

This month's Alert addresses the Supreme Court's decision rejecting the argument that Section 16(b)'s limitations period is tolled until the filing of a Section 16(a) statement. We also discuss an Eighth Circuit decision affirming summary judgment in favor of Ameriprise in a Section 36(b) suit alleging excessive mutual fund advisory fees, as well as the Southern District of New York's dismissal of all surviving Securities Act claims in the GE credit crisis-related suit.

In addition, we cover two decisions from the First Department: one addressing the heightened standard for fraud claims brought by sophisticated investors, and another affirming the dismissal of a Morgan Stanley shareholder derivative suit alleging excessive executive compensation. We also discuss a recent SEC study on the extraterritorial scope of Section 10(b) private actions. Finally, we address motions by two "Say on Pay" plaintiffs to voluntarily dismiss their suits.

Save the Date for Our Upcoming CLE Program

On Thursday, June 21st at 4:00 PM, we will host our annual CLE panel discussion on recent decisions, emerging trends and breaking developments in securities and corporate litigation and government and internal investigations. Cocktails to follow. Please RSVP for this event by contacting Emma Rotenberg at erotenberg@stblaw.com or 212-455-3529.

The Supreme Court Rejects the Argument That Section 16(b)'s Limitations Period Is Tolled Until the Filing of a Section 16(a) Statement

On March 26, 2012, the Supreme Court held that the two-year limitations period for bringing a Section 16(b) "short-swing" trading claim "is not tolled until the filing of a § 16(a) statement."¹ *Credit Suisse Sec. (USA) LLC v. Simmonds*, 132 S.Ct. 1414, at 1420, 1421

1. Chief Justice Roberts recused himself from the consideration and decision of the case
2. Simpson Thacher represented JP Morgan Securities, Inc. and Bear Stearns & Co., Inc. before the Supreme Court, as well as in the earlier proceedings before the Ninth Circuit and the district court.

(2012) (Scalia, J).² The Court also "reject[ed] the Second Circuit's rule that the 2-year period is tolled until the plaintiff 'gets actual notice that a person subject to Section 16(a) has realized specific short-swing profits that are worth pursuing.'" *Id.* at 1421 n.7 (quoting *Litzler v. CC Invs., L.D.C.*, 362 F.3d 203, 208 (2d Cir. 2004)). The Court did not issue a ruling on the question of whether Section 16(b)'s limitations period establishes a period of repose that is not subject to tolling at all.

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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*, *Credit Suisse Sec. (USA) LLC v. Simmonds*, 2011 WL 1479066, at 1 (U.S. Apr. 15, 2011) (No. 10-1261). The statute provides, however, 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, plaintiff Vanessa Simmonds brought actions under Section 16(b) to recoup profits allegedly realized by certain investment banks (the “underwriters”) between 1999 and 2000 in connection with over fifty initial public offerings. In 2009, the district court dismissed her Section 16(b) suits with prejudice on the grounds that “all of the facts giving rise to Ms. Simmonds’ complaints against the [u]nderwriter [d]efendants were known to the shareholders of the [i]ssuer [d]efendants for at least five years before these cases were filed.” *In re Section 16(b) Litig.*, 602 F.Supp.2d 1202, 1217 (W.D. Wash. 2009) (Robart, J.).

On appeal, the Ninth Circuit relied on its prior decision in *Whittaker v. Whittaker*, 639 F.2d 516 (9th Cir.

1981) (Tang, J.) to hold 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.” *Simmonds v. Credit Suisse Sec. (USA) LLC*, 638 F.3d 1072, 1095 (9th Cir. 2011) (Smith, C.J.). Because Simmonds did not allege that the underwriters had filed Section 16(a) reports disclosing the alleged “short-swing” trades, the Ninth Circuit “conclude[d] that [her] claims [were] not time-barred” under the *Whittaker* rule. *Id.* at 1096, 1097.

The underwriters successfully petitioned the Supreme Court for *certiorari*, citing a circuit split and arguing that “Section 16(b) establishes an absolute two-year period of repose that is not subject to tolling at all.” Petition for Writ of *Certiorari*, *Simmonds*, 2011 WL 1479066, at 1 (No. 10-1261).

The Supreme Court Rejects the *Whittaker* Rule

The Supreme Court began its analysis with the text of Section 16(b), which provides that “the 2-year clock starts from ‘the date such profit was realized.’” *Simmonds*, 132 S.Ct. at 1419 (quoting 15 U.S.C. § 78p(b)). Noting that “Congress could have very easily provided that ‘no such suit shall be brought more than two years after the filing of a statement under subsection (a)(2)(C),’” the Court found it significant that “it did not.” *Id.* (emphasis in the original). The Court determined that “[t]he text of § 16 simply does not support the *Whittaker* rule.” *Id.*

Moreover, the Court found that “[a]llowing tolling to continue beyond the point at which a § 16(b) plaintiff is aware, or should have been aware, of the facts underlying the claim would quite certainly be *inequitable* and inconsistent with the general purpose of statutes of limitations: ‘to protect defendants against stale or unduly delayed claims.’” *Id.* at *1420 (emphasis in the original). “The inequity of the *Whittaker* rule is especially apparent in a case such as this, where the



theory of § 16(b) liability of underwriters is so novel that petitioners can plausibly claim that they were not aware they were required to file a § 16(a) statement.” *Id.* “And where they disclaim the necessity of filing, the *Whittaker* rule compels them either to file or to face the prospect of § 16(b) litigation in perpetuity.” *Id.* The Court noted that “[t]he potential for such endless tolling in cases in which a reasonably diligent plaintiff would know of the facts underlying the action is ... especially at odds with a provision that imposes strict liability on putative insiders.” *Id.*

“[A]ssuming some form of tolling does apply” to Section 16(b) claims without deciding the issue, the Court explained that “it is preferable to apply [established equitable tolling principles], as opposed to the rule the Ninth Circuit has fashioned.” *Id.* at 1421. The Court rejected the Second Circuit’s “actual notice”-based tolling rule because it, too, “departs from usual equitable-tolling principles.” *Id.* at 1421 n.7. The Supreme Court “remand[ed] for the lower courts to consider how the usual rules of equitable tolling apply to the facts of this case.” *Id.* at 1421.

Lastly, the Court was “divided 4 to 4 concerning, and thus affirm[ed] without precedential effect, the [Ninth Circuit’s] rejection of [the underwriters’] contention that § 16(b) establishes a period of repose that is not subject to tolling.” *Id.* at 1421.

The Eighth Circuit Affirms Summary Judgment in Favor of Ameriprise in a Section 36(b) Suit Alleging Excessive Mutual Fund Advisory Fees

On March 30, 2012, the Eighth Circuit reconsidered whether certain mutual fund advisers (collectively, “Ameriprise”) were entitled to summary judgment in a breach of fiduciary suit alleging excessive mutual



fund advisory fees brought under Section 36(b) of the Investment Company Act of 1940. *Gallus v. Ameriprise Fin., Inc.*, 2012 WL 1058976 (8th Cir. Mar. 30, 2012) (Wollman, J.). Applying the standard for Section 36(b) claims set forth in *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418 (2010) (Alito, J.), the Eighth Circuit held that the plaintiffs had failed to establish that the advisory fee was “so disproportionately large that it ... could not have been the product of arm’s length bargaining.” *Gallus*, 2012 WL 1058976, at *2 (quoting *Jones*, 130 S.Ct. at 1426).

Background

“The Investment Company Act of 1940 ... regulates investment companies, including mutual funds.” *Jones*, 130 S.Ct. at 1422. Section 36(b) of the Act “impose[s] upon investment advisers a ‘fiduciary duty’ with respect to compensation received from a mutual fund, and grant[s] individual investors a private right of action for breach of that duty.” *Id.* at 1423 (internal citations omitted).

Here, shareholders of nine mutual funds managed and distributed by Ameriprise (the “Funds”) brought suit under Section 36(b) contending that Ameriprise had “provided comparable advisory services to institutional, non-fiduciary clients at substantially

lower fees than it charged the plaintiffs;" and had "misled" the Funds' board of directors (the "Board") with respect to "its arrangements with non-fiduciary clients to prevent the Board from questioning the higher fees charged to the plaintiffs." *Gallus*, 2012 WL 1058976, at *1. The plaintiffs also claimed that "the fee negotiation [between Ameriprise and the Board] was flawed because it was based on external factors—namely the fee agreements of similar mutual funds in the market." *Id.*

In 2007, the district court granted Ameriprise's motion for summary judgment. The court applied the standard set forth in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982) (Mansfield, J.), which holds that "[t]o be guilty of a violation of § 36(b), ... the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." *Gartenberg*, 694 F.2d at 928. In 2009, the Eighth Circuit reversed the district court's decision on the grounds that "excessive fees [are] not the only way in which a fund adviser can breach its fiduciary duties" under Section 36(b). *Gallus*, 2012 WL 1058976, at *1. Ameriprise petitioned for a writ of *certiorari*.

In 2010, in the *Jones* case, the Supreme Court issued guidance on "what a mutual fund shareholder must prove in order to show that a mutual fund investment adviser breached the 'fiduciary duty with respect to the receipt of compensation for services' that is imposed by § 36(b)." *Jones*, 130 S.Ct. at 1422. The Court "conclude[d] that *Gartenberg* was correct in its basic formulation of what § 36(b) requires." *Id.* at 1426.

Following the *Jones* ruling, the Supreme Court granted Ameriprise's petition for *certiorari*, vacated the Eighth Circuit's 2009 decision and remanded the case for further consideration. The district court subsequently reinstated its 2007 decision granting summary judgment in favor of Ameriprise, and the plaintiffs once again appealed.

The Eighth Circuit Finds That the Plaintiffs Failed to Meet Their Burden under *Jones*

In reconsidering the plaintiffs' claims, the Eighth Circuit explained that "*Jones* has altered the way in which we determine whether an adviser has breached its fiduciary duty under § 36(b)." *Gallus*, 2012 WL 1058976, at *3. "In our previous decision, we held that 'the proper approach to § 36(b) is one that looks to both the adviser's conduct during negotiation and the end result.'" *Id.* "[B]ut after *Jones*, a process-based failure alone does not constitute an independent violation of § 36(b)." *Id.* "Instead, we have been instructed that § 36(b) 'is sharply focused on the question of whether the fees themselves were excessive.'" *Id.* (quoting *Jones*, 130 S.Ct. at 1430).

The *Jones* Court "clarified that comparisons between the fees that an adviser charges its institutional clients and the fees it charges its mutual fund clients may be relevant[]" but cautioned that "'courts must be wary of inapt comparisons.'" *Id.* (quoting *Jones*, 130 S.Ct. at 1428). "Only where plaintiffs have shown a large disparity in fees that cannot be explained by the different services *in addition to other evidence that the fee is outside the arm's-length range* will trial be appropriate." *Jones*, 130 S. Ct. at 1429 n. 8 (emphasis added).

The plaintiffs contended that "the flawed fee-negotiation process constitute[d] additional evidence that the fees [were] outside the arm's length range." *Gallus*, 2012 WL 1058976, at *5. However, the Eighth Circuit found that "any deficiencies in the [fee-negotiation] process affect[] [only] the amount of deference we give to the board's decision to approve the adviser's fee." *Id.* If "the process of approving the fees was flawed—either because the board's process was deficient or because the adviser withheld material information—we must 'take a more rigorous look at the outcome' and give less deference to the board's decision to approve the adviser's fees." *Id.* at *3 (quoting *Jones*, 130 S.Ct. at 1430). The Eighth Circuit explained



that it did “not read *Jones* to allow a deficient process to be the additional evidence required to survive summary judgment.” *Id.* at *5.

The plaintiffs also “maintain[ed] that they [had] presented additional evidence in the following categories to show that the fees [were] beyond the arm’s length range: Ameriprise retained the economies of scale it realized from the Funds; Ameriprise recognized excessive ‘fall out’ financial benefits from its relationship with the Funds; and the Funds did not perform well.” *Gallus*, 2012 WL 1058976, at *5. The district court had previously “considered each of these categories” and “concluded that the evidence was insufficient to ... survive summary judgment.” *Id.* In its 2009 decision, the Eighth Circuit had “agreed with that part of the district court’s analysis.” *Id.* The Eighth Circuit found that “nothing in *Jones* requires us to revisit these arguments.” *Id.*

The Eighth Circuit concluded that “[w]hen considered in the light of *Jones*, the district court’s initial review of the other relevant circumstances and the disputed fees themselves was sufficiently detailed to constitute a ‘rigorous look at the outcome,’” and “there [was] thus no need to remand for further proceedings.” *Id.* (quoting *Jones*, 130 S.Ct. at 1430). Accordingly, the Eighth Circuit affirmed the district court’s grant of summary judgment in favor of Ameriprise.

The Southern District of New York Dismisses All Surviving Securities Act Claims in the GE Credit Crisis-Related Suit

On April 18, 2012, the Southern District of New York granted judgment on the pleadings dismissing all Securities Act claims in a credit crisis-related securities fraud suit against General Electric (“GE”). *In re Gen. Elec. Co. Sec. Litig.*, 2012 WL 1371016 (S.D.N.Y. Apr. 18, 2012) (Cote, J.) (“*GE II*”). The court’s ruling “dispose[d] of all remaining claims against forty-two defendants” in the case. *Id.* at *12.

Background

The plaintiffs alleged that 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.) (“January Opinion”). Specifically, the plaintiff asserted that “GE [had] 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 January 11, 2012, the Southern District of New York denied in large part the defendants’ motion to dismiss the suit.³ (To read our discussion of the January Opinion, please [click here](#).)

All defendants moved for partial reconsideration and judgment on the pleadings as to claims brought under the Securities Act of 1933. Specifically, the defendants requested reconsideration of the court’s rulings that the offering documents for GE’s \$12

3. Judge Holwell authored the January Opinion. After he retired, the GE case was assigned to Judge Cote, who authored the *GE II* decision.

billion secondary public stock offering, commenced in October 2008 (the “Offering Documents”), “contained materially false statements or omissions related to GE’s ability to issue commercial paper” and “the valuation of GE’s assets” in violation of the Securities Act. *GE II* at *4.

In addition, GE and its CFO Keith Sherin moved for partial reconsideration and judgment on the pleadings with respect to the court’s ruling that “Sherin’s statements about the quality of GE Capital’s loan portfolio gave rise to liability under the Exchange Act.” *Id.*

The Court Dismisses All Securities Act Claims Concerning Statements Related to GE’s Ability to Issue Commercial Paper

On motion for reconsideration, the Southern District of New York found that “[t]he January Opinion improperly relied on” statements “made in a press release attached to GE’s September 25, 2008 Form 8-K” providing that “demand remains strong for GE Capital’s commercial paper debt” and that “GE’s funding position is strong and GE has performed well during the recent market volatility[.]” *Id.* at *7 (internal quotations omitted). While the lead plaintiff contended that “this Form 8-K was incorporated into the Offering Documents,” the *GE II* court determined that “GE’s



October 2, 2008 Prospectus Supplement incorporates the Form 8-K with respect to Item 8.01 only,” which “does not include the relevant statements.” *Id.* “As such, these statements were not incorporated into the Offering Documents and should not have been relied upon in the January Opinion.” *Id.*

The *GE II* court also found that the January Opinion “improperly relied on ... statements that were modified and superseded by later statements.” *Id.* at *7. According to the complaint, “the Offering Documents included statements from GE’s Form 10-K/A for Fiscal Year 2004 and certain of its Forms 10-K from 2005-2007 characterizing commercial paper markets as ‘a reliable source of short-term financing,’ and indicating that impaired access to those markets was ‘unlikely.’” *Id.* The January Opinion “correctly” concluded “that these statements were incorporated by reference into the Offering Documents.” *Id.* However, the *GE II* court found that these statements were “superseded by subsequent statements in the Preliminary Prospectus” pursuant to SEC Rule 412(a).⁴ *Id.*

GE’s prospectus supplement stated that “[a]lthough GE Capital has continued to issue commercial paper, there can be no assurance that such markets will continue to be a reliable source of short-term financing[.]” *Id.* at *8 (emphasis added by the court). The *GE II* court determined that “[t]hese statements directly modify and replace the earlier statements from GE’s 2005-2007 Forms 10-K.”

4. SEC Rule 412(a) provides:

- (a) Any statement contained in a document incorporated ... by reference ... shall be deemed to be modified or superseded for purposes of the registration statement or the prospectus that is part of the registration statement to the extent that a statement contained in the prospectus that is part of the registration statement ... modifies or replaces such statement.
- (b) The modifying or superseding statement may, but need not, state that it has modified or superseded a prior statement ...
- (c) Any statement so modified shall not be deemed in its unmodified form to constitute part of the registration statement or prospectus for purpose of the Act. Any statement so superseded shall not be deemed to constitute a part of the registration statement or prospectus for purposes of the Act.

GE II at *8 (quoting 17 CFR § 230.412) (emphasis added by the court).

Id. Contrary to the lead plaintiff's claim that "this language ... is merely standardized 'boilerplate[.]'" the *GE II* court found that the statements at issue "specifically reference[] ongoing events in the financial crisis and directly modif[y] GE's earlier statements on the likelihood of impaired access to commercial paper markets and [the] reliability of commercial paper as a source of short-term financing." *Id.* at *9. Accordingly, the court held that "[t]he statements in GE's Forms 10-K from 2005-2007 are ... superseded and not deemed to constitute part of the Offering Documents." *Id.* at *8.

The *GE II* court also found that the January Opinion "improperly relied" on a statement by Jeffrey Immelt, GE's CEO, providing that "'in the recent market volatility, we continue to successfully meet our commercial paper needs.'" *Id.* at *9 (internal quotations omitted). The *GE II* court explained that "[t]his is a statement of opinion, not objective fact" and must therefore be judged against the standard set forth in *Fait v. Regions Financial Corporation*, 655 F.3d 105, 110 (2d Cir. 2011) (Parker, J.). *GE II*, 2012 WL 137016, at *9. Although *Fait* was issued on August 23, 2011, "the January Opinion did not address the impact of the *Fait* decision on its analysis." *Id.* at *5. (To read our discussion of the *Fait* ruling in the September edition of the Alert, please [click here](#).)

"Pursuant to *Fait*, 655 F.3d at 110, a statement of opinion is not actionable unless the speaker disbelieved it at the time he expressed it." *Id.* at *9. "In other words, the statement must be subjectively false." *Id.* Here, the complaint does not "allege that on October 1 Immelt disbelieved his statement that GE was continuing to meet its commercial paper needs." *Id.* "[If] Immelt had disbelieved this statement of opinion at the time he made it ... then he would have engaged in a form of knowing misconduct." *Id.* Because the complaint "disclaim[s] all such allegations[.]" the *GE II* court held that "it has not alleged subjective falsity" with respect to Immelt's statement. *Id.*

As to GE's statement that it has "continued to issue commercial paper," the *GE II* court found that this "merely states that GE was issuing *some amount* of



commercial paper." *Id.* The complaint "does not allege that GE had completely ceased to issue commercial paper at the time of the Offering." *Id.*

Finally, with respect to GE's statement that "there can be no assurance that commercial paper markets will continue to be a reliable source of short-term financing for GE Capital," *id.* (alterations and internal quotations omitted), the court held that "[a] statement that a source of financing is 'reliable' involves an evaluation of the likelihood of events that is 'not objectively determinable,' and that is a matter of 'opinions or beliefs held.'" *Id.* at *10 (quoting *Fait*, 655 F.3d 109, 111). The *GE II* court found that this statement is "not actionable because ... the [complaint] does not allege subjective falsity." *Id.* Moreover, the court explained that "the full statement in context is not misleading." *Id.*

The *GE II* Court Dismisses the Securities Act Claims Concerning GE's Alleged Reclassification of Assets

The *GE II* court held that "[t]he January Opinion wrongly concluded that GE's alleged reclassification of assets in violation of GAAP gave rise to material misrepresentations in the Offering Documents." *Id.* While the complaint "successfully makes out a claim

that GE's valuation was inflated" and that the Offering Documents "misstate the value of GE Capital's assets," the *GE II* court explained that "nowhere does [the complaint] make a plausible allegation as to *how much* this valuation was inflated and that this amount was material." *Id.* (emphasis in the original). "[T]he [complaint] alleges only that GE failed to adjust the carrying value of *some amount* of its assets upon transferring them from 'available to sale' to 'held to maturity' positions." *Id.* (emphasis in the original). "Without more of a description in the [complaint] of the significance of these assets to GE's balance sheet, there is not 'a substantial likelihood that a reasonable shareholder' would have considered this allegation 'important in deciding how to act.'" *Id.*

The *GE II* Court Declines to Dismiss the Exchange Act Claims Concerning Sherin's Statements Regarding the Quality of GE's Loan Portfolio

"For the reasons articulated in the January Opinion," the *GE II* court held that the "plaintiffs have stated plausible Exchange Act claims against GE and Sherin based on Sherin's statements about the quality of GE's loan portfolio." *Id.* at *12. "Although Sherin's characterizations of GE Capital's portfolio as 'fantastic,' 'great,' 'robust,' 'strong,' and 'very high quality' are prototypical opinion statements," the *GE II* court determined that the complaint "adequately pleads subjective falsity through, *inter alia*, its claims as to Sherin's scienter." *Id.* The complaint "has described a plethora of reports which tracked on a regular and detailed basis the quality of the assets as to which Sherin's remarks were directed." *Id.* The *GE II* court found that "[i]t is highly implausible that GE's CFO would be ignorant of basic facts contained in these reports about the quality of roughly one-third of GE Capital's assets." *Id.*

The First Department Addresses the Heightened Standard for Fraud Claims Brought by Sophisticated Investors

On March 27, 2012, the First Department dismissed a fraud claim brought by HSH Nordbank AG, a German commercial bank, against UBS AG and UBS Securities LLC (collectively, "UBS") alleging that UBS "induced" HSH to enter into a credit default swap transaction by "misrepresenting the risk involved and the manner in which UBS intended to manage the composition of the reference pool." *HSH Nordbank AG v. UBS AG*, 2012 WL 997166, at *1 (N.Y. App. Div. 1st Dept. Mar. 27, 2012). The First Department held that "HSH—a sophisticated commercial entity" could not "satisfy the element of justifiable reliance" because "HSH [had] agreed that it was not relying on any advice from UBS; assented to the inherent conflicts of interest ...; and was explicitly warned of the risks it was undertaking." *Id.* "Moreover," the court found that "HSH could have uncovered any misrepresentation of the risk of the transaction through the exercise of reasonable due diligence within the means of a financial institution of its size and sophistication." *Id.*

Background

The dispute concerned a credit default swap transaction in which "HSH was to receive (indirectly) a stream of premium payments from UBS and, in exchange, to assume a portion of the risk of defaults in ... a \$3 billion securities portfolio assembled by UBS, comprised predominantly of assets linked to the United States real estate market" (the "reference pool"). *Id.* The offering materials and contractual documents were "replete with detailed disclosures of the considerable risks involved and of the conflicts of interest arising from UBS's multiple roles" in the transaction. *Id.* at *2.

“In addition, the documents contain[ed] disclaimers establishing that, not only were UBS and HSH dealing with each other at arm’s length, but that HSH was not entering into the deal in reliance on any advice from UBS.” *Id.*

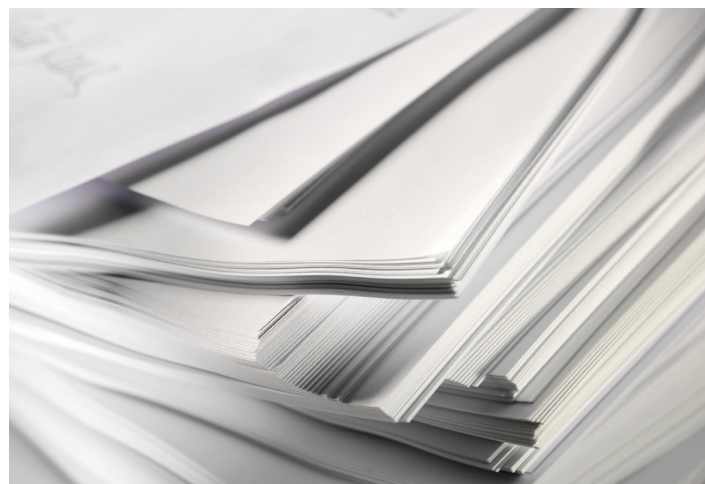
For the first six years, “no credit events occurred in the reference pool” and “HSH therefore collected the full amount of interest due on its notes.” *Id.* at *3. But in 2008, “with the collapse of the United States real estate market and the onset of the global financial crisis, credit events in the reference pool began to occur in abundance.” *Id.* “[C]redit events in the reference pool have [since] accumulated to such an extent that ‘HSH has [allegedly] experienced a near-total loss of its \$500 million investment.’” *Id.*

HSH eventually brought suit against UBS for fraud, negligent misrepresentation and breach of contract, and demanded punitive damages in connection with the transaction. The trial court granted UBS’s motion to dismiss HSH’s negligent misrepresentation claim and its demand for punitive damages, but denied the motion as to HSH’s fraud and breach of contract claims. UBS appealed only the denial of its motion to dismiss HSH’s fraud claim.

The First Department Dismisses HSH’s Fraud Claim against UBS as “Legally Insufficient”

The crux of HSH’s fraud claim was that “UBS harbored the undisclosed intent to engage in ‘ratings arbitrage’ in managing the reference pool.” *Id.* HSH explained the term ‘ratings arbitrage’ as “[t]he systematic selection and substitution of credits which had the requisite credit rating, but *traded at wide spreads* (i.e., were higher risk) for that rating.” *Id.* at *4 (emphasis in the opinion). “[B]y HSH’s own account, the potential for a discrepancy between a security’s credit rating and its actual risk was ... sufficiently well known that securities often traded at a discount to the price their

credit rating (if accurate) would have warranted.” *Id.* In other words, HSH was essentially claiming that UBS “induced it to enter into a deal that would enable UBS to exploit, at HSH’s expense, a feature of the relevant securities market that was common knowledge among participants in that market.” *Id.* The First Department held that “[t]his does not constitute a legally sufficient cause of action for fraud, certainly not when pleaded by a sophisticated business entity that disclaimed reliance on the party it now accuses of fraud.” *Id.*



The First Department explained that “[a]s a matter of law, a sophisticated plaintiff cannot establish that it entered into an arm’s length transaction in justifiable reliance on alleged misrepresentations if that plaintiff failed to make use of the means of verification that were available to it.” *Id.* at *5. “Here, the core subject of the complained-of representations was the reliability of the credit ratings used to define the permissible composition of the reference pool.” *Id.* “Far from being peculiarly within UBS’s knowledge, the reliability of the credit ratings could [have been] tested against the public market’s valuation of rated securities.” *Id.* “[A] study of the market for the relevant kinds of securities would have revealed that the credit rating conferred on a security by a rating agency did not necessarily correspond to the security’s risk level as perceived by the market.” *Id.* “Given that the amended complaint itself makes plain that an

examination of the relevant securities market would have revealed the fallibility of the credit ratings,” the First Department concluded that “HSH’s fraud claim would [have been] legally insufficient even in the absence of the disclaimers and disclosures set forth in the transactional documents.” *Id.* at *7.

The First Department also found that HSH could not “predicate a fraud claim upon the allegation that UBS disingenuously recommended that HSH enter into a transaction that, while favorable to UBS, was disadvantageous to HSH.” *Id.* at *4. “Under the disclaimers set forth in the extensively negotiated governing documents,” the court found that “HSH had no right to look to UBS for advice concerning the suitability of the deal for HSH.” *Id.* The First Department further determined that “UBS had no obligation to disclose [its] internal analyses [of the transaction] for which HSH made no request.” *Id.* at *6. “[I]n arm’s length dealings between sophisticated parties, the seller is not obligated to disclose to the buyer its internal valuation of the item sold.” *Id.* at *9.

Finally, the First Department held that “it was unjustifiable and unreasonable as a matter of law for HSH to place any reliance on UBS’s alleged extracontractual representations concerning a contemplated ‘alignment of interests’ between the two parties” with respect to UBS’s management of the reference pool of securities. *Id.* at *11. “[T]he transactional documents expressly disclosed the potential for conflicts of interests between UBS and HSH to arise in the course of UBS’s management of the reference pool and its other trading activities.” *Id.* at *10. The court found that “[a]ny limitations on UBS’s discretion in managing the reference pool or in its other trading activities that HSH expected to be observed should have been incorporated into the heavily negotiated transactional documents.” *Id.* at *11.

The First Department clarified it did not mean to “suggest that UBS, if it engaged in the sharp dealing alleged by HSH, is to be commended; such practices are indeed troubling.” *Id.* at *12. But “[t]o sustain HSH’s fraud cause of action” here “would put

in question whether any set of disclaimers and disclosures, no matter how detailed and specific, [could] afford[] protection against a fraud claim—even a claim by a commercial entity of a high degree of sophistication, and with the resources to hire any outside help it needs—concerning matters subject to discovery through due diligence, and as to which the claimant agreed that it was not relying on the party sitting across the table.” *Id.* at *12.

The First Department Affirms the Dismissal of a Morgan Stanley Shareholder Derivative Suit Alleging Excessive Executive Compensation

On March 22, 2012, the First Department affirmed the dismissal of a shareholder derivative action brought on behalf of nominal defendant Morgan Stanley in connection with the total compensation payments Morgan Stanley made to all of its employees world-wide in 2006, 2007 and 2009. *Sec. Police and Fire Prof’ls of Am. Ret. Fund v. Mack*, 940 N.Y.S.2d 609 (N.Y. App. Div. 1st Dep’t. Mar. 22, 2012) (Tom, C.J., Friedman, Acosta, DeGrasse, and Román, JJ.).⁵ The First Department found that the trial court had “correctly dismissed [the] case for failure to show that a prelitigation demand would have been futile.” *Id.* at 612.

Background

Shareholders filed suit against several of Morgan Stanley’s current and former directors and officers, asserting claims for waste, breach of the duty of

⁵ Simpson Thacher represents the outside directors in this matter.

loyalty, and unjust enrichment in connection with “the board’s alleged decisions in 2006, 2007, and 2009 regarding compensation for all of Morgan Stanley’s tens of thousands of employees.” *Id.* The plaintiffs did not make a demand on the board prior to filing suit.

On January 6, 2011, the trial court granted the defendants’ motion to dismiss the complaint with prejudice.

The Plaintiffs Failed to Establish That a Majority of Morgan Stanley’s Directors Were Interested or Lacked Independence

To show that demand would have been futile under Delaware law, “the complaint must allege particularized facts creating a reason to doubt that (1) the directors are disinterested and independent or ... (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.” *Id.* (internal quotations and alteration marks omitted).

The First Department found that the trial court had correctly determined that John Mack “was interested because, as a director, he approved his own compensation as CEO.” *Id.* at 613. In addition,



“[a]lthough defendant James P. Gorman (Morgan Stanley’s CEO since January 2010) did not join the board until 2010 and, hence, did not take part as a director in the challenged decisions,” the First Department “assume[d] that as an official of Morgan Stanley he would be found to be interested or lack independence” under Delaware’s demand futility test. *Id.*

As to the remaining directors, the First Department noted that a “substantial likelihood” of personal liability for approving a contested transaction may render directors personally interested in the decision whether to pursue the demanded litigation.” *Id.* at 614. In this case, however, the court found that “the likelihood of liability is significantly less because the corporate charter provides that directors are exculpated from liability to the extent authorized by 8. Del. C. § 102(b)(7), i.e., except for claims based on fraudulent, illegal or bad faith conduct.” *Id.* To plead a substantial likelihood of personal liability, “the complaint must [therefore] allege particularized facts that would show that the directors acted with scienter, i.e., that they had actual or constructive knowledge that their conduct was legally improper.” *Id.* (internal quotations omitted). The First Department found that “[t]he complaint does not allege such facts.” *Id.*

The First Department also addressed whether the complaint raised a reasonable doubt regarding the independence of the remaining directors, all of whom were outside directors. The court explained that “the complaint must create a reasonable doubt as to whether the outside director was beholden to an interested director or so much under the latter’s influence that his or her discretion would be sterilized.” *Id.* at 613 (internal quotations omitted). The First Department held that “[t]he allegation that each of the outside directors receives more than \$300,000 per year in director fees from Morgan Stanley is insufficient to create that doubt.” *Id.* Moreover, the court observed that the outside directors cannot “be fired by the interested inside directors” because the

inside directors are neither “controlling shareholders of Morgan Stanley” nor do they “control the process by which outside directors are nominated to the board.” *Id.* In addition, the First Department considered it significant that “the bulk of the outside directors’ fees is paid in Morgan Stanley stock, not cash”—a fact that “supports the presumption that the directors ‘objectively considered the merits of the proposed corporate transaction’ in deciding how to vote on it.” *Id.*

With respect to the plaintiffs’ allegation that one of the outside directors was a banker at Morgan Stanley from 1973 to 1995, the First Department found this claim insufficient “to raise a reasonable doubt that [the director] is not independent.” *Id.* The court also rejected as “conclusory” the plaintiffs’ allegation that Morgan Stanley conducts a “significant amount” of business with another outside director’s company. *Id.* (internal quotations omitted). Because the plaintiffs had failed to establish “that at least 7 members of Morgan Stanley’s 14-member board were interested or lacked independence,” the First Department declined to consider the plaintiffs’ other director-specific allegations. *Id.* at 613-14.

The Plaintiffs Failed to Raise a Reasonable Doubt That Morgan Stanley’s Compensation Decisions Were the Product of a Valid Exercise of Business Judgment

Turning to the second prong of the demand futility test, the plaintiffs contended that “they [had] alleged particularized facts creating a reason to doubt that the directors’ compensation awards were the product of a valid exercise of business judgment because waste does not constitute a valid exercise of business judgment and because the director defendants [had allegedly] breached their duty of loyalty to Morgan Stanley by failing to exercise oversight over



compensation.” *Id.* at 614 (internal citations omitted).

Rejecting these claims, the First Department first found that “[t]he complaint does not adequately plead waste.” *Id.* “It lacks the specific allegations of unconscionable transactions and details regarding who was paid and for what reasons they were paid that are necessary for a determination whether the work done by Morgan Stanley’s employees was of such limited value to the corporation that no reasonable person in the directors’ position would have approved their levels of compensation.” *Id.* (internal quotations omitted).

“As to the duty of loyalty and oversight liability,” the First Department “assum[ed], arguendo, that the duty of oversight includes the duty to monitor business risk.” *Id.* The court found that “the complaint fails to allege that ‘the board *consciously* failed to implement any sort of risk monitoring system or, having implemented such a system, *consciously* disregarded red flags signaling that the company’s employees were taking facially improper, and not just ex-post[,] ill-advised or even bone-headed, business risks.’” *Id.* (emphasis in the original).

Because the First Department found that “demand was not shown to be excused,” the court did not reach the merits of the defendants’ motion for failure to state a cause of action. *Id.* at *3.

The SEC Issues a Study on the Extraterritorial Scope of Section 10(b) Private Actions

On April 11, 2012, the SEC released a study “attempt[ing] to identify the relevant policy considerations that Congress might want to consider as part of a process for determining whether to enact legislation regarding the cross-border scope of Section 10(b) private actions.” Study on the Cross-Border Scope of the Private Right of Action Under Section 10(b) of the Securities Exchange Act of 1934, Apr. 11, 2012, at 69 (“SEC Study”).

Background

In *Morrison v. National Australia Bank, Ltd.*, the Supreme Court held that Section 10(b) applies only to “transactions in securities listed on domestic exchanges, and domestic transactions in other securities.” 130 S. Ct. 2869, 2884 (2010). “The *Morrison* decision rejected four decades of federal court of appeals’ precedents that had allowed Section 10(b) actions involving transnational securities frauds either when the fraud involved significant conduct within the United States causing injury to overseas investors, or substantial foreseeable effects occurring to investors or markets within the United States [(the “conduct and effects tests”).” SEC Study at 6.

Congress responded to the *Morrison* decision by enacting Section 929P(b)(2) of the Dodd-Frank Act, which “restored the ability of the [SEC] and the [DOJ] to bring enforcement actions under Section 10(b) in cases involving transnational securities fraud.” *Id.* Specifically, Section 929P(b)(2)(b) provides that federal district courts have jurisdiction over SEC and DOJ enforcement actions brought under Section 10(b) involving:

(1) conduct within the United States that constitutes significant steps in the furtherance of the violation, even if the securities transaction

occurs outside the United States and involves only foreign investors; or

(2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

Pub. L. No. 111-203, § 929P, 124 Stat. 1376 (codified as amended at 15 U.S.C. § 78aa).

Congress also signed into law Section 929Y(a) of the Dodd-Frank Act, which directed the SEC “to determine whether private rights of action under Section 10(b) should be similarly extended.” SEC Study at 7. Section 929Y(b) instructed the SEC to “consider and analyze, among other things”:

the scope of such a private right of action, including whether it should extend to all private actors or whether it should be more limited to extend just to institutional investors or otherwise;

what implications such a private right of action would have on international comity;

the economic costs and benefits of extending a private right of action for transnational securities frauds; and

whether a narrower extraterritorial standard [than was enacted for the Commission and the DOJ] should be adopted [for private actions].

Id. at 7 (quoting Pub. L. No. 111-203, § 929Y(b) (alterations in the original).

On October 25, 2010, the SEC invited public comment on the foregoing issues, among others, and ultimately received more than seventy comment letters. Following a careful consideration of “the views expressed in the comment letters,” as well “the pre- and post-*Morrison* case law,” the SEC released its study on April 11, 2012. *Id.* at 58.

The SEC Provides Congress with Potential Options for the Extraterritorial Expansion of Section 10(b) Private Actions

The SEC Study sets forth a series of options (not all of which are mutually exclusive) for potentially changing the rules governing the extraterritorial reach of Section 10(b) private actions. Some options involve reinstating versions of the conduct and effects tests. Other options are presented as supplements to and clarifications of *Morrison's* transactional test. The SEC Study acknowledges that Congress also has the option to “take no action” and allow the lower courts to “continue to interpret and refine the Supreme Court’s holding in *Morrison*.” *Id.* at 58-59.

Reinstating Versions of the Conduct and Effects Tests

The SEC found that “enactment of the [SEC] and DOJ conduct and effects tests for Section 10(b) private actions would involve policy trade-offs that could carry significant implications in many areas, including investor protection and international comity.” *Id.* at 60. However, the SEC identified “several alternative approaches that” in the SEC’s view “might alleviate certain of [these] potential negative consequences.” *Id.* at 60-61.

1. Enacting a Conduct Test with a “Direct Injury” Requirement

One approach would be to “adopt the conduct and effects tests, but to narrow the conduct test so that a private plaintiff seeking to base a Section 10(b) private action on it must demonstrate that the plaintiff’s injury resulted *directly* from conduct within the United States.” *Id.* at 61 (emphasis in the original). “This is the formulation of the conduct test that the Solicitor General, joined by the [SEC], recommended in the *Morrison* litigation in the Supreme Court.” *Id.* The SEC

noted that it “has not altered its view in support of this standard.” *Id.*

The SEC explained that “a conduct test with a direct injury requirement would further the strong federal interest in deterring fraudulent conduct that emanates from the United States.” *Id.* “Correspondingly, a direct injury requirement could serve as a filter to exclude those claims that have a closer connection to another jurisdiction.” *Id.* The SEC acknowledged that the “direct injury” version of the conduct and effects test “could still require a fact-intensive inquiry involving burdensome discovery and other significant litigation efforts to determine if the alleged U.S. conduct constituted a direct cause of the overseas injury.” *Id.* at 63. In certain cases, the test may also “pose challenges to international comity.” *Id.*

2. Limiting the Conduct and Effects Tests to Claims by U.S. Investors

Another possible approach would be to “enact conduct and effects tests available just to U.S. investors.” *Id.* The SEC found that this option “may pose less of a challenge to international comity ... because international law generally recognizes that nations have a strong and legitimate sovereign interest in protecting their residents from frauds directed at them.” *Id.* It would also “have the additional benefit of possibly fitting more closely with two of the principal regulatory interests of the U.S. securities laws—*i.e.*, protection of U.S. investors and U.S. markets—than the transactional test.” *Id.* at 64. However, the SEC noted that limiting the conduct and effects tests to U.S.



investors only could entail “potential drawbacks” such as “(i) costly discovery and ad-hoc factual analysis before any determination as to whether Section 10(b) reaches the conduct, and (ii) application of Section 10(b) to securities transactions that occur on foreign securities exchanges, which a number of foreign governmental authorities have opposed.” *Id.*

Supplementing and Clarifying the Transactional Test

Consistent with its mandate to “consider whether ‘a narrower extraterritorial standard’ than the conduct and effects test might be appropriate,” the SEC offered several options for “supplement[ing] and clarify[ing] the transactional test.” *Id.* at 64.

1. Extending Section 10(b) Private Actions to Reach Transactions Involving Any Security of the Same Class as Securities Registered in the United States by the Same Issuer

One option would to permit investors to “bring a private action whenever there is a violation of Section 10(b) involving a security that is of the same class of securities registered in the United States [by the same issuer] without regard to the location of the actual transaction.” *Id.* The SEC explained that “[f]ocusing on registration would ensure that investors ... retain the ability to pursue Section 10(b) claims against those companies that have sought to access the public U.S.



securities markets and are meeting the reporting and disclosure requirements of U.S. securities law.” *Id.* at 65. This approach “would [also] provide a bright line ... permit[ting] any issuer considering U.S. registration to estimate the potential liability exposure and to proceed accordingly.” *Id.*

However, the SEC cautioned that “private liability based solely on registration could be perceived as disruptive to international comity,” particularly because it “could result in a return to U.S. courts of so-called ‘foreign-cubed’ class actions—*i.e.*, private class actions brought by foreign investors suing foreign issuers involving transactions on foreign exchanges.” *Id.* “[U]nder a U.S.-registration standard, the *Morrison* litigation itself would have been decided differently because ... defendant National Australia Bank’s stock was registered in the United States.” *Id.* at 65-66. Enacting such a rule “could discourage foreign issuers from registering securities in the United States” and might thus “negatively impact the competitiveness of the United States capital markets.” *Id.* at 66.

2. Permitting Section 10(b) Private Actions against Securities Intermediaries That Engage in Securities Fraud in Connection with Foreign Securities Purchases or Sales on Behalf of U.S. Investors

A couple of courts have ruled that “a securities intermediary—*e.g.*, a broker-dealer or investment adviser—that defrauds a customer or client in connection with a foreign securities transaction may avoid Section 10(b) private liability under the transactional test, even if the intermediary is physically operating in the United States or actively providing services to U.S. investors.” *Id.*

To address what it deemed to be a “void in the Section 10(b) private liability regime,” the SEC suggested that “Congress may wish to consider affording a Section 10(b) private action against: (i) securities intermediaries located within the United States when they defraud a client in connection with

any securities transaction (*i.e.*, foreign or domestic); and (ii) foreign securities intermediaries when they are reaching into the United States to provide securities investment services for a U.S. client and commit fraud against that client in connection with any securities transaction." *Id.* at 66-67. The SEC explained that "[s]uch an approach would likely not offend principles of international comity given the significant U.S. interest in ensuring that securities intermediaries either physically operating here or reaching into the United States market to provide services for U.S. clients do not engage in fraud." *Id.* at 67.

3. Enacting a "Fraud in the Inducement" Test for Section 10(b) Private Actions Involving Foreign Securities Transactions

The SEC noted that a number of comment letters had suggested the enactment of a "fraud in the inducement" test, pursuant to which an investor could bring a private action under Section 10(b) "if the investor is in the United States 'at the time the investor is induced [by the fraudster] to purchase or sell securities in reliance on a materially false or misleading statement or pursuant to a manipulative act.'" *Id.* at 67 (alterations in the original). In the SEC's view, this approach "could help deter both domestic and foreign parties from targeting persons in the United States with deceptive or manipulative actions." *Id.* In addition, it "likely would not raise significant international comity concerns" because "the United States has a strong and well-recognized interest in ensuring that fraudulent conduct is not directed at investors in the United States." *Id.* at 68.

4. Clarifying When an Off-Exchange Transaction Takes Place in the United States

Because the *Morrison* ruling "did not specify when an off-exchange transaction takes place in the United States," "the lower federal courts have been struggling to determine when an off-exchange

transaction occurs here." *Id.* Certain courts have "applied ... a fact-intensive inquiry that looks to whether the moment of irrevocable liability occurred in the United States." *Id.* at 68. In *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 2012 WL 661771, at *6 (2d Cir. Mar. 1, 2012) (Katzmann, J.), the Second Circuit endorsed the irrevocable liability test.⁶ The SEC expressed concern that "an irrevocable liability' or similar narrow standard ... [could] cut against the bright-line purposes underlying the transactional test" and "could also serve as a roadmap for overseas fraudsters to structure transactions to avoid Section 10(b) private liability." SEC Study at 68.

Accordingly, the SEC suggested that "a statutory clarification of the transactional test's application to off-exchange transactions would be useful." *Id.* "Specifically, Congress might clarify that, in the case of off-exchange transactions, a domestic securities transaction occurs if a party to the transaction is in the United States either at the time that party made the offer to sell or purchase, or accepted the offer to sell or purchase." *Id.* The SEC noted that "this clarification for off-exchange transactions should not present international comity concerns because the United States has a strong and well-recognized interest in redressing fraud that occurs in transnational securities transactions that involve U.S. parties." *Id.* at 69.

Expanding the Reach of Section 10(b) Extraterritorially for Institutional Investors Only

Section 929Y(b) of the Dodd-Frank Act raises the possibility of "extending private rights of action extraterritorially under Section 10(b) 'just to institutional investors' such as pension funds and mutual funds, leaving other investors (including retail investors) with only the transactional test." *Id.* at 58 n. 217. The SEC explained that it "found no support

6. To read our discussion of the *Absolute Activist* decision in the March edition of the Alert, please [click here](#).

for such an approach either in the comment letters or during meetings with investors, including institutional investors.” *Id.*

Commissioner Luis A. Aguilar Issues a Dissenting Statement

On the same day that the SEC Study was issued, SEC Commissioner Luis A. Aguilar released a statement expressing his “strong disappointment that the Study fails to satisfactorily answer the Congressional request, contains no specific recommendations, and does not portray a complete picture of the immense and irreparable investor harm that has resulted, and will continue to result, due to *Morrison*.” Luis S. Aguilar, Commissioner, U.S. Securities and Exchange Commission, Statement by Commissioner: Defrauded Investors Deserve Their Day in Court (Apr. 11, 2012). In Commissioner Aguilar’s view, “[t]he Study should have recommended that Congress enact for private litigants a standard that is identical to the standard set forth in Section 929P of the Dodd-Frank Act—the standard for SEC and DOJ actions.” *Id.*

Two “Say on Pay” Plaintiffs Move to Voluntarily Dismiss Their Suits

Last month, we reported on multiple decisions granting motions to dismiss “Say on Pay” shareholder suits. (To read the March edition of the Alert, please [click here](#).) In the past several weeks plaintiffs in two “Say on Pay” suits—one brought derivatively on behalf of Helix Energy Solutions Group and the other brought derivatively on behalf of Umpqua Holdings Corporation—moved for voluntary dismissal of their actions without prejudice.⁷ See Motion for Voluntary Dismissal Pursuant to Fed. R. Civ. P. 23.1 and 41(a)(1),

⁷ Both sets of plaintiffs are represented by the same counsel.



City of Sterling Heights Police & Fire Ret. Sys. v. Kratz, C.A. No. 4:11-cv-02537 (S.D. Tex. Mar. 29, 2012) (“Helix Motion”); Motion for Voluntary Dismissal Pursuant to Fed. R. Civ. P. 23.1 and 41(a)(1), *Plumbers Local No. 137 Pension Fund v. Davis*, Case No. 3:11-cv-00633-AC (D. Or. Apr. 2, 2012) (“Umpqua Motion”). The plaintiffs explained that:

[T]he emerging case law, although recognizing that a negative advisory say-on-pay vote has ‘substantial weight’ and ‘may be considered as evidence by the court’ in assessing demand futility, appears to be consistent with the view that, under certain circumstances, a pre-suit litigation demand may be needed to begin a say-on-pay shareholder derivative action.

Helix Motion at 2; see also Umpqua Motion at 1. Both sets of plaintiffs stated that “[u]pon dismissal of the claims,” they “intend[ed] to explore making a litigation demand” on their respective boards to “investigate the claims” at issue. Helix Motion at 2; see also Umpqua Motion at 2 (“Upon dismissal of their claims, plaintiffs intend to explore making a litigation demand on the Umpqua Board to investigate the claims”).

On April 2, 2012, the Southern District of Texas denied the Helix Motion based on an objection by the defendants, who requested that the court rule on their fully-briefed motion to dismiss rather than dismissing the plaintiffs’ claims without prejudice. That same day, the District of Oregon granted the Umpqua Motion.

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