Simpson Thacher
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This month's Alert discusses the Southern District of New York's decision in the Bear Stearns subprime litigation dismissing the derivative and ERISA suits but allowing the securities fraud action to go forward, and a First Circuit decision holding that named plaintiffs in mortgage-backed securities suits may only bring claims based on securities they actually purchased. We also address four noteworthy decisions from Delaware: a decision from the Chancery Court upholding the Airgas board's use of a poison pill in the Air Products-Airgas takeover battle; a ruling from the Delaware Supreme Court that plaintiffs may, in certain circumstances, inspect a company's books and records even after filing a derivative action; a Chancery Court order requiring managing director-level Rule 30(b)(6) deposition testimony in the Calix-Occam merger litigation; and the Chancery Court's finding of *prima facie* evidence of collusive forum shopping in the Nighthawk Radiology-Virtual Radiologic Corp. merger litigation.

The Southern District of New York Dismisses the Bear Stearns Subprime-Related Derivative and ERISA Suits, But Permits the Securities Fraud Action to Proceed

In a 389-page opinion issued on January 19, 2011, the Southern District of New York dismissed a shareholder derivative suit and an ERISA action brought in connection with the March 2008 near-collapse of The Bear Stearns Companies Inc. ("Bear Stearns") and the subsequent acquisition of Bear Stearns by JPMorgan Chase & Co. for $10 per share. *In re Bear Stearns Co., Inc. Sec., Der., and ERISA Litig.*, No. 08 MDL 1963, 2011 WL 223540 (S.D.N.Y. Jan. 19, 2011) (Sweet, J.). However, the court denied the defendants' motions to dismiss the related consolidated securities class action suit.[1]

1. Simpson Thacher represents Samuel L. Molinaro, Jr., former Chief Financial Officer and Chief Operating Officer of Bear Stearns, in the securities fraud, derivative and ERISA actions.

The Court Dismisses the Bear Stearns Derivative Action

The court dismissed the "hybrid shareholder derivative and class action" brought by "a former shareholder of Bear Stearns stock and current holder of JPMorgan stock," purportedly on behalf of JPMorgan Chase and its shareholders against certain former Bear Stearns officers and directors. *Id*. at *84. On behalf of JPMorgan, the derivative action sought, "among other things, damages, corporate governance reforms, restitution and the declaration of a constructive trust." *Id*. On behalf of the purported class, the derivative action sought "relief against former Bear Stearns senior officers and directors arising out of their sale of Bear Stearns via an unfair process at an allegedly

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).

grossly inadequate and unfair price." *Id*.

The court concluded that the derivative plaintiff lacked standing because he no longer owned Bear Stearns stock, did not qualify for the fraud exception to the continuous ownership rule, and failed to meet the requirements for alleging a double derivative claim. The court further ruled that "equitable considerations weigh[ed] against a conferral of standing," and that dismissal was also warranted on "the independent ground that [the] [p]laintiff did not make a demand on JPMorgan's Board of Directors and … failed to plead particularized facts demonstrating that demand is excused." *Id*. at *101. Finally, the court dismissed the class claim on res judicata and collateral estoppel grounds, in view of a New York state court decision arising from the same allegations.

The Court Rules That the Fraud Exception to the Continuous Ownership Rule for Derivative Actions Does Not Apply

To assert a derivative claim, a shareholder-plaintiff must "own stock in the corporation continuously from the time of the alleged wrong until the termination of the litigation." *Id*. at *98 (*citing Lewis v. Ward*, 852 A.2d 896, 900-01 (Del. 2004) and *Lewis v. Anderson*, 477 A.2d 1040, 1049 (Del. 1984)). The plaintiff in this action ceased to own Bear Stearns stock upon JPMorgan Chase's acquisition of Bear Stearns. Nonetheless, the plaintiff maintained that he had standing under the fraud exception to the continuous ownership rule. Under this exception, "the continuous ownership rule does not require dismissal where the merger was 'perpetrated merely to deprive shareholders of standing to bring a derivative action.'" *Id*. (*quoting Ward*, 852 A.2d at 902).

In support of his claim that the JPMorgan Chase-Bear Stearns transaction constituted a fraudulent sale, the derivative plaintiff asserted "(1) that Bear Stearns was purchased for a low price, and (2) that JPMorgan agreed to indemnify Bear Stearns' officers and directors." *Id*. (internal citations omitted). However, the court held that the plaintiff's own allegations undercut his claim:

> Derivative Plaintiff's allegations that, in the days preceding the sale to JPMorgan, Bear Stearns was facing a severe liquidity crisis, a plummeting stock price, and an "alarming" loss of confidence on the part of investors, clients, and trading counterparties, plus the "heavy involvement" of the Federal Reserve in the sale, contradict any assertion that the sale was accomplished "merely to deprive" shareholder-plaintiffs of standing.

Id.

The Court Holds That the Derivative Plaintiff Failed to Meet the Requirements for Bringing a Double Derivative Action

"[W]here standing to maintain a standard derivative action is extinguished as a result of an intervening merger," the *Bear Stearns* court stated that Delaware "precedents not only validate but also encourage the bringing of double derivative actions …." *Id*. at *99 (*quoting Lambrecht v. O'Neal*, 3 A.3d 277, 288 (Del. 2010)). Under the Delaware Supreme Court's ruling in *Lambrecht*,[2] a plaintiff can bring a double-derivative suit even if he no longer owns shares of the acquired corporation, provided he now owns shares of the acquiring corporation. Because the derivative plaintiff here is a "current JPMorgan shareholder who also held JPMorgan stock at the time he filed the Derivative Complaint," the court ruled that he could "bring double derivative claims based on the JPMorgan Board of Directors' failure to prosecute Bear Stearns' pre-merger claims." *Id*.

However, the court held that the plaintiff's derivative suit still "fails because he does not

2. To read our discussion of the *Lambrecht* decision in the September edition of the Alert, please click here.

sufficiently allege that JPMorgan was harmed by [the] [d]erivative [d]efendants' misconduct." *Id*. at *100. The court emphasized that the "fundamental requirement of a double derivative suit [is] that the injury to the subsidiary must also cause injury to the parent." *Id*. "Without such a requirement, double derivative plaintiffs could bring suits against the interests of the parent company, whose stock they hold, for alleged wrongs to a subsidiary which did not harm, and may have benefitted, the parent and its shareholders." *Id*.

The derivative plaintiff alleged injury only to Bear Stearns, not to JPMorgan Chase. According to the allegations, JPMorgan benefited tremendously from its acquisition of Bear Stearns:

> The Derivative Complaint states that 'JPMorgan reaped huge benefits from this Acquisition', that it 'acquired divisions of Bear Stearns that are still profitable and strong,' and that it did so 'without paying a reasonable consideration to Bear Stearns' shareholders.' It also alleges that 'JPMorgan received all the benefits of owning one of the largest and strongest investment banking companies for next to nothing.

Id. (internal citations omitted). Consequently, the court concluded that the plaintiff "cannot bring a double derivative claim." *Id*.

The Court Rules That the Plaintiff Failed to Satisfy Rule 23.1(b)(3)'s Demand Requirement

Pursuant to Rule 23.1(b)(3) of the Federal Rules of Civil Procedure, a derivative complaint must "state with particularity" either that the plaintiff made a demand on a corporation's board of directors or the plaintiff's reasons for not making a demand. Because it was "undisputed" that the plaintiff "did not make a pre-suit demand," the court focused its inquiry on "whether such a demand would have been futile." *Id*. at *101.

The court noted that under *Lambrecht*, a plaintiff "in a double derivative action involving a wholly owned subsidiary … only must plead demand futility (or otherwise satisfy Rule 23.1) at the parent level." *Id*. at *102 (internal quotations omitted). The plaintiff here was required to "establish the futility of a demand on the JPMorgan Board only," which the court found that he "fail[ed] to do." *Id*.

First, the court ruled that "JPMorgan's statements that it will defend Bear Stearns against this suit … do not bring into question the independence and disinterestedness of the Board …." *Id*. at *104. Second, the court noted that indemnification agreements are "standard practice and do not render a Board unable to elect to sue the indemnified parties in good faith." *Id*. Third, the court held that the plaintiff's claim that "JPMorgan's Board does not wish to admit to underpaying for Bear Stearns … merely supports the conclusion that this suit is not in JPMorgan's interests." *Id*. Finally, the court concluded that allegations of "significant ties" between "two of the twelve JPMorgan Board members and two of the pre-merger Bear Stearns Board members" did not "put into question the independence of the entire JPMorgan Board …." *Id*.

The Court Dismisses the Class Claim on Res Judicata and Collateral Estoppel Grounds

Count XIII of the derivative complaint purported to assert a direct claim for breach of fiduciary duties

"on behalf of all holders of Bear Stearns stock who have been harmed by [the] [d]efendants' actions" against certain Bear Stearns directors and officers involved in JPMorgan Chase's acquisition of Bear Stearns. *Id.* at *95. The Southern District of New York ruled that the purported class claim must be dismissed on res judicata and collateral estoppel grounds, since the claim raised substantially identical issues to those previously litigated in a related New York state court action. *Id.* at *105 (*citing In re Bear Stearns Litig.*, 23 Misc. 3d 447, 870 N.Y.S.2d 709 (N.Y. Sup. Ct. 2008) (Cahn, J.)).

The Court Dismisses the Bear Stearns ERISA Action

The court also dismissed all three ERISA claims brought by a putative class of former Bear Stearns employees who participated in the Bear Stearns Employee Stock Ownership Plan (the "ESOP Plan"). According to the ERISA plaintiffs, the defendants breached their fiduciary duties under ERISA by permitting the ESOP Plan to hold Bear Stearns' stock when the defendants knew or should have known that Bear Stearns securities were an imprudent investment (the "prudence claim"). *Id.* at *127-128. The plaintiffs further claimed that the defendants failed to: avoid conflicts of interest; properly monitor the ESOP Plan's co-fiduciaries; and provide complete and accurate information to ESOP Plan participants.

The Court Dismisses the ERISA Plaintiffs' Prudence Claim

The *Bear Stearns* court ruled that the defendants named in the prudence claim (Bear Stearns and the ESOP Committee) were not fiduciaries with respect to the ESOP Plan's investment in Bear Stearns stock. The court held that these defendants could not "be held liable for failing" to divest plan assets under ERISA because under the Plan Agreement, "only Plan Participants may order their accounts divested or diversified," whereas, "[t]he ESOP Committee and Bear Stearns are given no authority to diversify or divest plan assets." *Id.* at *129.

The *Bear Stearns* court also dismissed the plaintiffs' prudence claim on the alternative ground that the ERISA plaintiffs failed to overcome the presumption of prudence first articulated by the Third Circuit in *Moench v. Robertson*, 62 F.3d 553, 571 (3rd Cir. 1995). The *Moench* presumption acts as a "'substantial shield' which requires plaintiffs to plead 'persuasive and analytically rigorous facts demonstrating that reasonable fiduciaries would have considered themselves bound to divest ….'" *Id.* at *134 (*quoting Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 256 (5th Cir. 2008)). To overcome the *Moench* presumption, plaintiffs must show that the ERISA fiduciaries had "knowledge at a pertinent time of an imminent corporate collapse or other 'dire situation' sufficient to compel an ESOP sell-off." *Id.* (*citing Lehman Bros. Sec. and ERISA Litig.*, 683 F. Supp. 2d 294, 301 (S.D.N.Y. 2010)). Although the plaintiffs here alleged a decline in Bear Stearns' stock price from over $171 per share to as little as $4.81 a share, the *Bear Stearns* court held that these allegations were insufficient to overcome the presumption of prudence where, *inter alia*, the stock price rebounded after the class period and the plaintiffs did not allege with precision "when Bear Stearns became subject to 'imminent collapse.'" *Id.* at *136.

Notably, in adopting and applying the *Moench* presumption at the motion to dismiss stage, the court followed the vast majority of recent ERISA "stock drop" cases in the Southern District, and disclaimed its own earlier holding in *In re Morgan Stanley ERISA Litig.*, 696 F. Supp. 2d 345, 359 (S.D.N.Y. 2009). *Id.* at *133 (recognizing that the court's prior holding in *Morgan Stanley* is "no longer appropriate."). The *Bear Stearns* court relied on the reasoning in *Gearren v. McGraw-Hill Cos., Inc.*, 690 F. Supp. 2d 254, 269-270 (S.D.N.Y. 2010), in which the Southern District of New York explained that *Moench* is a "standard of review" rather than an "evidentiary presumption." The *Gearren* court

had ruled that under *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009), the *Moench* presumption should be applied on a motion to dismiss because "[t]he applicability of the presumption of prudence directly affects the plausibility of an allegation that a particular action was imprudent." *Bear Stearns*, 2011 WL 223540, at *134 (*quoting Gearren*, 690 F. Supp. 2d at 270).

Although the weight of authority in the Southern District has adopted and applied the *Moench* presumption, the Second Circuit has yet to do so. Several of the cases relied upon by the *Bear Stearns* court, however, including *Gearren, In re Citigroup ERISA Litig.*, No. 07 Civ. 9790, 2009 WL 2762708 (S.D.N.Y. Aug. 31, 2009), and *Fisher v. JPMorgan Chase & Co.*, 703 F. Supp. 2d 374 (S.D.N.Y. 2010) are pending appellate review. A Second Circuit decision addressing the application of the *Moench* presumption will likely be issued in the coming months.

The Court Dismisses the ERISA Plaintiffs' Disclosure and Misrepresentation Claims

In addition to dismissing plaintiffs' prudence claim, the *Bear Stearns* court also dismissed the plaintiffs' disclosure and misrepresentation claims, again departing from its previous holding in *Morgan Stanley*. With respect to the plaintiffs' disclosure claim, the court followed the majority of recent Southern District decisions to hold that "ERISA provides no affirmative duty to disclose material non-public information and the Second Circuit has not established such a duty." *Id*. at *137. The *Bear Stearns* court explained that holding otherwise "would require an ERISA fiduciary to disclose financial information about the companies in which the plan is invested." *Id*. at *138. Adopting the plaintiffs' position would "'transform fiduciaries into investment advisors despite the fact that fiduciaries have no duty to 'give investment advice' or 'opine on the stock's condition.'" *Id*. (*quoting Citigroup*, 2009 WL 2762708, at *22).

As to the plaintiffs' misrepresentation claim, the *Bear Stearns* court held that allegedly misleading

statements contained in SEC filings, as well as statements made by former Bear Stearns directors and officers, could not be the basis of liability under ERISA because they were not made in a fiduciary capacity. *Id*. at *140 (explaining that "statements made by [these defendants], be they SEC filings, press releases, or speeches, are not statements made while 'acting as a fiduciary' for which they are liable under ERISA.").

Finally, the *Bear Stearns* court also dismissed the plaintiffs' conflict of interest, failure to monitor, and co-fiduciary liability claims on the ground that these are derivative claims which require an antecedent breach of the duties of prudence or loyalty—neither of which the plaintiffs had adequately alleged. *Id*. at *140 (noting that "a necessary predicate for a claim alleging conflicts of interest" is "[a]n adequate claim for breach of the fiduciary duty of loyalty"). The court also ruled that allegations that certain ERISA fiduciaries owned Bear Stearns stock and sold $90 million of that stock during the class period did not support a conflict of interest claim. Rather, "'compensation in the form of company stock aligns the interests of plan fiduciaries with those of plan participants.'" *Id*. at *142 (*quoting In re Huntington Bancshares ERISA Litig.*, 620 F. Supp. 2d 842, 849, n.6 (S.D. Ohio 2009)). "[I]f company stock ownership or compensation through company stock alone presented a conflict of interests, ERISA's statutory scheme allowing company officers and directors, who are often stock holders and are compensated with stock, to serve as fiduciaries would be contradictory." *Id*.

The Court Permits the Bear Stearns Securities Fraud Action to Go Forward

Although the court dismissed both the derivative and ERISA actions, it denied the defendants' motions to dismiss the securities fraud class action.

The Court Rules That the Complaint Adequately Alleged Materially False and Misleading Statements

The *Bear Stearns* court ruled that the "[d]efendants' allegedly false and misleading statements regarding Bear Stearns' asset valuations, risk management and modeling, GAAP violations, [Bear Stearns Asset Management] write-downs, and liquidity are such that a reasonable investor would consider them to significantly alter the total mix of the information made available about the Company and material to an investment decision." *Id.* at *49 (internal quotations and alterations omitted). Noting that the "[i]ndividual [d]efendants are all Directors or Officers of Bear Stearns with direct involvement in the everyday affairs of the Company," the court further held that the plaintiffs were entitled to rely on a presumption that Bear Stearns' SEC filings and other public statements were "the collective work" of the individual defendants under the group pleading doctrine. *Id.* at *47.

In evaluating the adequacy of the pleadings, the court placed weight on the plaintiffs' allegations that the SEC twice advised Bear Stearns, in both 2005 and 2006, of "deficiencies in models it used to value mortgage-backed securities … due to its failure to assess the risk of default or incorporate data about such risk, and further advised that its value at risk ('VaR') models did not account for key factors such as changes in housing prices." *Id.* at *4. The court also pointed to allegations in the complaint that "the Bear Stearns [d]efendants knew, or were reckless in not knowing, that the SEC had stated that Bear Stearns' valuation and VaR models were seriously flawed and that the models were never updated to reflect the housing and subprime mortgage downturn" and stated that it was significant that "Bear Stearns [allegedly] never adopted the necessary changes to its mortgage and VaR models, and that it was not until toward the end of 2007 that the Bear Stearns [d]efendants attempted to respond to the SEC's concerns." *Id.* at *51.

With respect to the defendants' argument that Bear Stearns "disclosed its mortgage securitization and origination and the impact of the subprime crisis and had no duty to disclose further facts," the court ruled that "[t]his defense does not meet the charge that the asset evaluations were not adequately calculated for risk." *Id.* at *52. The court explained that while a defendant need not "disclose every fact or assumption underlying a prediction, he must disclose material, firm-specific adverse facts that affect the validity or plausibility of that prediction." *Id.* (*quoting Lorman v. U.S. Unwired, Inc.*, 565 F.3d 228, 249 (5th Cir. 2009)).

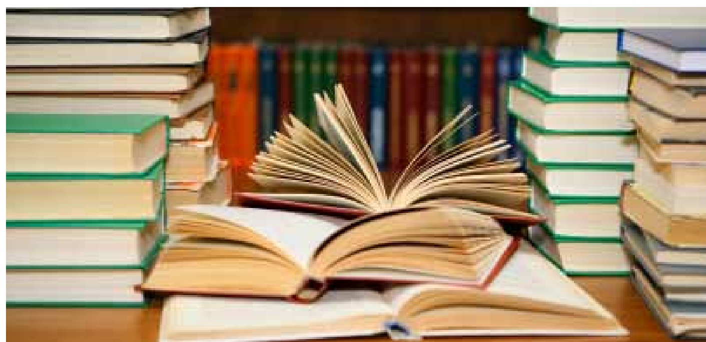
The court also rejected the defendants' claim that statements about Bear Stearns' valuation and risk models were non-actionable "matters of opinion rather than fact," holding that "[t]o the extent Bear Stearns knowingly used flawed models that would produce unreliable and skewed results, or recklessly disregarded such flaws, the results produced by those models and reported to investors are actionable misstatements." *Id.* at *53.

Furthermore, with respect to the defendants' contention that "statements about their VaR models are entitled to safe harbor protection," the court concluded that "the allegedly misleading statements about VaR models and the results provided by the VaR models are statements of present risk factors, rather than forward-looking predictions about future events." *Id.* at *54. "To the extent that some of [the] [d]efendants' statements relating to the VaR can be deemed forward-looking," the court held that these statements "still are not shielded under the safe harbor because they were not accompanied by meaningful cautionary statements." *Id.* at *56. "True cautionary language must 'warn[ ] investors of *exactly* the risk that plaintiffs claim was not disclosed.'" *Id.* While the court acknowledged that

Bear Stearns included some cautionary language with respect to VaR, it ruled that these "statements did not inform investors that Bear Stearns' VaR models did not provide for downturns in the markets or account for default risk." *Id.* at *56. The court explained that specific risk warnings "do not shelter defendants from liability if they fail to disclose hard facts critical to appreciating the magnitude of the risks described." *Id.* (*citing In re AIG, Inc. 2008 Sec. Litig.*, No. 08 Civ. 4772 (LTS), 2010 WL 3768146, at *15 (S.D.N.Y. Sept. 27, 2010)).

The Court Rules That the Complaint Adequately Pleads Scienter

The *Bear Stearns* court held that the plaintiffs have adequately "alleged circumstantial evidence to establish a strong inference of scienter through conscious misbehavior or recklessness." *Id.* at *62. In this respect, the court stated, *inter alia*, that "[t]he Securities Complaint has alleged that the Bear Stearns [d]efendants willfully or recklessly disregarded warnings from the SEC regarding Bear Stearns' risk and valuation models which allegedly were designed to give falsely optimistic accounts of the Company's



risk and finances during the Class Period." *Id.* at *63.

However, the court held that sales of Bear Stearns stock during the class period by the Section 20A individual defendants did not establish scienter and stated that fraudulent intent was "negate[d]" by the fact that "the Section 20A [d]efendants [ultimately] suffered more than $1.1 billion in losses when the [c]ompany collapsed." *Id.* at *62.

The Court Rejects the Defendants' Fraud-by-Hindsight Characterization of the Allegations

The defendants argued that the securities fraud complaint presented "a classic fraud by hindsight case" and that the plaintiffs "simply alleged 'that Bear Stearns did not predict the impact of the subprime mortgage crisis.'" *Id.* at *48. According to the defendants, they, "'along with virtually every other major financial institution and government regulator—were unable to predict the severe, rapid, and unexpected market implosion that led to the Company's collapse …." *Id.* at *66.

The court explained that "if all the Complaint allege[d]" was "[p]resent knowledge of the recession and its trigger, the subprime mortgages, their marketing and the housing crisis," then "the pleading would be inadequate." *Id.* at *48. However, here, the court stated, the plaintiffs "alleged that the Bear Stearns [d]efendants' made false and/or misleading statements and that the Bear Stearns [d]efendants knew or should have known the false and/or misleading nature of their statements when made, based on their position in the Company, warnings from the SEC and other indicators." *Id.* at *66. "The adverse consequences of Bear Stearns' disclosures relating to its exposure to declines in the housing market, and the adverse impact of those circumstances on the Company's business going forward, are alleged to have been entirely foreseeable to [the] [d]efendants at all relevant times." *Id.* Based on these allegations, the court rejected the defendants' characterization of the complaint as alleging fraud by hindsight, holding that "[t]he incantation of fraud-by-hindsight will not defeat an allegation of misrepresentations and omissions that were misleading and false at the time they were made." *Id.* at *48.

The Court Rules That the Complaint Adequately Alleges Loss Causation

The court held that "allegations that the March 14 and March 17, 2008 stock price drops were foreseeable

consequences of the disclosure of Bear Stearns' liquidity crisis and inaccurate asset valuations and, relatedly, its risk management practices and exposure to the subprime crisis, suffice to plead loss causation." *Id*. at *69. In response to the defendants' argument that "the drop in Bear Stearns' stock price was part of a market-wide downturn and not a consequence of the Company's disclosure of its liquidity position and exposure to toxic assets," the court noted that "the Securities Complaint has alleged that the banking indices were relatively stable during this period and did not share in the stock price decline seen at Bear Stearns." *Id*. at *68. Moreover, the court stated that "at the motion to dismiss stage, the Securities Complaint need not rule out all competing theories for the drop in Bear Stearns' stock price" as "that is an issue to be determined by the trier of fact on a fully developed record." *Id*. at *181.

The Court Rules That the Complaint Adequately Pleads a Section 20A Claim

The court concluded that the complaint adequately pleads a Section 20A claim against six individual defendants. Because the court ruled that the complaint "adequately alleged the 20A [d]efendants' recklessness and their scienter," the court stated that the only question was "whether the 20A [d]efendants' sales of Bear Stearns stock were contemporaneous with [the] [p]laintiffs' purchases." *Id*. at *70. The court held that the contemporaneousness requirement was met because the lead plaintiff alleged that "its purchase on December 26, 2007 fell within five trading days of sales by the 20A [d]efendants." *Id*.

The Court Denies Deloitte & Touche LLP's Motion to Dismiss the Securities Fraud Action

Finally, the court denied a motion by Bear Stearns' auditor, Deloitte & Touche LLP, to dismiss the securities fraud complaint, stating that Deloitte "recklessly disregard[ed] 'red flags'" in issuing its audit opinion on the Bear Stearns November 30, 2007 Financial Statement. *Id*. at *71. These alleged "red flags" included allegations that "the Company had persisted in using mortgage valuation models that the SEC had repeatedly criticized as inaccurate or outmoded." *Id*. at *72.

The First Circuit Holds That the Named Plaintiffs in a Mortgage-Backed Securities Class Action May Only Bring Claims Based on Securities They Actually Purchased

On January 20, 2011, the First Circuit affirmed in part and reversed in part the District of Massachusetts' dismissal with prejudice of a purported class action brought by three union pension funds against Nomura Asset Acceptance Corporation, the directors of Nomura, and various underwriters pursuant to Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 (the "'33 Act").[3] *Plumbers' Union Local No. 12 Pension Fund, et al. v. Nomura Asset Acceptance Corp.*, No. 09-2596, 2011 WL 183971 (1st Cir. Jan. 20, 2011) ("*Nomura II*"). The named plaintiffs in *Nomura* had attempted to assert claims based on securities they did not actually purchase, on the theory that the securities were sold pursuant to the same shelf registration as the securities they did purchase. The First Circuit held that in this case, "as in other[ ] [cases] involving mortgage-backed securities," named plaintiffs who purchase securities in one offering may not bring claims arising out of securities sold in a different

3. "Section 11 imposes liability for false or misleading statements contained in a registration statement; section 12(a)(2) imposes similar liability on sellers who make such statements in a prospectus or oral communication, Section 15 imposes liability on one who 'controls any person liable' under sections 11 or 12." *Nomura II* at *1 (internal citations omitted).

offering. *Id.* at *5.

The district court had dismissed the plaintiffs' claims in their entirety for lack of standing and failure to state a claim under Federal Rule of Civil Procedure 12(b)(6). While the First Circuit affirmed the district court's ruling on standing and the dismissal of claims involving appraisal practices and investment ratings, the First Circuit reversed the district court's dismissal of claims alleging false or misleading statements with respect to underwriting guidelines. The court also vacated the dismissal of the plaintiffs' Section 12(a)(2) and Section 15 claims.

Background

Nomura "established eight Alternative Loan Trusts … to hold pools of mortgages" and issue mortgage pass-through certificates, a type of mortgage-backed security. *Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, 658 F. Supp. 2d 299, 301 (D. Mass. Sept. 30, 2009) (Stearns, D.J.) ("*Nomura I*"). Each of the eight Trusts was a "separate legal entit[y]" and "each issued its own securities backed by different pools of mortgages." *Id.* at 303.

The company filed two registration statements in connection with the sale of these certificates. "Eight separate offerings were made pursuant to eight prospectuses supplementing the two registration statements." *Id.* at 301. Under the terms of the certificates, "a [c]ertificate holder was to receive a portion of the interest and/or principal payments from a specific pool of mortgage loans aggregated in a particular [t]rust." *Id.*

Although the named plaintiffs "in the aggregate purchased [c]ertificates issued by only two of the [t]rusts," the plaintiffs nonetheless sought to "represent a class consisting of all persons who purchased [c]ertificates issued by the eight defendant [t]rusts." *Id.* at 303.

The First Circuit Holds That the Plaintiffs Do Not Have Standing to Pursue Claims For Trust Certificates They Did Not Purchase

In the First Circuit's view, the "difficult threshold question" on appeal was "whether plaintiffs can pursue claims … based on offerings in which they did not participate and against trusts whose certificates they did not purchase." *Nomura II*, at *3. The district court had determined that "the named plaintiffs are incompetent to allege an injury caused by the purchase of [c]ertificates that they themselves never purchased." *Nomura I*, at 303. While the First Circuit arrived at the same conclusion, the appellate court noted that the issue was not completely "straightforward." *Nomura II*, at *3.

The First Circuit discussed at length Supreme Court precedent and decisions of other circuits, and found that "most district courts have continued to hold that named plaintiffs must themselves possess claims against each defendant." *Id.* at *5. However, the appellate court "reserve[d] judgment" on the question of whether this principle applies in cases where:

> [T]he claims of the named plaintiffs necessarily give them … essentially the same incentive to litigate the counterpart claims of the class members because the establishment of the named plaintiffs' claims necessarily establishes those of other class members. The matter is one of identity of issues ….

Id.

The First Circuit held that in this case, "as in other[ ] [cases] involving mortgage-backed securities, the necessary identity of issues and alignment of incentives is not present so far as the claims involve sales of certificates in the six trusts." *Id*. Because "[e]ach trust is backed by loans from a different mix of banks[,] no named plaintiff has a significant interest in establishing wrongdoing by the particular group of banks that financed a trust from which the named plaintiffs made no purchases." *Id*. The First Circuit concluded that "claims related to the six trusts from which the named plaintiffs never purchased securities were properly dismissed, as were the six trusts and defendants connected only to those six trusts." *Id*. Additionally, the appellate court held that claims against Nomura also failed to the extent that they were based on those six trusts.

The First Circuit Finds That the Plaintiffs' Adequately Alleged False and Misleading Statements With Respect to Underwriting Guidelines

Reversing the district court's ruling, the First Circuit held that the plaintiffs had adequately stated a claim that the offering documents contained false and misleading statements regarding the underwriting guidelines used by loan originators to ensure the creditworthiness of borrowers. The plaintiffs alleged that First National Bank of Nevada ("FNBN"), one of the loan originators for the two remaining trusts at issue, "'routinely violated' its lending guidelines and instead approved as many loans as possible, even 'scrub[bing]' loan applications of potentially disqualifying material." *Id*. at *7. "[C]ontrary to the registration statement, borrowers [allegedly] did not 'demonstrate[ ] an established ability to repay indebtedness in a timely fashion' and employment history was [allegedly] not 'verified.'" *Id*. According to the complaint, FNBN effectively engaged in a "wholesale abandonment" of the underwriting guidelines. *Id*.

The offering documents for the certificates contained a number of "warnings" stating, for example, that:

> [The] "underwriting standards … typically differ from, and are … generally less stringent than, the underwriting standards established by Fannie Mae or Freddie Mac"; that "certain exceptions to the underwriting standards … are made in the event that compensating factors are demonstrated by a prospective borrower"; and that FNBN "originates or purchases loans that have been originated under certain limited documentation programs" that "may not require income, employment or asset verification."

Id. Based on what it considered to be a "fusillade of cautionary statements," *Nomura I*, at 307, the district court held that the plaintiffs had failed to allege false and misleading statements regarding underwriting guidelines. However, the First Circuit found these same warnings insufficient to protect the defendants from potential securities fraud liability: "Neither being 'less stringent' than Fannie Mae nor saying that exceptions occur when borrowers demonstrate other 'compensating factors' reveals what plaintiffs allege, namely, a wholesale abandonment of underwriting standards." *Nomura II*, at *7.

To address the defendants' defense that "no detailed factual support is provided for the [underwriting standards] allegation," the First Circuit

instructed the district court to permit "some initial discovery aimed at these precise allegations." *Id.* at *8. The *Nomura II* court explained that "[t]he district court is free to limit the discovery stringently and to revisit the adequacy of the allegations thereafter." *Id.*

The First Circuit Affirms the Dismissal of Claims Involving Appraisal Practices and Investment Ratings

Concurring with the district court's findings, the First Circuit affirmed the dismissal of allegations that "the offering documents contained false statements relating to the methods used to appraise the property values of potential borrowers." *Id.* The *Nomura II* court found that there was "no allegation that any specific bank that supplied mortgages to the trusts did exert undue pressure, let alone that the pressure succeeded." *Id.* Rather, the complaint "fairly read" simply alleges that "many appraisers in the banking industry were subject to such pressure." *Id.* The First Circuit "agree[d] with the district court" that these allegations were not enough to survive dismissal, and noted that "[s]everal other district courts have reached precisely this conclusion." *Id.* at *9, n.13 (*citing, inter alia, In re IndyMac Mortgage-Backed Sec. Litig.*, 718 F. Supp. 2d 495, 510 (S.D.N.Y. 2010) (rejecting allegation "that the appraisers of the properties underlying the [c]ertificates … succumbed to [pressure] in a way that violated [the Uniform Standards of Professional Appraisal Practice]")).

As to the plaintiffs' allegations that the prospectus supplements for the trusts included misleading ratings for the certificates at issue, the First Circuit held that these claims were also properly dismissed. The plaintiffs argued that the ratings were "based on 'outdated models, lowered ratings criteria, and inaccurate loan information.'" *Id.* at *9. Not persuaded, the First Circuit emphasized that ratings are not facts but rather, "*opinions* purportedly expressing the agencies' professional judgment about the value and prospects of the certificates." *Id.* "Defendants are not liable under the securities laws when their opinions … were honestly held when formed but simply turn out later to be inaccurate; nor are they liable only because they could have formed 'better' opinions." *Id.* Moreover, allegations that rating agencies "should have been using better methods and data" are not sufficient to render ratings "false or misleading." *Id.*

The First Circuit Vacates the Dismissal of Claims Under Sections 12(a)(2) and 15 of the '33 Act

The First Circuit found that the district court had erroneously dismissed the plaintiffs' Section 12(a)(2) claims on the grounds that the plaintiffs "did not adequately allege that [the] defendants sold the certificates to the plaintiffs or solicited the sales."[4] *Id.* at *10. Citing allegations that the plaintiffs "acquired … [c]ertificates from defendant Nomura Securities" and that the "[d]efendants promoted and sold the [c]ertificates to [the p]laintiffs and other members of the [c]lass," the First Circuit held that the plaintiffs had adequately stated a claim under Section 12(a)(2) to the extent that material misstatements or omissions are also alleged. *Id.* (alterations and emphasis in original).

The *Nomura II* court also vacated the dismissal of the plaintiffs' Section 15 "control person liability" claims, which was based on the district court's finding that the "plaintiffs failed to state a violation of the securities laws to begin with." *Id.* The First Circuit held that "[g]iven the 'highly factual nature' of the control person inquiry, resolving th[e] issue [of control person liability] on a motion to dismiss is often inappropriate." *Id.*

4. Under Section 12(a)(2), a claim may only be brought against "a defendant who either sold its own security to the plaintiff or (for financial gain) successfully solicited the sale of that security to the plaintiff." *Id.* at *10.

The Delaware Chancery Court Upholds the Use of a Poison Pill in the Air Products-Airgas Hostile Takeover Battle

On February 15, 2011, the Delaware Chancery Court upheld a refusal by the board of directors of Airgas, Inc. ("Airgas"), to redeem a poison pill used in defense of a hostile takeover by Air Products and Chemicals, Inc. ("Air Products"). *Air Products and Chemicals, Inc. v. Airgas, Inc.*, Nos. 5249-CC, 5256-CC (Del. Ch. Feb. 15, 2011) ("*Air Products*"). Airgas had alleged a threat of "inadequate price, coupled with the fact that a majority of Airgas's stock [was] held by merger arbitrageurs who might [have] be[en] willing to tender into such an inadequate offer. . . ." *Id*. at 106-07. The Chancery Court explained that it was constrained by Delaware precedent in reaching this decision: "I have a hard time believing that inadequate price alone (according to the target's board) in the context of a non-discriminatory, all-cash, all-shares, fully financed offer poses any 'threat' … under existing Delaware law, it apparently does. Inadequate price has become a form of 'substantive coercion' as that concept has been developed by the Delaware Supreme Court in its takeover jurisprudence." *Id*. at 7. Applying the heightened standard of judicial scrutiny under *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), the Chancery Court found that the Airgas board had met its burden "to articulate a legally cognizable threat … and ha[d] taken defensive measures that fall within the range of reasonable responses proportionate to that threat." *Air Products*, at 3.

Background

In February 2010, Air Products initiated a public tender offer to acquire 100% of the shares of Airgas, a competitor in the industrial gas business. Concurrent with the public announcement of its tender offer, Air Products, later joined by the Airgas stockholders, filed suit seeking, *inter alia*, an order directing Airgas to redeem its Shareholder Rights Plan (more commonly known as the "poison pill") that was allegedly "stopping Air Products from moving forward with its hostile offer, and to allow Airgas's stockholders to decide for themselves whether they want to tender into Air Products' (inadequate or not) $70 'best and final' offer." *Id*. at 5.

During the course of the litigation, Air Products increased its initial offer of $60 per share several times, to $62, $63.50, and to $65.50 in September 2010. The Airgas board, in consultation with financial advisors Goldman Sachs and Bank of America Merrill Lynch, rejected all these offers as inadequate and refused to negotiate with Air Products. After its rejection of Air Products' $65.50 offer, the Airgas board informed Air Products that the Airgas price-per-share value was at least $78.

On September 15, 2010, Airgas stockholders elected three Air Products nominees to the board and adopted Air Products' proposed bylaw amendment to change the date of Airgas's annual board meeting from September to January 2011. Airgas immediately brought suit to invalidate the January meeting bylaw. While the Chancery Court upheld the validity of the bylaw in October 2010, the Delaware Supreme Court reversed in November 2010 on the grounds that Airgas annual meetings must be spaced one year apart. (For a discussion of this decision in the December 2010 edition of the Alert, please click here.)

In October, the Chancery Court held a week-long trial on the Airgas poison pill. After the trial, Air Products raised its offer to what it publicly announced as its "best and final offer" of $70 per share. Three financial advisors to Airgas—Goldman Sachs, Bank of America Merrill Lynch, and Credit Suisse[5]—counseled the Airgas board that the $70 offer was inadequate. "Interestingly," the Chancery Court noted, "the Air Products [n]ominees were some of the most vocal

5. By this time, at the urging of the three newly-elected Air Products directors, the Airgas board had retained Credit Suisse as a third independent financial advisor.

opponents to the $70 offer." *Id*. at 71. The court held a supplementary evidentiary hearing in January to complete the record on the $70 offer.

On February 15, 2011—the day that the Air Products bid was set to expire—the Chancery Court ruled that "the Airgas board, in proceeding as it has since October 2009, has not breached its fiduciary duties owed to the Airgas stockholders … [and] has acted in good faith and in the honest belief that the Air Products offer, at $70 per share, is inadequate." *Id*. at 7.

The Court Holds That the Airgas Board's Refusal to Redeem the Poison Pill Meets Both Prongs of the *Unocal* Standard

The *Airgas* litigation addressed what the Chancery Court characterized as "one of the most basic questions animating all of corporate law, which relates to the allocation of power between directors and stockholders." *Id*. at 2.

> [W]hen, if ever, will a board's duty to the corporation and its shareholders require [the board] to abandon concerns for long term values (and other constituencies) and enter a current share value maximizing mode? More to the point, in the context of a hostile tender offer, who gets to decide when and if the corporation is for sale?

Id. (internal quotations omitted).

The Chancery Court found that "it is well-settled that when a poison pill is being maintained as a defensive measure and a board is faced with a request to redeem the rights, the *Unocal* standard of enhanced judicial scrutiny applies." *Id*. at 77. Under the *Unocal* standard, the board of the target corporation must demonstrate "(1) that it had 'reasonable grounds for believing a danger to corporate policy and effectiveness existed' (i.e., the board must articulate

a legally cognizable threat) and (2) that any board action taken in response to that threat is 'reasonable in relation to the threat posed.'" *Id*. (*quoting Unitrin, Inc. v. Am. Gen. Corp*., 651 A.2d 1361, 1373 (Del. 1995)). The first prong of *Unocal* is essentially a "process-based review" for "good faith and reasonable investigation" on the part of the directors. *Id*. at 78. Directors must also "articulate some legitimate threat to corporate policy and effectiveness." *Id*. The second prong of *Unocal* is a "substantive review of the board's defensive actions" to determine if the board's response is proportional to the threat posed and not a result of the board acting in its own interests. *Id*. at 78-79. A board's actions are not proportional if they are either preclusive of a takeover or coercive to shareholders.

Applying the first prong of *Unocal*, the court concluded that "it is undeniable that Airgas meets this test" of "good faith and reasonable investigation." *Id*. at 103. The court noted that Airgas's board, comprised of independent directors and three newly-elected Air Products directors, unanimously rejected the offer after consulting with three independent financial advisors. Moreover, the Chancery Court found that the threat of an inadequate price was legitimate under *Unocal*. Many arbitrageurs—a majority of Airgas's stockholders—had bought into Airgas at a lower price

after Air Products announced its interest in a deal. Airgas had contended that these investors would be willing to sell at what the board deemed to be a grossly inadequate offer in order to make a significant return in the short term rather than retaining Airgas shares for long-term growth. Air Products had responded that there was no such threat because Airgas had not demonstrated "a single fact supporting" the contention that short-term stockholders would accept the $70 offer if they believed it to be inadequate. *Id*. at 117. Agreeing with the Airgas board, the court found that these "'short-term, deal-driven investors pos[e] a threat to the company and its shareholders" because they would likely support a $70 offer. *Id*. at 112.

Applying the second prong of *Unocal*, the Chancery Court concluded that the Airgas board had "acted in good faith" in rejecting what it believed to be an inadequate offer and permissibly "'employ[ed] a poison pill as a proportionate defensive response to protect its stockholders from a 'low ball' bid.'" *Id*. at 120. The Court found it significant that the defensive measures were only "preclusive for now" as opposed to "preclusive forever" because Airgas's staggered board prevented the takeover of Airgas's board "*in the very near future*" and merely slowed the process by which Air Products could control the Airgas board and remove the pill. *Id*. at 122. Air Products' options were to (1) call a special meeting to remove the entire board with a supermajority vote of the outstanding shares, or (2) wait until the 2011 annual Airgas meeting to nominate new directors. Though achieving a supermajority vote was unlikely, the Chancery Court found that Air Products would likely have the victory it sought at the 2011 Airgas board meeting. Accordingly, the court ruled that Air Products' unwillingness to wait another eight months, according to the Court, was merely a business decision of its board rather than the result of a "preclusive" measure by Airgas.

The Delaware Supreme Court Holds That a Plaintiff May, Under Certain Circumstances, Inspect a Company's Books and Records Even After Filing a Derivative Action

In *King v. VeriFone Holdings, Inc.* ("*VeriFone III*"), No. 330, 2010, 2011 WL 284966, at *1 (Del. Jan. 28, 2011), the Delaware Supreme Court considered "whether a stockholder-plaintiff who has brought a stockholder's derivative action without first prosecuting an action to inspect books and records under 8 Del. C. § 220 is … legally precluded from prosecuting a later-filed Section 220 proceeding." The *VeriFone III* court reversed a ruling by the Chancery Court and held that a stockholder-plaintiff may bring a Section 220 inspection action even after filing a derivative suit where the plaintiff's derivative complaint is dismissed on demand futility-related grounds without prejudice and with leave to amend.

The issue arose in the context of a derivative action brought in connection with VeriFone's December 2007 restatement announcement, following which the company's stock price dropped by more than forty-five percent. In May 2009, the Northern District of California dismissed the derivative suit without prejudice for failure to make a pre-suit demand on VeriFone's board of directors. *In re VeriFone Holdings, Inc. Shareholder Der. Litig.*, No. C 07-06347 MHP, 2009 WL 1458233, at *12 (N.D. Cal. May 26, 2009) (Patel, J.) ("*VeriFone II*"). However, the district court granted the plaintiffs leave to amend their complaint, and stated that plaintiffs may "engage in further investigation to assert additional particularized facts" in support of their demand futility claim by filing a Section 220 action in Delaware state court. *Id*. at *13.

In accordance with the district court's suggestion, the lead plaintiff filed a Section 220 action to obtain a copy of VeriFone's Audit Committee Report, which

reflected the results of an internal investigation conducted after the December 2007 restatement. The plaintiff alleged that the Audit Report was "essential to enable him to plead demand futility in the California [f]ederal action," because it would "likely show that VeriFone's officers and [b]oard knew of the company's inadequate financial reporting controls, yet consciously disregarded that fact …." *VeriFone III*, at *2.

The Delaware Chancery Court rejected the plaintiff's request for inspection, noting that "it is improper for a stockholder to rush to court to file a derivative suit … and then seek to remedy the stockholder's own lack of pre-suit investigation by filing … a books and records action, to obtain information to help the stockholder remedy deficiencies that its own self-serving rush to court undoubtedly helped create." *King v. VeriFone Holdings, Inc.*, 994 A.2d 354, 356 (Del. Ch. 2010) ("*VeriFone I*"). The *VeriFone I* court held that "stockholders who seek books and records in order to determine whether to bring a derivative suit should do so *before* filing the derivative suit." *Id.* at 356-57 (emphasis added). "Once a plaintiff has chosen to file a derivative suit, it … may not … burden the corporation (and its other stockholders) with yet another lawsuit to obtain information it cannot get in discovery in the derivative suit." *Id.* at 357.

In reversing the Chancery Court's ruling, the Delaware Supreme Court found that the *VeriFone I* court's "bright-line rule barring stockholder-plaintiffs from pursuing [Section 220] inspection relief … solely because they filed a derivative action first, does not comport with existing Delaware law or with sound policy." *Verifone III*, at *3. While "Delaware courts have strongly encouraged stockholder-plaintiffs to utilize Section 220 before filing a derivative action," the *VeriFone III* court explained that "[a] failure to proceed in that specific sequence … has not heretofore been regarded as fatal." *Id.* at *4.

The Delaware Supreme Court noted there have been "several instances" in which "a stockholder-plaintiff initiated a derivative suit without first prosecuting a Section 220 books and records action." *Id.* "Where those derivative suits were dismissed for failure to plead demand futility adequately, both this Court and the Court of Chancery [have] permitted the stockholder-plaintiffs to utilize the Section 220 inspection process to gather new information and replead their derivative complaints." *Id.*

The Delaware Supreme Court concluded that the *VeriFone* plaintiffs had a "proper purpose"[6] for bringing an action under Section 220:

> [I]t is a proper purpose under Section 220 to inspect books and records that would aid the plaintiff in pleading demand futility in a to-be-amended complaint in a plenary derivative action, where the earlier-filed plenary complaint was dismissed on demand futility-related grounds without prejudice and with leave to amend.

Id. at *7. The court noted that its decision "should not be read as an endorsement" for bringing a Section 220 action after the filing of a derivative action. *Id.* Rather, the *VeriFone III* court cautioned that "filing a plenary derivative action without having first resorted to the inspection process … may well prove imprudent and cost-ineffective." *Id.*

As to the Chancery Court's concern "that the premature filing of a plenary derivative action may be a potential abuse," the Delaware Supreme Court agreed that "it is wasteful of the court's and

6. Section 220 provides that a stockholder may inspect the books and records of a corporation upon a showing of a "proper purpose." 8 Del. Code. Ann. § 220 (2010).

the litigant's resources to have a regime that could require a corporation to litigate repeatedly the issue of demand futility." *Id*. at *8. However, the *VeriFone III* court explained that there are a number of "narrower remedies" for the problem of prematurely-filed derivative actions, such as the denial of 'lead plaintiff' status to a stockholder who races to the courthouse without conducting an appropriate pre-suit investigation. *Id*.

The Delaware Chancery Court Requires Managing Director-Level Rule 30(b)(6) Deposition Testimony in the Calix-Occam Merger Litigation

In an oral ruling on January 24, 2011, the Delaware Chancery Court temporarily enjoined Calix, Inc.'s acquisition of Occam Networks, Inc. on grounds of inadequate disclosures, but denied an injunction on process grounds after reviewing the transaction under an enhanced scrutiny standard. Transcript of the Ruling of the Court on the Plaintiffs' Motion for a Preliminary Injunction, *Steinhardt, et al. v. Howard-Anderson, et al.*, No. 5878-VCL (Del. Ch. Jan. 24, 2011) (Laster, V.C.). The court ordered the defendants to provide details as to how the road show changed the total mix of consideration because "the record seems to suggest … a reduction in the cash value of approximately 25 million." *Id*. at 11. The court also instructed the defendants to provide a "fair summary" of the accretion/dilution analysis from the final book, as well as certain other additional disclosures. *Id*. at 12.

A notable feature of the court's order was its requirement that Jefferies & Co., Occam's financial advisor, produce a managing director-level banker to appear for a second deposition under Federal Rule of Civil Procedure 30(b)(6). The court found that the witness Jefferies & Co. provided for its first 30(b)(6) deposition was too junior to provide adequate information as to the final deal metrics.

The court expressed concern as to "longitudinal changes" between the deal metrics reflected in internal Jefferies deal books, and the metrics used in the final deal book. *Id*. at 15. These figures made "the deal look better than it would have had the same metrics been used that were used in prior books." *Id*. Recognizing that "[t]his is an issue that comes up with some regularity," the court explained that "we're not going to require some type of longitudinal disclosure to contrast your negotiation book with your real internal book." *Id*.

However, the court suggested that the level of disclosures as to these "longitudinal changes" was inadequate because the Rule 30(b)(6) witness produced by Jefferies was not "sufficiently knowledgeable about what Jefferies did in this deal." *Id*. at 15-16. The court stated that "[i]t is not acceptable to send a fifth year junior banker who has only done six fairness opinions, and who came into the process late in the game with only three months left [on the transaction], as your 30(b)(6) witness." *Id*. at 18.

To provide the shareholder plaintiffs with the opportunity to obtain further information regarding these "longitudinal changes," the court ordered a second Rule 30(b)(6) deposition of one of the two senior Jefferies bankers involved in the transaction. The court was harsh in its criticism for Jefferies' failure to produce a managing director for the first Rule 30(b)(6) deposition:

> Frankly, if it turns out [the second Rule 30(b)(6) deposition] is prolonging the length of the injunction, blame your bankers. The managing directors who quarterbacked the process need to do so with the expectation that when there is expedited litigation challenging the deal, that they will respond and be available for a deposition and testimony if warranted about what happened in the deal.

Id.

The court was unequivocal in its expectation of cooperation from managing director-level bankers in merger litigation: "It would not allow these cases to be adjudicated responsibly if managing directors could decide that they are simply too busy to play a role in terms of the actual adjudication of the deals for which their investment banks are making seven-figure fees, and that they … have better things to do, and therefore, they will send one of their junior members instead." *Id*. at 19.

The Delaware Chancery Court Takes Aim at Potential Collusive Forum Shopping in the NightHawk Radiology-Virtual Radiologic Corp. Merger Litigation

In multi-district merger litigation arising out of the $170 million merger of NightHawk Radiology Holdings, Inc. with Virtual Radiologic Corp., the Delaware Chancery Court found that there was *prima facie* evidence of collusive forum shopping and ordered an inquiry into counsel's roles in the forum selection process. Transcript of Courtroom Status Conference, *Scully v. Nighthawk Radiology Holdings, Inc.*, No. 5890-VCL (Del. Ch. Dec. 17, 2010) (Laster, V.C.).

Following the September 2010 announcement of the NightHawk-Virtual merger, shareholders brought suit to enjoin the transaction. Counsel for the defendants brought a motion to expedite the litigation in Delaware Chancery Court, and expressed a strong preference for having the litigation proceed in Delaware. During the hearing on the motion to expedite, the Chancery Court stated that the disclosure claims at issue were "not colorable" but "made clear that … there were meaningful, litigable process" issues in the deal. *Id*. at 3.

Not long after the hearing on the motion to expedite, the parties informed the Chancery Court that they had entered into a memorandum of understanding that would result in a global disclosure-only settlement; and that they intended to present the settlement for approval in Arizona state court. Upon receiving a letter from plaintiffs about the settlement, the Chancery Court scheduled a status conference.

The Chancery Court expressed great "surprise" that the parties had opted to settle the disclosure-based claims that the court had found "not colorable" and yet "[t]here was no apparent effort to address the [process] claims" that the court had found "colorable." *Id*. at 3-4. Moreover, instead of presenting the settlement agreement to the Chancery Court for approval, the parties "decided to go to the Arizona state courts" even though there had been no meaningful litigation activity in the matter outside of Delaware:

> This was the only court that had looked at these things. This is a case that involved issues of Delaware law on the internal affairs doctrine, yet here the parties were running to a different court not familiar with Delaware law to seek approval from a court that hadn't done anything to look at the case yet.

Id. at 4-5. Given these circumstances, the Chancery Court expressed "serious concerns … that what was going on here was collusive forum shopping." *Id*. at 5.

Counsel for the defendants responded that "the goal … wasn't to twist anybody's arm or to run away

from Delaware." *Id*. at 14. "The situation, as we saw it, was that we were faced with seven actions in Arizona … [a]nd so our goal was to get a global resolution." *Id*. The Chancery Court remained unconvinced:

> What happened here is the plaintiffs filed a case that really had legs. And I told you guys … it had legs. And what do you know. All of a sudden [counsel for the defendants and the plaintiffs] are both working over the plaintiffs to get them to Arizona.

Id. at 17. When it became clear during the hearing on the motion to expedite that the parties "couldn't legitimately settle at that point in front of [the Chancery Court] for disclosures," the court found that the lawyers involved placed "affirmative pressure on [the] Delaware plaintiffs to shift everything to Arizona." *Id*. at 23-24. "[T]he next thing we had is the [memorandum of understanding] for the disclosure settlement." *Id*. at 24. The *Scully* court determined that "this situation has all the hallmarks of collusive activity." *Id*. at 23.

In the Chancery Court's view, "what's gone on here is the classic reverse auction … where defendants benefit and utilize multiple forum[s] to force plaintiffs essentially to constructively reverse-bid for the lowest possible settlement." *Id*. at 11. Through strategies such as "giving preferential access to documents" or "stipulat[ing] to the consolidation and certification of a class," the Chancery Court noted that defendants "can do things to try to advance one action over another, and ultimately … settle with the least-cost player." *Id*. at 20. The Chancery Court found that part of the problem is that tactical forum-selection negotiations are built into the system: "You're [all] repeat players, and repeat players establish understandings as to how things work and how the game is played." *Id*. at 21.

In the Chancery Court's view, "collusive forum shopping and collusive settlement[s] … undercut the fairness of the proceedings." *Id*. at 22. "'When competition among different sets of plaintiffs' counsel exists, [there's] the ever present danger that unscrupulous counsel may 'sell out' the class in order to receive a fee.'" *Id*. at 20-21 (*quoting Prezant v. De Angelis*, 636 A.2d 915, 922 (Del. 1994)). The *Scully* court suggested that defense counsel should tread very carefully in settlement negotiations in multi-district merger litigation: "[Y]ou're dealing with fiduciaries for a class. And when you knowingly induce a fiduciary breach, you're an aider and abettor. You're not an arm's-length negotiator. You're an aider and abettor." *Id*. at 22.

The *Scully* court stated that it would give full faith and credit to the Arizona court's decision on whether or not to approve the settlement in this action. However, "to ensure that the Arizona [c]ourt is informed" about the prior history in this action, the Chancery Court directed that copies of the status conference transcript and other case files be sent to the Arizona court. *Id*. at 25. The *Scully* court also indicated that Vice Chancellor J. Travis Laster would "make himself available to speak with the Arizona [c]ourt, should that be helpful to the judge." *Id*.

As to the parties' conduct before the Chancery Court in this action, the *Scully* court found that "there's a prima facie case of collusion" and "there needs to be some factual showing to convince [the court] otherwise." *Id*. at 30. The court indicated its intent to "determine if a wrong was committed and, if so, to determine what the appropriate remedy would be." *Id*. at 25-26. One potential remedy under the court's consideration is the revocation of *pro hac vice* status for counsel found to have engaged in inappropriate conduct.

Finally, to address the broader issue of forum shopping in multi-district merger litigation, the court stated that it would "appoint special counsel to weigh in on these issues" and "provide specific input on the interests of the State [of Delaware] and judicial system as a whole." *Id*. at 28.

The Arizona court has since scheduled a pre-trial conference in the action for early March.

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

Linda H. Martin
212-455-7722
lmartin@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

Alan C. Turner
212-455-2472
aturner@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

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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