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This month's Alert addresses a Second Circuit opinion affirming the dismissal of a suit brought against Refco's former corporate officers; a New York Court of Appeals decision holding that the Martin Act does not preempt nonfraud common law claims; and a Delaware Supreme Court ruling that Spanish law standing requirements apply in a multi-tier derivative action brought by a shareholder of a Spanish corporation.

We also discuss two rulings from the Southern District of New York: one largely denying a motion to dismiss a credit crisis-related suit against GE; and another holding that investors in Madoff feeder funds do not qualify as "customers" under the Securities Investor Protection Act. Finally, we address a magistrate judge's recommendation that the Umpqua "Say on Pay" shareholder derivative action be dismissed.

The Second Circuit Affirms the Dismissal of the Refco Securities Fraud Suit

On January 10, 2012, the Second Circuit affirmed the dismissal of a suit brought by former customers of Refco Capital Markets, Ltd. ("RCM")—a subsidiary of the now-bankrupt Refco, Inc.—against Refco's former corporate officers and its former corporate auditor, Grant Thornton LLP. *Capital Mgmt. Select Fund Ltd. v. Bennett*, 2012 WL 48169 (2d Cir. Jan 10, 2012) (Winter, J.). The Second Circuit found that the plaintiffs "have no remedy under the securities laws because … they fail[ed] to make sufficient allegations that their agreements with RCM [had] misled them or that RCM [had] not intend[ed] to comply with those agreements at the time of contracting." *Id*. at *1.

Background

RCM was a "securities and foreign exchange broker … organized under the laws of Bermuda." *Id*. On October 10, 2005, RCM's parent company "announced a previously undisclosed $430 million uncollectible receivable and disavowed its financial statements for the previous three years." *Id*. at *4. On October 17, 2005, RCM—along with Refco and a number of other Refco affiliates—filed for Chapter 11 bankruptcy protection in the Southern District of New York.

Various RCM customers subsequently brought a securities fraud action alleging that "Refco's corporate officers [had] caused RCM to improperly sell or lend securities and other assets from RCM [c]ustomers' trading accounts to various Refco affiliates in order to fund Refco's operations." *Id*. The plaintiffs claimed that "they [had been] deceived into believing that … RCM would not rehypothecate excess margin or fully-paid securities." *Id*. at *7. According to the complaint, RCM instead "routinely rehypothecated all of its customers' securities, regardless of the customers'

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outstanding margin debt." *Id*.

On August 28, 2008, the Southern District of New York dismissed the plaintiffs' second amended complaint for failure to "adequately plead deceptive conduct," as well as lack of standing. *Id*. at *5. The plaintiffs appealed.

The Second Circuit Finds That the Customer Agreement Granted RCM Full Rehypothecation Rights with Respect to Customers' Excess Margin Securities

On appeal, "[t]he crux of the issue [was] … whether RCM's rehypothecation of securities even when they were not deemed collateral was so inconsistent with the provisions of the [RCM] Customer Agreement that the Agreement was itself a deception." *Id*. at *7. The Second Circuit explained that "[b]reaches of contract generally fall outside the scope of the securities laws." *Id*. at *6. "Private actions may succeed under Section 10(b) if there are particularized allegations that the contract itself was a misrepresentation …." *Id*. at *7. However, "a simple disagreement over the meaning of an ambiguous contract combined with a conclusory allegation of intent to breach at the time of execution will not do." *Id*.

Here, the Customer Agreement "state[d] that upon RCM's extension of margin financing to a customer—even a dime—RCM would obtain a 'first priority, perfected security interest in all of RCM Customers' cash, securities and other property (whether held individually or jointly with others) and the proceeds thereof.'" *Id*. at *8. The Customer Agreement further provided that "if a customer's securities [were] no longer deemed collateral to secure the customer's outstanding margin debt, RCM was obligated to 'return' such securities to the customer." *Id*.

The Second Circuit found it "evident" that "the promised 'return' did not contemplate either securities or their value being returned to the actual possession of the RCM Customers." *Id*. Rather, "'return' must mean that, with respect to securities not deemed to be collateral, the customer could demand their return from the fungible pool" of RCM customers' assets. *Id*. at *9. "[I]n the case of a requested 'return,' RCM had the option of transferring physical securities or the 'cash value thereof in the event of any liquidation of collateral.'" *Id*. at *9. "Thus, RCM, after rehypothecating all of its customers' securities, could have satisfied a demand for 'return' of excess securities by paying their cash value in lieu of the actual securities." *Id*.

The Second Circuit concluded that these provisions "unambiguously warned the RCM [c]ustomers that RCM intended to exercise full rehypothecation rights as to the [c]ustomers' excess margin securities." *Id*.

The Second Circuit Holds That SEC Rules on Broker Rehypothecation Rights Do Not Govern the Construction of the RCM Customer Agreement

On appeal, the plaintiffs contended that any "ambiguities in the Customer Agreement should be construed to comply with applicable [SEC and state] legal rules … which would have limited RCM's

rehypothecation rights with respect to excess margin securities." *Id.* at *10. "[E]ven assuming *arguendo* the existence of ambiguities in the Customer Agreement," the Second Circuit found no basis for the plaintiffs' argument because "RCM's Customer Agreement and its standard form Trade Confirmation expressly disclosed … RCM's status as an offshore unregulated entity." *Id.* at *11. "Here, more than simply remaining silent as to whether it was complying with U.S. law, RCM represented that it was *not* a U.S.-regulated company." *Id.* at *10.

The SEC, as *amicus curiae*, suggested that RCM should be subject to Section 10(b) liability under the "shingle theory," which provides that "a broker makes certain implied representations merely by 'hanging out its professional shingle.'" *Id.* The Second Circuit found that "the facts alleged in the instant matter do not … give rise to liability based on 'conduct inconsistent with … a broker-dealer's implied representation under the 'shingle theory' that it will deal fairly with the public in accordance with the standards of the profession.'" *Id.* at *11. "Surely, RCM's affirmative representation that it was *not* a U.S.-regulated company trump any implied representations under the shingle theory." *Id.*

The New York Court of Appeals Holds That the Martin Act Does Not Preempt Nonfraud Common Law Claims

On December 20, 2011, the New York Court of Appeals ruled that the Martin Act "does not preclude a private litigant from bringing a nonfraud common-law cause of action" provided that the claim "is not entirely dependent on the Martin Act for its viability." *Assured Guar. (UK) Ltd. v. J.P. Morgan Inv. Mgmt. Inc.*, 2011 N.Y. Slip Op. 09162, at 7, 10 (N.Y. Dec. 20, 2011) (Graffeo, J.) ("*Assured Guaranty III*"). The *Assured Guaranty III* decision addressed a division of authority in New York state and federal courts on whether the Martin Act preempts nonfraud common law claims arising out of New York securities transactions.

Background

Assured Guaranty (UK) Ltd. brought suit against J.P. Morgan Investment Management Inc. alleging that the defendant had "mismanaged the investment portfolio of an entity—Orkney Re II PLC—whose obligations [the] plaintiff guaranteed." *Id.* at 2. The plaintiff asserted claims for breach of fiduciary duty, gross negligence, and breach of contract.

The defendant moved to dismiss the complaint, arguing that the Martin Act preempted the plaintiff's common law tort claims. The Martin Act "authorizes the [New York] Attorney General to investigate and enjoin fraudulent practices in the marketing of stocks, bonds and other securities within or from New York State." *Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. P'ship*, 12 N.Y.3d 236, 243 (2009) (Read, J.).

In January of 2010, the trial court granted the motion to dismiss, holding that the plaintiff's breach of fiduciary duty and gross negligence claims fell "within the purview of the Martin Act and [that] their prosecution by [the] plaintiff would be inconsistent with the Attorney General's exclusive enforcement powers under the Act." *Assured Guar. (UK) Ltd. v. J.P. Morgan Inv. Mgmt. Inc.*, 2010 WL 2977934, at *5 (N.Y. Sup. Ct. Jan. 28, 2010) (Kapnick, J.).

In November of 2010, the Appellate Division reinstated the plaintiff's breach of fiduciary duty and gross negligence claims. The Appellate Division found "nothing in the plain language of the Martin Act, its legislative history or appellate level decisions in [New York] that supports [the] defendant's argument that the Act preempts otherwise validly pleaded common-law causes of action." *Assured Guar. (UK) Ltd. v. J.P. Morgan Inv. Mgmt., Inc.*, 80 A.D.3d 293, 304 (N.Y. App. Div. 2010) (Sweeny, J.). The defendant appealed.

The New York Court of Appeals Finds No "Clear and Specific" Legislative Mandate For Martin Act Preemption of Common Law Claims

The Court of Appeals explained that "[l]egislative intent is integral to the question of whether the Martin Act was intended to supplant nonfraud common-law claims." *Assured Guaranty III*, 2011 N.Y. Slip. Op. 09162, at 6. "'[A] clear and specific legislative intent is required to override the common law' and … such a prerogative must be 'unambiguous.'" *Id.*

Here, the Court of Appeals found that "the plain text of the Martin Act … does not expressly mention or otherwise contemplate the elimination of common-law claims." *Id.* Moreover, the court noted that the defendant could not "point to anything in the legislative history of the various amendments that demonstrates a 'clear and specific' legislative mandate to abolish preexisting common-law claims that private parties would otherwise possess." *Id.* at 6-7.

The *Assured Guaranty III* Court Concludes That Prior Court of Appeals Decisions Do Not Support Martin Act Preemption of Common Law Claims

The defendant contended that the Court of Appeals' prior decisions in *CPC International v. McKesson Corp.*, 70 N.Y.2d 268 (N.Y. 1987) (Hancock, Jr., J.) and *Kerusa Co. LLC v. W10Z/515 Real Estate Ltd. Partnership*, 12 N.Y.3d 236 (2009) "settled the issue in favor of preemption." *Assured Guaranty III*, 2011 N.Y. Slip Op. 09162, at 7. The Court of Appeals found that the defendant had "overread[ ] the import of these cases." *Id.*

In *CPC International*, the Court of Appeals held that the Martin Act does not create a private cause of action. *See* 70 N.Y.2d at 276-77 (finding that "an implied private action is not consistent with the legislative scheme underlying the Martin Act"). However, the *CPC International* court "did not address whether the Martin Act preempted or abrogated otherwise viable and independent common-law claims." *Assured Guaranty III*, 2011 N.Y. Slip Op. 09162, at 8.

In *Kerusa*, the plaintiff brought a cause of action for common-law fraud "predicated solely on alleged material omissions from the offering plan amendments mandated by the Martin Act … and the Attorney General's implementing regulations." 12 N.Y.3d at 239. The *Kerusa* court held that accepting the plaintiff's "pleading as valid would invite a backdoor private cause of action to enforce the Martin Act." *Id.* at 245.

The *Assured Guaranty III* court found that when "[r]ead together, *CPC Intl.* and *Kerusa* stand for the proposition that a private litigant may not pursue a common-law cause of action where the claim is predicated solely on a violation of the Martin Act or its implementing regulations and would not exist but for the statute." 2011 N.Y. Slip Op. 09162, at 10. The *Assured Guaranty III* court held that "an injured investor may [nevertheless] bring a common-law claim (for fraud or otherwise) that is not entirely dependent on the Martin Act for its viability," and explained that "[m]ere overlap between the common law and the Martin Act is not enough to extinguish common-law remedies." *Id.*

The *Assured Guaranty III* Court Determines That Public Policy Considerations Weigh in Favor of Permitting the Plaintiff's Common Law Claims to Proceed

The Court of Appeals found that "policy considerations militate in favor of allowing [the] plaintiff's common-law claims [for breach of fiduciary duty and gross negligence] to proceed." *Id.* Concurring with the views advanced by the New York State Attorney General as *amicus curiae*, the Court of Appeals determined that "the purpose of the Martin Act is not impaired by private common-law actions that have a legal basis independent of the statute because proceedings by the Attorney General and private actions further the same goal—combating fraud and deception in securities transactions." *Id.*

"For all of these reasons," the Court of Appeals "conclude[d] that the plaintiff's breach of fiduciary duty and gross negligence claims are not barred by the Martin Act." *Id.* at 11.

The Delaware Supreme Court Holds that Spanish Law Standing Requirements Apply in a Multi-Tier Derivative Action Brought by a Shareholder of a Spanish Corporation

On December 28, 2011, the Delaware Supreme Court affirmed a Chancery Court decision dismissing a multi-tier derivative action brought by a shareholder of a Spanish corporation to enforce a claim held by its wholly owned Delaware subsidiary on the grounds

that the shareholder had failed to satisfy presuit demand requirements under applicable Spanish law. *Sagarra Inversiones, S.L. v. Cementos Portland Valderrivas, S.A.*, 2011 WL 6793775 (Del. Dec. 28, 2011) (Jacobs, J.).

Background

Sagarra Inversiones, S.L. ("Sagarra")—the sole minority shareholder of Corporación Uniland S.A. ("Uniland"), a Spanish corporation—brought suit in Delaware Chancery Court to rescind Uniland's purchase of Giant Cement Holdings, Inc. (the "Giant transaction"). Sagarra purported to sue derivatively on behalf of Uniland Acquisition Corp. ("UAC"), Uniland's wholly owned Delaware subsidiary created as the acquisition vehicle for the Giant transaction.

In August of 2011, the Chancery Court held that Spanish law governed Sagarra's standing to bring suit on behalf of UAC. *Sagarra Inversiones, S.L. v. Cementos Portland Valderrivas, S.A.*, 2011 WL 4391727 (Del. Ch. Aug. 05, 2011) (Noble, V.C.). Under Spanish law, Sagarra was obligated to ask the Uniland Board to convene a shareholder meeting to determine whether Uniland should bring suit against its own board. *Id.* at *4. Because Sagarra made no request for a Uniland shareholder meeting prior to bringing suit, the Chancery Court held that Sagarra lacked standing and dismissed all of Sagarra's derivative claims. *Id.* at *4-5.

On appeal, Sagarra contended that "the Court of Chancery [had] erred in determining that Spanish law [rather than Delaware law] governed the derivative standing requirements applicable to Sagarra." *Sagarra*, 2011 WL 6793775, at *3. Sagarra advanced three arguments in support of this position. First, Sagarra emphasized that it was suing to "enforce a right possessed by UAC, which is a Delaware corporation." *Id*. Second, Sagarra asserted that "a proper application of the internal affairs doctrine requires the application of Delaware's derivative standing rules." *Id*. Finally, Sagarra claimed that "sound public policy compels" the court to apply Delaware standing law. *Id*.

The Delaware Supreme Court Finds That Sagarra Was Required to Establish Standing at the Parent (Uniland) Level, Not at the Subsidiary (UAC) Level

The Delaware Supreme Court explained that "[u]nder Delaware law, a shareholder that holds shares only in a parent corporation must establish its standing to proceed derivatively at the parent level, in order to claim standing to enforce, on the parent's behalf, a claim belonging to that parent's Delaware subsidiary." *Id*. at *4. "[B]ecause Uniland is the only corporation in which Sagarra owns shares," the court found that "Sagarra's standing to sue derivatively on behalf of UAC must necessarily derive from its ownership of shares of Uniland." *Id*. "Without that ownership stake, Sagarra would have no basis to claim standing to sue on behalf of any entity within the Uniland corporate hierarchy." *Id*.

The Delaware Supreme Court considered its prior decision in *Lambrecht v. O'Neal*, 3 A.3d 277 (Del. 2010) (Jacobs, J.), in which it addressed the standing requirements that apply when the shareholder of a parent corporation brings suit to enforce the claims of that corporation's wholly owned subsidiary (a "double derivative" action). The *Lambrecht* court "recognized" that "the underlying basis for double derivative standing is the parent's ability to 'enforce [the subsidiary's] claim by the direct exercise of [the parent's] 100 percent control' of the subsidiary." *Sagarra*, 2011 WL 6793775, at *4 (quoting *Lambrecht*, 3 A.3d at 288) (alterations in original). "Applying that principle here," the Delaware Supreme Court held that "Sagarra's standing to sue derivatively, including its presuit demand obligations, is governed by the derivative standing rules that apply at the parent (Uniland) level." *Id*.

The Delaware Supreme Court Finds That the Internal Affairs Doctrine Compels the Application of Spanish Law Standing Requirements

After concluding that Sagarra must establish derivative standing at the parent (Uniland) level, not at the subsidiary (UAC) level, the Delaware Supreme Court next turned to the question of "what body of standing law applies … the law of Delaware (as Sagarra claims) or of Spain (as the Vice Chancellor held)?" *Id*. The court explained that the question "must be resolved under the governing choice of law principle, which in Delaware is the internal affairs doctrine." *Id*.

The internal affairs doctrine "requires that the law of the state (or, in this particular case, the sovereign nation) of incorporation must govern" a corporation's internal affairs, which "encompass[ ] 'those matters that pertain to the relationships among or between the corporation and its officers, directors, and shareholders.'" *Id*. (quoting *VantagePoint Venture Partners 1996 v. Examen, Inc*., 871 A.2d 1108, 1113 (Del. 2005)). "Under that doctrine and in this context," the Delaware Supreme Court held that "the rule of decision is that of the jurisdiction of incorporation of the entity in which the plaintiff owns shares here, Spain." *Id*.

Sagarra claimed that the internal affairs doctrine does not apply in this case because "the presuit demand requirement should not be deemed an 'internal affair' of Uniland that falls within the

scope of the internal affairs doctrine." *Id.* The court rejected Sagarra's argument, explaining that "[t]he presuit demand requirement is quintessentially an 'internal affair' that falls within the scope of the internal affairs doctrine." *Id.* "[T]he presuit demand requirement serves a core function of substantive corporate law, in that it allocates, as between directors and shareholders, the authority to sue on behalf of the corporation." *Id.* Moreover, "[t]he decision to bring a lawsuit or to refrain from litigating a claim … is a decision concerning the management of the corporation." Because the "'contours of the demand requirement' fall firmly within the gravitational pull of the internal affairs doctrine," the Delaware Supreme Court concluded that Spanish law governs Sagarra's presuit demand requirements. *Id.* at *5.

The Delaware Supreme Court Holds That Public Policy Principles Do Not Override the Application of the Internal Affairs Doctrine

Lastly, the Delaware Supreme Court found meritless Sagarra's assertion that the internal affairs doctrine "should be set aside in this specific case for policy reasons." *Id.* "Sagarra contend[ed] that Delaware has a strong interest in preventing its corporations from being used for abusive purposes, such as the Giant transaction." *Id.* The court explained that this policy interest is "already served by the General Assembly having conferred jurisdiction on Delaware's courts to police fiduciary breaches committed through a misuse of Delaware corporate form." *Id.* "For Delaware courts to fulfill that role, however, their power to act must first be properly invoked." *Id.* Delaware's public policy interest "does not, and cannot, operate as a protean ethic that trumps, on an *ad hoc* basis, settled choice of law rules that govern the right of a stock holder to enforce, derivatively, claims that belong to the corporation in which it owns shares." *Id.*

The Southern District of New York Denies a Motion to Dismiss a Credit Crisis-Related Securities Fraud Action Against GE

On January 11, 2012, the Southern District of New York denied in large part a motion to dismiss a securities fraud action brought by the State Universities Retirement System of Illinois alleging that General Electric ("GE") had "concealed information about its financial health from the investing public in the wake of the economic collapse beginning in September 2008." *In re Gen. Elec. Co. Sec. Litig.*, 2012 WL 90191, at *1 (S.D.N.Y. Jan. 11, 2012) (Holwell, J.). The court permitted most of the plaintiff's Section 10(b) claims, as well as a number of the plaintiff's claims under Sections 11 and 12(a)(2), to proceed.

Background

The complaint alleged that "during a time when the financial markets were crumbling and companies across the United States were scrambling to disclose their holdings in subprime loans, GE withheld information regarding its substantial holdings in subprime and non-investment grade loans and touted

GE as safe in comparison to its competitors, despite the fact that GE was also feeling the impact of the financial crisis." *Id*. Specifically, the plaintiff asserted that "GE concealed: its difficulty issuing commercial paper; the quality of many of its investments; the fact that many of its assets were overvalued; its inability to pay the full dividend promised; the fact that business at GE Capital was drying up; and the precariousness of its AAA rating." *Id*.

On February 27, 2009, "GE announced that it would be forced to cut its dividend significantly." *Id*. at *3. "On March 12, 2009, GE lost its AAA rating." *Id*. "And on March 19, 2009, GE [allegedly] disclosed to the world that its portfolio contained a number of lower quality loans and corporate bonds." *Id*. "Throughout its complaint, [the] plaintiff allege[d] that GE should have disclosed the dangers it faced sooner." *Id*.

The Court Finds That the Complaint Adequately Alleges Material Misrepresentations Regarding GE's Access to Commercial Paper Markets

The plaintiff "allege[d] that during the fall of 2008, GE was experiencing difficulty issuing its commercial paper, while telling the public the opposite." *Id*. at *16. In support of this claim, the plaintiff pointed to private conversations between former Treasury Secretary Henry Paulson and GE's Chief Executive Officer Jeffrey Immelt, as described in Paulson's memoir, *On the Brink*. The plaintiff contended that in September of 2008, Immelt told Paulson that "GE 'was finding it very difficult to sell its commercial paper for any term longer than overnight.'" *Id*. at *2. Paulson was "allegedly 'stunned'" by this news. *Id*. at *16.

The plaintiff contrasted Immelt's disclosures to Paulson with "the company's contemporaneous public statements that it was having no difficulty funding itself and had never had such difficulties." *Id*. For example, during a conference call to discuss GE's third-quarter earnings release, Immelt allegedly stated that "[w]e have great [commercial paper] programs … [and] [w]e have no issues funding ourselves." *Id*. at *5. Similarly, GE's Chief Financial Officer Keith Sherin allegedly stated that "[w]e've got a commercial paper program that's broad and deep … you really don't have any near term pressure of any magnitude." *Id*. at *6.

Based on these contentions, the Southern District of New York found that the complaint "adequately alleges that GE made material misrepresentations regarding its access to commercial paper markets." *Id*. at *16. The court noted that if information regarding GE's commercial paper challenges "was of importance to Paulson," then "it was likely to be of interest to a reasonable investor." *Id*.

The Court Holds That the Complaint Plausibly Alleges Material Misrepresentations Regarding GE's 2009 Dividend

The plaintiff contended that GE's "repeated statements that its $1.24 dividend was 'safe' and 'secure' through 2009 … were false and misleading when made in light of the sudden evaporation of GE Capital's deal flow, the extent of its subprime exposure, and the company's continuing liquidity problems." *Id*. at *19-20. "The most categorical assurance was made by Immelt on December 16, 2008 when he stated: 'What can you count on? You can count on a great dividend, $1.24 board approved at the board meeting last Friday, $1.24 in 2009, $0.31 a share in the first quarter." *Id*. at *19.

The court found that the plaintiff "plausibly allege[d] that a reasonable investor would consider Immelt's statement … to be tantamount to a guarantee." *Id*. "Taking … as true" the plaintiff's "underlying allegations" regarding GE's financial difficulties, the court held that the complaint "plausibly asserts that GE's statements regarding its 2009 dividend were materially false." *Id*. at *20.

The Court Finds That the Complaint Adequately Alleges Material Misrepresentations Concerning the Makeup of GE's Loan Portfolio

The plaintiff claimed that "GE made material misrepresentations when it praised the quality of its loan portfolio and made material omissions by failing to disclose its many subprime and non-investment grade holdings." *Id.* at *17. For example, Sherin had at various times described GE's loan portfolio as "'fantastic,' 'great,' 'robust,' 'strong,' and 'really high quality.'" *Id.* at *18. In March of 2009, however, GE "released detailed information revealing that 42% of GE Capital's $183 billion in consumer loans were made to non-prime borrowers, and at least $145 billion of its $230 billion commercial lending and leasing portfolio consisted of loans to non-investment grade companies." *Id.* The court held that the plaintiff "plausibly allege[d] that these disclosures suggest[ed] that GE's loan portfolio was not as high quality as billed." *Id.*

The court found meritless GE's assertion that "it had no independent duty to 'break out' details concerning its subprime exposure." *Id.* "[O]nce a company chooses to speak—as GE insistently did with respect to the 'high quality' of GE Capital's portfolio—'it has a duty to disclose any additional material fact necessary to make the statements already contained therein not misleading.'" *Id.* (quoting *In re Citigroup Inc. Bond Litig.*, 723 F. Supp. 2d 568, 590 (S.D.N.Y. 2010)).

The Court Holds That the Complaint Adequately Alleges Scienter

The court determined that Immelt's "contradictory statements to Henry Paulson" regarding "GE's ability to issue commercial paper … support an inference that Immelt himself had actual knowledge that GE was able to issue only overnight commercial paper and yet represented to the public that GE was having no difficulties issuing commercial paper." *Id.* at *28. The court also held that the plaintiff's allegations "give rise to an inference that Immelt had actual knowledge of facts tending to call into question the accuracy of his guarantee of a $1.24 dividend for 2009." *Id.*

The court found no more plausible the competing inference advanced by GE that "Immelt was attempting to come to terms with the financial crisis, but had difficulty making meaningful disclosures to the public in a constantly changing environment." *Id.* at *29. "Instead, it can be argued that Immelt was attempting to convince the public that the economic crisis was not affecting GE too drastically and that they should continue to invest in GE." *Id.* The court explained that "a CEO is allowed to convince the public to invest in his company, but not at the expense of providing it with accurate information about the company's financial health." *Id.*

The court further held that the plaintiff "adequately alleged that Sherin knowingly made materially misleading statements when he touted the quality of GE Capital's portfolio … even though the portfolio contained many loans to subprime consumer borrowers and companies with junk-level bond ratings." *Id.* at *26. The court found it "highly improbable that Sherin, the CFO of a company 50% of whose revenues were derived from financial services in 2008, would not inquire into whether his company was exposed to the subprime consumer borrower and its counterpart in the commercial sector." *Id.* at *27.

The Southern District of New York Holds That Investors in Madoff Feeder Funds Do Not Qualify as "Customers" Under SIPA

On January 4, 2012, the Southern District of New York held that "[i]nvestors in various 'feeder funds' that invested in Bernard L. Madoff Investment Securities, LLC ('BLMIS') … do not qualify as 'customers' under the plain language of the Securities Investor Protection Act ('SIPA')." *Aozora Bank Ltd. v. Sec. Investor Prot. Corp.*, 2012 WL 28468, at *1 (S.D.N.Y. Jan 4. 2012) (Cote, J.). The court accordingly affirmed the Bankruptcy Court's denial of the investors' claims in the SIPA liquidation of BLMIS.

Background

"SIPA provides certain benefits to customers of failed brokerage firms." *Id.* "During a SIPA liquidation, customers share in the recovery of 'customer property,' which generally consists of the cash and securities held by the liquidating broker-dealer for customers, on the basis of their respective 'net equities' and to the exclusion of the brokerage firm's general creditors." *Id.*

Irving H. Picard, the trustee for the SIPA liquidation of BLMIS (the "Trustee"), denied claims brought by investors in a number of BLMIS feeder funds. These investors "did not have accounts at the [f]eeder [f]unds" but had instead "purchased ownership shares in the [f]eeder [f]unds." *Id.* at *4 n.3. The feeder funds had, "in turn, invested a significant portion of their assets with BLMIS." *Id.* at *1. The Trustee determined that "although the [f]eeder [f]unds themselves qualified as 'customers' of BLMIS under SIPA, the [investors in those feeder funds] did not." *Id.*

On June 28, 2011, the Bankruptcy Court issued an order upholding the Trustee's denial of the investors' claims. The court found that the feeder funds were independent legal entities that had "invested directly with BLMIS and [had] maintained BLMIS accounts." *Sec. Investor Prot. Corp. v. BLMIS*, 454 B.R. 285, 292 (Bkrtcy. S.D.N.Y. 2011) (Lifland, J.). The court further found that the investors had "yielded the exclusive right to make all decisions concerning the investment and other disposition of [f]eeder [f]und assets to managers of the [f]eeder [f]unds, including … whether to afford investment discretion to any third-party investment professional …." *Id.* at 293. "In light of these findings, the Bankruptcy Court concluded that [the feeder fund investors were] not 'customers' of BLMIS pursuant to the plain language of SIPA, the relevant case law, and principles of agency or equity." *Aozora Bank*, 2012 WL 28468, at *2. The investors appealed the Bankruptcy Court's decision to the Southern District of New York.

The Southern District of New York Affirms the Bankruptcy Court's Decision

"The principal legal issue on appeal" before the Southern District of New York was "the interpretation of SIPA's definition of the term 'customer.'" *Id.* at *3. SIPA defines the term 'customer' as:

> [A]ny person (including any person with whom the debtor deals as principal or agent) who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting transfer. The term 'customer' includes any person who has a claim against the debtor arising out of sales or conversions of such securities, and any person who has deposited cash with the debtor for the purpose of purchasing securities ….

15 U.S.C. § 78lll(2). The Second Circuit has noted that "the critical aspect of the 'customer' definition is the entrustment of cash or securities to the broker-dealer for the purposes of trading securities." *In re BLMIS LLC*, 654 F.3d 229, 236 (2d Cir. 2011) (Jacobs, C.J.) (internal citations and emphasis omitted).

Here, "[t]he appellants did not have accounts at BLMIS; only the [f]eeder [f]unds had accounts at BLMIS." *Aozora Bank*, 2012 WL 28468, at *4. The Southern District of New York accordingly held that "[u]nder the plain language of SIPA, the appellants do not qualify as customers of BLMIS." *Id.* The court explained that "the most natural reading of the 'customer' definition excludes persons … who invest in separate third-party corporate entities [], that in turn invest their assets with the debtor." *Id.* at *5. In the instant case, "it cannot be said that the debtor BLMIS ha[d] 'received, acquired, or held' securities 'from or for the securities accounts' of the appellants." *Id.* "Rather, any securities were 'received, acquired, or held … from or for the securities accounts' of the [f]eeder [f]unds, and it is those entities that qualify as 'customers' under SIPA." *Id.*

The Southern District of New York noted that "[c]ontrolling precedent supports this reading [of] SIPA." *Id.* In *Securities Investor Protection Corp. v. Morgan, Kennedy & Co.*, 533 F.2d 1314 (2d Cir. 1976) (Moore, J.), the Second Circuit "discussed a number of factors that are indicative of 'customer' status." *Aozora Bank*, 2012 WL 28468, at *5. These factors include:

> [M]aking purchases with the debtor, transacting business with the debtor, having dealings with the debtor, being known by the debtor, owning cash or securities held by the debtor, having securities accounts in one's name with the debtor, having a capacity to have dealings with the broker-dealer, and having a name that appears on the debtor's books or records.

Id. at *8 (citing *Morgan, Kennedy*, 533 F.2d at 1315-19). Because the investors in the Madoff feeder funds at issue "did or had none of these things," the court found that they were "therefore not 'customers' of BLMIS." *Id.* at *5.

The Southern District of New York further determined that "SIPA's additional definitions of 'customer' do not provide alternative avenues of relief for the appellants." *Id.* "The second definition includes 'any person who has a claim against the debtor arising out of sales or conversions of *such* securities.'" *Id.* (quoting 15 U.S.C. § 78lll(2) (emphasis added by the court)). "The term 'such securities' refers back to the first definition," which "are those that are 'received, acquired, or held' by the debtor 'from or for the securities accounts' of the investor." *Id.* The court noted that "BLMIS has not 'received, acquired, or held' securities 'from or for the securities accounts' of any appellant." *Id.* "To the extent BLMIS held any securities for any securities account, it was for the securities accounts of the appellants' [f]eeder [f]unds." *Id.*

"Lastly," the court concluded that "the appellants do not fit within the final portion of SIPA's definition of customer," which "include[s] 'any person who has deposited cash with the debtor for the purpose of purchasing securities.'" *Id.* at *6. The court cited the "well established legal principle that the assets of a corporation belong to the corporation itself, not to its shareholders." *Id.* "[A]t the moment each appellant used assets to purchase an ownership interest in a [f]eeder [f]und, those assets became property not of the appellants but of the [f]eeder [f]und." *Id.* Thus,

"[i]t was the [f]eeder [f]unds who entrusted assets to BLMIS, and not the appellants." *Id*.

A Magistrate Judge Recommends the Dismissal of the Umpqua "Say on Pay" Action

On January 11, 2012, a magistrate judge recommended that the District of Oregon dismiss a "Say on Pay" shareholder derivative action brought on behalf of Umpqua Holdings Corporation. *Plumbers Local No. 137 Pension Fund v. Davis*, 2012 WL 104776 (D. Or. Jan. 11, 2012) (Acosta, M.J.) ("*Umpqua*"). The magistrate judge found that the plaintiffs "failed to meet their burden with respect to the presuit demand requirement and, for this reason, [the] [p]laintiffs' claims should be dismissed." *Id*. at *1.[1]

Background

Umpqua's board of directors unanimously approved 2010 compensation increases ranging from 60% to 160% for each of Umpqua's executive officers. The company's Proxy Statement explained that "Umpqua's compensation policy rewards performance with compensation based on both financial and non-financial metrics." *Id*. The Proxy Statement further noted that Umpqua's "executives [had] met their collective and independent goals and, as such, were rewarded with incentive pay." *Id*.

The Umpqua board subsequently "submitted its executive compensation program to [the] shareholders for an advisory vote for the shareholders' approval, or lack thereof." *Id*. at *2. "This vote was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act [as codified at 15 U.S.C. § 78n-1(a), (c)] … which provides that, at least once every three years, a shareholder vote be held to approve or disapprove executive compensation, though this vote is expressly non-binding on the board of directors, nor does it otherwise modify the powers and duties of the board of directors." *Id*. The Proxy Statement made clear that while the shareholder vote would "not be binding upon the [b]oard," the board's Compensation Committee would "take into account the outcome of the vote when considering future executive compensation arrangements." *Id*.

On April 22, 2011, approximately 62% of Umpqua's shareholders rejected the company's 2010 executive compensation. "A few months later, the board notified Umpqua shareholders that, in light of the results of the say on pay vote, the board would endeavor to 'more closely link executive compensation to stock price and dividend performance.'" *Id*.

In May of 2011, the plaintiffs filed a shareholder derivative action without first making a presuit demand on Umpqua's board. The plaintiffs alleged that the board had "breached its fiduciary duty of loyalty to Umpqua," and further contended that the company's executive officers had been "unjustly enriched by the board's disloyal action." *Id*. at *1.

The Magistrate Judge Finds That the Plaintiffs Failed to Adequately Allege Demand Futility

"Futility of demand must be pleaded where no demand is made." *Id*. at *4. "Demand futility is determined under the law of the company's incorporating state—in this case, Oregon." *Id*. at *3 n.3. The *Umpqua* court noted that "[t]his area of law is 'undeveloped' in Oregon, and [Oregon] courts often look to Delaware law for guidance." *Id*.

Accordingly, the *Umpqua* court began its demand futility analysis with the two-pronged test set forth in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984). *Id*. at *4.

1. The deadline to file objections to the magistrate judge's Findings and Recommendation is January 25, 2012. As of January 24, 2012, no objection had been filed.

To allege demand futility under *Aronson*, a plaintiff must plead particularized facts creating a "reasonable doubt" that either "(1) the directors are disinterested and independent" or "(2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Aronson*, 473 A.2d at 814, *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

The Magistrate Judge Finds That Allegations of a "Substantial Likelihood of Director Liability" Do Not Establish Director Interestedness

With respect to the first prong of the demand futility test, the plaintiffs contended that "the interest required to excuse the demand required is present because the board members face a substantial likelihood of liability in this derivative action." *Umpqua*, 2012 WL 104776, at *5. "The only case [the] [p]laintiffs cite[d] to support this novel theory" was *NECA-IBEW Pension Fund v. Cox*, 2011 WL 4383368 (S.D. Ohio Sept. 20, 2011) (Black, J.) ("*Cincinnati Bell*"). *Id.* In *Cincinnati Bell*, the Southern District of Ohio declined to dismiss a "Say on Pay" shareholder derivative suit similar to the *Umpqua* action. The *Cincinnati Bell* court found that the plaintiff had adequately pled demand futility by "demonstrat[ing] sufficient facts to show that there is reason to doubt the[ ] … directors could exercise their independent

business judgment over whether to bring suit against themselves for breach of fiduciary duty in awarding the challenged compensation." *Cincinnati Bell*, 2011 WL 4383368, at *4. (To read our discussion of the *Cincinnati Bell* ruling in the September edition of the Alert, please click here.)

The *Umpqua* court noted that *Cincinnati Bell's* "holding was recently called into question in light of the court's apparent lack of subject matter jurisdiction." *Umpqua*, 2012 WL 104776, at *5.[2] "Notwithstanding any continued life [*Cincinnati Bell*] might retain," the *Umpqua* court "decline[d] to embrace [the] [p]laintiffs' argument because its logic is circular and thus unpersuasive." *Id.* "The implicit premise of [the] [p]laintiffs' argument is that the self-interest sufficient to trigger demand futility is present whenever board members face the possibility of a lawsuit filed against them in response to a decision or other board action." *Id.* "This would permit every derivative action plaintiff to argue that demand is futile and need not be made because no board would be able to act objectively in evaluating a presuit demand." *Id.* "Such a result would effectively erase the demand requirement …." *Id.*

The Magistrate Judge Further Finds That the Plaintiffs Failed to Plead Facts Sufficient to Overcome the Business Judgment Presumption

As to the second prong of the demand futility test, the plaintiffs contended that "the shareholder vote rejecting the compensation package is prima facie evidence that the board's action was not in the corporation or shareholder's best interests and that this vote shifts the [business judgment] presumption in [the] [p]laintiffs' favor." *Id.* at *7. The plaintiffs argued that "it is impossible to justify the board's

2. *See* Order Granting Defendants' Motion to Strike Plaintiffs' Amended Complaint and Notice of Voluntary Dismissal, *NECA-IBEW Pension Fund v. Cox*, No. 11-cv-451 (S.D. Ohio Dec. 21, 2011).

compensation vote" "in light of the poor performance of Umpqua and the shareholders' clear statement ... express[ing] their disapproval of the compensation package[.]" *Id*. The plaintiffs further claimed that their position was "corroborated by the board's subsequent statement that, in the future, it would link performance and pay more closely ('pay for performance')" and "characterize[d] this as an admission against interest that the board's action was unreasonable." *Id*.

The *Umpqua* court rejected the plaintiffs' contentions in their entirety, explaining that "compensation determinations are typically within the business judgment of the board." *Id*. The court found that "the board's actions [did] not directly defy or violate any Umpqua bylaw, any shareholder agreement, or any legally mandated disclosure or reporting requirement." *Id*. Moreover, the court noted that the plaintiffs "rel[ied] on a policy, pay for performance, that does not establish a binding standard for compensation" and "was not [even] made until after the compensation package had been approved." *Id*. The court also found meritless the plaintiffs' claim that "a simple comparison reveal[ing] a level of compensation inconsistent with general corporate performance" is sufficient to defeat the business judgment presumption. *Id*.

In addition, the court found the plaintiffs' "reliance" on *Cincinnati Bell* to be "misplaced for two reasons." *Id*. at *8. First, "it is unlikely that the case remains viable legal authority" in view of the recently identified defects in the court's subject matter jurisdiction. *Id*. Second, "the [*Cincinnati Bell*] court relied upon Ohio law in reaching its decision, which is different from Delaware law, the body of law to which Oregon looks for guidance." *Id*.

Rather than following *Cincinnati Bell*, the Umpqua court found instructive a Georgia state court decision dismissing a "Say on Pay" shareholder derivative suit against Beazer Homes USA. In *Teamsters Local 237 v. McCarthy*, No. 2011-cv-197841 (Ga. Super. Ct. Sept. 16, 2011) (Westmoreland, J.) ("*Beazer*"), the court held that "an adverse say on pay vote" does not "*alone* suffice[ ] to rebut the presumption of business judgment protection applicable to directors' compensation decisions." *Beazer*, slip op. at 12. The *Beazer* court explained that "Delaware law, which the Dodd-Frank Act explicitly declined to alter, places authority to set executive compensation with corporate directors, not shareholders." *Id*. (To read our discussion of the *Beazer* ruling in the September edition of the Alert, please click here.)

The *Umpqua* court found that the *Beazer* ruling "hews directly to the law of Delaware, which Oregon follows, and its reasoning is clear and well-taken, particularly given that its facts parallel those present here." *Umpqua*, 2012 WL 104776, at *8. *Cincinnati Bell*, on the other hand, "applied a legal framework different from that which controls the court's decision here." *Id*.

Finally, the *Umpqua* court "rejected" the plaintiffs' argument "that they have pleaded facts sufficient to overcome the business judgment presumption by alleging [that] the board made a material misrepresentation regarding the pay for performance policy." *Id*. The *Umpqua* court explained that a claim that "the board's compensation decision does not square with [the] [p]laintiffs' interpretation of the pay for performance policy is not the equivalent of an allegation that the board intentionally misled shareholders that it would follow the policy when, instead, it had no intention of doing so." *Id*.

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