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This month's Alert discusses: the Ninth Circuit's decision affirming the dismissal of the Oracle securities litigation; the dismissal of the Morgan Stanley shareholder derivative litigation over "excessive" compensation by the Supreme Court, New York County; a New York Appellate Division, First Department ruling addressing the scope of preemption of common law claims under the Martin Act, New York's blue sky law; the Delaware Supreme Court's ruling invalidating a bylaw changing the date of Airgas, Inc.'s annual meeting; the Second Circuit's decision affirming the dismissal of the Refco Trustee's suit against Refco insiders, professional service providers and advisors; and the recent amendments to the expert disclosure requirements of Federal Rule of Civil Procedure 26.

The Ninth Circuit Affirms the Dismissal of the Oracle Securities Litigation

On November 16, 2010, the Ninth Circuit affirmed the dismissal on summary judgment of a securities fraud action against Oracle Corporation stemming from a two-cent per-share earnings miss in the third quarter of 2001. *See In re Oracle Corp. Sec. Litig.*, No. 09-16502, 2010 WL 4608794 (9th Cir. Nov. 16, 2010). Although "[a] legion of analysts blamed the miss on a late quarter reaction by several key [Oracle] customers to the unfolding U.S. economic downturn," the plaintiffs contended that "the miss was actually caused by an elaborate scheme to defraud the public about the quality of Oracle products and the revenue gained therefrom." *Id.* at *1. Specifically, the plaintiffs alleged that the earnings miss reflected customer dissatisfaction with defects in Suite 11i, Oracle's integrated business software.

The Ninth Circuit held that dismissal was warranted because the plaintiffs had failed to establish that alleged misrepresentations regarding Oracle products—rather than the burst of the dot-com bubble—caused the plaintiffs' losses. In view of Oracle's "thorough" forecasting process, *id.* at *8, the court also found that Oracle's third quarter 2001 earnings projections did not constitute material misrepresentations, even though the projections later proved inaccurate.

Background

On December 14, 2000, Oracle projected earnings per share of 12 cents for the third quarter 2001 ("3Q01"), the period from December 1, 2000 to February 28, 2001. This projection was "based upon an accounting process that had generated projections that Oracle had met or exceeded for seven consecutive quarters." *Id.* at *1. The company's bottom-up process for forecasting earnings took numerous factors into account, including: data from Oracle sales representatives on potential sales in the pipeline, assessments by key financial personnel as to whether the forecasts were realistic, and evaluations

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as to the percentage of potential sales that would materialize by the end of the quarter. *See id*. at *6–*7.

From the beginning of 3Q01 until early February, "every internal forecast that Oracle produced indicated that the company could fulfill its 3Q01 guidance." *Id*. at *2. In February, however, internal projections "began to fluctuate." *Id*. A forecast on February 5th, 2001 projected earnings per share of 11 cents. On February 12th, the forecast returned to an estimate of 12 cents. The following day, Oracle's Executive Vice President publicly stated that "our [earnings] guidance remains the same that we indicated at the beginning of Q3." *Id*. at *8. On February 21, 2001, Oracle's Chief Financial Officer expressed continued confidence in the 3Q01 projections, stating that "we do not expect the slowing economy, barring a serious slide to a recession, to significantly impact near term guidance." *Id*. at *9. Five days later, a revised forecast predicted earnings per share of 11 cents.

At the time, Oracle sold a majority of its products at the tail end of each quarter, when the company offered substantial price cuts in an effort to boost sales and meet quarterly projections. This sales trend was known as the "hockey-stick effect" because "plotting the quarterly sales on a graph resembled the shape of a hockey stick—the sharp upswing at the end representing the bulk of quarterly sales." *Id*. at *2. In 3Q01, unlike previous quarters, "the recurring surge in late-quarter sales historically resulting from the hockey-stick effect did not materialize." *Id*.

On March 1, 2001, Oracle preliminarily announced earnings per share of 10 cents—missing 3Q01 projections by 2 cents. *Id*. The announcement attributed the earnings miss to underlying economic trends: "'[A] substantial number of our customers decided to delay their IT spending based on the economic slowdown in the United States …. The problem is the U.S. economy.'" *Id*. A day after the announcement, Oracle's stock price dropped by $4.50, to $16.88.

The Court Holds That the Plaintiffs Failed to Establish Loss Causation

The Ninth Circuit agreed with the district court that the plaintiffs had failed to demonstrate loss causation. To establish loss causation, a plaintiff must show that "the market learn[ed] of a defendant's fraudulent act or practice, the market react[ed] to the fraudulent act or practice, and [the] plaintiff suffer[ed] a loss as a result of the market's reaction." *Id*. at *10. Under Ninth Circuit precedent, a plaintiff must "allege that the market learned of and reacted to the practices the plaintiff contends are fraudulent, as opposed to merely reports of the defendant's poor financial health generally." *Id*. at *10 (*citing Metzler Inv. GMBH v. Corinthian Colls., Inc.*, 540 F.3d 1049, 1063 (9th Cir. 2008)).

Here, the crux of the plaintiffs' fraud claims was that Oracle "misrepresent[ed] the quality and success of Oracle's Suite 11i product." *Id*. at *11. While the market was "already aware of initial rollout issues with Suite 11i," the plaintiffs contended that Oracle "downplayed defects in the product." *Id*. According to the plaintiffs, "the March 1, 2001 earnings miss revealed this 'truth': Suite 11i was defective and customers had not bought it as a result of the defects." *Id*. To establish loss causation under this theory, the plaintiffs were required to "create a triable dispute that Oracle's share price dropped as a result of the market learning of and reacting to [Oracle's] purported fraud, as opposed to

Oracle's poor financial health generally." *Id.*

The Ninth Circuit found that the record was devoid of any evidence linking the decline in Oracle's stock price to defects in Oracle software products. Rather, the "overwhelming evidence produced during discovery indicates the market understood Oracle's earnings miss to be a result of several deals lost in the final weeks of the quarter due to customer concern over the declining economy." *Id.* "In other words, the market reacted to reports of Oracle's 'poor financial health generally.'" *Id.*

The court squarely rejected the plaintiffs' claim that they "should be able to prove loss causation by showing that the market reacted to the purported 'impact' of the alleged fraud—the earnings miss—rather than to the fraudulent acts themselves." *Id.* at *10. Citing the Ninth Circuit's earlier decision in *Metzler*, the *Oracle* court held that "[l]oss causation requires more than an earnings miss." *Id.*

In *Metzler*, the court explained that "[s]o long as there is a drop in a stock's price, a plaintiff will always be able to contend that the market 'understood' a defendant's statement precipitating a loss as a coded message revealing the fraud." *Metzler*, 540 F.3d at 1064. "Enabling a plaintiff to proceed on such a theory would effectively resurrect what [*Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 347 (2005)] discredited—that loss causation is established through an allegation that a stock was purchased at an inflated price." *Id.*

The Court Finds that Oracle's 3Q01 Forecasts Were Not Misrepresentations

The plaintiffs claimed that Oracle's 3Q01 forecast constituted a material misrepresentation because "the guidance failed to account for the serious impact that purported Suite 11i defects had on sales or the effects of a declining economy." *Oracle*, 2010 WL 4608794, at *6. The plaintiffs further alleged that statements by Oracle management "express[ing] confidence in the 3Q01 forecast or den[ying] the effects of a weakening economy were material misrepresentations." *Id.* at *8.

In order for "a forward-looking statement such as Oracle's 3Q01 public guidance to constitute a material misrepresentation giving rise to Section 10(b) or Rule 10b-5 liability," a plaintiff must establish that: (1) the speaker did not believe the statement at the time it was made; (2) there was no "reasonable basis" for the belief; or (3) the speaker is aware of "undisclosed facts tending seriously to undermine the statement's accuracy." *Id.* at *6 (internal quotations omitted). Given "Oracle's thorough forecasting process," the Ninth Circuit found that the plaintiffs were "unable to prove that [the Oracle defendants] lacked at least a reasonable basis for their belief in the 3Q01 forecast." *Id.* at *8. The court emphasized that "the fact that Oracle's forecast turned out to be incorrect does not retroactively make it a misrepresentation." *Id.*

The *Oracle* court reached the same conclusions with respect to the mid-quarter statement by the company's Executive Vice President, explaining that "[t]he fact that the February 13 prediction proved incorrect in hindsight does not make it untrue when made." *Id.* at *9. Because "[t]he most recent internal forecast to precede [the February 13] statement supported Oracle's 3Q01 guidance," the court found that the "statement … had a reasonable basis." *Id.*

Notably, the Ninth Circuit discounted the plaintiffs' arguments that certain internal data available to the Executive Vice President indicated that Oracle would not necessarily meet 3Q01 projections. The court explained that "issuers need not reveal all internal projections." *Id.* "Companies generate numerous estimates internally, and they may reveal the projection they think best while withholding others, as long as the projection revealed had a reasonable basis." *Id.*

Finally, the court found that the mid-quarter statement by Oracle's Chief Financial Officer expressing confidence in the 3Q01 projections contained an express contingency: "barring a serious slide to a recession." *Id.* This contingency was triggered when the dot-com bubble burst in March 2001, simultaneously with Oracle's earnings miss.

A New York State Court Dismisses the Morgan Stanley Shareholder Derivative Litigation Alleging "Excessive" Compensation

Earlier this month, a New York state court dismissed with prejudice a purported shareholder derivative action brought against Morgan Stanley's board of directors and several of its executive officers challenging the compensation Morgan Stanley paid to its executives and employees in the years 2006, 2007, and 2009[1]. *See Sec. Police & Fire Prof'ls v. Mack*, Index No. 600359/2010 (N.Y. Sup. Ct., Dec. 9, 2010).

The plaintiffs alleged that Morgan Stanley's directors "approved excessive employee compensation" in 2006, 2007, and 2009; "failed to continually assess the company's compensation scheme" during those years; and "failed to recoup the compensation paid to employees in 2006." *Id*. at 3. The plaintiffs further claimed that the compensation during those years was excessive "relative to the contributions that Morgan Stanley's employees made to the company." *Id*. at 5. Citing the decline in Morgan Stanley's stock price between 2007 and 2009, the plaintiffs argued that "Morgan Stanley's employees caused substantial damage to shareholder capital and the company's overall financial health." *Id*.

Prior to filing suit, the plaintiffs did not make a demand on the Board. The court found that the demand requirement was "neither excused nor satisfied," because the complaint "fails to raise a reasonable doubt that a majority of the Board is disinterested, independent, or that the Board's decision is protected by the business judgment rule." *Id*. at 25.

1. Simpson Thacher represents the outside directors in this matter.

The Court Rejects the Plaintiffs' "Conclusory" Allegations Regarding "Excessive" Compensation

The court noted that "compensation to employees rest[s] in the discretion of the corporation's board of directors in the exercise of its business judgment," barring particularized facts demonstrating fraud or a gross abuse of discretion. *Id*. at 17. Under this standard, the court held that the plaintiffs had failed to raise a reasonable doubt that the compensation Morgan Stanley paid in 2006, 2007 and 2009 was either "excessive in light of the company's performance," *id*. at 16, or "'disproportionately' large or 'unconscionable' in light of employee contributions." *Id*. at 19.

The court determined that the complaint was devoid of any "specific evidence that Morgan Stanley's *total* compensation [rather than simply executive bonuses] was approved by the Board." *Id*. at 14-15. With respect to the plaintiffs' allegations that "*total* compensation increased in 2007 despite a decrease in revenues and profits," the court found that the plaintiffs failed to establish that "the increase in total compensation resulted from a bonus increase." *Id*. at 15. The court declined to infer that bonuses increased along with total compensation in 2007, noting that "[s]everal equiprobable explanations exist for the increase in total compensation, the most salient of which include an increase in the total number of employees, an increase in non-bonus compensation,

and an increase in the price of labor." *Id*.

With respect to the plaintiffs' allegations that the compensation/revenue ratio increased to a "record" 62% in 2009, *id*. at 4, the court concluded that "[t]he compensation/revenue ratio increased because the decrease in compensation (thirteen percent) did not perfectly correspond to the decrease in revenue (seventeen percent)." *Id*. at 16. The court "found no evidence to suggest that this misalignment exceeded the Board's ordinary discretion to set compensation. … even if the media finds the particular revenue/ compensation ratio to be 'astonishing.'" *Id*.

The Court Holds That the Plaintiffs Failed to Raise a Reasonable Doubt as to the Disinterestedness of the Morgan Stanley Board

For a claim of demand futility to succeed, plaintiffs must raise a reasonable doubt as to both the disinterestedness and independence of "a majority of the board of directors sitting at the time the complaint is filed." *Id*. at 9. Central to the inquiry is whether "'officers and directors are under an influence which sterilizes their discretion.'" *Id*. at 8.

Of the fourteen directors on the Morgan Stanley board at the time the complaint was filed, two were current company employees. The plaintiffs argued that the non-employee directors were also interested because if they pursued the derivative claims asserted in this action, they would face "a substantial likelihood of liability" for breach of the duty of loyalty for wasting corporate assets or acting in bad faith. *Id*. at 11.

The court explained that "the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient" to raise a reasonable doubt as to director disinterestedness. *Id*. "Rather, the court must be able to 'conclude from the face of the complaint that this is a rare case where the circumstances are so *egregious* that there is a *substantial* likelihood of liability.'" *Id*.

In this case, "the setting of compensation is *presumed* to have been in good faith." *Id*. at 13 (emphasis added). Allegations that the compensation paid was out of proportion to Morgan Stanley's revenues and net income does not establish that the directors could be held liable for violating the duty of good faith. "The mere fact that a company takes on business risk and suffers losses—even catastrophic losses—does not evidence misconduct, and without more, is not a basis for personal director liability." *Id*. at 13. Thus, the court held that the allegations "are insufficient to raise a reasonable doubt as to the disinterestedness of the remaining, non-employee directors." *Id*. at 11.

The Court Determines That the Plaintiffs Failed to Raise a Reasonable Doubt as to the Independence of the Morgan Stanley Board

In support of their claim that "the non-employee directors lack independence because they are "beholden to Morgan Stanley and its executives[,]" the plaintiffs pointed to the annual stipends paid to these directors. *Id*. at 21. The court noted that "[t]he allegation that directors are paid fees for their services, without more, does not establish lack of independence." *Id*. Here, the complaint "contains no allegations regarding what is commonly understood and accepted to be a usual and customary director's fee," nor do the plaintiffs allege that "the non-employee director fees were massively increased or … awarded as *quid pro quo* for a specific directorial action." *Id*. at 21-22.

The plaintiffs also contended that several individual directors had relationships with entities linked to Morgan Stanley that impacted their independence. In rejecting these claims, the court noted that "[a]llegations of natural bias not supported by tangible evidence of an interest … in the outcome of the litigation do not demonstrate a lack of independence." *Id*. at 20-21.

The Court Determines That the Business Judgment Rule Protects the Board's Compensation-Related Decisions

Under the business judgment rule, directors are insulated from liability for their decisions provided that "a challenged decision does not constitute … waste." *Id.* at 25. A claim of waste "will arise only in the rare, unconscionable case where directors irrationally squander or give away corporate assets." *Id.* at 17.

Because the complaint "fails to raise a reasonable doubt that the compensations approved for 2006, 2007 and 2009 constituted waste," the court concluded that the business judgment rule applies to protect the directors from liability for their compensation decisions. *Id.* at 25.

The Delaware Supreme Court Invalidates a Bylaw Amendment Changing the Date of Airgas, Inc.'s Annual Meeting

On November 23, 2010, the Delaware Supreme Court invalidated a bylaw changing the date of Airgas, Inc.'s annual meeting to January 2011. *See Airgas, Inc. v. Air Prods. and Chems., Inc.*, No. 649, 2010, 2010 WL 4734305 (Del. Nov. 23, 2010) ("*Airgas II*"). The ruling reversed a decision by the Chancery Court, and marked a victory for Airgas in its dispute with Air Products and Chemicals, Inc. ("Air Products").

Background

In February 2010, Air Products initiated a public tender offer to acquire 100% of the shares of Airgas, a direct competitor in the industrial gas business. The Airgas board of directors has since rejected numerous bids from Air Products, stating that each bid undervalued the company.

At the September 2010 annual meeting of Airgas shareholders, three of the nine members of Airgas's staggered board of directors were up for election. Air Products launched a proxy contest, successfully nominating three directors to the Airgas board and proposing a bylaw moving up the date of the next annual meeting to January 2011 (the "January Bylaw")—four months after the 2010 meeting. The January Bylaw was approved by 51.8% of the shares voted in the election. The court stated that by changing the date of the annual meeting, the January Bylaw "effectively reduced the full term of the incumbent directors by eight months." *Id.* at *1.

Airgas Challenges the January Bylaw

Airgas filed suit, arguing that the January Bylaw was "inconsistent" with the Airgas corporate charter and Section 141(d) of Delaware General Corporate Law ("DGCL"), which provides for staggered boards in corporations. *Id.* at *1–*2. Article 5, Section 1 of the Airgas corporate charter provides in relevant part:

> At each annual meeting of the stockholders of the Corporation, the successors to the class of Directors whose term expires at that meeting shall be elected to hold office for *a term expiring at the annual meeting of stockholders held in the third year following the year of their election*.

Id. at *2 (emphasis added). The court found that virtually identical language appears in Article III, Section 1 of Airgas's bylaws. Under Article 5, Section 6 of the Airgas corporate charter, no provision "inconsistent" with Article III of the bylaws may be adopted without a supermajority vote consisting of "at least 67% of the voting power of all the shares of the Corporation entitled to vote generally in the election of Directors." *Id.* at *3 (internal quotations omitted). Pursuant to Article 5, Section 3 of the Airgas corporate

charter, a supermajority vote is also required to remove an Airgas director from office without cause. *Id*. Finally, Section 141(d) of the DGCL provides, *inter alia*, that directors "shall be chosen for a *full term*." *Id*. at *2 (emphasis added).

Airgas contended that the supermajority voting requirements applied because the January Bylaw is "'plainly inconsistent with Article III'" of the Airgas bylaws. *Airgas, Inc. v. Air Prods. and Chems., Inc.*, Civil Action No. 5817-CC, 2010 WL 3960599, at *5 (Del. Ch. Oct. 8, 2010) ("*Airgas I*") (internal quotations omitted). The company claimed that the January Bylaw "'impermissibly shorten[s] the terms" of the incumbent directors by "allowing a director election to take place at an 'annual meeting' that is not a true 'annual' meeting." *Id*. According to Airgas, "each annual meeting must be separated by 'approximately one year' (or 365 days) and the next annual meeting must take place 'around' August or September 2011." *Id*. at *6. Airgas further argued that a "full term" of a class of Airgas directors within the meaning of Section 141(d) of the DGCL is "approximately three years." *Id*.

Air Products responded by pointing out that Article III of Airgas's bylaws does not specify that directors must serve a three-year term. Rather, Article III simply provides that directors are elected "for a term expiring at the annual meeting of stockholders held in the third year following the year of their election." *Id*. (emphasis omitted). In view of the fact that "Airgas did not specify a particular term length," Air Products claimed that "moving the annual meeting to January does not conflict with any provision of Airgas's charter." *Id*.

The Delaware Chancery Court Upholds the January Bylaw

In a decision dated October 8, 2010, the Delaware Chancery Court ruled that the January Bylaw is "not inconsistent with or in conflict with the language used in Article III" of the Airgas bylaws. *Id*. at *5. The court

found that "Airgas's charter provision is not crystal clear on its face"—particularly with respect to the meaning of the term "annual." *Id*. at *6. While Airgas argued that "'annual' must mean separated by approximately twelve months," Air Products contended that "'annual' means once a year." *Id*. at *7. Since neither Airgas's charter nor its bylaws defined the term "annual," the Delaware Chancery Court turned to the dictionary for guidance. Merriam-Webster confirmed that "annual" has two meanings: "'covering the period of a year' or 'occurring or happening every year or once a year.'" *Id*. "[C]onstruing the ambiguous terms of the charter in favour of the shareholder franchise," the Delaware Chancery Court determined that "'annual' in this context must mean occurring once a year." *Id*.

The court also found that the term "year" presented a question of interpretation: "the charter and bylaws are ambiguous as to whether directors' terms run in accordance with a calendar year or a fiscal year." *Id*. Under "the rule of construction in favour of franchise rights," the court held that "Airgas's annual meeting cycle can validly run on a calendar year basis and still be consistent with the charter." *Id*.

In the court's view, a different conclusion might have been warranted had the Airgas charter or bylaws set forth a "minimum durational interval between meetings (i.e. 'annual meetings must be held no less than nine months apart')" or specifically provided that directors "shall serve 'three-year terms.'" *Id*.

The Delaware Supreme Court Reverses and Strikes Down the January Bylaw

In late November, the Delaware Supreme Court reversed the Chancery Court's decision. The Delaware Supreme Court agreed with the Chancery Court that "the Airgas charter language defining the duration of directors' terms is ambiguous." *Airgas II*, 2010 WL 4734305, at *1. Instead of turning to dictionary definitions, however, the Delaware Supreme Court "look[ed] to extrinsic evidence to interpret the intent of the charter language." *Id.*

The Court found that "the [relevant] language has [long] been understood to mean that the Airgas directors serve three year terms." *Id.* As an initial matter, the Court looked to Airgas's corporate history. The Court found that the "accelerated meeting date would contravene nearly two and a half decades of Airgas practice, during which Airgas never held its annual meeting earlier than July 28." *Id.* at *4. It "would also mark the first time Airgas held an annual meeting without having new fiscal results to report to its shareholders." *Id.*

Next, the Court considered the director terms in place at Fortune 500 corporations that use substantially similar staggered board language (defined by the Court as the "Annual Meeting Term Alternative") in their corporate charters. *See id.* at *7. The vast majority of these corporations—including Air Products—"expressly represent in their proxy statements that their staggered-board directors serve three year terms." *Id.*

The Court then turned to the literature on staggered board provisions. The ABA's *Public Company Organizational Documents: Model Forms and Commentary* "confirms the understanding that the Annual Meeting Term Alternative intends to provide that each class of directors is elected for a three year term." *Id.* at *8.

Finally, the Court looked to a fifty-year-old Delaware decision in which the court struck down a bylaw authorizing the removal of directors by a majority shareholder vote on the grounds that the bylaw was inconsistent with a charter provision that provided for staggered, three-year director terms. *See Essential Enterprises Corp. v. Automatic Steel Prods., Inc.*, 159 A.2d 288 (Del. Ch. 1960). In *Essential Enterprises*, the court found that "the 'full term' visualized by the statute is a period of three years—not up to three years." *Id.* at 290–91. The court determined that the removal bylaw would "frustrate the plan and purpose behind the provisions for staggered terms… ." *Id.* at 291.

The Delaware Chancery Court in *Airgas I* had distinguished *Essential Enterprises* on the grounds that the corporate charter at issue in that case "explicitly called for three-year terms" while "Airgas's charter does not." *Airgas I*, 2010 WL 3960599, at *11. In *Airgas II*, the Delaware Supreme Court found this distinction insignificant, explaining that the "Annual Meeting Term Alternative was intended, and has been commonly understood, to provide for three year terms." *Airgas II*, 2010 WL 4734305, at *9.

Air Products also argued that "*Essential Enterprises* was a director 'removal' case whereas this case is an 'annual meeting' case." *Id.* While the Delaware Supreme Court agreed that "*[i]n form*, the January Bylaw addresses the date of Airgas's annual meeting[,]" the court found that "in substance, the January Bylaw so extremely truncates the directors' terms as to constitute a *de facto* removal that is inconsistent with the Airgas charter." *Id.* The Court concluded that "the January Bylaw is invalid not only because it impermissibly shortens the directors' three year staggered terms … , but also because it amounted to a de facto removal without cause of those directors without the affirmative vote of 67% of the voting power of all shares entitled to vote[.]" *Id.*

The New York Appellate Division – First Department Holds That the Martin Act Does Not Preempt Common Law Claims

In the September edition of the Alert, we reported on a Southern District of New York decision rejecting the principle that the Martin Act—New York's blue sky law—preempts all common law claims except for common law fraud actions. *See Anwar v. Fairfield*

Greenwich Ltd., No. 09 Civ. 0118, 2010 WL 3022848 (S.D.N.Y. July 29, 2010).[2] (Please click here to read the complete article.) The *Anwar* court found that the rule reflected an "unwitting perpetuation of [judicial] error" that would not survive Court of Appeals scrutiny. *Id*. at *2.

On November 23, 2010, the First Department aligned itself with the *Anwar* decision. *See Assured Guar. (UK) Ltd. v. J.P. Morgan Inv. Mgmt. Inc.*, 2010 WL 4721590 (N.Y. App. Div. Nov. 23, 2010) ("*Assured Guaranty*"). Among the issues in *Assured Guaranty* was whether the Martin Act preempted breach of fiduciary duty and gross negligence claims. The First Department reversed the trial court's dismissal of the complaint, and reinstated the plaintiff's common law claims.

Like the Southern District of New York in *Anwar*, the First Department in *Assured Guaranty* placed weight on the "general rule of statutory construction 'that a clear and specific legislative intent is required to override the common law.'" *Id*. at *6. The court stated that "[t]he plain language of the Martin Act does not explicitly preempt all common-law claims." *Id*. at *3. The court also stated that "there is nothing in the act or its legislative history, despite a number of amendments, that indicates any intention on the part of the Legislature to replace common-law causes of action." *Id*. at *6. Therefore, the First Department concluded that the Martin Act *augments*—rather than replaces—the remedies available under the common law. *See id*. at *3 (explaining that "'[t]he general rule has been that 'when the common law gives a remedy, and another remedy is provided by statute, the latter is cumulative, unless made exclusive by the statute.'") (internal citations omitted).

The First Department recognized that "a private action cannot be maintained based upon the provisions of the Martin Act." *Id*. at *4. However, the court explained that just because "there is no private right of action under a statute[,]" it "does not automatically mean that the statute preempts common law causes of action." *Id*. The First Department found that the Martin Act preempts only those common law claims that derive *exclusively* from violations of the statute:

> [W]here a pleading is drafted in such a way as to cast what is clearly an obligation under the Martin Act as a common-law cause of action, that complaint would constitute, in effect, a prohibited private action based upon the provisions of the Martin Act and [would be] preempted by the statute.

Id. Under the *Assured Guaranty* ruling, other "properly

2. Simpson Thacher represents certain defendants in the *Anwar* action.

pleaded common-law causes of action" are not preempted. *Id*.

The court found support for its opinion in *Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. Partnership*, 906 N.E.2d 1049 (N.Y. 2009) and a recent Second Department decision interpreting *Kerusa*. In *Kerusa*, the New York Court of Appeals rejected the plaintiff's fraud claims on Martin Act grounds where the claims were based solely on inadequate disclosures in offering documents—omissions that fall under the purview of the Martin Act. The *Kerusa* court determined that "to accept [the plaintiff's] pleading as valid would invite a backdoor private cause of action to enforce the Martin Act." *Id*. at 1054.

Kerusa confirms that plaintiffs may not reframe what are essentially Martin Act violations as common law claims. Earlier this year, the Second Department found that *Kerusa* does not restrict plaintiffs from bringing other common law claims, even if those claims arise from New York securities transactions covered under the Martin Act, provided that the claims "'fit within a cognizable legal theory … [and] do not 'rely entirely on alleged omissions from filing required by the Martin Act and the Attorney General's implementing regulations.'" *Assured Guaranty*, 2010 WL 4721590, at *4 (*quoting Board of Mgrs. of Marke Gardens Condominium v. 240/242 Franklin Ave., LLC*, 71 A.D.3d 935, 936 (N.Y. App. Div. 2010)).

The First Department in *Assured Guaranty* acknowledged that its decision departed from the long-held view that the Martin Act precludes common law claims (other than common law fraud claims). *See Assured Guaranty*, 2010 WL 4721590, at *5 ("We are mindful of the fact that, in recent years, a majority of the federal courts in the Southern District of New York have held that, except for fraud, the Martin Act forecloses any private common-law causes of action.")

The Second Circuit Affirms the Dismissal of a Suit Brought by the Refco Trustee, Finding that the Adverse Interest Exception to the *Wagoner* Rule Does Not Apply

On November 18, 2010, the Second Circuit affirmed the Southern District of New York's decision dismissing an action brought by the trustee of the Refco Litigation Trust (the "Refco Trustee") against certain Refco insiders, professionals and advisors. *See Kirschner v. KPMG LLP*, Nos. 09-2020-cv (L), 09-2027-cv (CON), 2010 WL 4644062 (2d. Cir. Nov. 18, 2010) ("*Kirschner IV*"). The Second Circuit held that the Refco Trustee lacked standing under the *Wagoner* rule, which provides that a bankruptcy trustee may not recover against third parties for losses caused by the actions of the debtor company's management. The *Kirschner IV* ruling confirms that the "adverse interest" exception to the *Wagoner* rule does not apply unless a corporate employee's actions harmed the corporation at the time the conduct took place; a showing that the corporate employee intended to profit personally from his or her actions is not sufficient, standing alone, to trigger the exception.

Background

Until the company's collapse in 2005, Refco was "among the world's largest providers of brokerage and clearing services in the international derivatives, currency, and futures markets." *Kirschner v. Grant Thornton LLP*, No. 07 Civ. 11604 (GEL), 2009 WL 1286326, at *1 (S.D.N.Y. May 6, 2009) ("*Kirschner I*"). According to the court, the company's apparent success was allegedly the result of a "complex fraudulent scheme" that the company's controlling officer-shareholders "orchestrated" with the assistance of third-party professional service providers and financial advisors.

Id. Through the alleged "concealment of Refco's uncollectible debt and the misappropriation of customer assets," company insiders "enhance[d] Refco's performance and conceal[ed] Refco's true financial condition." *Id*. The complaint alleged that the insiders ultimately "cash[ed] out their interests in Refco on lucrative terms" in the company's August 2004 leveraged buy-out and August 2005 initial public offering. *Id*. A few weeks after the initial public offering, Refco's allegedly fraudulent practices came to light, and the company and its subsidiaries and affiliates declared bankruptcy.

In August 2007, the Refco Trustee brought suit against a number of Refco insiders, professional service providers and advisors—including Mayer Brown International LLP, KPMG LLP, and Ernst & Young LLP—for breach of fiduciary duty and malpractice, among other claims. The threshold issue in dispute was whether or not the Trustee had standing to bring suit under the adverse interest exception to the *Wagoner* rule.

New York law holds that "a bankruptcy trustee lacks standing to seek recovery on behalf of a debtor company against third-parties for injuries incurred by the misconduct of the debtor's controlling managers"—a principle known as the *Wagoner* rule. *Id*. at *5 (*citing Shearson Lehman Hutton v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991)). "Because management's misconduct is imputed to the corporation, and because a trustee stands in the shoes of the corporation, the *Wagoner* rule bars a trustee from suing to recover for a wrong that he himself essentially took part in." *Id*.

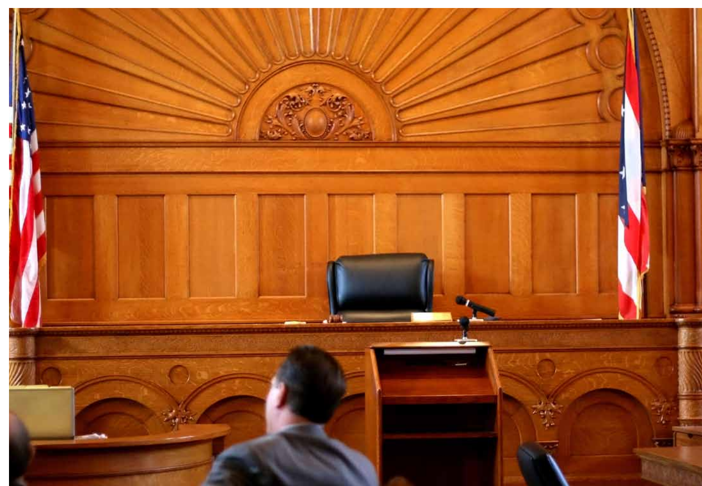
The *Wagoner* rule's "usual presumption" is only rebutted if the adverse interest exception applies. *Id*. "[W]here an officer acts entirely in his own interests and adversely to the interests of the corporation, that misconduct cannot be imputed to the corporation." *Id*. To trigger the "narrow" adverse interest exception, "the guilty manager must have totally abandoned his corporation's interests." *Id*. at *6 (*quoting In re CBI Holding Co. Inc. v. Ernst & Young*, 529 F.3d 432, 448 (2d. Cir. 2008)) (internal quotations omitted).

The District Court Finds That the Adverse Interest Exception to the *Wagoner* Rule Does Not Apply

In *Kirschner I*, the Southern District of New York held that the adverse interest exception to the *Wagoner* rule did not apply to the claims of the Refco Trustee. Rejecting the Trustee's argument that the adverse interest exception was triggered because the Refco insiders "'intended to benefit only themselves,'" the court held that "the participants' intent is not the 'touchstone' of the [adverse interest] analysis." *Id*. at *7. The court further held that in order to establish the applicability of the adverse interest exception, "the Trustee must allege … that the corporation was *harmed* by the scheme, rather than being one of its beneficiaries." *Id*. Finding that "[t]he complaint is saturated by allegations that Refco received substantial benefits from the insiders' alleged wrongdoing," the court determined that the adverse interest exception did not apply. *Id*. at *6.

The Second Circuit Asks the New York Court of Appeals to Clarify the Scope of the Adverse Interest Exception

On appeal, the Second Circuit found that "issues concerning imputation and the adverse interest



exception raise questions of New York law as to which considerable uncertainty exists." *Kirschner v. KPMG LLP*, 590 F.3d 186, 188 (2d Cir. 2009) ("*Kirschner II*"). The *Kirschner II* court certified several questions to the New York Court of Appeals, but asked the court to "focus its attention" on two key inquiries:

> (2) whether the adverse interest exception is satisfied by showing that the insiders intended to benefit themselves by their misconduct;
>
> (3) whether the exception is available only where the insiders' misconduct has harmed the corporation;

Id. at 194-95.

With respect to the first key question, the New York Court of Appeals found that a corporate insider's intent to profit from misconduct does not—standing alone—trigger the adverse interest exception. *Kirschner v. KPMG LLP*, 2010 N.Y. Slip Op. 07415, 2010 WL 4116609 (N.Y. Oct. 21, 2010) ("*Kirschner III*"). The court explained that holding otherwise would allow the exception to swallow the rule: "'[C]orporate officers, even in the most upright enterprises, can always be said, in some meaningful sense, to act for their own interests.'" *Id*. (citing *Grede v. McGladrey & Pullen LLP*, 421 B.R. 879, 886 (N.D. Ill. 2008)). "To allow a corporation to avoid the consequences of corporate acts simply because an employee performed them with his personal profit in mind would enable the corporation to disclaim, at its convenience, virtually every act its officers undertake." *Id*.

With respect to the second question, the New York Court of Appeals held that the adverse interest exception "cannot apply unless the scheme that benefitted the insider operated at the corporation's expense." *Id*. The *Kirschner III* court found that harm to the corporation is an essential component of the adverse interest exception: "[t]he crucial distinction is between conduct that defrauds the corporation and conduct that defrauds others for the corporation's benefit." *Id*.

The court further determined that harm to the corporation must be assessed at the time of the conduct in dispute. In response to the Refco Trustee's claims that "'bankruptcy is harm enough[,]'" the *Kirschner III* court held that "the mere fact that a corporation is forced to file for bankruptcy does not determine whether its agents' conduct was, *at the time it was committed*, adverse to the company." *Id*. (emphasis added). "[A]ny harm the discovery of the fraud—rather than from the fraud itself—does not bear on whether the adverse interest exception applies." *Id*.

The Second Circuit Affirms the Dismissal of the Refco Trustee's Suit

The Second Circuit concluded that "[t]he responses from the Court of Appeals have authoritatively announced New York law on the issues on which we were in doubt." *Kirschner IV*, 2010 WL 4644062, at *5. Finding that "these answers demonstrate that [the district court] correctly understood New York law in reaching [its] decision," the Second Circuit affirmed the dismissal of the Refco Trustee's action under the *Wagoner* rule. *Id*.

Amendments to Federal Rule of Civil Procedure 26 Explicitly Create Work Product Protection for Draft Expert Reports and Attorney-Expert Communications

Federal Rule of Civil Procedure 26 ("Rule 26") governs disclosures related to expert opinions. In an effort to clarify the scope of such disclosures and streamline the expert discovery process, Rule 26 has been amended effective December 1, 2010. The new rule clarifies that work product protection is afforded to draft expert reports and to communications between counsel and experts expected to testify at trial. The new rule also requires counsel to provide a written summary of the facts and opinions of experts who are not otherwise required to file expert reports. The amended rule will govern in all proceedings commenced after December 1st, as well as in all pending proceedings where practicable, at the discretion of the court. The amendments eliminate some of the reporting burden for experts and expand the scope of work product protection of attorney-expert communications.

Historical Background

In 1993, Rule 26 was amended, expanding the scope of information provided to opposing counsel regarding expert witnesses. The changes included the creation of Rule 26(a)(2)(B), which required the retained expert to write a report disclosing "all data or other information" considered by the expert in forming opinions. Fed. R. Civ. P. 26(a)(2)(B)(ii) (1993). Many courts adopted a broad interpretation of the term "other information" to "authorize discovery of *all* communications between counsel and expert witnesses and *all* draft reports. Fed. R. Civ. P. 26 Advisory Committee's Note (emphasis added). According to the Advisory Committee's Notes, attorneys were, as a result, more guarded in their interaction with testifying experts and expended significant time and resources to avoid creating a discoverable record of expert communications (by, for example, hiring two sets of experts—one to consult and develop opinions, and one to provide the testimony). *Id.*

The 2010 Amendments

According to Judge Mark B. Kravitz, Chair of the Judicial Conference Advisory Committee on Civil Rules, the 2010 amendments to Rule 26 will "reduce cost, focus discovery and trial on the merits of the experts' opinions, and allow parties and their counsel to make better use of their experts." Interview by The Third Branch with Judge Mark Kravitz, Chair, Judicial Conference Advisory Committee on Civil Rules (July, 2010), *available at*, http://www.uscourts.gov/News/TheThirdBranch/10-07-01/Examining_the_State_of_Civil_Litigation.aspx. The amendments focus on two important issues: non-reporting experts and the expansion of work product protection.

A. Non-Reporting Experts

The amendments clarify that experts not specifically retained to testify at trial—for example,

treating physicians—are not obligated to submit Rule 26(a)(2)(B) expert reports. Although originally intended to affect only those witnesses "retained or specially employed to provide expert testimony in the case or one whose duties as the party's employee regularly involve giving expert testimony[,]" some have been inclined to apply the reporting requirement to all experts. Fed. R. Civ. P. 26 Advisory Committee's Note.

The 2010 amendments create Rule 26(a)(2)(C), which balances the desire for advance notice of an expert's testimony with efficiency concerns. New Rule 26(a)(2)(C) provides that if the expert does not fall within the category of witnesses specified under Rule 26(a)(2)(B), he/she need not prepare a report; the retaining attorney must simply disclose the subject matter of the expert's proposed testimony and a summary of the facts and opinions.

B. Expansion of Work Product Protection

The 2010 amendments to Rule 26 deem work-product protection applicable to the discovery of drafts of both retained expert reports and summary disclosures for non-reporting experts. Fed. R. Civ. P. 26(b)(4)(B). Furthermore, the amendments limit the required disclosure in retained expert reports to "*facts* or data" rather than "data or *other information*" considered by the witness. Fed. R. Civ. P. 26(a)(2)(B)(ii) (emphasis added).

With three excepted topics, communications between retaining counsel and testifying expert witnesses are also protected under the work product doctrine. Fed. R. Civ. P. 26(b)(4)(C). The three categories exempted from such protection are communications related to: (i) expert compensation, (ii) facts or data provided by counsel and considered by the expert in forming opinions, and (iii) assumptions provided by counsel and relied upon by the expert in forming opinions. *See id*. The objective of these exceptions is to "permit full inquiry into … potential sources of bias." Fed. R. Civ. P. 26 Advisory Committee's Note.

While the amendments protect draft expert reports and communications with counsel, they "do not impede discovery about the opinions to be offered by the expert or the development, foundation, or basis of those opinions." *Id*.

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