286, at *6-*7. The *Société Générale* court found that "[t]rade in ADRs is considered to be a predominantly foreign securities transaction" because an ADR "represents one or more shares of a foreign stock or a fraction of a share." *Id.* at *6 (internal quotations and citations omitted). Whether other courts will follow this decision to rule out Section 10(b) claims involving ADRs remains to be seen.

## The Second Circuit Relies on *Morrison* to Hold That RICO Does Not Apply Extraterritorially

Last month, we discussed the Southern District of New York's decision in *Cedeño v. Intech Group, Inc.*, No. 09 Civ. 9716 (JSR), 2010 WL 3359468 (S.D.N.Y. Aug. 25, 2010), in which the court applied *Morrison* to hold that RICO does not apply extraterritorially. *Id.* at *2. The Second Circuit in *Norex Petroleum Ltd. v. Access Industries, Inc.*, No. 07-4553-cv, 2010 WL 3749281 (2d Cir. Sept. 28, 2010) recently arrived at the same conclusion. The *Norex* court found that RICO did not reach the claims of plaintiffs alleging "a massive racketeering scheme to take over a substantial portion of the Russian oil industry." *Id.* at *1 (internal quotations omitted). Citing *Morrison*, the Second Circuit held that RICO does not apply extraterritorially because the statute is "silent as to its extraterritorial application." *Id.* at *3. The court concluded that RICO did not govern the Russian conspiracy at issue on the grounds that "[t]he slim contacts with the United States alleged … are insufficient to support extraterritorial application of the RICO statute." *Id.*

## Courts Limit the Application of *Morrison*'s Presumption Against Extraterritoriality

Recent decisions have found that *Morrison*'s presumption against extraterritoriality does not apply to all statutes that are silent on the issue. In *United States v. Finch,* Cr. No. 10-00333 SOM-KSC, 2010 WL 3938176 (D. Haw. Sept. 30, 2010), the District of Hawaii held that certain federal criminal statutes were applicable to "conduct that allegedly occurred in Afghanistan" even though the statutes do not explicitly address extraterritorial application. *Id.* at *2. The court distinguished *Morrison*, finding that the Supreme Court's ruling "does not … hold that all federal statutes lacking express language authorizing extraterritorial application must necessarily apply only to acts occurring entirely in the United States." *Id.* at *4. Citing the Ninth Circuit's decision in *Love v. Associated Newspapers, Ltd.*, 611 F.3d 601 (9th Cir. 2010), which upheld the extraterritorial application of the Lanham Act notwithstanding *Morrison*, the *Finch* court found that it was appropriate to apply the criminal statutes in question extraterritorially because "the language of the conspiracy and bribery laws in this case are broader in scope than the Securities Exchange Act provision in *Morrison*." *Finch*, 2010 WL 3938176, at *4.

We are continuing to monitor decisions applying *Morrison*, and will report any noteworthy new developments in future issues of the Securities Law Alert.

## NEW YORK

**Bruce D. Angiolillo**
212-455-3735
bangiolillo@stblaw.com

**Michael J. Chepiga**
212-455-2598
mchepiga@stblaw.com

**Mark G. Cunha**
212-455-3475
mcunha@stblaw.com

**Paul C. Curnin**
212-455-2519
pcurnin@stblaw.com

**Michael J. Garvey**
212-455-7358
mgarvey@stblaw.com

**Paul C. Gluckow**
212-455-2653
pgluckow@stblaw.com

**David W. Ichel**
212-455-2563
dichel@stblaw.com

**Peter E. Kazanoff**
212-455-3525
pkazanoff@stblaw.com

**Joshua A. Levine**
212-455-7694
jlevine@stblaw.com

**Mary Elizabeth McGarry**
212-455-2574
mmcgarry@stblaw.com

**Joseph M. McLaughlin**
212-455-3242
jmclaughlin@stblaw.com

**Lynn K. Neuner**
212-455-2696
lneuner@stblaw.com

**Barry R. Ostrager**
212-455-2655
bostrager@stblaw.com

**Thomas C. Rice**
212-455-3040
trice@stblaw.com

**Mark J. Stein**
212-455-2310
mstein@stblaw.com

**George S. Wang**
212-455-2228
gwang@stblaw.com

**David J. Woll**
212-455-3136
dwoll@stblaw.com

**Jonathan K. Youngwood**
212-455-3539
jyoungwood@stblaw.com

## LOS ANGELES

**Michael D. Kibler**
310-407-7515
mkibler@stblaw.com

**Chet A. Kronenberg**
310-407-7557
ckronenberg@stblaw.com

## PALO ALTO

**Alexis S. Coll-Very**
650-251-5201
acoll-very@stblaw.com

**James G. Kreissman**
650-251-5080
jkreissman@stblaw.com

## WASHINGTON, D.C.

**Peter H. Bresnan**
202-636-5569
pbresnan@stblaw.com

**Peter C. Thomas**
202-636-5535
pthomas@stblaw.com


"An amazing work ethic and absolutely top-notch client service."

*—CHAMBERS USA 2010*

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication.

## UNITED STATES

**New York**
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

**Los Angeles**
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

**Palo Alto**
2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

**Washington, D.C.**
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

## EUROPE

**London**
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

## ASIA

**Beijing**
3119 China World Office 1
1 Jianguomenwai Avenue
Beijing 100004
China
+86-10-5965-2999

**Hong Kong**
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

**Tokyo**
Gaikokuho Jimu Bengoshi Jimusho
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

## SOUTH AMERICA

**São Paulo**
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000