Simpson Thacher
SECURITIES LAW ALERT
AUGUST 2013

This edition of the Alert addresses a Second Circuit decision discussing the materiality standard for Section 11 claims; a Fifth Circuit decision holding that tolling under *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974) ends when a class certification order is vacated; and a Seventh Circuit decision reversing dismissal of a shareholder derivative suit against the directors and officers of Baxter International.

We also discuss a Delaware Chancery Court opinion addressing the standard for judicial review of third-party transactions with companies with controlling shareholders; and a Maryland state court ruling applying Delaware law to dismiss a shareholder derivative action involving a real estate investment trust cash-out merger.

Second Circuit Addresses the Materiality Standard for Section 11 Claims

On July 22, 2013, the Second Circuit affirmed dismissal of a securities fraud action brought under Sections 11 and 15 of the Securities Act of 1933 against ProShares Trust and ProShares Trust II ("ProShares") based on plaintiffs' failure to plead material omissions or misrepresentations in the prospectuses for ProShares exchange-traded funds ("ETFs"). *In re ProShares Trust Sec. Litig.*, 2013 WL 3779364 (2d Cir. July 22, 2013) (Wesley, J.). The Second Circuit explained that when evaluating materiality for purposes of a Section 11 claim, courts must read prospectuses "as a whole" and with the assumption "that a reasonable investor can comprehend the basic meaning of plain-English disclosures."

Background

The registration statements at issue for the ProShares ETFs disclosed that ProShares ETFs "pursued daily investment objectives and daily investment results." Instead of setting their sights on long-term results, ProShares ETFs "focused only on meeting a benchmark tied to an underlying index one

The Securities Law Alert is edited by Paul C. Gluckow (pgluckow@stblaw.com/212-455-2653), Peter E. Kazanoff (pkazanoff@stblaw.com/212-455-3525) and Jonathan K. Youngwood (jyoungwood@stblaw.com/212-455-3539).

day at a time with a portfolio of different securities." The registration statements warned that the use of aggressive investment techniques and volatile financial instruments could result in "potentially dramatic" losses.

Investors who suffered losses in connection with their investments in ProShares ETFs brought a putative class action alleging that "ProShares [had] failed to disclose the magnitude and probability of loss for beyond-a-day investments in ProShares ETFs." Plaintiffs further contended that "the registration statements contained various 'contra-indicators' of successful long-term investments which [these] omissions made materially misleading."

In 2012, the Southern District of New York dismissed plaintiffs' complaint with prejudice, finding that "the disclosures in the registration statements accurately conveyed the specific risk that the plaintiffs assert materialized." *In re ProShares Trust Sec. Litig.*, 889 F. Supp. 2d 644 (S.D.N.Y. 2012) (Koeltl, J.). "[W]hen investors held the ETFs for periods longer than one day the funds' performance widely diverged from the performance of the underlying indices sometimes resulting in losses despite the overall direction of the underlying indices." Plaintiffs appealed.

Second Circuit Finds Plaintiffs Failed to Allege Material Omissions in the ETF Prospectuses

In order to "state a plausible [S]ection 11 claim based on an alleged omission, a complaint must pass two distinct hurdles: it must identify an omission that is (1) unlawful and (2) material." *Proshares*, 2013 WL 3779364. While materiality "will rarely be dispositive in a motion to dismiss" a Section 11 claim, the Second Circuit explained that "the materiality hurdle remains a meaningful pleading obstacle." Dismissal of a Section 11 claim is warranted if an "alleged omission was 'so obviously unimportant to a reasonable investor' that reasonable minds would agree on that omission's unimportance."

The Second Circuit noted that the Supreme Court "has been careful not to set too low of a standard of materiality, for fear that management would bury the shareholders in an avalanche of trivial information." *ProShares*, 2013 WL 3779364 (quoting *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011) (internal quotation marks omitted)). For materiality purposes, the Second Circuit stated that what matters is whether there is a "*substantial* likelihood" that disclosure of the omitted information "would have been viewed by the *reasonable* investor as having *significantly* altered the total mix of information [already] made available."

The Second Circuit explained that "[i]n evaluating a prospectus," a court must "read it as a whole." After reviewing "the prospectus cover-to-cover," a court should "consider whether the disclosures and representations, 'taken together and in context,' would have misled a reasonable investor." The Second Circuit emphasized that prospectuses need not address reasonable investors "as if they were children in kindergarten."

Applying this standard to the case before it, the Second Circuit found that the ProShares "prospectuses adequately warned the reasonable investor of the

allegedly omitted risks." Here, the thrust of the plaintiffs' Section 11 claim was that "the registration statements omitted the risk that the ETFs, when held for a period of greater than one day, could lose substantial value in a relatively brief period of time." While the prospectuses "warned that the value of long-term ETF investments 'may diverge significantly' from the ETF's underlying index," plaintiffs contended that "the 'diverge significantly' disclosure [did] not speak to a divergence that result[ed] in actual, substantial loss." Plaintiffs claimed that the phrase "diverge significantly" was "not a synonym for 'loss.'"

The Second Circuit found it "implausible that substituting 'actual loss' for 'diverge significantly'" would be "a change substantially likely to be viewed by a reasonable investor as having significantly altered the import of the total mix of information ProShares made available." "'Significant' means large or important; in the context of the offering documents, 'divergence' means the opposite from one's expectation." The court explained that "ProShares' 'significant divergence' disclosures, fairly read, put investors on notice that an ETF's value might move in a direction quite different from and even contrary to what an investor might otherwise expect."

The Second Circuit determined that "the 'diverge significantly' disclosure" took on "additional meaning within the context of the prospectus as a whole." The court noted that the ProShares prospectuses made "absolutely clear that the ETFs operated pursuant to daily investment objectives, that they utilized leveraged investment techniques to achieve those objectives, and that mathematical compounding combined with leveraging prevented the ETFs from achieving their stated objectives over a period of time greater than one day." Quoting the district court's decision, the Second Circuit found that "the disclosures in the registration statements accurately conveyed the specific risk that [plaintiffs] assert materialized."

The Second Circuit also found no basis for plaintiffs' claim that the ProShares prospectuses failed to disclose "that certain market circumstances would '*necessarily* [cause] quick and potentially large losses' despite an investor's correct prediction of the overall, beyond-a-day direction of an ETF's underlying index." In the court's view, this did "not constitute an actionable omission of an objective fact, but rather a general omission regarding the risks associated with (1) hypothetical investments over (2) hypothetical periods of time during (3) hypothetically volatile market conditions." The Second Circuit underscored that ProShares could not "be expected to predict and disclose all possible negative results across any market scenario." Here, "no reasonable investor could read [the ProShares] prospectuses without realizing that volatility, combined with leveraging, subjected that investment to a great risk of long-term loss as market volatility increased."

Issuing Amended Disclosures Does Not Amount to an Acknowledgement That Earlier Disclosures Were Misleading

The Second Circuit rejected plaintiffs' claim that ProShares' issuance of amended prospectuses amounted to a tacit acknowledgement that its earlier prospectuses "failed to reveal critical facts." Among other changes, the revised prospectuses "acknowledge[d] that volatility could cause an ETF to 'move in [the] opposite direction as the index.'"

The Second Circuit determined that ProShares' issuance of revised prospectuses did "not alter [its] conclusion that the earlier ProShares prospectuses adequately warned of volatility's effect on the magnitude and probability of loss." If the "quality" of a disclosure "could have been improved," the issuance of a revised disclosure does not render the prior disclosure "deceptive or misleading." The key question is "'whether the [original] prospectuses, as written, adequately apprise[d] the reader of the essential nature' of the securities."

The Second Circuit found it to be "of no matter that ProShares came to use different, arguably clearer language" for describing the inherent risks of its ETF products. "To hold an issuer who alters disclosures deemed adequate in the first instance suddenly liable because it found a better way to say what has already been said would perversely incentivize issuers not to strive for better, clearer disclosure language."

Finding no basis for plaintiffs' claims under Section 11 or Section 15, the Second Circuit affirmed dismissal of plaintiffs' complaint with prejudice.

Fifth Circuit Holds *American Pipe* Tolling Ends When a Class Certification Order Is Vacated

In *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974), the Supreme Court held that "the commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class who would have been parties had the suit been permitted to continue as a class action." On August 15, 2013, the Fifth Circuit held that "*American Pipe* tolling ceases when a [class] certification order is vacated." *Hall v. Variable Annuity Life Ins. Co.*, 2013 WL 4233103 (5th Cir. Aug. 15, 2013) (Davis, J.).

Background

Plaintiffs "were members of a certified class of securities fraud plaintiffs whose certification order was vacated." More than five years after the vacatur of class certification, plaintiffs "attempted to re-file their class action." Defendants moved to dismiss plaintiffs' complaint on the grounds that the five-year statute of repose applicable to securities fraud actions had already expired. *See* 28 U.S.C. § 1658(b). The parties agreed that the original class action filing "'tolled,' or temporarily suspended the running of the statute of repose against putative class members" under *American Pipe*. However, "they disagreed about whether the … court's vacatur of class certification caused the tolling to cease."

The district court held that the statute of repose began to run again after the class certification order was vacated, and determined that plaintiffs' claims had therefore been extinguished. Plaintiffs appealed.

Fifth Circuit Finds a Vacatur of Class Certification Has the Same Effect as a Denial of Class Certification for Purposes of *American Pipe* Tolling

The Fifth Circuit observed that the *American Pipe* Court "created a special rule to 'freeze the clock' for putative class members once a class action lawsuit [has been] filed." However, the Fifth Circuit explained that "this tolling does not continue indefinitely." Rather, "the statute of limitations for the putative class members resumes running when class certification is denied or

when a certified class is decertified." This is because after the denial of certification or a decertification order, "the putative class members ha[ve] no reason to assume that their rights [a]re being protected." *Hall*, 2013 WL 4233103. (quoting *Taylor v. United Parcel Serv., Inc.*, 554 F.3d 510 (5th Cir. 2008)).

In the case at hand, "the district court found that the … vacatur of certification was the functional equivalent of a denial of certification." Since the vacatur "'un-certified' the class and left no room for the action to proceed as a class," the district court determined that "it had effectively denied certification." The Fifth Circuit agreed, finding "no real reason to distinguish between a decertification order and a vacatur of certification."

The Fifth Circuit determined that "[t]he principles enunciated" in its earlier decision in *Taylor* "weigh[ed] in favor of finding that *American Pipe* tolling ceases when a certification order is vacated." The *Taylor* court explained that "if the district court denies class certification under Rule 23, tolling of the statute of limitations ends." *Taylor*, 554 F. 3d 510. A court's "refusal to certify the class" is "tantamount to a declaration that only the named plaintiffs were parties to the suit" and thus "putative class members [have] no reason to assume that their rights [are] being protected." The Fifth Circuit found that "[p]laintiffs whose class certification has been vacated" similarly "have no reason to think that an ex-class representative will continue to protect their interests." *Hall*, 2013 WL 4233103.

The Fifth Circuit stated that "a contrary rule would allow non-class members to sit on their rights indefinitely while awaiting full appellate review of a decision that does not legally apply to them." "In contrast, the resumption of a statute of repose after a vacatur of certification puts the onus of filing individual claims only on those putative class members who have officially *lost their status as a class*."

The Fifth Circuit therefore affirmed dismissal of plaintiffs' complaint on statute of limitations grounds.

Seventh Circuit Reverses Dismissal of a Shareholder Derivative Suit, Finding Plaintiffs Had Adequately Pled Demand Futility

On August 16, 2013, the Seventh Circuit reversed dismissal of a shareholder derivative suit against the directors and certain officers of Baxter International, a medical device manufacturer. *Westmoreland Cnty. Emp. Ret. Sys. v. Parkinson*, 2013 WL 4266586 (7th Cir. Aug. 16, 2013) (Wood, J.). The Seventh Circuit found the complaint adequately alleged "bad faith" sufficient to excuse demand under Delaware law based on defendants' failure to comply with the terms of a consent decree with the Food & Drug Administration ("FDA").

Background

Beginning in the mid-1990s, Baxter manufactured and sold the Colleague Infusion Pump, which delivered fluids to patients intravenously. These pumps "suffer[ed] from a range of defects." In October 2005, the FDA brought suit seeking forfeiture of all Baxter-owned Colleague Infusion Pumps. On June 29, 2006, Baxter entered into a consent decree with the FDA pursuant to which Baxter agreed to cease manufacturing and distributing Colleague Infusion Pumps in the United States. The consent decree further provided that Baxter would bring into compliance the 200,000 Colleague Infusion Pumps that were already in use by U.S. health care professionals.

Following entry of the consent decree, "Baxter devoted significant attention and resources to the task of fixing the Pumps." Nevertheless, "problems with the Pumps persisted, and FDA officials grew increasingly frustrated with Baxter's unsuccessful remedial efforts." After several years of failed attempts to fix the Pumps, Baxter's remedial "spending tapered off: in the fourth

quarter of 2008, Baxter did not record any charges related to the Pumps, and in 2009, the company spent a relatively modest" sum remediating the Pumps.

In November 2008, the FDA informed Baxter that it would have to submit clinical data on the Pumps as part of its next 510(k) submission to the FDA. Although "[t]his filing was a critical part of the remediation process," "Baxter failed to generate clinical data (or even take preliminary steps necessary to set up such clinical trials)." The FDA repeatedly warned Baxter throughout 2009 that its "timeline for complying with the Consent Decree was unsatisfactory." By late 2009, it had become "clear within the FDA that Baxter had failed to take the appropriate and timely corrective actions to remediate the violative Colleague Pumps."

During a conference call in September 2009, Baxter's CEO told investors that the Colleague Infusion Pump was an "old device" lacking many of the features of the newer pumps. While the company would continue its remedial efforts, Baxter's CEO stated that the company was going to reassess the company's "promotional focus in [its] resources." In April 2010, Baxter submitted a revised timeline to the FDA pursuant to which it would "begin the latest round of corrections [to the Pumps] in May 2012" and complete all repairs in 2013.

Finding this proposal unacceptable, the FDA invoked its authority under the consent decree to order Baxter "to recall and destroy all Colleague Infusion Pumps then in use in the United States; to reimburse customers for the value of the recalled device; and to assist in finding replacement devices for these customers." This marked the first time that the FDA had ever required a medical device company to refund customers for a recalled device. Following the announcement, Baxter's stock price fell by more than 5%, and the company ultimately recorded a pre-tax charge of $588 million in connection with the recall.

Baxter's shareholders subsequently brought a derivative action alleging that Baxter's directors and officers had breached their fiduciary duties with respect to the Colleague Infusion Pump remedial effort. The shareholders claimed that between late 2008 and May 2010, Baxter's directors had "consciously disregarded their duty to bring Baxter into compliance with the Consent Decree and related health and safety laws." Defendants moved to dismiss for failure to allege demand futility under Rule 23.1 of the Federal Rules of Civil Procedure.[1]

Northern District of Illinois Dismisses the Complaint for Failure to Allege Demand Futility

On September 19, 2012, the Northern District of Illinois granted defendants' motion to dismiss on the grounds that plaintiffs had failed to meet their burden to show that demand would have been futile. *North Miami Beach Gen. Emps. Ret. Fund v. Parkinson*, 2012 WL 4180566 (N.D. Ill. Sept. 19, 2012) (Tharp, Jr. J.). The court explained that "[t]he law of the state of incorporation governs whether a demand may be excused when a shareholder files a derivative suit on behalf of a corporation." Because Baxter is incorporated in Delaware, Delaware law applied.

Under the Delaware Supreme Court's decision in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), plaintiffs seeking to establish demand futility must raise a "reasonable doubt" either that (1) "the directors [were] disinterested and independent" or (2) "the challenged transaction was otherwise the product of a valid exercise of business judgment." The district court found that plaintiffs had failed to satisfy either test. In the court's view, the allegations "reveal[ed] that Baxter [had] tried to correct the problems with the Colleague Pump but failed to do so to the FDA's

1. Rule 23.1 provides that a shareholder derivative complaint must "state with particularity" "any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members" or "the reasons for not obtaining the action or not making the effort." Fed. R. Civ. P. 23.1(b).

satisfaction." *Parkinson*, 2012 Wl 4180566. The fact that "Baxter failed to solve the problems, however, [did] not permit an inference that [Baxter's] board [had] ignored the problem or that its efforts were not in good faith." The district court emphasized that "[t]he development and manufacture of complex medical devices and pharmaceuticals is risky business." "Executives in that industry do not forfeit the protections of the business judgment rule simply because their initiatives fail—even if they fail spectacularly."

Seventh Circuit Reverses, Citing Its Earlier Decision in *In re Abbott Laboratories*

On appeal, the Seventh Circuit underscored that "the business judgment rule affords no protection" if "a director breaches the fiduciary duty of loyalty." *Westmoreland*, 2013 WL 4266586. The court explained that "the intentional dereliction of duty or the conscious disregard for one's responsibilities [constitutes] bad faith conduct, which results in a breach of the duty of loyalty." The Seventh Circuit found that "[i]n this case, the question of demand futility hinge[d] on whether the defendants' actions (or, more accurately, the defendants' considered inactions) amounted to 'bad faith' under Delaware law."

Here, plaintiffs contended that Baxter's directors and officers had "improperly '[thrown] in the towel'" on Colleague Infusion Pump remedial efforts by November 2008. Notwithstanding "repeated warnings from the FDA that Baxter's remedial efforts were insufficient, … the board took no action to ensure the company's timely compliance with the law." Plaintiffs claimed that "[t]his conscious disregard of Baxter's responsibilities under the Consent Decree and FDA regulations … jeopardized the health of thousands of patients who relied on Colleague Infusion Pumps for their medical treatment and ultimately exposed Baxter shareholders to significant financial losses."

The Seventh Circuit found these allegations bore "strong similarities" to its earlier decision in *In re Abbott Laboratories Derivative Shareholders Litigation*, 325 F.3d 795 (7th Cir. 2003). There, the Seventh Circuit held that allegations of the Abbott Laboratories' board's failure to resolve FDA violations in connection with adulterated diagnostic kits were sufficient to establish demand futility. Over the course of six years, the FDA repeatedly identified compliance failures at Abbott's manufacturing facilities. For two and a half years, the FDA worked with Abbott to address those issues pursuant to a "comprehensive Voluntary Compliance Plan." The FDA ultimately closed out the Compliance Plan based on continuing "deviations" by Abbott. Six months later, Abbott entered into a consent decree with the FDA which required Abbott to pay a $100 million civil fine and barred Abbott from manufacturing certain devices until FDA inspectors certified that Abbott's facilities were in compliance.

The Seventh Circuit found that plaintiffs had sufficiently alleged that Abbott's directors had "[known] of the violations of law" but "took no steps in an effort to prevent or remedy the situation," and that the board's "failure to take any action for such an inordinate amount of time resulted in substantial corporate losses." Based on these allegations, the

Seventh Circuit in *Abbott* determined that plaintiffs had pled "a breach of the duty of good faith" sufficient for the court "to reasonably conclude that the directors' actions fell outside the protection of the business judgment rule."

In the case against Baxter's directors and officers, the Seventh Circuit found that "[i]n some ways, the arguments for 'bad faith,' and thus for demand futility, [were] even stronger." *Westmoreland*, 2013 WL 4266586. The court explained that *Abbott* "did not involve any affirmative obligations imposed on the board of directors by virtue of a consent decree; there the directors faced potential personal liability simply for failure to rectify ongoing and known noncompliance with FDA quality-standards regulations." Here, however, the complaint "allege[d] not only that Baxter's directors consciously flouted the same FDA regulations, but also that the directors knowingly steered Baxter on a course that was all but certain to prompt the FDA to take enforcement action under the 2006 Consent Decree." The Seventh Circuit held that these allegations were sufficient to "cast a reasonable doubt that the [Baxter] defendants' conduct was the product of a valid exercise of business judgment."

In so holding, the Seventh Circuit emphasized that "[t]he totality of the complaint's allegations need only support a *reasonable doubt* of business judgment protection, not a 'judicial finding that the directors' actions [were] not protected by the business judgment rule.'" The "proper inquiry" for demand futility purposes is whether plaintiffs have made an adequate "threshold showing, through the allegation of particularized facts," that their "claims have some merit."

Finding that plaintiffs had "cleared [this] significant hurdle," the Seventh Circuit reversed the district court's dismissal of the action and remanded for further proceedings consistent with its opinion.

Delaware Chancery Court Discusses the Standard for Reviewing Third-Party Transactions with Companies with Controlling Shareholders

On August 5, 2013, the Delaware Chancery Court held that a third-party transaction with a company with a controlling stockholder is "entitled to review under the business judgment rule" provided two conditions are met: "the transaction is (1) recommended by a disinterested and independent special committee and (2) approved by stockholders in a non-waivable vote of the majority of all the minority stockholders." *Southeastern Pennsylvania Trans. Auth. v. Volgenau*, 2013 WL 4009193 (Del. Ch. Aug. 5, 2013) (Noble, V.C.) (*SEPTA*).

Background

SRA International was "a leading provider of technology solutions and professional services, primarily to the federal government." Ernst Volgenau, SRA's founder, had been the company's controlling shareholder since its inception.

In the spring of 2010, Providence Equity Partners LLC approached SRA about a possible leveraged buyout. That fall, SRA established a special committee "charged with evaluating, soliciting third-party interest in, and negotiating potential strategic transactions." The Special Committee hired its own independent financial advisor and legal counsel.

Over the ensuing months, the Special Committee negotiated with Providence and solicited a number of other buyers. Volgenau wanted to ensure that "SRA's name, values, and culture [would be] preserved." To address his reservations, "the Special Committee established a bifurcated process in which … it exclusively address[ed] issues of price and certainty while Volgenau [met] with strategic acquirers to

discuss his 'humanistic concerns.'" In October 2010, "Volgenau indicated that Providence was the only potential bidder that had ever interested him and that it was committed to maintain[ing] [SRA's] values and culture."

Following a multi-round bidding contest, Providence ultimately offered $31.25 per share—a $3.25 increase over Providence's initial offer. On March 31, 2011, the Special Committee unanimously recommended that the SRA Board accept Providence's offer. With the exception of Volgenau, who abstained from the vote, the Board unanimously voted in favor of the merger. The merger was also subject to a non-waivable majority of the minority vote. On July 15, 2011, 81.3% of the total outstanding minority shares approved the merger.

Following announcement of the merger, the Southeastern Pennsylvania Transportation Authority ("SEPTA"), one of SRA's minority shareholders, brought suit alleging that SRA's directors had breached their fiduciary duties in connection with the merger. Defendants moved for summary judgment.

Chancery Court Finds Procedural Protections Are Necessary for Third Party-Transactions Involving Controlling Shareholders to Qualify for Business Judgment Review

At the outset of its analysis, the Chancery Court observed that its recent decision in *In re MFW Shareholders Litigation*, 67 A.3d 496 (Del. Ch. 2013) (Strine, C.),[2] "illuminate[d] many of the procedural issues in this case." There, the court addressed for the first time the question of "whether, and under what conditions, a merger between a controlling stockholder and its subsidiary could be reviewed under the

business judgment rule, as opposed to the [more rigorous] entire fairness standard." The Chancery Court held that "the business judgment rule standard of review applies" in cases when:

> [A] controlling stockholder merger has, from the time of the controller's first overture, been subject to (i) negotiation and approval by a special committee of independent directors fully empowered to say no, and (ii) approval by an uncoerced, fully informed vote of a majority of the minority investors.

"Unlike *MFW*, which involved a controlling stockholder on both sides of the transaction," the Chancery Court explained that "this case involves a merger between a third-party and a company with a controlling stockholder." *SEPTA*, 2013 WL 4009193. The court observed that "a controlling stockholder may … inappropriately influence the outcome of the sale process." A controlling stockholder effectively competes with minority stockholders for portions of the consideration the acquirer is willing to pay, and has the ability to "effectively veto any transaction." Consequently, "robust procedural protections" are necessary "to ensure that the minority stockholders have sufficient bargaining power and the ability to

2. Please click here to read our discussion of the *MFW* decision in the June 2013 edition of the Alert.

make an informed choice of whether to accept the third-party's offer for their shares."

The Chancery Court explained that its prior decision in *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009), "set[ ] forth the procedural protections necessary for a third-party transaction involving a controlling shareholder to qualify for review under the business judgment rule." First, "the transaction must be recommended by a disinterested and independent special committee" with "sufficient authority and opportunity to bargain on behalf of minority stockholders, including the 'ability to hire independent legal and financial advisors.'" Second, "the transaction must be approved by stockholders in a non-waivable majority of the minority vote." Finally, "the stockholders must be fully informed and free of any coercion."

Chancery Court Determines the Business Judgment Standard of Review Applies to Providence's Acquisition of SRA

The Chancery Court next considered whether it should review Providence's acquisition of SRA "under the entire fairness standard or the business judgment standard." SEPTA claimed that "entire fairness [was] warranted because Volgeneau stood on both sides of the transaction." The director defendants contended that the business judgment standard applied because "the transaction was subject to robust procedural protections, namely, a non-waivable majority of the minority vote and a disinterested and independent Special Committee."

The Chancery Court found SEPTA's "contention that Volgenau stood on both sides of the transaction" unsupported by either "the factual record or Delaware law." The court explained that "under Delaware law, '[w]hen a corporation with a controlling stockholder merges with an unaffiliated company, the minority stockholders of the controlled corporation are cashed-out, and the controlling stockholder receives a minority interest in the surviving company, the controlling stockholder does not 'stand on both sides' of the merger."

Because the court saw "no genuine issue of material fact as to whether Volgenau [stood] on both sides of the transaction," the court reviewed the merger "under the business judgment standard to determine if it satisfie[d] the test set forth in *Hammons*."

The Court Grants Summary Judgment in Favor of the Director Defendants

Applying *Hammons*, the Chancery Court first addressed whether the Special Committee was disinterested and independent. The court considered and rejected SEPTA's contentions that (1) Michael Klein, one of the members of the Special Committee, "had a secret motivation to deliver a deal with Providence to Volgeneau" and (2) the Special Committee was "dominated by Volgenau and Klein." The court further determined that "the Special Committee was fully functioning," "had authority to select its advisors freely," and "had the authority to recommend or not to recommend any transaction." Therefore, the court held that "the Merger was recommended by a disinterested and independent special committee."

The Chancery Court further determined that "the stockholders were fully informed when they approved the Merger in a non-waivable majority of the minority vote." The court emphasized that "Delaware law does not require that companies 'bury the shareholders in an avalanche of trial information,'" nor does it mandate a "play-by-play description of every consideration or action taken by a Board."

Finding the merger "attributable to a rational business purpose" and concluding that Providence "was an arms-length bidder," the court granted summary judgment in favor of the director defendants.

Maryland State Court Applies Delaware Law in Dismissing a Shareholder Derivative Action Involving a REIT Cash-Out Merger

On August 14, 2013, a Maryland state court issued a written decision explaining its August 7, 2013 decision from the bench dismissing a shareholder derivative action in connection with the cash-out merger of CreXus Investment Corporation, a real estate investment trust ("REIT"), by Annaly Capital Management, another REIT. *Frederick v. Corcoran*, No. 370685-V (Md. Cir. Ct. Aug. 14, 2013) (Rubin, J.). The court stated that it would continue to look to Delaware law to address issues of corporate law that have not been resolved by Maryland courts.

The court rejected plaintiffs' claim that "a pre-market check or an auction is required of a Special Committee in a related-party merger or other change of control transaction." Moreover, the court emphasized that directors have the discretion "to consider a host of business factors" in structuring a company's sale process.

Background

Annaly established CreXus in 2008. In CreXus's September 2009 initial public offering ("IPO"), Annaly acquired 25% of CreXus's outstanding stock. CreXus entered into a management agreement with Fixed Income Discount Advisory Company ("FIDAC"), an external REIT manager and wholly-owned subsidiary of CreXus. In a subsequent CreXus IPO, Annaly's CreXus holdings were reduced to 12.4%.

On November 9, 2012, Annaly's CEO advised the CreXus board that it was interested in purchasing the company. "The CreXus board determined that, in view of Annaly's 100% ownership of FIDAC and significant ownership of the company, it needed to

form a Special Committee of independent directors to review any proposal from Annaly." On November 12, 2012, Annaly and CreXus announced Annaly's offer to acquire CreXus for $12.50 per share. Several days later, the Special Committee hired its own counsel and its own financial advisor.

On December 17, 2012, Annaly submitted a proposed draft merger agreement. Annaly's Special Committee decided not to respond to the proposal until it had first determined "whether to remain independent or to sell the company." In the meantime, Annaly signed an agreement "precluding Annaly from increasing its stock ownership [of CreXus] as long as the Special Committee was considering its offer."

On January 11, 2013, the Special Committee "decided to pursue a strategic transaction" and determined that "having a definitive agreement with Annaly before a market check was performed was the preferred route, as long as it included a 45 day go shop provision." The Special Committee reasoned that "third party bidders would be more likely to submit their highest bids if they knew in advance the definite terms of the Annaly transaction." The Special Committee further determined that "[a] 45 day go shop provision was sufficient … due to the relative ease of valuing CreXus' mortgage assets." Furthermore, the Special Committee "concluded that third party bidders would be in no worse position if an agreement were signed because Annaly would have to credit the FIDAC termination fees against its own termination fee."

On January 30, 2013, "the Special Committee

approved a definitive merger agreement with Annaly" at $13 per share. Among other reasons, the Special Committee recommended the Annaly transaction because "[t]he offer price of $13.00 represented a 17% premium over the closing share price of November 9, 2012, the last trading day prior to the first public announcement" of the transaction; Annaly offered "[a]n all cash transaction, with no financing contingencies;" "[t]he company's stock price had not exceeded the offer price in the last twelve months;" and "[t]he maximum termination fee was only 2.5% of the deal value, and it was fully creditable to the FIDAC termination fee."

On January 31, 2013, CreXus's financial advisor "began the 45 day go shop period and contacted 47 potential bidders, including all of the parties which had previously expressed an interest in the company." But "[u]ltimately no superior bids emerged." Following this "solicitation period, over 82% of [CreXus'] public stockholders, not including Annaly, voted in favor of the transaction." The transaction closed on May 23, 2013.

CreXus shareholders brought a derivative suit claiming that CreXus's directors had breached their fiduciary duties by approving the Annaly transaction. Defendants moved to dismiss. The case involved "two central questions." First, had plaintiffs "sufficiently pled the lack of independence of the Special Committee such that its decision should not be accorded deference under the business judgment rule." Second, had plaintiffs "stated a cognizable claim that the Special Committee failed to discharge [its] '*Revlon* duties' in connection with negotiating and approving the transaction with Annaly, which amounted to the sale of the company for cash."[3]

3. The Delaware Supreme Court's decision in *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182-83 (1986), "imposes enhanced judicial scrutiny of certain transactions involving a sale of control." *Malpiede v. Townson*, 780 A.2d 1075 (Del. Supr. 2001) (discussing *Revlon*). "*Revlon* emphasizes that the board must perform its fiduciary duties in the service of a specific objective: maximizing the sale price of the enterprise."

Court Finds Plaintiffs Failed to Challenge the Independence and Disinterestedness of the Special Committee

Plaintiffs claimed that "the members of the Special Committee were so dominated and controlled by Annaly, such that their actions should be viewed as those of Annaly itself." The court found these allegations "quite conclusory or simply too general." "Viewing the … complaint in the light most favorable to the plaintiffs," the court determined that plaintiffs had "insufficiently alleged that the Special Committee was either conflicted or controlled by Annaly, or interested in the transaction, or that their independence may reasonably be called into question."

"Fundamentally," the court found that "plaintiffs' theory of the case rest[ed] on the notion that because CreXus was externally managed by an affiliate of Annaly there [was] virtually no transaction structure that would be appropriate whereby Annaly could acquire CreXus, absent a pre-market check or an auction." Plaintiffs made this argument "notwithstanding that Maryland law does not prohibit, and indeed permits, externally managed REITs and to date, no Maryland appellate case has required a pre-market check or an auction." The court explicitly rejected plaintiffs' "implicit structural bias argument" and their claim that "a pre-market check or an auction is required of a Special Committee in a related-party merger or other change of control transaction as a prerequisite to independence."

Applying Delaware Law, the Court Finds Meritless Plaintiffs' Price and Process Claims

At the outset of its analysis, the court noted that in *Shenker v. Laureate Education, Inc.*, 411 Md. 317 (2009), the Maryland "Court of Appeals essentially

imposed *Revlon* duties on directors of a Maryland corporation 'at least in the context of negotiating the amount shareholders will receive in a cash-out merger transaction.'" The *Shenker* court held that "in a cash-out merger transaction *where the decision to sell the corporation already has been made*, shareholders may pursue direct claims against directors for breach of their fiduciary duties of candor and maximization of shareholder value." Because the CreXus-Annaly case involved a cash-out merger, the court held that "*Shenker* applie[d]." *Frederick*, No. 370685-V.

However, the court found that *Shenker* "did not undertake to specify or delineate what directors are supposed to do other than to be loyal, tell the truth and maximize shareholder value." The court therefore sought "guidance from other decisions." The court explained that "[u]ntil the Court of Appeals rules otherwise," it would "continue to look to Delaware law to the extent it is not inconsistent with Maryland law."

Citing Delaware law, the court explained that "when a board of directors decides to sell a company for cash," "there exists no fixed litany or playbook that must be followed and directors are allowed to consider a host of business factors." "[J]udicial review in this context is not a license for courts to 'second guess reasonable, but debatable, tactical choices that directors have made in good faith." (quoting *In re Toys "R" Us S'holder Litig.*, 877 A.2d 975 (Del. Ch. 2005)).

The court rejected plaintiffs' argument that "the mere signing of a merger agreement with Annaly, without first engaging in a market check, either scared off potential bidders or resulted in a failure to maximize stockholder value." The court found "no facts alleged to suggest that this was the case." Rather, "the agreement with Annaly established *a floor* for a cash-out … transaction, not *a ceiling*." "And that floor was adequately tested in this case by a post-agreement market check."

"Here, the Special Committee negotiated for and obtained a 45 day go shop period, and had the right to negotiate with *any* bidder which put forth a superior proposal." The court determined that "[t]hese were reasonable and effective protectors of stockholder value under the circumstances of this case." While "a target company (or other potential bidder) might desire, or even achieve in some cases a longer go shop period or a lower termination fee, the merger agreement in this case afforded a reasonable and effective post-signing market check."

The court explained that "[t]he simple fact that no one in the REIT community was willing to pay more than $13.00 a share in cash for CreXus [did] not give rise to the inference that the process was flawed or the price was inadequate." "It mean[t] simply that no one wanted to put up the cash needed to top Annaly's bid."

"In short," the court concluded that "the deal protection devices complained of by the plaintiffs in this case, singly or in combination, ha[d] not been shown to be unreasonable and [did] not rise to the level of a breach of fiduciary duty."

NEW YORK

Bruce D. Angiolillo
212-455-3735
bangiolillo@stblaw.com

Mark G. Cunha
212-455-3475
mcunha@stblaw.com

Paul C. Curnin
212-455-2519
pcurnin@stblaw.com

Michael J. Garvey
212-455-7358
mgarvey@stblaw.com

Paul C. Gluckow
212-455-2653
pgluckow@stblaw.com

Nicholas Goldin
212-455-3685
ngoldin@stblaw.com

David W. Ichel
212-455-2563
dichel@stblaw.com

Peter E. Kazanoff
212-455-3525
pkazanoff@stblaw.com

Joshua A. Levine
212-455-7694
jlevine@stblaw.com

Linda H. Martin
212-455-7722
lmartin@stblaw.com

Joseph M. McLaughlin
212-455-3242
jmclaughlin@stblaw.com

Lynn K. Neuner
212-455-2696
lneuner@stblaw.com

Barry R. Ostrager
212-455-2655
bostrager@stblaw.com

Thomas C. Rice
212-455-3040
trice@stblaw.com

Mark J. Stein
212-455-2310
mstein@stblaw.com

Alan C. Turner
212-455-2472
aturner@stblaw.com

Mary Kay Vyskocil
212-455-3093
mvyskocil@stblaw.com

George S. Wang
212-455-2228
gwang@stblaw.com

David J. Woll
212-455-3136
dwoll@stblaw.com

Jonathan K. Youngwood
212-455-3539
jyoungwood@stblaw.com

LOS ANGELES

Michael D. Kibler
310-407-7515
mkibler@stblaw.com

Chet A. Kronenberg
310-407-7557
ckronenberg@stblaw.com

PALO ALTO

Alexis S. Coll-Very
650-251-5201
acoll-very@stblaw.com

James G. Kreissman
650-251-5080
jkreissman@stblaw.com

WASHINGTON, D.C.

Peter H. Bresnan
202-636-5569
pbresnan@stblaw.com

Cheryl J. Scarboro
202-636-5529
cscarboro@stblaw.com

Peter C. Thomas
202-636-5535
pthomas@stblaw.com

"Simpson Thacher's "commercial and securities litigation capabilities see it retained by high-profile clients."

— CHAMBERS USA 2013

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000