Simpson Thacher

SECURITIES LAW ALERT

JULY 2011

This month's Alert addresses the Supreme Court's grant of *certiorari* to consider whether the statute of limitations for a Section 16(b) short-swing trading claim is subject to tolling. We also review the Supreme Court's decision in *Wal-Mart* as it applies to class actions generally.

In addition, we discuss: a First Circuit decision finding an exclusivity provision in a financing agreement "ambiguous;" two Second Circuit rulings, one addressing "group" violations under Section 13(d) and another holding that D&O liability policies cover investigative and special litigation expenses; an Eighth Circuit decision rejecting the "pattern" theory of the duty to disclose; and an Eleventh Circuit ruling holding that *Morrison* may not require dismissal where the complaint alleges a domestic closing for a foreign securities transaction. We also address the Central District of California's decision declining to hear Japanese securities law claims in the *Toyota* litigation.

Finally, we discuss the recent trend of shareholder derivative litigation brought on the heels of negative "Say on Pay" votes.

The Supreme Court Will Address Section 16(b)'s Statute of Limitations for Short-Swing Trading Claims

On June 27, 2011, the Supreme Court granted *certiorari* to review the Ninth Circuit's decision in *Simmonds v. Credit Suisse Securities (USA) LLC*, 638 F. 3d 1072 (9th Cir. 2011) (Smith, M.). The Court will consider whether the two-year statute of limitations for bringing a Section 16(b) short-swing trading claim is "subject to tolling, and, if so, whether tolling continues even after the receipt of actual notice of the facts giving rise to the claim." Petition for Writ of *Certiorari*, *Credit Suisse Securities (USA) LLC v. Simmonds*, 2011 WL 1479066, at i (U.S. Apr. 15, 2011) (No. 10-1261) ("Petition for Writ of *Certiorari*"); Order Granting Petition for Writ of *Certiorari*.

Background

Section 16(b) "bars a defined set of corporate insiders from profiting from a 'short swing' purchase and sale of corporate securities within a six-month period, and allows a shareholder – after adequate demand on the corporate issuer of those securities – to bring a cause of action for disgorgement on the issuer's behalf." Petition for Writ of *Certiorari* at 1. The statute provides that "no such suit shall be brought more than two years after the date such profit was realized." 15 U.S.C. § 78p(b).

In 2007, the plaintiff brought Section 16(b) claims against a number of underwriters in connection with

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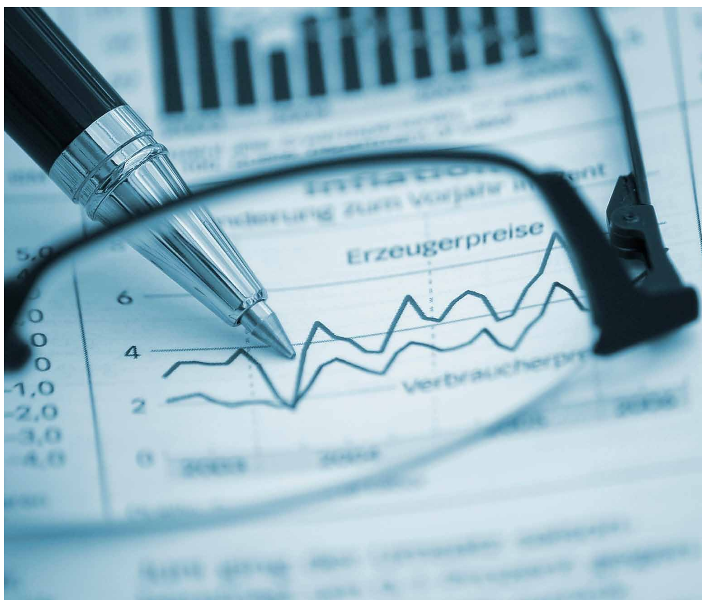
fifty-four initial public offerings ("IPOs") between 1999 and 2000. *Simmonds*, 638 F.3d at 1084. The plaintiff alleged that the underwriters engaged in short-swing trading through, *inter alia*, "a practice known as 'laddering.'" *Id.* at 1085. "[I]n exchange for giving their customers access to IPO allocations, the [u]nderwriters [allegedly] required their customers … to purchase shares 'at progressively higher prices' following the IPO." *Id.*

In 2009, the district court dismissed thirty of the fifty-four consolidated actions for demand inadequacy, and dismissed the remaining twenty-four actions with prejudice on statute of limitations grounds. *Id.* at 1086 (*citing In re Section 16(b) Litig.*, 602 F. Supp. 2d 1202, 1211-18 (W.D. Wash. 2009)).

While the Ninth Circuit affirmed the district court's decision as to the thirty actions dismissed for demand inadequacy, it reversed the district court's dismissal of the remaining twenty-four actions. *Id.* at 1094, 1097. The Ninth Circuit held that "Section 16(b)'s two-year statute of limitations begins to run from the time that the defendant files a Section 16(a) disclosure statement." *Id.* at 1096-97. Because the plaintiff did not allege that the defendants filed Section 16(a) reports, the Ninth Circuit "conclude[d] that [the plaintiff's] claims are not time-barred." *Id.* at 1097.



The *Simmonds* Court Follows Ninth Circuit Precedent in Applying Section 16(b)'s Statute of Limitations

In construing Section 16(b)'s statute of limitations, the *Simmonds* court explained that it was "bound by [the Ninth Circuit]'s prior holding" in *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir. 1981) (Tang, T.). *Simmonds*, 638 F. 3d at 1094. The *Whittaker* court considered "three competing approaches" to applying the statute of limitations. *Id.* at 1095. Under the "'strict' approach," Section 16(b)'s limitations period is "treated as a statute of repose – that is, a firm bar that is not subject to tolling." *Id.* Under the "'notice' or 'discovery' approach," the statute of limitations is tolled until the issuing corporation has "sufficient information to put it on notice of its potential § 16(b) claim." *Id.* Finally, under the "'disclosure' approach," the statute of limitations is tolled "until the insider discloses the transactions at issue in his mandatory § 16(a) reports." *Id.*

"After thoroughly analyzing the merits of the competing interpretations," the *Whittaker* court "held unequivocally that 'the disclosure interpretation is the correct construction of § 16.'" *Id.* "Under this approach, 'an insider's failure to disclose covered transactions in the required § 16(a) reports tolls the two year limitations period for suits under § 16(b) to recover profits connected with such a non-disclosed transaction.'" *Id.*

In light of *Whittaker*, the *Simmonds* court did not consider arguments that the plaintiff "knew or should have known of the alleged wrongful conduct many years before she filed her [c]omplaints." *Id.* The *Whittaker* ruling establishes that "the Section 16(b) statute of limitations is tolled until the insider discloses his transactions in a Section 16(a) filing, regardless of whether the plaintiff knew or should have known of the conduct at issue." *Id.*

The *Simmonds* court also rejected the defendants' contention that "the Section 16(b) limitations period should not be tolled indefinitely unless the defendant actively 'conceal[s] the facts necessary to trigger a

Section 16(b) lawsuit.'" *Id.* at 1096. In *Whittaker*, the Ninth Circuit explained that "[t]he failure to disclose in § 16(a) reports, whether intentional or inadvertent, is deemed concealment." 639 F.2d at 527 n.9. The *Whittaker* court's "emphasis on creating a rule that can be 'mechanically calculated from objective facts' … would be undermined if courts were required to conduct case-specific inquiries into the insiders' state of mind about their failure to file Section 16(a) reports." *Simmonds*, 638 F.3d at 1096.

Circuit Judge Smith Issues a "Specially Concurring" Opinion Suggesting That Section 16(b)'s Statute of Limitations Should Be Treated as a Statute of Repose

Although Circuit Judge Smith authored the Ninth Circuit's opinion in *Simmonds*, he issued a "specially concurring" opinion expressing his personal view that "the statutory text and statutory structure [of Section 16(b)'s statute of limitations] clearly point to the repose approach." *Id.* at 1100. "Were it not for *Whittaker*," Judge Smith stated that he would "hold that Section 16(b) suits may not be brought more than two years after the short-swing trades take place." *Id.* at 1100-01.

Judge Smith's concurring opinion pointed to *dictum* in the Supreme Court's decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991) (Blackmun, J.), in which the Court stated that Section 16(b) "sets a 2-year … period of repose." *Id.* at 360 n.5. (The *Lampf* Court considered the applicable statute of limitations for Section 10(b) claims, and mentioned Section 16(b) by way of comparison.)

Judge Smith also found that a review of other statutes of limitations in the securities laws supports "[t]his straightforward textual reading" of Section 16(b)'s limitations period. *Simmonds*, 638 F.3d at 1099. Under the Sarbanes-Oxley Act of 2002, for example, securities fraud suits "may be brought not later than … 5 years after such violation." *Id.* (*citing* 28 U.S.C. § 1658(b)(2)). "The Supreme Court recently noted that this provision 'giv[es] defendants *total repose* after five years.'" *Id.* (*quoting Merck & Co., Inc. v. Reynolds,* 130 S.Ct 1784, 1797 (2010)). Judge Smith explained that there is "little meaningful distinction between the language of 28 U.S.C. § 1658(b)(2) and Section 16(b)," and thus there should be "'total repose'" under both statutes. *Id.*

Moreover, Judge Smith noted that a "restrictive statute of limitations" for Section 16(b) claims is "eminently logical" from a policy perspective. *Id.* at 1100. "Section 16(b) imposes an inflexible penalty on corporate insiders even if they are not at fault and third parties are unharmed." *Id.* "It makes no sense to allow individuals to be hauled into court years – or even decades – after they unintentionally violate Section 16." *Id.*

The Underwriters Cite a Circuit Split in Their Petition for *Certiorari*

On petition for *certiorari*, the underwriters contended that the Ninth Circuit's disclosure approach "squarely and concededly conflicts with the Second Circuit's rule that Section 16(b) tolling ends upon" the "receipt of actual notice of the facts giving rise to the claim." Petition for Writ of *Certiorari* at 1. The Second Circuit has held that:

> [T]he two year limitations period of Section 16(b) is subject to equitable tolling when a covered party fails to comply with Section 16(a) and that such tolling ends when a potential claimant otherwise receives sufficient notice that short-swing profits were realized by the party covered by Section 16(a).

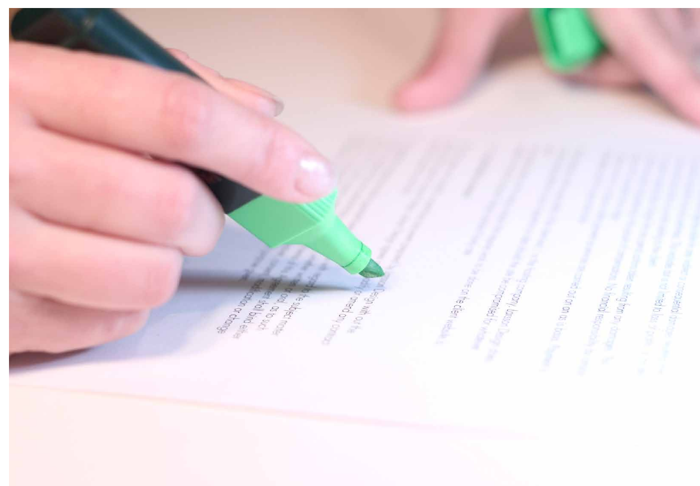
Litzler v. CC Invs., L.D.C., 362 F.3d 203, 205 (2d Cir. 2004) (Jacobs, D.). Because the "the issuers on whose behalf this case was brought and their shareholders had actual notice of the underlying facts for at least six

years before this lawsuit was filed," the underwriters claimed that the actions at issue here "would have been time-barred if brought in the Second Circuit." Petition for Writ of *Certiorari* at 2. The underwriters further asserted that "both the Second and Ninth Circuits' tolling rules conflict with this Court's recognition that Section 16(b) establishes an absolute two-year period of repose that is not subject to tolling at all." *Id.* at 1 (*citing Lampf*, 501 U.S. at 360 n.5).

The Supreme Court Leaves the Second Circuit's Decision in *PIMCO v. Mayer Brown* Undisturbed

On June 20, 2011, the Supreme Court denied a petition for *certiorari* to review the Second Circuit's decision in *Pacific Investment Management Co. LLC ("PIMCO") v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010) (Cabranes, J.). The *PIMCO* ruling reaffirmed the Second Circuit's adherence to the bright-line attribution rule for secondary actor liability. *See id.* at 155 (holding that "secondary actors can be liable in a private action under Rule 10b-5 for only those statements that are explicitly attributed to them"). Based on this bright-line rule, the Second Circuit held that a law firm could not face Section 10(b) liability for "draft[ing] portions of [a company's] security offering documents that [allegedly] contained false information." *Id.* at 148. The *PIMCO* court explained that "[w]ithout explicit attribution," reliance on the law firm's "participation can only be shown through 'an indirect chain … too remote for liability.'" *Id.* at 156.

The Supreme Court recently addressed the scope of secondary actor liability under Section 10(b) in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (June 13, 2011) (Thomas, J.). In *Janus*, the Court stated that "in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it was attributed." *Id.* at



2302. The Court adopted the rule that "the maker of a statement is the entity with authority over the content of the statement and whether and how to communicate it." *Id.* at 2303. Because the plaintiffs in *Janus* failed to allege attribution, the Court declined to consider the argument that the secondary actor defendant "made" the allegedly misleading statements at issue *indirectly* within the meaning of Rule 10b-5. *Id.* at 2305. "More may be required to find that a person or entity made a statement indirectly," the Court explained, "but attribution is necessary." *Id.* at 2305 n.11.

The Supreme Court Addresses Class Certification Requirements in *Wal-Mart Stores, Inc. v. Dukes*

On June 20, 2011, the Supreme Court vacated the certification of the largest class action in history. *See Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011) (Scalia, J.). Although the Court's decision primarily addressed the hurdles for plaintiffs seeking class certification in employment discrimination cases, the *Wal-Mart* ruling includes several pronouncements of significance to class actions generally, which we address below. (For a more comprehensive discussion of the Court's decision in *Wal-Mart*, please click here to read the Firm's client memorandum.)

Courts Must Resolve Merits Issues on Class Certification If Relevant to Certification

The *Wal-Mart* Court held that "Rule 23 does not set forth a mere pleading standard." *Id.* at 2551. Rather, certification is "proper only if 'the trial court is satisfied, after a rigorous analysis, that the prerequisites of Rule 23(a) have been satisfied.'" *Id.* "Frequently, that 'rigorous analysis' will entail some overlap with the merits of the plaintiff's underlying claim." *Id.* The Court explained that there is nothing "unusual about that consequence" since "[t]he necessity of touching aspects of the merits in order to resolve preliminary matters, *e.g.*, jurisdiction and venue, is a familiar feature of litigation." *Id.* at 2552.

In a footnote, the *Wal-Mart* Court mentioned that "[p]erhaps the most common example of considering a merits question at the Rule 23 stage arises in class-action suits for securities fraud." *Id.* at 2552 n.6. The requirements of Rule 23(b)(3) "would often be an insuperable barrier to class certification, since each of the individual investors would have to prove reliance on the alleged misrepresentation." *Id.* However, "the problem dissipates if the plaintiffs can establish the applicability of the so-called 'fraud on the market' presumption." *Id.* Citing the Court's recent decision in *Erica P. John Fund, Inc. v. Halliburton, Co.*, 131 S. Ct. 2179 (2011), the *Wal-Mart* Court explained that "plaintiffs seeking 23(b)(3) certification must prove that their shares were traded on an efficient market" to rely on this presumption. *Wal-Mart*, 131 S. Ct. at 2552 n.6. The *Wal-Mart* Court stated that this is "an issue [that plaintiffs] will surely have to prove *again* at trial in order to make out their case on the merits." *Id.*

Individualized Money Damages Claims Belong Only in Rule 23(b)(3) Classes

The Court held that "Rule 23(b)(2) applies only when a single injunction or declaratory judgment would provide relief to each member of the class." *Id.* at 2557. "It does not authorize class certification when each class member would be entitled to an individualized award of monetary damages." *Id.* The *Wal-Mart* Court found it "clear that individualized monetary claims belong in Rule 23(b)(3)." *Id.* at 2558.

The Advisory Committee on the Federal Rules of Civil Procedure noted that Rule 23(b)(2) "'does not extend to cases in which the appropriate final relief relates *exclusively or predominantly* to money damages.'" *Id.* at 2559. Relying on this language, the plaintiffs argued that their claims for monetary relief were appropriately certified under Rule 23(b)(2) "because those claims do not 'predominate' over their requests for injunctive and declaratory relief.'" *Id.* The Court explicitly rejected this contention, holding that "it is the Rule itself, not the Advisory Committee's description of it, that governs." *Id.*

The Commonality Hurdle of Rule 23(a) Matters and Must Be Carefully Considered

The *Wal-Mart* Court found that "[t]he crux of this case is commonality – the rule requiring a plaintiff to show that 'there are questions of law or fact common to the class.'" *Id.* at 2550-51. "That language is easy to misread, since '[a]ny competently crafted class complaint literally raises common 'questions.''" *Id.* at 2551. "What matters to class certification … is not the raising of common 'questions' – even in droves – but, rather the capacity of a classwide proceeding to generate common *answers* apt to drive the resolution of the litigation." *Id.*

The Court underscored that plaintiffs' claims "must depend on a common contention – for example, the assertion of discriminatory bias on the part of the same supervisor." *Id.* "That common contention, moreover, must be of such a nature that it is capable of classwide resolution – which means that determination of its truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke." *Id.*

Daubert Gatekeeper Determinations May Be Appropriate at the Certification Stage

The Court expressly stated that it "doubt[ed]" the district court's determination that "*Daubert* [does] not apply to expert testimony at the certification stage of class-action proceedings." *Id.* at 2553-54.

The Court Voices Skepticism of Extrapolation Techniques

The Court rejected the Ninth Circuit's determination that the defendant's right to present individual defenses could be preserved by allowing it to defend randomly selected sample cases, and then extrapolating those findings to the claims of the remaining class members. "Because the Rules Enabling Act forbids interpreting Rule 23 to 'abridge, enlarge or modify any substantive right,'" the *Wal-Mart* Court held that "a class cannot be certified on the premise that [a defendant] will not be entitled to litigate its statutory defenses to individual claims." *Id.* at 2561.

The First Circuit Finds a Broad Exclusivity Provision "Ambiguous"

On June 23, 2011, the First Circuit held that the District of Massachusetts did not err in instructing a jury that a broad exclusivity provision in connection with a potential financing agreement was "ambiguous." *See Gemini Investors Inc. v. AmeriPark, Inc.*, 643 F.3d 43 (1st Cir. 2011) (Stahl, N.). The binding exclusivity provision precluded AmeriPark, Inc. from "discuss[ing] th[e] opportunity … with any person or entity." *Id.* at 45. The First Circuit found that "'reasonably intelligent persons' could disagree about what or who qualified as a 'person or entity'" within the meaning of this exclusivity provision. *Id.* at 52.

Background

In January 2007, AmeriPark entered into an agreement to purchase Mile Hi Valet Services, Inc., one of its direct competitors. AmeriPark sought financing for the transaction from Gemini Investors Inc., a private equity firm. At the time, Greenfield Partners, L.L.C. owned a 24.9% stake in AmeriPark. On March 15, 2007, AmeriPark and Gemini executed an "Outline of Key Transaction Terms." The Outline "contemplated a recapitalization of AmeriPark and a redemption of Greenfield's shares." *Id.* at 45. To proceed with the financing, AmeriPark needed Greenfield's approval.

Only the exclusivity and confidentiality provisions of the Outline were binding. The exclusivity provision provided, in relevant part, that:

> AmeriPark (and any officers, directors or representatives of AmeriPark) agrees not to discuss this opportunity or reach any agreement with any person or entity regarding financing for this Transaction or the pursuit of any sale or major other financing until April 16, 2007.

Id. The confidentiality provision provided that:

> [N]either [the Outline] nor its substance shall be disclosed by you to any third party except those in a confidential relationship with [AmeriPark] such as directors, senior executive officers, legal counsel and accountants. **Disclosure to investment banking firms, mezzanine, venture capital or private equity funds or any other individual investors is strictly prohibited.**

Id. (emphasis in original).

While the exclusivity provision was in effect, Robert K. Patterson, the head of AmeriPark, inquired whether "Greenfield would be interested in financing the Mile Hi acquisition in lieu of the Gemini-led financing." *Id.* Patterson also "approached Robert Stroup, the Chief Executive Officer and sole shareholder of Mile Hi, about the possibility of seller financing." *Id.* at 45-46. Mile Hi ultimately agreed to finance the acquisition, and the transaction closed on May 4, 2007.

In June, Gemini brought suit alleging that "AmeriPark [had] breached the Outline's exclusivity provision by pursuing financing for the Mile Hi acquisition from both Greenfield and Stroup." *Id.* at 46. The case went to trial, where AmeriPark "argued that the phrase 'any person or entity' [in the exclusivity provision] referred to the persons or entities expressly set forth in the confidentiality provision – investment banks, private equity funds, etc. – and therefore AmeriPark's financing-related discussions with Greenfield and Stroup did not constitute a breach of AmeriPark's contractual obligations." *Id.* Gemini took the position that "the exclusivity provision was unambiguous and prohibited discussions with 'any person or entity,' including Greenfield and Stroup." *Id.* The district court found the exclusivity provision ambiguous and instructed the jury accordingly.

The jury returned a verdict in favor of AmeriPark, and Gemini appealed.

The First Circuit Upholds the District Court's Finding of Ambiguity

On appeal, the First Circuit held that "[t]he district court did not err in concluding that the exclusivity provision was ambiguous." *Id.* at 52. The appellate court found that a "literal reading" of the exclusivity provision would preclude AmeriPark from discussing the potential financing opportunity "with any person or entity." *Id.* However, the Outline "implicitly contemplated that AmeriPark would in fact 'discuss' the acquisition's financing with other 'person[s] or entit[ies].'" *Id.* "For example, the confidentiality provision permitted AmeriPark to disclose the contents of the Outline to 'those in a confidential relationship with [AmeriPark] such as directors, senior executive officers, legal counsel, and accountants.'" *Id.* at 52 n.16. In addition, the terms of the Outline rendered

it inevitable that AmeriPark would engage in "some discussion of the financing with Greenfield" because "part of the financing would be used to repurchase Greenfield's equity position in AmeriPark." *Id.*

The First Circuit explained that since "[t]he Outline did not define 'person or entity,'" the district court "correctly concluded that the terms were ambiguous" and "did not err in instructing the jury accordingly." *Id.* at 52.

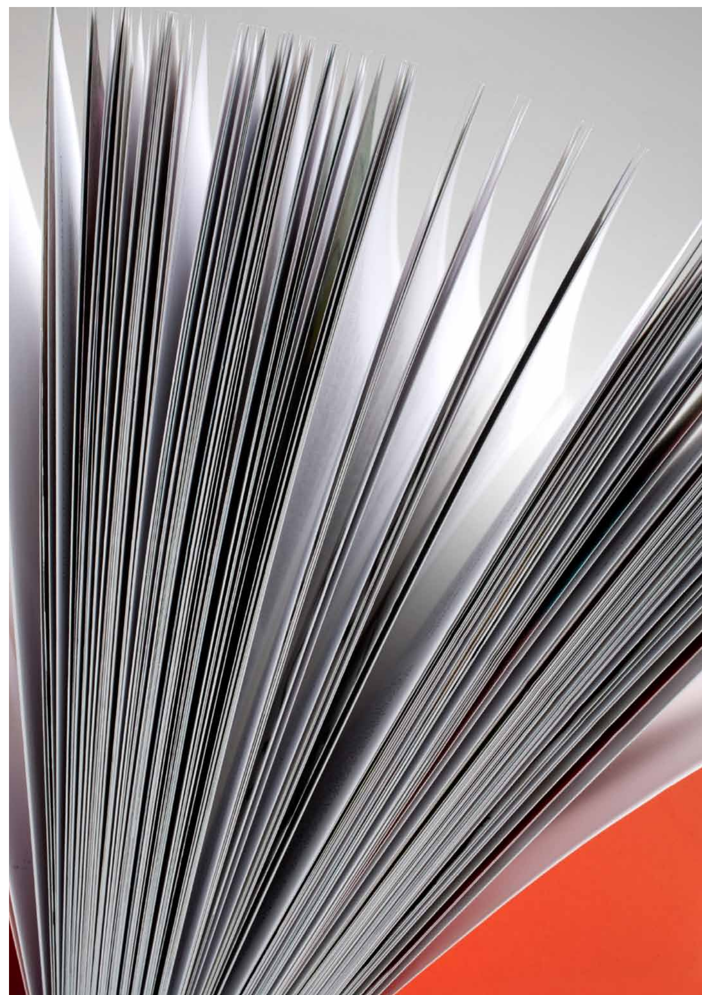
The Second Circuit Addresses Section 13(d)'s Disclosure Requirements in the CSX Litigation

On July 18, 2011, the Second Circuit vacated a permanent injunction prohibiting two hedge funds from engaging in future violations of Section 13(d), and remanded the case to the district court for additional findings. *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 2011 WL 2750913 (2d Cir. July 18, 2011) (Newman, J.). The Second Circuit's decision addressed, among other issues, the question of when a "group" may be subject to Section 13(d)'s disclosure requirements.

Background

Two hedge funds, the Children's Investment Fund Management ("TCI") and 3G Capital Partners ("3G") (together, "the Funds"), entered into cash-settled total-return equity swap agreements referencing shares of CSX Corporation, a leading railroad and transportation company. "The Funds were the long parties, and several banks were the short parties" with respect to these agreements. *Id.* at *2. The party that receives the stock-based return is the "long" party, while the party was that receives the interest-based return is the "short" party. *Id.* "Although the swap contracts did not require the short parties – the banks – actually to own any CSX shares, the Funds understood that the banks would most likely hedge their short swap positions by purchasing CSX shares in amounts matching the number of shares referenced in the swaps, and the banks generally did so." *Id.*

The Funds allegedly "wanted to avoid disclosure under [Section 13(d)] until a time they believed suitable." *Id.* at *3. Thus, they allegedly carefully "disperse[d] … swaps among multiple counterparties so that no one particular counterparty would trigger disclosure under [Section 13(d)] by purchasing as a hedge more than 5 percent of a class of CSX securities." *Id.* The Funds allegedly "communicated between themselves [regarding CSX] at various times in 2007, but not until December 19, 2007, did they file a Schedule 13D with the SEC disclosing that they had formed a 'group' by



'enter[ing] into an agreement to coordinate certain of their efforts'" with respect to CSX shares. *Id.* On January 8, 2008, the Funds proposed a minority slate of directors for the CSX board, to be voted upon at the June 2008 CSX shareholders' meeting. In March 2008, CSX filed suit, alleging that the Funds "had failed to comply in a timely fashion with the disclosure requirements of [S]ection 13(d)." *Id.* at *1. CSX "sought injunctions barring the Funds from any future violations of [S]ection 13(d) and preventing the Funds from voting CSX shares at the 2008 CSX annual shareholders' meeting." *Id.*

In June 2008, the district court ruled that the Funds had violated Section 13(d) and issued a broad permanent injunction precluding the Funds from engaging in any further Section 13(d) violations with respect to the shares of any company. However, the court did not enjoin the Funds from voting their CSX shares at the June 2008 annual shareholders' meeting. In September 2008, the Second Circuit affirmed the district court's denial of the voting injunction, but did not explain the reasons for its affirmation until its July 2011 opinion.

The Second Circuit Considers Whether the Funds Formed a "Group" Within the Meaning of Section 13(d)

At the outset of its opinion, the Second Circuit explained that "the panel is divided on numerous issues concerning whether and under what circumstances the long party to a credit-default swap may be deemed, for purposes of [S]ection 13(d), the beneficial owner of shares purchased by the short party as a hedge." *Id.* at *4. "In view of [this] disagreement," the Second Circuit found it "appropriate at this time to limit [its] consideration to the issue of group formation" under Section 13(d). *Id.*

Section 13(d)(3) provides that the disclosure requirements of Section 13(d) apply to the aggregate holdings of any "group" formed "for the purpose of acquiring, holding, or disposing of securities of an issuer." 15 U.S.C. § 78m(d)(3). The district court "found that TCI and 3G formed a group, within the meaning of [S]ection 13(d)(3), '*with respect to* CSX securities.'" *CSX*, 2011 WL 2759013 at *5 (emphasis added). However, the court "did not explicitly find a group formed *for the purpose of acquiring* CSX securities." *Id.* at *6 (emphasis added). The court also "did not distinguish in its group finding between CSX shares deemed to be beneficially owned by the Funds and those owned outright by the Funds." *Id.*

On appeal, the Second Circuit determined that the district court's "findings are insufficient for proper appellate review." *Id.* The Second Circuit remanded the case to the district court for "a precise finding, adequately supported by specific evidence, of whether a group existed for purposes of acquiring CSX shares outright during the relevant period." *Id.* "Only if such a group's outright ownership of CSX shares exceeded the 5 percent threshold prior to filing of a [S]ection 13(d) disclosure can a group violation of [S]ection 13(d) be found." *Id.*

The Second Circuit Addresses the Appropriateness of the Broad Injunction Issued by the District Court

The Second Circuit noted that the district court "predicated [its] broad injunction" against the Funds "on the basis of a [S]ection 13(d) violation that took into account not only the shares of CSX that the Funds owned outright but also the much larger quantity of shares purchased as hedges by the short parties to CSX-referenced swaps." *Id.* at *7.

On remand, the Second Circuit instructed the district court to consider "whether the evidence permits findings as to the formation of a group … and whether such a group's outright ownership of CSX shares crossed the 5 percent threshold prior to the filing of a [S]ection 13(d) disclosure." *Id.* at *8. "If a [S]ection 13(d) violation is found," the Second Circuit explained that "the threat of future violations would

be less substantial than [it] appeared to the [d]istrict [c]ourt, which based its broad injunction … on its view that the Funds were deemed to be beneficial owners of the hedged shares purchased by the short parties to the swap agreements." *Id.* at *7. The Second Circuit directed the district court to "reconsider the appropriateness and scope of injunctive relief based only on the group's failure to disclose outright ownership of more than 5 percent of CSX's shares." *Id.* at *8.

The Second Circuit Affirms the District Court's Denial of an Injunction Precluding the Funds from Voting Their CSX Shares

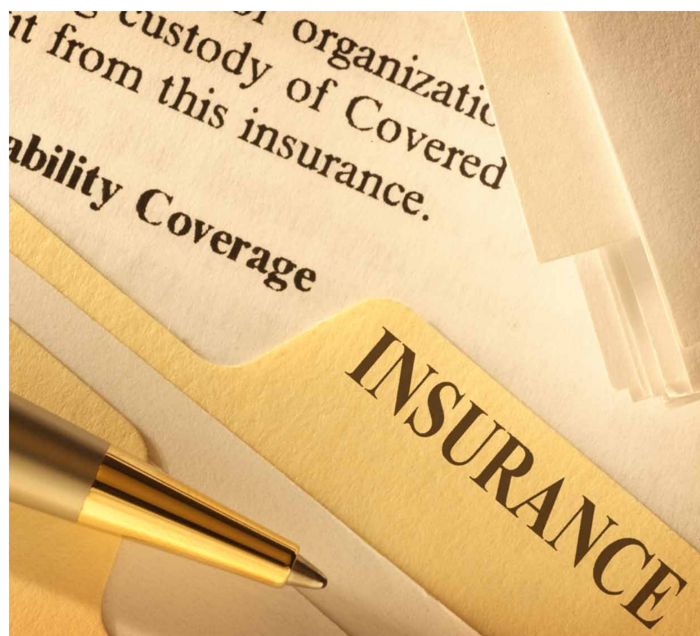
CSX moved to enjoin the Funds from voting their CSX shares "acquired between the latest date on which their [S]ection 13(d) disclosure obligations might have begun and the date on which they actually made those disclosures." *Id.* Because the Funds made Section 13(d) disclosures six months prior to the June 2008 shareholders' meeting, the district court declined to issue such an injunction. The Second Circuit affirmed in September 2008.

In its July 2011 opinion, the Second Circuit explained that under its prior ruling in *Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980), "'an injunction will issue for a violation of § 13(d) only on a showing of irreparable harm to the interests which that section seeks to protect.'" *CSX*, 2011 WL 2759013 at *8. Because the shareholders in *Treadway* received the required information four months prior to the proxy contest at issue, the Second Circuit there held that "'there was no risk of irreparable injury and no basis for injunctive relief.'" *Id.*

Following *Treadway*, the Second Circuit in the *CSX* litigation found that "injunctive share 'sterilization'" is not available. *Id.* The court held that "in the case of [S]ection 13(d), an injunction prohibiting the voting of shares is inappropriate when the required disclosures were made in sufficient time for shareholders to cast informed votes." *Id.* at *9. "Whether timely or not, the stated purpose of disclosure – allowing informed action by shareholders … —was fulfilled" here. *Id.*

The Second Circuit Holds That MBIA's D&O Insurance Policies Cover Regulatory Investigations and Special Litigation Expenses

On July 1, 2011, the Second Circuit affirmed the district court's decision holding that MBIA Inc.'s directors and officers ("D&O") liability insurance policies provide coverage for investigative and special litigation expenses incurred in connection with regulatory investigations of MBIA's accounting practices and related derivative actions. *See MBIA Inc. v. Fed. Ins. Co.*, 2011 WL 2583080 (2d Cir. July 1, 2011) (Preska, L.). Further, the Second Circuit held that MBIA's D&O policies provide coverage for independent



consultant expenses associated with MBIA's settlement negotiations with government regulators, reversing the district court's denial of coverage for such costs.

Background

As part of "a larger investigation into certain accounting practices in the insurance industry," pursuant to a formal order of investigation issued in 2001, the Securities & Exchange Commission ("SEC") issued a subpoena in November 2004 compelling MBIA to produce "all documents concerning transactions involving 'Non-Traditional Product[s].'" *Id.* at *1-*2. The subpoena encompassed, in part, "'any product … that could be or was used to affect the timing or amount of revenue or expense recognized in any particular reporting period.'" *Id.* at *2. The initial SEC subpoena did not identify specific MBIA transactions as the subject of the SEC's investigation. A week later, the New York Attorney General ("NYAG") issued a subpoena to MBIA that "mirrored" the SEC's subpoena. *Id.*

Regulators ultimately investigated three MBIA transactions: (1) MBIA's alleged retroactive purchase of reinsurance on its guarantee of bonds issued by a hospital group owned by Allegheny, Health, Education and Research Foundation ("the AHERF transaction"); (2) MBIA's alleged transfer of the risk of loss in connection with the company's purchase of an interest in Capital Asset Holdings, GP, Inc. (the "Capital Asset transaction"); and (3) MBIA's alleged guarantee of securities used to purchase airplanes for U.S. Airways (the "U.S. Airways transaction"). *Id.* at *2-*3. In each of these of transactions, MBIA allegedly took steps to "avoid recognizing a loss." *Id.* at *3. The SEC issued a specific subpoena only with respect to the AHERF transaction. The NYAG's investigation of the AHERF transaction and the SEC's investigation of the Capital Asset Transaction and U.S. Airways transaction proceeded without transaction-specific subpoenas.

After the foregoing investigations commenced, two shareholders sent demand letters asking the board of MBIA to file suit against certain directors and officers. When the board declined to file suit, the shareholders filed derivative lawsuits against MBIA. At that point, MBIA established a Special Litigation Committee, comprised of independent directors, to determine if maintenance of the derivative suits was in the best interests of MBIA.

MBIA submitted claims under two D&O policies, a primary policy purchased from Federal Insurance Company and an excess policy purchased from ACE American Insurance Company, to recover costs associated with the regulatory investigations and related litigations. The two policies were "parallel in nearly all respects." *Id.* at *1. Both provided coverage for "Securities Claims," defined to include "'a formal or informal administrative or regulatory proceeding or inquiry commenced by the filing of a notice of charges, formal or informal investigative order or similar document.'" *Id.* The policies also provided coverage for "Securities Defense Costs," defined to include costs "'incurred in defending or investigating Securities Claims.'" *Id.* MBIA's insurers agreed to cover losses only with respect to the SEC's investigation of the AHERF transaction, which proceeded pursuant to a transaction-specific subpoena, and the lawsuits that related to the AHERF transaction. The insurers declined coverage for: (i) the NYAG's investigation of the AHERF transaction; (ii) the SEC's and NYAG's investigation of the Capital Asset transaction and the U.S. Airways transaction; and (iii) the costs of the SLC's investigation.

The Second Circuit Holds That the NYAG's Subpoena Regarding the AHERF Transaction Constitutes a Covered "Securities Claim" Within the Meaning of the D&O Policies

The insurers contended that the NYAG's subpoena in connection with the AHERF transaction was a "'mere discovery device' that is not even 'similar' to an investigative order" within the meaning of a covered "Securities Claim" under the policies. *Id.* at *6. The Second Circuit "reject[ed] the insurers' crabbed view," and explained that "New York case law makes it crystalline that a subpoena is the primary investigative implement in the NYAG's toolshed." *Id.* "Backed by the enforcement authority of the state, the NYAG subpoena is at least a 'similar document' to a 'formal or informal investigative order' that commenced a regulatory proceeding, as stated in the policies." *Id.* at *5.

The Second Circuit "agree[d] with the district court's sensible intuition that a businessperson 'would view a subpoena as a 'formal or informal investigative order' based on the common understanding of those words.'" *Id.* at *6. "Because the plain-language understanding of a 'Securities Claim' includes [the NYAG's] subpoena," the Second Circuit held that "'Securities Loss' arising from this investigation is covered." *Id.*

The Second Circuit Finds That the SEC and NYAG Investigation of the Capital Asset and U.S. Airways Transactions Fall Within the Scope of Securities Claim Coverage

The insurers argued that the SEC subpoena did not encompass documents concerning the Capital Asset and U.S. Airways transactions on the grounds that the caption of the SEC's formal order, *In re Loss Mitigation Insurance Products*, "delimits the scope of the SEC's investigation to a certain sub-class of financial transactions." *Id.* at *7. The Second Circuit found this argument "unpersuasive." Referring to the SEC's 2001 formal order of investigation, the court concluded that "the plain meaning of the formal order includes these transactions within its scope because they involved a course of business 'of similar purport or object' to that described in the formal order." *Id.*

In the subpoena accompanying the formal order, the SEC specifically "sought documents involving transactions designed to 'affect the timing or amount of revenue or expense recognized,' including 'extinguishing liabilities,' and 'deferring the recognition of a known and quantifiable loss.'" *Id.* at *6. The Second Circuit found that "[a]lthough the mechanics MBIA employed in each of the three transactions differed somewhat," there was "no doubt that all of them involved efforts to delay, reduce, or eliminate the reporting of a loss, precisely as described in the subpoena." *Id.* "These courses of business fall within the scope of the transactions for which documents were subpoenaed by the SEC as 'Non-Traditional Product[s].'" *Id.* Accordingly, the SEC's investigation, pursuant to the formal order, of the Capital Asset transaction and the U.S. Airways transaction fell within the scope of coverage for Securities Loss under the insurers' policies. Because "[t]he NYAG's subpoena contained the same definition of 'Non-Traditional Product[s]' as the SEC's subpoena," the Second Circuit found that the NYAG's investigation relating to these transactions was included in the scope of coverage as well. *Id.* at *8.

In the summer of 2005, the SEC and the NYAG "considered issuing additional subpoenas." *Id.* at *3. "[T]o avoid adverse publicity," MBIA negotiated "voluntary compliance with [the regulators'] demands for records in lieu of [further] subpoenas." *Id.* The insurers contended that the regulators' informal document demands did not constitute covered "Securities Claims" because they "were conducted by way of oral request rather than subpoena or other formal process." *Id.* at *7. The Second Circuit found this argument "meritless," explaining that

"[t]he investigation[s], oral or by way of subpoena, [were] connected to the formal order." *Id.* The court emphasized that "insurers cannot require that as an investigation proceeds, a company must suffer extra public relations damage to avail itself of coverage a reasonable person would think was triggered by the initial investigation." *Id.*

The Second Circuit Holds That MBIA's Special Litigation Committee Is an "Insured Person"

The insurers further contended that the policies do not cover the costs incurred in the course of the SLC's investigation regarding the derivative suits, maintaining that the SLC is not an "Insured Person" under the policies. *Id.* at *9. The insurers argued that the SLC was "required to operate independently of MBIA," and therefore, the "SLC took on an identity and exercised powers separate and apart from those granted to MBIA." *Id.* at *10.

The Second Circuit rejected this argument as a "sleight of hand." *Id.* "'Independent' in this context means independence of judgment – a lack of conflicts of interest." *Id.* "Independence of judgment does not generate a new source of authority to terminate derivative litigation; that authority is still exercised by the corporation, which can act only through its agents." *Id.*

In addition, the Second Circuit found meritless the insurers' argument that "coverage of the SLC's costs would eviscerate the [$200,000] sublimit applicable to the investigation of shareholder demands." *Id.* The court found that the referenced sublimit applied only to the initial demand by the shareholders that the MBIA board bring suit. Once the shareholder litigation was filed, that sublimit no longer applied, and coverage for the SLC's costs fell squarely within the general insuring clauses of the policies.

The Second Circuit Concludes That the Policies Cover MBIA's Independent Consultant Expenses

In October 2005, MBIA signed a preliminary offer of settlement for both the state and federal claims. *Id.* at *3. At the time, regulators had not yet completed their investigations of the Capital Asset and U.S. Airways transactions. *Id.* "To allow settlement talks to proceed," MBIA retained an independent consultant ("IC") to "complete a review of those transactions and report on a proposed remedy if misconduct was uncovered." *Id.*

The district court held that the policies do not cover the IC costs, finding that "the addition of the IC in the course of the settlement discussions breached the 'right to associate' clause in the policies." *Id.* at *12. The Second Circuit reversed, finding that the "IC review was not a standalone or separate claim about which MBIA had to invite the insurers to associate in defending or negotiating." *Id.* at *14. Rather, the IC review "was part of the settlement with the regulators, each of which conducted a single, comprehensive investigation into all of the transactions at issue." *Id.* "The addition of the IC may have been a twist in settlement discussions, but it was not a new claim, nor was it an unforeseeable component of the settlement discussions." *Id.*

The Second Circuit found that MBIA had "provided sufficient notice of the claims involved in settlement discussions early enough in the process to allow the insurers to exercise their option to associate effectively." *Id.* "[I]t is not the insured's duty to return to the nonparticipating insurer each time negotiations about the same claim take a new twist and ask if the insurer still wants to opt out." *Id.* The court held that since the insurers were notified about the IC previously and did not object, "MBIA was entitled in this case to presume that the insurers would not raise lack of written consent as a defense to coverage with respect to the IC costs." *Id.* at *16.

The Eighth Circuit Rejects the "Pattern" Theory for the Duty to Disclose

On June 17, 2011, the Eighth Circuit held that a corporation had no duty to disclose production disruptions despite its prior "pattern" of promptly disclosing similar production issues. *See Minneapolis Firefighters' Relief Ass'n v. MEMC Elec. Materials, Inc.*, 641 F.3d 1023 (8th Cir. 2011) ("*MEMC*") (Riley, W.). The court expressly "decline[d] to recognize a new cause of action" for failure to disclose based on a past pattern of disclosures, explaining that doing so "could encourage companies to disclose as little as possible." *Id.* at 1029.

Background

MEMC Electronic Materials produces silicon wafers for the semiconductor industry. The company creates the base material for these wafers at manufacturing plants in Pasadena, Texas and Merano, Italy. In June 2008, a fire at the Pasadena plant caused a weeklong production halt. That same month, a heat exchanger failed at the Merano plant. MEMC "did not immediately disclose either incident." *Id.* at 1026.

In September 2008, the plaintiff filed suit, alleging that the defendants "had a duty to disclose the [June] 2008 incidents at the Pasadena and Merano plants" in light of MEMC's alleged "'pattern' of disclosing similar disruptions in production." *Id.* at 1028. The district court dismissed the suit, holding that "the pre-class period disclosures could not create a duty on MEMC's part to disclose the incidents." *Id.* Notably, the district court found that the plaintiff "cite[d] no case law to support the contention that … a 'pattern' [of disclosing events that affect stock prices] can give rise to a duty' to disclose promptly all such events." *Id.*

The Eighth Circuit Affirms, Holding That the Plaintiff Failed to Allege a Duty to Disclose

Affirming the district court's dismissal, the Eighth Circuit stated that it was "unable to find any legal authority directly supporting [the plaintiff's] pattern theory." *Id.* The appellate court found that the "best support" for the plaintiff's proposed "pattern" theory "may be inferred" from *dictum* in the Supreme Court's decision in *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011) (Sotomayor, J.). There, the Court stated that "[e]ven with respect to information that a reasonable investor might consider material, companies can control what they have to disclose … by controlling what they say to the market." *Id.* at 1322. However, the Eighth Circuit explained that "[e]ven if we should infer from *Matrixx* that a pattern of disclosure may spawn a duty to disclose, we do not believe [the plaintiff] has alleged circumstances giving rise to such a hypothetical duty here." *MEMC*, 641 F.3d at 1029. "This is not a case, for example, in which MEMC had just told investors the Pasadena and Merano facilities were fully operational or in perfect working order." *Id.*

The Eighth Circuit held that "absent extraordinary circumstances not present here," a corporation's "pattern" of prior disclosures cannot give rise to a duty to disclose subsequent events. *Id.* at 1029.

The Eleventh Circuit Holds That Section 10(b) Reaches Foreign Securities Transactions That Close in the United States

On July 8, 2011, the Eleventh Circuit vacated the Southern District of Florida's dismissal of securities fraud claims involving one Bahamian corporation's purchase of shares in another. *See Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada*, 2011 WL 2654004 (11th Cir. July 8, 2011) ("*Quail II*") (per curiam). The district court had ruled that under the Supreme Court's decision in *Morrison v. National Australia Bank, Ltd.*, 130 S. Ct. 2869 (2010), allegations that the parties intended to close the transaction in the United States were inadequate to state a claim under Section 10(b). *See Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada*, 732 F. Supp. 2d 1345, 1349 (S.D. Fla. 2010) ("*Quail I*"). On appeal, the Eleventh Circuit found that the complaint alleged that the closing did in fact occur in the United States, and held that these allegations were sufficient under *Morrison* to survive dismissal.

Background

The case concerns claims that the defendants – including a Brazilian corporation and two U.S. corporations – "fraudulently induced" a Bahamian corporation to purchase a cruise ship via a stock purchase transaction involving another Bahamian corporation. *Quail I*, 732 F. Supp. 2d at 1347. After the plaintiff brought suit, the Supreme Court handed down its decision in *Morrison*, holding that Section 10(b) applies "only [to] transactions in securities listed on domestic exchanges, and domestic transactions in other securities." 130 S. Ct. at 2884. The plaintiff contended that "its allegations satisfy the second prong of *Morrison*'s transaction test because [it] purchased stock in the United States." *Quail I*, 732 F. Supp. 2d at 1349. Specifically, the plaintiff alleged that "'the parties intended the closing to occur'" in the United States. *Id.*

The district court found that "[t]he Amended Complaint does not allege that the closing actually occurred in the United States but merely that the parties so intended." *Id.* Moreover, the court determined that "the principle takeaway from *Morrison* is that Congressional intent, not the intent of the parties, is dispositive of the application of federal securities law to foreign securities transactions." *Id.* at 1350. "Adopting a rule that permits the intent of parties located abroad and contracting from their home countries in a wholly off-shore transaction to apply United States securities law is inconsistent with *Morrison*." *Id.* The district court concluded that "the Amended Complaint does not allege the requisite domestic transaction," and accordingly dismissed the plaintiff's securities fraud claims. *Id.*

The Eleventh Circuit Rules That *Morrison* May Not Require Dismissal Where the Complaint Alleges a Domestic Closing

On appeal, the Eleventh Circuit found that the district court had misread the complaint as "alleging only that the parties *intended* the closing to occur in the United States." *Quail II*, 2011 WL 2654004, at *2. The Eleventh Circuit determined instead that the plaintiff "clearly alleged (and we must accept as true) that '[t]he transaction … closed in Miami, Florida on June 10, 2008 by means of the parties submitting the stock transfer documents by express courier … ." *Id.* Based on these pleadings, the Eleventh Circuit held that the plaintiff "alleged that the closing *actually* occurred in the United States." *Id.* The appellate court also found it significant that "the purchase and sale agreement confirms that it was not until this domestic closing that title to the shares was transferred to [the plaintiff]." *Id.*

The Eleventh Circuit noted that under *Morrison*, Section 10(b) "applies only where the security at issue is listed on a domestic stock exchange or, if not so listed, where 'its purchase or sale is made in the United States.'" *Id.* (*quoting Morrison*, 130 S. Ct. at 2886). "Given that the Supreme Court in *Morrison* deliberately established a bright-line test based exclusively on the location of the purchase or sale of the security, we cannot say at this stage in the proceedings that the alleged transfer of title to the shares in the United States lies beyond § 10(b)'s territorial reach." *Id.* Thus, the Eleventh Circuit held that "the district court erred by dismissing [the plaintiff's] claim," and remanded the case for "further proceedings consistent with this opinion." *Id.* at *2-*3.

The Central District of California Declines to Hear Japanese Securities Law Claims in the Toyota Litigation

On July 7, 2011, the Central District of California rejected efforts by plaintiffs in the *Toyota* litigation to circumvent the Supreme Court's ruling in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010) by asserting claims under the Japanese securities laws. *See In re Toyota Motor Corp. Sec. Litig.*, 2011 WL 2675395 (C.D. Cal. July 7, 2011) (Fischer, D.). Finding no original jurisdiction over these claims under the Class Action Fairness Act ("CAFA"), the court also declined to exercise supplemental jurisdiction. The *Toyota* court explained that its ruling comported with *Morrison*'s "clear underlying rationale" that "foreign governments have the right to decide how to regulate their own securities markets." *Id.* at *7. "This respect for foreign law would be completely subverted if foreign claims were allowed to be piggybacked into virtually every American securities fraud case." *Id.*

Background

The litigation involves alleged "statements by [Toyota] employees … made against a background of allegations of defects in Toyota vehicles." *Id.* at *1. The company allegedly received reports of unintended acceleration in several vehicle models as early as 2000. However, it was not until 2010, "in the face of increasing reports of accidents related to unintended acceleration," that Toyota "admit[ted] that many of its vehicles were subject to several design defects." *Id.* "By the end of a wave of revelations, Toyota's stock price had dropped at least 11%." *Id.*

Only a small fraction of Toyota securities (less than ten percent) trade in the United States as American Depositary Receipts ("ADRs"). Most Toyota securities trade on foreign stock exchanges. Courts to date have

applied *Morrison* to hold that Section 10(b) does not reach transactions involving securities sold on foreign exchanges. *See, e.g., Cornwell v. Credit Suisse Group,* 729 F. Supp. 2d 620, 623-24 (S.D.N.Y. 2010) (Marrero, J.) (relying on *Morrison* to hold that Section 10(b) does "*not* apply to transactions involving … a purchase or sale, wherever it occurs, of securities listed only on a foreign exchange").

Rather than contending that Section 10(b) applies to the claims of class members who purchased their Toyota stock on foreign exchanges, the plaintiffs asserted claims under the Japanese securities laws on behalf of these class members. The plaintiffs argued that under CAFA, the Central District of California had original jurisdiction over these claims.

The Court Holds That There Is No Original Jurisdiction over the Japanese Securities Law Claims under CAFA

CAFA provides, *inter alia*, that district courts shall have "original jurisdiction" over class actions involving a matter in controversy that exceeds $5 million in which "any member of a class of plaintiffs is a citizen of a State and any defendant is … a citizen or subject of a foreign state." 28 U.S.C. § 1332(d)(2)(B). CAFA does not reach claims concerning a "covered security," 28 U.S.C. § 1332(d)(9)(A), which is defined to include a security "listed, or authorized for listing, on the New York Stock Exchange." 15 U.S.C. § 77r(b)(1)(A).

Here, the complaint "explicitly allege[d] that the Toyota common stock at issue is listed on the New York Stock Exchange" (as part of the company's ADR program). *Toyota,* 2011 WL 2675395 at *6. However, the plaintiffs argued that "the stock must actually be *traded* to qualify" as a "covered security" for purposes of the CAFA exemption. *Id.*

The Central District of California dismissed this contention as "an attempt to escape the obvious conclusion that the [Toyota] common stock is a covered security." *Id.* Under the "plain language of the statute," there is no requirement that stock be *traded* as well as listed to constitute a "covered security." *Id.* "Indeed, according to the statute, a stock need not even be listed to be 'covered'; it need only be 'authorized for listing.'" *Id.* "Because the [Japanese law] claims relate to 'covered securities,'" the court held that "they are exempted from CAFA." *Id.*

The Court Declines to Exercise Supplemental Jurisdiction over the Japanese Law Claims

The court determined that it "has supplemental jurisdiction [under 28 U.S.C. § 1367(a)] because the Japanese law claims form part of the same case or controversy and arise from a common nucleus of

operative facts as the American securities fraud claims." *Id.* Nonetheless, the court declined to exercise supplemental jurisdiction for two reasons.

First, the court found that "[t]he Japanese law claims substantially predominate over the American law claims." *Id.* Given that "[t]he vast majority of [class] members … purchased their stock on foreign exchanges," they "have only a Japanese law claim." *Id.*

Second, the Central District of California concluded that "[t]he exceptional circumstance of comity to the Japanese courts also strongly argues against the exercise of supplemental jurisdiction." *Id.* at *7. "While there may be instances where it is appropriate to exercise supplemental jurisdiction over foreign securities fraud claims," the court held that "any reasonable reading of *Morrison* suggests that those instances will be rare." *Id.*

Negative "Say on Pay" Advisory Votes Spawn Shareholder Litigation

Pursuant to Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, public companies that are subject to the proxy rules must provide their shareholders with the opportunity for an *advisory* "Say on Pay" vote on compensation paid to the named executive officers at least once every three years. *See* 15 U.S.C.A. §78n-1(a)(1). "Say on Pay" votes "do not require the company or its board of directors to take [any] specific action." SEC Office of Investor Education and Advocacy, *Investor Bulletin: Say-on-Pay and Golden Parachute Votes* 4 (2011), *available at* www.sec.gov/investor/alerts/sayonpay.pdf. In fact, the statute expressly provides that "Say on Pay" votes "may not be construed" as "overruling a decision" by the company or its board of directors, "creat[ing] or imply[ing] any change to [their] fiduciary duties," or imposing "any additional fiduciary duties." 15 U.S.C.A. §78n-1(c).

Notwithstanding the advisory nature of "Say on Pay" votes, plaintiffs have begun filing derivative suits on the heels of negative votes. To date, eight suits have been filed, of which two have settled. The complaints all recite similar allegations, including breach of the duty of loyalty, inadequate disclosure, failure to clawback, and a mismatch between the companies' pay-for-performance policies and the compensation actually paid.

Plaintiffs contend that these negative "Say on Pay" votes reflect the shareholders' "independent business judgment" that the company's executive compensation is "excessively large, irrational, and not in the best interest" of the company and its shareholders. Complaint at ¶ 42, *Matthews v. Rynd*, No. 2011-34508 (Tex. Dist. Ct. June 8, 2011) ("*Hercules* Complaint"); *see also* Complaint at ¶ 34, *Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy*, No. 2011 CV 197841 (Ga. Super. Ct. Mar. 15, 2011) ("*Beazer* Complaint") (alleging that the "Beazer shareholders concluded, in their independent business judgment, that the 2010 pay hikes were not pay-for-performance, but rather windfalls for the Beazer executives … and not in the best interest of Beazer and its shareholders"); Complaint at ¶ 42, *Plumbers Local No. 137 Pension Fund v. Davis*, No. CV '11-633 (D. Or. May 25, 2011) ("*Umpqua* Complaint") (alleging that "[b]y voting against the Umpqua Board's 'say-on-pay' resolution, Umpqua shareholders in general and institutional shareholders in particular concluded, in their independent business judgment, that the 2010 pay hikes approved by the Umpqua Board were … not in the best interest of Umpqua and/or its shareholders").

Plaintiffs further argue that these negative "Say on Pay" votes rebut the business judgment presumption and shift the burden of proof to the board of directors to establish that the compensation plan is in the company's best interests. For example, Hercules shareholders have alleged that:

> In light of the adverse shareholder vote, the presumption of business judgment surrounding the Hercules Board's 2010 executive

> compensation decision has been rebutted, and the burden of proof to demonstrate that the 2010 pay hikes did not violate the Hercules Board's own pay-for-performance executive compensation policy and were, in fact, in the best interest of Hercules now rests with the Hercules Board.

Hercules Complaint at ¶ 43; *see also* Complaint at ¶ 51, *Witmer v. Martin*, No. BC454543 (Cal. Super. Ct. Feb. 4, 2011) (alleging that "there is doubt that the Board's [compensation] decisions … were reasonable and/or that they acted in good faith and/or that these decisions were protected business judgments"); *Beazer* Complaint at ¶ 35 (alleging that the "adverse shareholder vote rebuts the presumption that the Beazer Board's 2010 pay hikes were the product of a valid exercise of business judgment"); *Umpqua* Complaint at ¶ 43 (alleging that "[i]n light of the adverse shareholder vote, the presumption of business judgment surrounding the Umpqua Board's 2010 executive compensation decisions has been rebutted, and the burden of proof to demonstrate that the 2010 pay hikes … were in the best interest of Umpqua now rests with the Umpqua Board").

Overcoming the protections of the business judgment presumption is typically exceedingly difficult. Plaintiffs must establish egregious violations – such as an "intentional dereliction of duty" or a "conscious disregard for [board] responsibilities" – to rebut the business judgment presumption. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 64-66 (Del. 2006).

These "Say on Pay"-based derivative suits are all in their earliest stages. We are closely monitoring these cases and will report any developments in future editions of the Alert.

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