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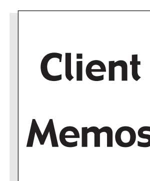

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SECURITIES DISCLOSURE

The SEC and Social Media

Recent Securities and Exchange Commission guidance provides that companies may, under certain circumstances, use social media to comply with Regulation FD disclosure requirements. However, companies must take certain steps and consider a number of factors to determine if primary disclosure via social media is appropriate for them.

By Elizabeth A. Ising and Kevin M. Heilenday

On April 2, 2013, the Securities and Exchange Commission (SEC) issued a report of investigation pursuant to Section 21(a) of the Securities Exchange Act of 1934 providing guidance to public companies on the application of Regulation FD to corporate disclosures made through social media (Report).[1] The Report clarifies that guidelines issued by the SEC in 2008 regarding disclosures on corporate websites apply to public companies' use of social media to disseminate material, nonpublic information. While many companies already use social media on a regular basis to promote their businesses and communicate with customers, we expect that the conditions to satisfying the SEC's guidance and other considerations will, at least in the near term, result in most companies using social media channels to supplement, rather than replace, traditional methods for disclosure of material, nonpublic information, just as companies have done in response to the SEC's prior guidance regarding disclosures on corporate websites. Nevertheless, the Report serves as an important reminder of the need to consider securities law implications of evolving communication channels and for companies to evaluate the effectiveness of their disclosure controls and procedures in the context of social media disclosures.

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Regulation FD Background

The SEC adopted Regulation FD in 2000 to prevent public companies from selectively disclosing material information to those who would reasonably be expected to trade securities on the basis of the information or provide others with advice about securities trading. Regulation FD requires that material, nonpublic information be publicly disclosed on Form 8-K or an alternative method of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public.[2] In adopting Regulation FD, the SEC stated that compliance with the regulation "does not require use of a particular method, or establish a 'one size fits all' standard for disclosure."[3]

In 2008, the SEC issued Guidance on the Use of Company Websites (2008 Guidance)[4] to clarify that company websites can, in certain circumstances, serve as an effective means for disseminating material information to investors consistent with Regulation FD. In the 2008 Guidance, the SEC stated:

> in evaluating whether information is public for purposes of our guidance, companies must consider whether and when: (1) a company web site is a recognized channel of distribution, (2) posting of information on a company web site disseminates the information in a manner making it available to the securities marketplace in general, and (3) there has been a reasonable waiting period for investors and the market to react to the posted information.[5]

The 2008 Guidance did not expressly apply to social media.

Despite the 2008 Guidance, relatively few companies use corporate websites to satisfy their Regulation FD obligations.[6] Instead, most public companies file a Form 8-K and/or issue a press release to disseminate material information, although many then post the same information, or links to the information, on their corporate websites as supplemental disclosure. Some companies post the information to their Facebook page, Twitter account, or other social media channels as well.[7]

The Netflix Investigation

The Report follows an inquiry by the SEC's Division of Enforcement regarding a July 2012 post by Netflix Chief Executive Officer Reed Hastings on his personal Facebook page stating that Netflix's monthly online viewing had exceeded one billion hours for the first time, which represented a nearly 50 percent increase in hours from what Netflix had announced six months earlier.[8] Netflix did not disclose this information to investors through a press release or Form 8-K filing, and Mr. Hastings and Netflix had not previously used Mr. Hastings' Facebook page to announce company metrics. Rather, Netflix consistently had directed the public to its own Facebook page, Twitter feed, blog, and company website for information about Netflix. Netflix's stock price had begun rising before Mr. Hastings' post and increased from $70.45 at the time of the post to $81.72 at the close of the following trading day.

Applicability of the SEC's 2008 Guidance on Company Websites to Social Media

The Report notes that there has been uncertainty concerning how Regulation FD and the 2008 Guidance apply to disclosures made through social media channels. It states the SEC's view that any company communications made through social media should be examined for compliance with Regulation FD. This includes determining (1) whether a disclosure using social media is to specific individuals enumerated under Regulation FD (*e.g.*, securityholders and securities professionals), (2) whether the disclosure includes material, nonpublic information, and (3) if not otherwise distributing the information in compliance with Regulation FD, whether disseminating the information via the social media channel is "reasonably designed to provide broad, non-exclusionary distribution of the information to the public."[9]

In assessing the third prong, the Report states that "[t]he central focus of this inquiry is whether the company has made investors, the

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market, and the media aware of the channels of distribution it expects to use, so these parties know where to look for disclosures of material information about the company or what they need to do to be in a position to receive this information."[10] The Report explains that the 2008 Guidance provides a relevant framework for applying Regulation FD to social media channels of distribution.

The 2008 Guidance uses a non-exhaustive list of factors to evaluate whether a company's posting of information on its website constitutes the use of a "recognized channel of distribution" and whether the information has been made accessible to the securities marketplace, such that the information posted is public for purposes of Regulation FD. These factors, revised to address social media channels, include:

- whether and how the company has let investors and the markets know that the company uses the particular social media channel;
- whether the company has made investors and the markets aware that it will disseminate important information through the particular social media channel and whether it has a pattern or practice of doing so;
- whether the company's use of the social media channel leads investors and the market efficiently to information about the company, including information specifically addressed to investors, whether the information is prominently disclosed, and whether the information is presented in a format readily accessible to the general public;
- the extent to which information released through the social media channel is regularly picked up by the market and readily available media;
- the steps the company has taken to make the social media channel and the information contained therein accessible, including the use of "push" technology or other distribution methods;
- whether the company keeps the social media channel current and accurate;
- whether the company uses other methods to disseminate the information and whether and to what extent those other methods are the predominant methods the company uses to disseminate information; and
- the nature of the information posted on the social media channel.[11]

The Report reiterates that public disclosures of material, nonpublic information, even if not directed to stock analysts or other persons enumerated[12] under Regulation FD, must be made in a manner that conforms with Regulation FD whenever such information is disclosed to any group that includes one or more enumerated persons. The Report also states that, while every case must be evaluated on its own particular facts, the disclosure of material, nonpublic information on the personal social media site of an individual corporate officer—without advance notice to investors that the social media site may be used for such purpose—is generally unlikely to qualify as a method "reasonably designed to provide broad, non-exclusionary distribution of the information to the public" within the meaning of Regulation FD. Without adequate advance notice, some investors may not have the opportunity to access the information at the same time as other investors.[13]

What Companies Should Do Now

The Report has various implications for public companies' compliance efforts. Set forth below are several steps that a public company should take now in light of the Report.

1. View the Report as a catalyst for reassessing which disclosure methods are most appropriate for the company. Most companies are likely to continue to use Forms 8-K and/or press releases as their primary disclosure channel(s). Even though the SEC has now expressly stated that companies can use social media to disseminate material,

nonpublic information to investors consistent with Regulation FD, companies need to carefully consider whether to begin the process towards relying on social media in this regard. For example, doing so will require:

- *Consideration of other securities law implications*. For example, there is an exception to the requirement to file an Item 2.02 Form 8-K for information that is complementary to, and is made shortly after, an earlier disclosure of earnings information that is available only if the earlier information was promptly included on a Form 8-K. Recordkeeping and document retention requirements may also pose additional challenges in the social media context.
- *Examination of industry- or company-specific regulatory requirements*. Other regulatory requirements may apply to the company's use of social media to disseminate material, nonpublic information, such as the January 2013 proposed guidance by the Office of the Comptroller of the Currency and other banking regulators addressing the applicability of consumer protection and compliance laws, regulations and policies to the social media context.[14]

2. For a company that decides to begin the process towards establishing a specific social media channel as a "recognized channel of distribution," consider the factors from the 2008 Guidance in the social media context (as described above). While the question of whether a company's use of social media qualifies as a "recognized channel of distribution" requires a careful facts-and-circumstances analysis, a company can take various actions to lay the right groundwork. As suggested by the 2008 Guidance factors, these actions include:
   - notifying investors and the markets (through SEC filings, press releases, and the company's website) that the company plans in the future to disseminate material, nonpublic information through a particular social media channel and provide the Internet address for investors to access that channel;
   - establishing a pattern of regularly disclosing such information via that social media channel whenever disclosure is warranted, in addition to ongoing disclosures on Form 8-K and/or through press releases;
   - using the social media channel in a way that leads investors and the market efficiently to information about the company, such as by making disclosures prominent and presenting the information in an easy-to-understand format;
   - presenting and maintaining information that is current and accurate;
   - monitoring the social media channel to verify that communications are being viewed by investors, such as by monitoring the number of followers; and
   - considering ways to "push" disclosure affirmatively via the social media channel.
3. Reexamine the company's disclosure controls and procedures to confirm that they apply to any release of company information on social media channels—personal and corporate—even if those channels are not the sole method for the company's dissemination of such information.
4. Review and update the company's Regulation FD policy to make it consistent with the company's disclosure controls and procedures and to take into account the company's approach to the use of social media. Re-evaluate which officers, employees, and agents are authorized to regularly communicate with any persons enumerated under Regulation FD (including the company's securityholders) and whose statements are thus subject to Regulation FD. Provide those persons with updated training on Regulation FD that specifically addresses use of both company-sponsored and personal social media.
5. Enact or update social media guidelines or policies for officers and key employees,

particularly those who have access to material, nonpublic information, and implement training programs for officers and key employees regarding the application of the securities laws to information disseminated through social media, the overlap between personal and professional online presences, and the multiplying effect of social media on reputational risk.

6. Keep in mind that other regulatory requirements apply to the release of material information, regardless of the method used. Under Section 202.06 of the NYSE Listed Company Manual, during market hours, the NYSE requires ten minutes' advance notice prior to the dissemination of news that is deemed to be of a material nature or that might impact trading in the company's securities. Similarly, NASDAQ IM-5250-1 requires that NASDAQ-listed companies provide notice ten minutes prior to any releases of information relating to (1) financial-related disclosures; (2) corporate reorganizations and acquisitions; (3) new products or discoveries, or developments regarding customers or suppliers; (4) senior management changes of a material nature or a change in control; (5) resignation or termination of independent auditors, or withdrawal of a previously issued audit report; (6) events regarding the company's securities; (7) significant legal or regulatory developments; or (8) any event requiring the filing of a Form 8-K.

Conclusion

The use of social media for disclosure purposes is an evolving issue that companies should continue to monitor as communications practices develop. While the Report confirms that social media can be used in a manner that satisfies Regulation FD, even when persons must enroll with a third-party service to have access, it also is clear that there are hurdles to doing so. As with company websites, social media cannot instantly be deployed as an FD-sufficient means of dissemination for material, nonpublic information.

Notes

1. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings, Release No. 69279 (Apr. 2, 2013), available at *http://www.sec.gov/litigation/investreport/34-69279.pdf*.
2. *See* 17 C.F.R. § 243.100(a); 17 C.F.R. § 243.101(e).
3. Final Rule: Selective Disclosure and Insider Trading, Exchange Act, Release No. 34-43154, 65 Fed. Reg. 51,716, 51,724 (Aug. 24, 2000) (the Adopting Release).
4. Commission Guidance on the Use of Company Websites, Release No. 34-58288 (Aug. 7, 2008), available at *http://www.sec.gov/rules/interp/2008/34-58288.pdf*.
5. 2008 Guidance at 18.
6. In a 2012 survey conducted by the National Investor Relations Institute, only 8% of respondents reported having used a corporate website as the only channel for disclosing material information, with 88% of respondents stating that their companies had no immediate plans to use their corporate website as the only means of disclosing material information. NIRI, USE OF CORPORATE WEBSITES FOR DISCLOSURE-2012 SURVEY (10/17/12) , available at *http://www.niri.org/Main-Menu-Category/resource/publications/Executive-Alert/2012-Executive-Alert-Archive/NIRI-Use-of-Corporate-Websites-for-Disclosure-2012-Survey-10172012.aspx*.
7. A 2012 survey conducted by Bank of New York Mellon showed that 26% of global companies report using social media to connect with investors, up from 20% in 2011 and 9% in 2010. *See* BNY MELLON, GLOBAL TRENDS IN INVESTOR RELATIONS 4, available at *http://www.adrbnymellon.com/files/PB30916.pdf*.
8. Mr. Hastings' personal Facebook page has over 260,000 followers, who can receive Mr. Hastings' public posts in their Facebook News Feed without being "friends" with Mr. Hastings.

9 Report at 6.

10 *Id.* at 3.

11. *See* 2008 Guidance at 20-22.

12 *See* 17 C.F.R. § 243.100(b)(1) (listing brokers, dealers, persons associated with a broker or dealer, investment advisors, institutional investment managers, persons associated with an investment advisor or institutional investment manager, investment companies, affiliates of investment companies, and holders of the issuer's securities).

13. Report at 7-8.
14. Social Media: Consumer Compliance Risk Management Guidance, No. FFIEC-2013-0001 (Jan. 23, 2013), available at *http://www.occ.gov/news-issuances/federal-register/78fr4848.pdf*.

MERGERS AND ACQUISITIONS

M&A Litigation Goes Global

A recent lawsuit signals the potential for new litigation against foreign private issuers in U.S. courts. For the first time, a shareholder plaintiff has filed a lawsuit in the U.S. attempting to block a "going private" transaction involving an issuer based in the People's Republic of China (PRC) and incorporated offshore, with American depositary receipts (ADRs) traded in U.S. markets. The lawsuit could have implications not only for foreign private issuers, but also for private equity firms and others market participants in global mergers and acquisitions.

By Paul W. Boltz, Jr., Scott A. Jalowayski, Kim B. Nemirow, and Peter L. Welsh

On February 22, 2013, a case captioned *Iron Workers Mid-South Pension Fund v. Focus Media Holding Ltd. et al.*, Case No. 13 0827, was filed in the United States District Court for the Northern District of California in San Francisco, California, challenging the acquisition of Focus Media, a Cayman Islands corporation headquartered in the PRC with ADRs listed on NASDAQ. The suit alleged that Focus Media's directors violated federal securities laws and the law of the Cayman Islands in connection with a proposal to sell Focus Media to a buyout consortium led by The Carlyle Group, LP (Carlyle). Although the lawsuit was dismissed voluntarily on March 26, 2013—less than a week before a California federal judge was scheduled to hear a motion to dismiss—the lawsuit calls into question the widely-held assumption that merger and acquisition (M&A) transactions involving companies listed in, but incorporated outside of, the U.S. do not carry a meaningful risk of litigation in U.S. courts.

Conversely, suits challenging public company M&A transactions by U.S.-incorporated public issuers have become almost universal. In 2012, roughly 93 percent of merger transactions involving publicly traded targets in the United States were subject to shareholder litigation.[1] On average, 4.8 lawsuits were filed per deal in 2012.[2] For deals over $500 million, the numbers were even more staggering, with 96 percent of U.S. merger transactions facing such challenges.[3] In the U.S, these suits are brought routinely by a handful of "frequent filer" plaintiffs-side law firms that specialize in attacking public merger transactions. The typical playbook for such claims involves issuing a press release within days of a merger announcement soliciting a shareholder to serve as lead plaintiff, filing a cookie-cutter complaint challenging the proxy disclosures, the adequacy of the sales process, and specific deal terms such as termination fees, and threatening to enjoin the shareholder vote on the deal. Although many of these lawsuits are still filed in Delaware Chancery Court, filings in other state and federal jurisdictions also are common.[4] The goal of these lawsuits is to pressure issuers, and their boards of directors, to provide supplemental proxy disclosures regarding the terms of the deal. The supplemental disclosures, in turn, provide the plaintiffs' attorneys with grounds for seeking attorneys' fees from the company for having—conferred a "benefit"—*i.e.*, additional proxy disclosures–on the shareholders. Most settlements based on supplemental disclosures

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involve attorneys' fees in the range of $500,000 to $1 million, although some also include the establishment of larger settlement funds.[5]

The *Focus Media* litigation represents the first suit of its kind filed in a U.S. court against a U.S.-listed, PRC-based issuer incorporated offshore. The *Focus Media* case is noteworthy, then, because it may signal the beginning of a new frontier for plaintiffs' lawyers looking to "go east."

Foreign Private Issuers

Foreign corporations seeking to gain access to U.S. capital markets are afforded special status under federal securities laws if they meet certain criteria. A "foreign private issuer" (FPI) is defined by Rule 405 under the Securities Act of 1933 (Securities Act) and Rule 3b-4(c) under the Securities Exchange Act of 1934 (Exchange Act) as any foreign entity, other than a foreign government, that issues securities in the U.S., unless more than 50 percent of the issuer's outstanding voting securities are held directly or indirectly in the U.S., and any one of the following applies:

1. The majority of the issuer's executive officers or directors are U.S. citizens or residents;
2. More than 50 percent of the issuer's assets are located in the U.S.; or
3. The issuer's business is administered principally in the U.S.[6]

FPI status confers the benefits of access to U.S. capital markets without all of the regulations (and associated costs) applicable to domestic issuers. For example, FPIs are not required to file quarterly reports with the SEC, and are provided a longer window within which to file their annual reports from the date of year-end than domestic issuers.[7]

Perhaps a more significant distinction for purposes of analyzing the *Focus Media* complaint is that securities issued by FPI are treated as "exempted securities" under Section 14(a) of the Exchange Act, which governs the issuance of proxy statements. Exchange Act Rule 3a12-3 specifically defines securities issued by entities meeting the definition of "foreign private issuers" as "exempt" from Section 14(a) of the Exchange Act.

ADRs

An ADR is a type of security that trades in the same way as the securities of any U.S. domestic issuer. The legal nature of an ADR differs, however, in that unlike a share of common stock of a Delaware corporation, for example, which represents a direct equity ownership interest in the issuer, an ADR represents an indirect interest in the shares of a foreign private issuer which are deposited with a depositary bank. An ADR can represent a fraction of a share, a single share, or multiple shares of a foreign security.[8] The rights of ADR holders are governed by a depositary agreement, and the depositary bank is the record owner of the shares underlying the ADRs.

The* Morrison *decision did not rule out the potential for liability of foreign private issuers in U.S. courts arising from "transactions in securities listed on domestic exchanges."

When looking to create a trading market in the U.S., foreign private issuers often choose to list ADRs (called a "sponsored ADR program"), instead of directly listing their own shares, for the simple reason that ADRs can make life easier for issuers in a number of respects. For example, an ADR holder can effect a transfer of its ADRs on the books of the depositary in the U.S., similar to the way common stock of a U.S. issuer is transferred through a U.S. stock transfer agent, rather

than having to effect settlement through a non-U.S. transfer agent. Depositary banks will also assist in the distribution of dividends and shareholder meeting materials to ADR holders.

A sponsored ADR program requires that the issuer and depositary must register the ADRs with the SEC and the issuer must also separately register the shares underlying the ADRs. Depositary banks can also establish an "unsponsored ADR program" with respect to the securities of foreign private issuers which have an existing listing outside of the U.S. (but not in the U.S.) with little or no involvement of the issuers. Unsponsored ADRs trade over-the-counter, while sponsored ADRs can trade either over-the-counter or on national exchanges such as NASDAQ and NYSE.

The vast majority of U.S.-listed, PRC-based foreign private issuers, including Focus Media, elected to use sponsored ADR programs at the time of their IPO (and most of those issuers are listed only in the U.S.).

Previous Litigation Against Foreign Private Issuers

Prior to 2010, numerous lawsuits were filed by holders of ADRs against foreign private issuers located in the PRC alleging violations of Rule 10b-5 for misrepresentations or omissions allegedly causing a drop in the prices of the securities. A number of courts denied motions to dismiss, thereby recognizing the rights of American holders of ADRs to sue foreign private issuers in U.S. courts in "stock drop" cases.[9]

In 2010, the U.S. Supreme Court issued its landmark ruling in *Morrison v. National Australia Bank Ltd.*, limiting the territorial application of Rule 10b-5 and holding that Section 10(b) of the Exchange Act covers only: (1) transactions in securities listed on domestic exchanges; and (2) domestic transactions in other securities.[10] A subsequent case from a U.S. federal appellate court, *Absolute Activist Value Master Fund Ltd. v. Ficeto*, held that "foreign-cubed" cases—*i.e.*, those involving foreign issuers, foreign plaintiffs, and foreign transactions—may no longer be brought in the U.S. courts.[11] Thus, *Morrison* and *Absolute Activist* have rendered non-actionable in the U.S. previously common class-action litigation in U.S. courts involving suits against foreign issuers based upon shares purchased in foreign countries.

The next wave of litigation may push the territorial limits of U.S. courts one step farther.

The *Morrison* decision, however, did not rule out the potential for liability of foreign private issuers in U.S. courts arising from "transactions in securities listed on domestic exchanges." While it is clear that the holder of a foreign corporation's stock cannot bring suit in the United States based upon the purchase of that stock in a foreign market, the *Morrison* court was not explicit as to whether the purchase of an ADR on a U.S.-based exchange constitutes a "domestic" transaction.[12] At least one federal district court has allowed claims brought by holders of ADRs to proceed at the motion to dismiss stage, while another has interpreted *Morrison* as precluding 10b-5 litigation against foreign private issuers even by purchasers of ADRs on U.S. exchanges.[13]

While the dust has not yet settled on whether plaintiffs may continue to bring "stock drop" cases against foreign private issuers in U.S. courts based upon purchases of ADRs on U.S. exchanges, the next wave of litigation may push the territorial limits of U.S. courts one step farther by asking courts to enjoin foreign M&A transactions for the benefit of domestic ADR holders. The subject of that battle may be "going private" transactions by foreign issuers, particularly those based in the PRC, seeking to avoid certain risks associated with exposure to U.S. capital markets.

"Going Private" Transactions

"Going private" transactions involving U.S.-listed, PRC-based issuers have become more common in the last few years, representing a reversal of the trend toward capital markets fund-raising in the U.S. by such issuers. Several years ago, PRC-based issuers eager for access to fertile U.S. capital markets began listing their securities on U.S. stock exchanges, either through reverse mergers into a public shell company often incorporated in Nevada or Delaware (*e.g.*, domestic issuers) or through underwritten initial public offerings as foreign private issuers using a Cayman or British Virgin Islands (BVI) holding company structure to effect the listing.

> ***More than forty "going private" deals involving U.S.-listed, PRC-based issuers have been announced since 2011.***

More recently, however, accounting scandals, regulatory scrutiny, and allegations by short-sellers have eroded investor confidence in U.S.-listed, PRC-based issuers. Depressed valuations and limited trading volume of many of these issuers has meant that, among other things, further share issuances and debt financings are more difficult, it is harder for pre-IPO private equity investors to sell down their positions at attractive prices or at all, and equity compensation to officers and employees becomes significantly less attractive. This downward spiral of investor confidence has caused these companies to rethink the benefits of listing in the U.S. Although market sentiment has been particularly negative toward PRC-based domestic issuers that listed through reverse mergers, the valuations of PRC-based foreign private issuers have also been adversely affected. Moreover, as discussed above, PRC-based foreign private issuers also face the increased possibility of U.S. litigation risk from "stock drop" cases that appeared to recognize the rights of U.S. holders of ADRs to sue foreign private issuers in U.S. courts.

For these and other reasons, more than forty "going private" deals involving U.S.-listed, PRC-based issuers have been announced since 2011. Of these, at least a dozen deals involving PRC-based foreign private issuers with ADRs traded in the U.S. have been completed. While some of these deals involving PRC-based domestic issuers have been challenged in U.S. courts, until recently, no lawsuits had been filed in the U.S. involving PRC-based foreign private issuers that are incorporated in the Cayman Islands or other offshore jurisdictions. Although a number of plaintiffs' firms have posted press releases announcing "investigations" into such transactions, the *Focus Media* complaint represents the first time litigation of this kind has been filed.

The *Focus Media* Lawsuit

Focus Media Holding Limited (Focus Media) is China's largest multi-platform digital media network, operating LCD displays, billboards, and other advertising displays.[14] While based in the PRC, Focus Media is incorporated in the Cayman Islands. Certain holders of Focus Media's ADRs filed a complaint in federal court in California on February 22, 2013, seeking to enjoin the going private acquisition of Focus Media by a consortium of private equity firms and the company's chairman and CEO and his affiliates. While the complaint is typical in some respects for U.S. M&A litigation, it also presents novel issues concerning the applicability of U.S. securities laws to foreign transactions.

The *Focus Media* complaint included several allegations that have become typical of boilerplate shareholder plaintiffs' complaints filed in U.S. M&A litigation, including that the consideration paid to Focus Media shareholders was allegedly insufficient, that the disclosures concerning the deal were allegedly inadequate and misleading, and that the Focus Media board allegedly failed to conduct a full and fair sales

process, and instead entered into a merger agreement with a favored bidder that includes preclusive deal-protection devices.[15]

Accounting scandals, regulatory scrutiny, and allegations by short-sellers have eroded investor confidence in U.S.-listed, PRC-based issuers.

The complaint asserted two distinct types of legal claims: misrepresentations under the U.S. federal securities laws, and a claim under Section 92 of the Cayman Companies Law for a judicial order requiring the "winding up" of the company.[16]

As to the first claim, plaintiffs alleged that the company violated Section 14(a) of the Exchange Act by making material misrepresentations and omissions in the proxy statement announcing the deal, and that its directors are liable for such misrepresentations under Section 20(a) of the Exchange Act as "control persons."[17] As is the case in much M&A litigation in the U.S., the complaint sought monetary damages and attorneys' fees, rescission of the merger agreement, and, most importantly, injunctive relief preventing the closing of the transaction and requiring, instead, the implementation of a "fair" sales process.

The second claim was brought under Section 92 of the Cayman Islands Companies Law. Under Section 92, shareholders of a Cayman Islands entity may present an application to a Cayman court to wind up a company under certain circumstances, including when the affairs of the corporation are being conducted in an abusive or oppressive manner that is detrimental to shareholders.[18] In support of their claim under Section 92, Plaintiffs alleged that the directors of the company acted in a manner detrimental to the shareholders of the company by failing during the sales process to maximize the value of Focus Media to its public shareholders, failing to value the company and its assets properly, and ignoring the purported conflicts of interest resulting from the merger agreement's provisions entitling the directors to continued employment and equity compensation following the transaction's closing.

Interestingly, while the complaint included factual allegations regarding the conduct of the Focus Media board similar to allegations that might be brought in typical U.S. deal litigation for breach of fiduciary duties under the law of the target corporation's state of incorporation, the *Focus Media* complaint does not actually include a count for breach of the board's fiduciary duties under Cayman Islands law.

Focus Media filed a motion to dismiss on March 19, 2013.[19] In its motion, Focus Media argued that the Section 14(a) and Section 20(a) claims should be dismissed because, as a foreign private issuer, Focus Media's ADRs are "exempted securities" under Section 14(a).[20] As to the two remaining claims against Focus Media's directors under Section 20(a) and Chapter 92(e) of the Cayman Islands Companies law, Focus Media argued that the directors had not been served properly.[21] However, Focus Media argued that those claims would nevertheless be subject to dismissal on substantive grounds as well.[22] As to the Section 20(a) claim, Focus Media argued that, absent primary liability of the company under Section 14(a), Focus Media's board members could not be liable as "control persons" under Section 20(a).[23] As to the Chapter 92(e) claim, Focus Media argued that U.S. courts lack the authority to enforce claims under Chapter 92 of the Cayman Islands Companies Laws, which is only enforceable in Cayman courts.[24]

Will Claims Like the *Focus Media* Plaintiffs' Survive Motions to Dismiss in the Future?

On March 26, 2013, the plaintiff in *Focus Media* voluntarily dismissed its complaint,

thereby removing an obstacle to the closing of Focus Media's proposed going private deal and leaving the questions raised by Focus Media's motion to dismiss unanswered. However, there is reason to believe that U.S. courts will be skeptical of claims like that filed against Focus Media seeking to block transactions by PRC-based issuers on the basis of Section 14(a) violations and Cayman Islands law—a reason, perhaps, that the *Focus Media* plaintiffs chose not to pursue their claims further.

> ***Whether plaintiff shareholders will seek to assert other claims under Cayman law in the future remains to be seen.***

While Section 14(a) is a staple of plaintiffs challenging M&A transactions in the U.S., foreign private issuers with ADRs that trade in the U.S. are, as argued by Focus Media, generally exempt from Section 14(a). Section 14(a) provides that proxy solicitation must comport with SEC rules, including that proxy statements may not be "false or misleading with respect to any material fact."[25] However, Section 14(a) excuses from compliance with SEC rules any "exempted security," including, as provided by SEC Rule 3a12-3, securities registered by "foreign private issuers."[26] Numerous courts have recognized this exception.[27] Thus, it is highly possible that the court would have dismissed the Section 14(a) claim (and accompanying Section 20(a) claim for control person liability) on that basis.[28]

It also is possible that Focus Media could have sought dismissal of the complaint on jurisdictional grounds. Although Focus Media's motion to dismiss did not delve into the jurisdictional issues raised by *Morrison*, it is conceivable that, even if the court were to recognize the rights of ADR holders to bring claims against the company, the court would be hesitant to enjoin a foreign merger agreement involving a corporation that is both based and incorporated in a foreign country. Even if the court attempted to block the merger, it is unclear as a jurisdictional matter what authority it would have to prevent a Cayman corporation based in the PRC from being acquired by a consortium of private equity firms and company insider.

As for claims under Cayman law, *Focus Media* appears to be the first case in which a U.S. court has been asked to provide relief under Section 92(e).[29] That provision of the Cayman Islands Companies Law allows the Grand Court of the Cayman Islands to wind up a Cayman company under certain circumstances.[30] However, as Focus Media argued in its motion to dismiss, under the Companies Laws, a Section 92 claim may not be asserted outside of the Cayman courts.[31] As a result, it appears that U.S. courts do not have the authority to conduct a Cayman winding up proceeding.

What's more, Section 92 claims may only be brought by the shareholders of the Cayman entity who have held their shares for over 6 months.[32] Given the structure of ADRs, in which the depository bank—not the ADR holder—is the shareholder of record, it is not clear that ADR holders have standing to bring Section 92 claims even in Cayman courts.[33] In addition, a Section 92 claim is an extraordinary remedy reserved only for circumstances in which the dissolution of a company is warranted.

> ***The application in the U.S. of Cayman fiduciary duty principles is not well-developed.***

Whether plaintiff shareholders will seek to assert other claims under Cayman law in the future remains to be seen. In U.S-based M&A litigation involving domestic issuers, claims for breach of fiduciary duty are among the most frequently used weapons in the shareholder plaintiffs' arsenal.

However, entities like Focus Media that are incorporated in the Cayman Islands may pose peculiar challenges for shareholder plaintiffs looking to assert breach of fiduciary duty claims to disrupt M&A activity. In the case of domestic issuers, shareholder plaintiffs assert claims for breaches of fiduciary duties based on duties owed to the organization for the clear benefit of the shareholders of the organization. ADR holders such as the Focus Media plaintiffs, however, are not shareholders of the issuer. Although the directors of Cayman entities owe fiduciary duties for the benefit of the organization's shareholders, there are significant questions as to whether those duties extend under Cayman law to holders of ADRs and, if not, how ADR holders could assert such claims, whether directly or derivatively. Still, the application in the U.S. of Cayman fiduciary duty principles is not well-developed, thereby creating uncertainty for any entities potentially subject to such claims.

Looking Forward

The *Focus Media* complaint, which was filed by one of the handful "frequent filer" shareholder plaintiffs' law firms in the U.S., may serve as a lesson for other plaintiffs' attorneys looking to diversify their litigation portfolio beyond challenging U.S.-based public company merger transactions. This path may be perceived as an attractive opportunity to the plaintiff's bar in the wake of the Supreme Court's *Morrison* decision, which significantly curtailed the volume of litigation challenging international deals in U.S. courts. As the first complaint of its kind, *Focus Media* raises a number of issues that many companies—including foreign private issuers and private equity firms involved in buyout deals—may be unaccustomed to.

First, claims brought under Section 14(a) of the Exchange Act based on alleged misrepresentations in proxy statements are not actionable against entities that qualify as a "foreign private issuer." However, foreign issuers should consult with their legal advisors to be certain they qualify for such status and to assess the risk of any other disclosure-based claims, such as disclosure claims based on the required disclosures under Exchange Act Rule 13e-3 and Schedule 13E-3.[34]

Differences between U.S. and Cayman law may pose significant obstacles to the plaintiffs' attorneys who bring these claims.

Second, like many other foreign issuers who have announced going private transactions in recent years, Focus Media is incorporated in the Cayman Islands. Shareholder plaintiffs therefore may pursue other claims under Cayman fiduciary duty law that were not asserted in the *Focus Media* complaint. Differences between U.S. and Cayman law, relating to, among other things, the ability to litigate through a class action, the existence of direct, non-derivative, claims for breach of fiduciary duty and the availability of fee-shifting to support an award of attorneys fees to the plaintiff's attorneys, may pose significant obstacles to the plaintiffs' attorneys who bring these claims. However, the law in the U.S. relating to such claims based on Cayman fiduciary duty principles is not well-developed, thereby creating uncertainty for any entities subject to such claims. While the *Focus Media* complaint did not include a count for breach of Cayman fiduciary duties, plaintiffs may attempt to do so in the future, and how U.S. courts will handle those claims remains an open question.

Third, it is very likely the *Focus Media* plaintiffs included their Section 92 claim, not because they wished to wind up Focus Media, but to increase the potential settlement value of their claims. In order to close a statutory merger in the Cayman Islands, the directors of a Cayman company must sign a certification stating that there is no proceeding under Section 92 of the Companies Law pending. It would appear, then, that the

plaintiffs in *Focus Media* included the Section 92 claim as an attempt to prevent the closing of the Focus Media deal through the pendency of a Section 92 action under the Companies Law—just as U.S. shareholders frequently bring claims to enjoin shareholder votes on merger closing. As described above, such claims may face substantial obstacles in U.S. courts. Nevertheless, they may cause reticence on the part of the directors of Cayman entities asked to sign certifications prior to a closing and prompt directors to seek hasty, and potentially costly, settlements.

Replication of archetypal Delaware deal terms may be unnecessarily cautious in transactions involving foreign private issuers.

Finally, even before the *Focus Media* lawsuit, legal counsels involved in going private deals for U.S.-listed, PRC-based foreign private issuers have been debating the necessity of borrowing transaction terms and processes used frequently by Delaware corporations for going private deals on the theory that such approach would tend to lower the liability exposure for offshore companies as well.[35] With this lawsuit, foreign private issuers and the private equity investors who fund their going private transactions may face increased pressure from special committees to mimic the types of contractual deal protections utilized by Delaware corporations. However, whether such pressure is justified remains to be seen. While the *Focus Media* complaint suggests that similar litigation may ensue in the future, given the high hurdles and uncertainty as to whether plaintiffs can succeed in such litigation and the fact that there is often no statutory or common law basis in many offshore jurisdictions such as the Cayman Islands to conclude that the Delaware approach does in fact offer enhanced protection from claims, replication of archetypal Delaware deal terms may be unnecessarily cautious in transactions involving foreign private issuers.

Conclusion

While the legal authorities for defending against M&A litigation in the U.S. are well-developed and familiar, the same cannot be said for M&A litigation involving a foreign private issuer. The uncertainty surrounding these cases will pose additional risks for both foreign issuers engaging in going private or other types of M&A transactions and the private equity firms that finance them. Accordingly, entities involved in such transactions should be aware of the allegations being set forth and should consult with counsel regarding how best to prepare for the associated risks.

Notes

1. Cornerstone Research, Shareholder Litigation Involving Mergers and Acquisitions, 2013, at 1 (available at ("Cornerstone").
2. *Id.*
3. *Id.*
4. *See* Cornerstone at 2–3.
5. *Id* at 6. Two of the larger settlements in recent years were reached in 2012: $110 million in the El Paso Corp./Kinder Morgan Inc. deal and $49 million in the acquisition of Delphi Financial Groun, Inc. By Tokio Marine Holdings, Inc. *Id.*
6. Exchange Act Rule 3b-4.
7. Exchange Act Rule 13a-13(b)(2); Form 20-F, General Instruction A(b)(2).
8. Sometimes the terms "ADR" and "ADS" (American depositary share) are used interchangeably. An ADR is the negotiable certificate that evidences ownership of an ADS (in the same ways that a stock certificate evidences ownership of shares of stock), and an ADS is the security that represents an ownership interest in the foreign deposited securities (in the same way that a share of stock represents an ownership interest in the corporation). For practical purposes, ADRs are the instruments that are actually traded on the market.
9. *See, e.g.*, *In re Sadia, S.A. Securities Litigation*, 643 F. Supp. 2d 521 (S.D.N.Y. 2009); *In re Vivendi Universal, S.A.*, 381 F. Supp. 2d 158 (S.D.N.Y. 2003); *Reese v. Malone*, 2009 WL 506820 (W.D.Wash. 2009); *Menkes v. Stolt-Nielsen S.A.*, 2006 WL 1699603 (D. Conn. 2006).
10. 130 S. Ct. 2869 (2010) (emphasis added).
11. 677 F.3d 60 (2d Cir. 2012) (holding that plaintiffs "must allege facts suggesting that irrevocable liability was incurred or title was transferred within the United States.").

12. *See Morrison*, 130 S. Ct. at 2884–85 ("And it is in our view only transactions in securities listed on domestic exchanges, and domestic transactions in other securities, to which § 10(b) applies.").

13. *In re Vivendi Universal, S.A. Securities Litigation,* 765 F. Supp. 2d 512 (S.D.N.Y. 2011) (recognizing that purchase of ADRs on NYSE constitutes "domestic transaction" and therefore is not precluded by *Morrison*); *compare In re Societe Generale Securities Litigation*, 2010 WL 3910286 (S.D.N.Y. 2010) ("[t]rade in ADRs is considered to be a predominantly foreign securities transaction").

14. Annual Report, Form 20F, for fiscal year filed with the SEC on April 29, 2012, available at *http://www.sec.gov/Archives/edgar/data/1330017/000119312512190320/d302853d20f.htm*.

15. Focus Media Compl. at ¶¶ 5–8.

16. *Id*. at ¶¶ 89–107.

17. *Id*.

18. Cayman Islands Companies Law Section 92.

19. *See Iron workers Mid-South Pension Fund v. Focus Media et al*., No. 3:13-cv-00827-JST (N.D.C.A, filed Feb. 22, 2013), docket no. 9 ("Focus Media Motion").

20. Focus Media Motion at 4–7.

21. Focus Media Motion at 8 n.8.

22. *Id*.

23. *Id*.

24. *Id*.

25. 17 C.F.R. § 240.14a-9(a).

26. 17 C.F.R. 240.3a12-3(b).

27. *See, e.g.*, *Batchelder v. Kawamoto*, 147 F.3d 915, 923 (9th Cir. 1998) (upholding dismissal of Section 14(a) claim against foreign private issuer); *Schiller v. Tower Semiconductor, Ltd.*, 449 F.3d 286 (2d Cir. 2006) (concluding that "Rule 3a12-3 is a valid Commission rule and therefore affirm[ing] the judgment of the district court" granting a motion dismiss a Section 14(a) claim against a foreign private issuer); *In re Vivendi Universal, S.A. Sec. Litig.*, 381 F. Supp. 2d 158, 171 (S.D.N.Y. 2003) (dismissing Section 14(a) claim related to merger proxy filed with SEC as attachment to foreign private issuer's Form F-4 registration statement because "Rule 240.3a12–3(b) … exempts 'foreign private issuers' from liability under § 14(a)"); *In re Stillwater Capital Partners Inc. Litig.*, 853 F. Supp. 2d 441, 458 (S.D.N.Y. 2012) (dismissing § 14(a) claim against foreign private issuer); *In re Royal Dutch/Shell Transp. Sec. Litig.*, 380 F. Supp. 2d 509, 564 (D.N.J. 2005) (same); *see also Litwin v. OceanFreight, Inc.*, 865 F. Supp. 2d 385, 396 (S.D.N.Y. 2011) (denying motion for preliminary injunction challenging merger because, *inter alia*, plaintiffs could not demonstrate likelihood of success for Section 14(a) claim because "foreign private issuers … are exempt").

28. While going private foreign private issuers are generally exempt from section 14(a), they do not make their disclosure in a regulatory vacuum. Foreign private issuers are still subject to Exchange Act Rule 13e-3 and the disclosure requirements contained in the instruction to Schedule 13E-3. Exchange Act Rule 13e-3.

29. Cayman Islands Companies Law Section 92(e).

30. *Id*.

31. *Id*.

32. *Id*.

33. *Id*.

34. Although Exchange Act Section 13(e) does not expressly provide for a private right of action, the Sixth Circuit has held that a private right of action for damages to enforce Rule 13e-3 exists by implication. *See Howing Co. v. Nationwide Corp*., 826 F.2d 1470 (6th Cir. 1987), *cert. denied*, 486 U.S. 1059 (1988). Two district courts have split on the existence of such a right. *Compare Kalmanovitz v. G. Heileman Brewing Co.*, 595 F. Supp. 1385 (D. Del. 1984) (denying right of action) *with Fisher v. Plessey Co*., *Ltd*., No. 82-1183, 1983 WL 1329, at *4 (S.D.N.Y. June 22, 1983) (assuming the right's existence). In light of the Sixth Circuit's holding, it is worth observing that the safe harbor provided by the Private Securities Litigation Reform Act of 1995 for forward-looking statements does not apply to disclosures made in SEC filings in a Rule 13e-3 transaction. Exchange Act 21E(b)(2)(C).

35. For example, in a few going private transactions by U.S.-listed, PRC-based foreign private issuers to date, the special committees of independent directors charged with negotiating the merger agreement on behalf of the issuers have insisted on the transaction being approved by a majority of the disinterested minority shareholders. Such "majority-of-the-minority" shareholder approval threshold is common in certain M&A transactions involving Delaware companies as Delaware courts have held that it shifts to anyone challenging the merger the burden of proving that the merger is not fair to the minority shareholders. Such judicial precedent does not exist, however, in offshore jurisdictions such as the Cayman Islands.

SECURITIES ENFORCEMENT

SEC Enforcement Actions After *Gabelli*

In the aftermath of the U.S. Supreme Court's Gabelli *ruling, the Court's reasoning may impact more SEC enforcement remedies than just civil monetary penalties.*

By John H. Sturc and Colin C. Richard

In *Gabelli v. SEC,*[1] the Supreme Court held that an action by the government seeking a civil money penalty must be commenced within five years of the alleged violation, regardless of the nature of the claim. Some observers, including some SEC staff members, have suggested that the Court's holding has a limited impact on potential enforcement actions and will be confined to civil money penalties, but a closer analysis suggests that the effect may be significantly broader.

The *Gabelli* Decision

In a 9-0 decision explained by an opinion by Chief Justice Roberts, the Court held that the five-year period in 28 U.S.C. § 2462's "catch-all" statute of limitations provision applicable to securities enforcement actions begins to run at the time an alleged violation occurs—not, as argued by the Securities and Exchange Commission (SEC or Commission), at the time it is discovered. It concluded that, in the civil monetary penalty context, an alleged fraud does not toll the operation of the statute.

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The Decisions Below: S.D.N.Y. and the Second Circuit

Gabelli arose out of a SEC civil enforcement action filed in April 2008 against petitioners Bruce Alpert and Marc Gabelli, two employees of an investment adviser to a mutual fund, in the U.S. District Court for the Southern District of New York. The SEC alleged that the petitioners permitted one of the mutual fund's investors to engage in market timing in exchange for an investment in a separate hedge fund also managed by the adviser. The market timing and the *quid pro quo* transaction were allegedly not disclosed to the mutual fund's other investors who were prohibited from market timing. The complaint alleged violations of the anti-fraud provisions of the Investment Advisers Act of 1940. They were said to have occurred between 1999 and August 2002, more than five years before the complaint was filed.

The petitioners moved to dismiss, arguing, *inter alia*, that the penalties were barred by 28 U.S.C. § 2462, the "catch-all" statute of limitations applicable to many penalty provisions. It states:

> Except as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued if, within the same period, the offender or the property is found within the United States in order that proper service may be made thereon.

The District Court agreed with the Petitioners and dismissed the civil penalty claim, but the Second Circuit reversed, accepting the SEC's argument that the common law, equitable "discovery rule" should apply to this provision—that is, that

the statute of limitations does not begin until the alleged fraud is, or could have reasonably been, discovered.

U.S. Supreme Court

The Supreme Court reversed. The Court explained that the petitioners' interpretation of the statute "is the most natural reading" of it,[2] emphasized the importance of the policies underlying statutes of limitations,[3] and dismissed the government's argument that the discovery rule should apply. While the Court acknowledged that equitable courts had developed and applied a discovery rule as an exception for defrauded parties who were prevented by a defendant's conduct from knowing of their injury, the Court stated that it had "never applied the discovery rule … [where] the Government [is] bringing an enforcement action for civil penalties."[4] Instead, the Court found that "[t]here are good reasons why the fraud discovery rule has not been extended to Government enforcement actions for civil penalties."[5]

First, the government is "a different kind of plaintiff."[6] The Court wrote that "the discovery rule exists in part to preserve the claims of victims who do not know they are injured … [because m]ost of us do not live in a state of constant investigation."[7] The law does not expect private citizens to continually investigate whether others are concealing frauds committed against them. On the other hand, "a central 'mission' of the Commission is to 'investigat[e] potential violations of the federal securities laws.'"[8] Such investigations are among the SEC's core functions, and the Court highlighted the SEC's examination authority, its investigative powers, and its more recently adopted whistleblower awards and cooperation agreements as extraordinary pre-litigation powers to collect information that distinguish the SEC from "the defrauded victim the discovery rule evolved to protect."[9] The Court reasoned that the SEC should not then also need the discovery rule.

Second, the government is seeking "a different kind of relief."[10] When a private citizen makes use of the discovery rule, it is to further the injured party's ability to gain compensation for the injury. The government instead seeks to punish the defendant by imposing penalties that go beyond compensation and "label defendants wrongdoers."[11]

Third, the Court focused on the difficulties of applying a discovery rule to the Government when many different decision makers may be involved, and different and separate agencies may have overlapping responsibilities.[12] Because determining when a government reasonably should have known of a claim also implicated decisions regarding the allocation of government resources and priorities and could also implicate privileges from disclosure that the government could assert,[13] the Court feared that a discovery rule would be difficult to apply.

Fourth, the Court cited the long-standing policy interest in ensuring that there are time limits on exposure to liabilities. If the Court were to permit the government's use of the discovery rule here, the Court noted that it effectively would be removing the protections of this statute of limitations.

The Court expressly noted that it was not considering the SEC's prayer for an injunction and disgorgement.[14] Because the SEC abandoned reliance on the fraudulent concealment doctrine or other equitable tolling principles in proceedings below, the Court also specifically noted that those issues "are not before us."[15] But Section 2462 has broad wording and applies to "any action, suit or proceeding for the enforcement of any civil fine, *penalty*, or forfeiture, pecuniary or *otherwise*."[16] Thus, the breadth of application leads to two questions: (1) how does the holding affect other doctrines, such as "fraudulent concealment" or "continuing violations"; and (2) how far does the *Gabelli* reasoning extend beyond monetary penalties to other

civil enforcement remedies? These issues are discussed in the following sections.

Other Doctrines That May Delay the Statute of Limitations

Fraudulent Concealment

While *Gabelli* focused on the issue of when a claim accrues, the Court's reasoning has significant implications for the possible application of doctrines of equitable tolling, including fraudulent concealment. Several courts distinguish efforts constituting "fraudulent concealment" from the operation of the fraud itself,[17] noting that tolling under the discovery rule "presupposes that the plaintiff has discovered, or, as required by the discovery rule, should have discovered, that the defendant injured him, and denotes efforts by the defendant—above and beyond the wrongdoing upon which the plaintiff's claim is founded—to prevent the plaintiff from suing in time."[18] Thus, the date when a claim accrues determines when the limitation period beings, while fraudulent concealment could theoretically operate to suspend the running of the limitations period.

In *SEC v. Wyly,* and before the *Gabelli* Supreme Court decision, a district court applied the doctrine of fraudulent concealment in denying the defendants' motions to dismiss. After *Gabelli*, and in response to a renewed motion to dismiss, the SEC has argued that "[t]he two issues are quite distinct. Ruling that a cause of action 'accrues' when the acts creating the cause of action are completed, regardless of when they are discovered, says nothing about whether equity will toll a statute of limitations when a defendant separately engages in affirmative acts of concealment."[19] In evaluating the Commission's position on fraudulent concealment, courts may need to weigh a variety of considerations. In *Gabelli*, the Court noted four reasons not to imply a discovery rule for Section 2462, as discussed above.[20] These considerations may apply to a possible interruption of the limitations period by a claim of fraudulent concealment, although in the *Wyly* case, the SEC contended that the defendants had sought to conceal their acts from the SEC itself.

Other aspects of the Court's reasoning also may be considered in weighing an assertion of fraudulent concealment. The Court's analysis rested on a "natural" and textual reading of Section 2462.[21] Congress has provided only two exceptions to the five-year period set forth in Section 2462: "(1) where the 'offender or the property' is not 'found within the United States in order that proper service may be made thereon'; and (2) '[e]xcept as otherwise provided by an Act of Congress.'"[22] Elsewhere, the Court has held that "[w]here Congress explicitly enumerates certain exceptions to a general prohibition, additional exceptions are not to be implied, in the absence of evidence of a contrary legislative intent."[23] And, in concluding its *Gabelli* opinion, the Court wrote "cases in which 'a statute of limitations may be suspended by causes not mentioned in the statute itself … are very limited in character, and are to be admitted with great caution; otherwise, the court would make the law instead of administering it.'"[24] Since Congress considered and adopted exceptions to the limitations period, courts may not wish to adopt an exception that is not contained in the statute.

The Continuing Violation Doctrine

On occasion, both the government and other litigants have asserted that a claim based on facts occurring before the limitations period is nevertheless viable because of the continuing violation doctrine under which a plaintiff claims that discrete unlawful acts, some of which are time barred, are a part of a continuing unlawful practice which extended into the limitations period and which may therefore be pursued.[25]

Prior to *Gabelli,* courts have suggested that whether a particular securities law violation is a continuing violation turns on the plain language

of the statute or whether the nature of the particular violation is such that Congress must have intended that it be treated as a continuing one.[26] Thus, whether an otherwise stale claim may be saved by this doctrine turns on the elements of the alleged violation and the facts at issue. The United States District Court for the District of Columbia has recently found that the Court of Appeals for the D.C. Circuit had not considered whether the doctrine can be applied to securities claims, and that "[d]istrict courts in the Second and Third Circuits have indicated great skepticism that it does."[27]

On the other hand, one district court judge in the Southern District of New York applied the continuing violation doctrine to an SEC enforcement action.[28] The district court for the Northern District of California though, in discussing the SEC's reliance on *Kelly*, clarifies that "the application of the [continuing violation] doctrine to Section 2462 has been questioned."[29] A district judge in the Eastern District of Virginia concluded that, for purposes of a criminal securities case, each sale made as part of a pattern of a fraudulent distribution was a separate violation and not subject to the continuing violation doctrine.[30] Although the *Gabelli* decision does not bear directly on the continuing violation doctrine, the Court's emphasis on the social values underlying repose and its caution against judicial expansion of limitations periods suggest that courts may become cautious in the application of that doctrine.

Implications of *Gabelli* for Other Enforcement Remedies

The Court in *Gabelli* focused solely on civil monetary penalties; additional remedies initially sought by the SEC—an injunction and disgorgement—were not before the Court.[31] But the SEC has a panoply of other sanctions which it may seek or impose—injunctions, cease and desist orders, censures and limitations on the ability of persons to associate with registered entities, limitations on a person's ability to serve as an officer or director of a public company, and the ability to practice and appear as a professional before the Commission. Recently, several courts have found that, as applied to older cases, these remedies too are punitive and are subject to the five year bar of Section 2462.

Suspensions

Long before the *Gabelli* decision, the United States Court of Appeals for the District of Columbia held that an administrative censure and six-month suspension from acting as a supervisor in a brokerage firm were barred by Section 2462 because they were a "form of punishment imposed by the government for unlawful or proscribed conduct which goes beyond remedying the damage caused to the harmed parties by the defendant's actions."[32] In the wake of the *Johnson* decision, the Commission dismissed two pending Rule 102(e) proceedings initiated more than five years after the alleged violations, albeit without deciding the limitations issue.[33] And, while the authority is split, even before *Gabelli,* several courts have expressed doubt about granting an officer and director bar in an action commenced more than five years after the violation.[34]

Injunctive Relief

Injunctions are expressly intended to be remedial rather than a penalty. But, years after the events, an injunction may be ill-suited to protect investors and but still carry collateral consequences which can have punitive effects. Accordingly, several recent decisions have deemed such requests as also barred by Section 2462.[35]

Conclusion

While some may suggest that the *Gabelli* decision was a setback for the government, in the long run, the result may prove beneficial. One of the SEC's key missions is to protect investors from current and ongoing violations. While

Congress has determined that it should also have some expressly punitive sanctions, their principal effect is deterrence of others. As a former SEC Enforcement Director observed, enforcement should be strategic, swift, smart and successful.[36] Those objectives are best achieved by focusing attention and resources on investigations of recent matters that may have an ongoing effect on investors.

Notes

1. 568 U.S. ___ (Feb. 27, 2013).
2. *Gabelli v. SEC*, 568 U.S. _, 4 (2013).
3. *Id.* at 7-10.
4. *Id.* at 2.
5. *Id*. at 7.
6. *Id*. at 8.
7. *Id*. at 7.
8. *Id*. at 8.
9. *Id*.
10. *Id*.
11. *Id.* at 2.
12. *Id.* at 9-10.
13. *Id.* at 10.
14. The District Court dismissed the injunctive relief claim because the SEC "ha[d] not plausibly alleged that Defendants are reasonable likely to engage in future violations.'" *SEC v. Gabelli*, No. 08 Civ. 3868 (DAB), 2010 WL 1253603, at *11 (S.D.N.Y. Mar. 17, 2010). The Second Circuit notes that then, "[b]elieving that disgorgement would not provide significant relief, the SEC moved to voluntarily dismiss the remaining [disgorgement] claim without prejudice to the SEC's refiling this claim if, but only if, the SEC were successful in this appeal. The District Court granted the motion over the defendants' objections and entered judgment accordingly." *Gabelli*, 653 F.3d at 56.
15. *Gabelli*, 568 U.S. at 4, n.2 (2013).
16. 28 U.S.C. § 2462 (emphasis added).
17. *See, e.g.*, *Gabelli*, 653 F.3d at 59 ("As an initial matter, we note that Gabelli's latter argument reflects the all-too-common mistake by which the discovery rule is 'sometimes confused with the concept of fraudulent concealment of a cause of action,' *see Pearl v. City of Long Beach*, 296 F.3d 76, 80 (2d Cir. 2002), and we take this opportunity to once again clarify that these two doctrines are distinct."); *SEC v. Wyly*, 788 F. Supp. 2d 92, 104, n.78 (S.D.N.Y. Mar. 31, 2011) ("Equitable estoppel in the limitations setting is sometimes called fraudulent concealment, *but must not be confused with efforts by a defendant in a fraud case to conceal the fraud* ").
18. *Wyly*, 788 F. Supp. 2d 92, at 104, n.78.
19. "Plaintiff Securities and Exchange Commission's Memorandum of Law in Opposition to Defendants' Consolidated Motion for Partial Summary Judgment," *SEC v. Wyly*, Case 1:10-cv-05760-SAS, 3 (Apr. 4, 2013).
20. *Gabelli*, 568 U.S. at 7-9; *see also supra*, pp.2–3.
21. *See id.* at 4.
22. "Defendants' Joint Motion for Partial Dismissal of the SEC's Amended Complaint," *SEC v. Jackson*, Case 4:12-cv-00563, 10 (Feb. 22, 2013).
23. *TRW Inc. v. Andrews*, 534 U.S. 19, 28 (2001).
24. *Gabelli*, 568 U.S. at 11 (quoting *Amy v. Watertown (No. 2),* 130 U.S. 320, 234 (1889)).
25. *See National Railroad Passenger Corporation v. Morgan*, 536 U.S. 101, 117-118 (2002).
26. *United States v. Harris*, 2013 WL 325610 (E.D. Va. Jan. 29, 2013), citing *Toussie v. United States,* 397 U.S. 112 (1970) (holding that the statute of limitations for failure to register for the draft began to run on the date when registration was first required and was not extended by a continued failure to register over several years) and *United States v. Smith,* 373 F.3d 561 (4th Cir. 2004) (embezzlement scheme may be a continuing offense).
27. *SEC v. Brown*, 740 F. Supp. 2d 148, 158–59 (D.C. 2010).
28. *See, e.g.*, *SEC v. Kelly*, 663 F. Supp. 2d 276, 287–88 (S.D.N.Y. 2009) (holding that a continuous accounting scheme to inflate revenue can fit within the continuing violation doctrine).
29. *SEC v. Leslie*, Case No. C 07-3444 (N.D.CA July 29, 2010).
30. *Harris*, 2013 WL 325610.
31. *See supra*, n.14.
32. *Johnson v. SEC,* 87 F.3d 484, 488 (D.C. Cir. 1994).
33. *See In Re Stayner,* 67 SEC Docket 282, 1998 WL 42127 (1998); *In Re Dana*, 64 SEC Docket 720, 1997 WL 197555 (1997).
34. *SEC v. DiBella,* 409 F. Supp. 122, 128 (D. Conn. 2004) (director and officer bar is a penalty); *SEC v. Brown, supra* (whether bar is a penalty depends on the facts); *Brown*, 740 F. Supp. 2d at 159 (deferring decision on application of Section 2462 until a factual record is developed); *cf., e.g., SEC v. Schiffer,* 1998 US Dist. LEXIS 6339, *8 (SDNY, 1998) (director and officer bar may be an equitable remedy).
35. *See, e.g., SEC v. Bartek,* 484 F. App'x 949, 956–57 (5th Cir. 2012), *aff'g. SEC v. Microtune, Inc.,* 783 F. Supp. 2d 867, 886 (N.D.Tex. 2011); *SEC v. Jones,* 476 F. Supp. 2d 374, 383–85 (S.D.N.Y. 2007).
36. "Testimony Concerning Strengthening the SEC's Vital Enforcement Responsibilities," Robert Khuzami, U.S. Senate Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance, and Investment (May 7, 2009).

IN THE COURTS

Disclosure Obligations of Fiduciaries in Private Stock Sales with Stockholders

By John F. Grossbauer and David B. DiDonato

Despite commentators suggesting that directors of Delaware corporations always have an affirmative duty to disclose material information when purchasing shares from or selling shares to a stockholder in a private transaction, Vice Chancellor Laster recently, in *In re Wayport, Inc. Litigation*,[1] reaffirmed that Delaware adheres to the "special facts doctrine." This more limited rule that imposes a duty of disclosure on corporate fiduciaries engaged in a private stock sale with stockholders *only* where certain special circumstances exist, such as when the fiduciary has knowledge of a substantial transaction. The Vice Chancellor further clarified that despite not having a duty to speak absent special facts under such circumstances, a duty to speak will arise if the fiduciary previously made statements that, although true when made, subsequently become false. If the fiduciary fails to update its statement to the extent subsequent events render it materially misleading, then, for purposes of evaluating a claim of common law fraud, the court will treat remaining silent the same as making a false representation. Vice Chancellor Laster also devoted a portion of his opinion to reviewing the law concerning the various circumstances in which a corporate fiduciary's duty of disclosure arises along with the corresponding governing principles.

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Governing Principles of the Duty of Disclosure

In *Wayport*, the Vice Chancellor comprehensively reviewed four prominent recurring scenarios in which a director's duty of disclosure arises: (1) when seeking classic common law ratification; (2) when requesting stockholder action; (3) when making affirmative statements not connected with a request for stockholder action; and (4) when purchasing shares directly from or selling shares directly to an existing outside stockholder.[2] A brief recap of the principles governing these four scenarios follows.

Classic Common Law Ratification

The first species of ratification Vice Chancellor Laster reviewed is the one the Delaware Supreme Court has described as "classic ratification." When directors seek stockholder approval to ratify a conflict transaction that does not otherwise require a stockholder vote under the General Corporation Law of the State of Delaware, then the directors have a duty " 'to disclose all facts that are material to the stockholders' consideration of the transaction and that are or can reasonably be obtained through their position as directors.' "[3] Failing to disclose material information under this scenario could result in the elimination of any effect that a favorable stockholder vote otherwise would have on the validity of the transaction or the applicable standard of review.[4]

Requesting Stockholder Action

When directors request stockholder approval of a non-interested transaction that requires stockholder approval (such as a statutory merger) or a stockholder investment decision (such as a tender offer), directors have a duty to "'exercise reasonable care to disclose all facts that are material to

the stockholders' consideration of the transaction or matter and that are or can reasonably be obtained through their position as directors.'"[5] Failing to disclose material information under this scenario could result in an injunction against, or rescission of, the transaction. However, there will be no basis for damages against directors who fail to meet this standard "'absent proof of (1) a culpable state of mind or non-exculpated gross negligence, (2) reliance by the stockholders on the information that was not disclosed, and (3) damages proximately caused by that failure.'"[6]

Certain Other Statements

When a board of directors communicates publicly or directly with stockholders about corporate affairs, "directors owe a duty to stockholders not to speak falsely."[7] The consequences of speaking falsely under this scenario could include derivative claims, damages, and other equitable relief.[8]

Private Sales of Stock Between Corporate Fiduciaries and Stockholders

When a corporate fiduciary purchases shares of stock directly from, or sells shares of stock directly to, an existing outside stockholder, the fiduciary may owe a duty to disclose material information to that stockholder.[9] In determining the scope of this duty under Delaware law, Vice Chancellor Laster reviewed the majority rule, the minority rule, and the "special facts doctrine."[10]

The Majority Rule, the Minority Rule, and the Special Facts Doctrine

Under the "majority" rule, "directors have no special disclosure duties in the purchase and sale of the corporation's stock, and need only refrain from misrepresentation and intentional concealment of material facts."[11] At the other end of the spectrum, the "minority" rule requires that directors "disclose all material information bearing on the value of the stock when they buy it from or sell it to another stockholder."[12] In the middle, the "special facts doctrine" limits directors' duty of disclosure to:

> special circumstances…where otherwise there would be a great and unfair inequality of bargaining position by the use of inside information. Such special circumstances or developments have been held to include peculiar knowledge of directors as to important transactions, prospective mergers, probable sales of the entire assets or business, agreements with third parties to buy large blocks of stock at a high price and impending declarations of unusual dividends.[13]

Right Idea, Wrong Law

After reviewing the relevant Delaware case law, Vice Chancellor Laster concluded in *Wayport* that Delaware adheres to the special facts doctrine.[14] In so doing, the Vice Chancellor examined the assertion made by Professor Larry Hamermesh, a well-respected scholar on issues of Delaware corporate law, that the Delaware Supreme Court, in fact, had adopted the minority rule of full disclosure. The Vice Chancellor explained that although he agreed with the policy rationales for adherence to the minority rule that Professor Hamermesh advanced, he disagreed that the Delaware Supreme Court had endorsed the minority rule. Rather, the Vice Chancellor found that the rule established by the Delaware Supreme Court in *Lank v. Steiner*[15] remained the law of Delaware. Thus, "[a]bsent further guidance from the high court, the 'special facts' doctrine remains the standard in this context."[16]

The Facts in *Wayport*

The facts of the *Wayport* case are extensive and detailed. In sum, the issues in Wayport arose from certain sales of Wayport stock by Brett Stewart, a former director/officer and stockholder of Wayport, Inc., a privately held Delaware corporation (Wayport) that pioneered

Wi-Fi hotspots. Stewart had made a series of sales of stock to certain fiduciaries of Wayport, which included Trellis Partners, a venture capital firm and stockholder of Wayport with a director designee on the Wayport board (Trellis), and New Enterprise Associates, a venture capital firm and stockholder of Wayport with a board observer on the Wayport board (NEA). At the same time the negotiations of these stock sales were occurring, Wayport was evaluating ways to monetize its patents and began auctioning a family of patents (the MSSID Patents).

During the negotiation of the first completed stock sale between Stewart and Trellis, a dispute arose about Trellis's proposed inclusion in the Stock Purchase Agreement of mutual representations concerning knowledge of facts relating to Wayport. In response to Stewart's request that Trellis (but not Stewart) make such a representation, Alex Broeker, a partner at Trellis, emailed Stewart stating:

> *We are not aware of any bluebirds of happiness in the Wayport world right now and have graciously offered to [represent] that*. But what happens if Google walks in in 30 days and says 'we'd like to buy [Wayport]". [sic] The way the [representation] is worded, you would come to use and say foul-you should have told me. I think we can address this but we need to focus on solutions that will meet [Wayport's] guidance for existing investors and [B]oard members and our counsel.[17]

Stewart responded, stating: "[i]f you know of any Google deal in play, perhaps you ought to refrain from this transaction, or arrange for us to be on a level information playing field."[18] The Trellis stock sale and a related sale of stock to NEA subsequently closed. Shortly thereafter, Cisco Systems, Inc. and Wayport executed a patent sale agreement for the MSSID Patents (the Cisco Sale). No one informed Stewart of these developments.

A few days after the Cisco Sale, negotiations began among Stewart and Trellis and NEA with respect to additional sales of shares of Wayport stock by Stewart. That final stock sale closed a few weeks later. Stewart sold his shares of Wayport stock in each of the aforementioned stock sales for $2.50 per share.

Stewart did not learn about the Cisco Sale until after the last stock sale closed. Stewart proceeded to file a Section 220 demand, and then a books and records action when Wayport failed to respond to his demand for further information about the Cisco transaction. Wayport eventually provided Stewart a list of its currently held patents, which allowed Stewart to deduce which patents had been sold. Wayport, however, never disclosed the gross proceeds, timing, or purchaser of the patents.

Several months later, Wayport announced it would be acquired by AT & T Inc. for $7.20 per share. The discussions between Wayport and AT & T began a few months after Stewart completed the final stock sale with Trellis and NEA. Less than two weeks after the announcement of the AT & T deal, Stewart filed suit in the Delaware Court of Chancery alleging, among other things, breach of fiduciary duty and fraud. Several additional claims were dismissed in an earlier opinion by former Vice Chancellor Lamb. The litigation proceeded to trial on claims for breach of fiduciary duty, aiding and abetting a breach of fiduciary duty, common law fraud, and equitable fraud.

No Special Facts

Vice Chancellor Laster held that Trellis and NEA had no fiduciary duty to disclose information about Wayport or its prospects when it purchased shares from other Wayport stockholders "unless the information related to any event of sufficient magnitude to constitute a 'special fact.' If they knew of a 'special fact,' then they had a duty to speak and could be liable if they deliberately mislead the plaintiffs by remaining

silent."[19] Vice Chancellor Laster explained that "[t]o satisfy the 'special facts' requirement, a plaintiff generally must point to knowledge of a substantial transaction, such as an offer for the whole company."[20] Moreover, Vice Chancellor Laster emphasized that the standard for a "special fact" exceeds the standard of materiality. Out of all the omissions plaintiffs identified, Vice Chancellor Laster concluded that only one, the Cisco Sale, was material. Notwithstanding the materiality of the Cisco Sale, the Court held that plaintiffs failed to prove that the Cisco Sale substantially affected the value of their stock to the extent necessary to trigger the special facts doctrine. In fact, Stewart admitted that the Cisco Sale "did not necessarily imply anything about the market value of the remaining patents." Accordingly, the Court held that Trellis and NEA knew of no "special facts" and therefore had no fiduciary duty of disclosure when purchasing shares from plaintiffs.

The Duty to Update

Nevertheless, the Court held that plaintiffs had proven that Trellis committed common law fraud in connection with the final stock sale with Stewart. Vice Chancellor Laster explained that

> [a] duty to speak … can arise because of statements a party previously made. A party to a business transaction is under a duty to … disclose to the other [party] before the transaction is consummated … subsequently acquired information that [the speaker] *knows will make untrue or misleading a previous representation that when made was true* … . The fact that a statement was true when made does not enable the speaker to stand silent if the speaker subsequently learns of new information that renders the earlier statement materially misleading.[21]

The Court concluded that NEA never spoke; therefore, NEA had no duty to update any statements. On the other hand, Trellis spoke and made a representation about lack of "bluebirds of happiness" that subsequently became untrue.[22] Trellis's director designee was included in the email and knew of the representation. At the time Broeker sent the email, the statement was true. By speaking, however, Trellis assumed the duty to update the statement to the extent subsequent events rendered the representation materially misleading, which the Court found had occurred when the Wayport board learned about the Cisco Sale. At that time, Trellis's director designee became aware of the Cisco Sale and the falsity of the Broeker email (and this knowledge was imputed to Trellis). The Court held that once the Cisco Sale occurred and Trellis learned of it, the representation in the Broeker email became materially misleading, and Trellis had a duty to speak, but did not. Vice Chancellor Laster explained that remaining silent under the circumstances was equivalent to knowingly making a false misrepresentation. The Court concluded that plaintiffs also had proven the other elements of common law fraud against Trellis and awarded damages in favor of Stewart and against Trellis in the amount of $470,000.

Conclusion

Besides representing a useful resource for practitioners looking to refresh their knowledge regarding directors' duty of disclosure, *Wayport* contains important takeaways with respect to the obligations of fiduciaries when purchasing shares from or selling shares to stockholders. Absent "special facts," an onerous standard characterized as higher than materiality, fiduciaries are under no Delaware law fiduciary obligation to disclose information known to them when negotiating a private stock sale with a stockholder. However, to the extent the fiduciary speaks, he or she must ensure that if any events occur or facts arise making untrue or misleading any previous representation, the previous representation is corrected before the consummation of the transaction. In light of the possible consequences of unnecessarily speaking, fiduciaries may now decide to remain silent whenever possible.

Notes

1. 2013 WL 1811873 (Del. Ch. May 1, 2013).
2. *Id.* at *14–16.
3. *Id.* at *14 (citing *Gantler v. Stephens*, 965 A.2d 695, 713 (Del. 2009)).
4. *Wayport*, 2013 WL 1811873, at *14.
5. *Id.* at *15 (citing *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992)).
6. *Wayport*, 2013 WL 1811873, at *15 (quoting *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 146–47 (Del. 1997)).
7. *Wayport*, 2013 WL 1811873, at *15 (citing *Malone v. Brincat*, 722 A.2d 5, 10–11 (Del. 1998)).
8. *Wayport*, 2013 WL 1811873, at *15.
9. *Id.*
10. *Id.* at *16.
11. *Id.* at *17.
12. *Id.*
13. *Id.* at *17–18.
14. *Id.* at *18–19 (discussing *Kors v. Carey*, 158 A.2d 136 (Del. Ch. 1960) and *Lank v. Steiner*, 224 A.2d 242 (Del. 1966)).
15. 224 A.2d 242 (Del. 1966) (approving rule adopted in *Kors v. Carey*, 158 A.2d 136 (Del. Ch. 1960)).
16. *Wayport*, 2013 WL 1811873, at *20.
17. *Id.* at *11 (emphasis in original).
18. *Id.*
19. *Id.* at *20.
20. *Id.* at *21.
21. *Id.* at *23 (emphasis in original).
22. *Id.* at *24.

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STATE CORNER

Legislation Amending the New Jersey Business Corporation Act

By Ronald Janis, Michael Rave, and Elizabeth Kim

On April 1, New Jersey Gov. Chris Christie signed legislation amending the New Jersey Business Corporation Act. The legislation was drafted by the New Jersey Corporate and Business Law Study Commission, a legislative commission formed to study and review New Jersey corporate law, with the goal of modernizing these laws and making New Jersey a more attractive state within which to incorporate.

The legislation:

- Creates a new section regarding shareholder derivative litigation that, if adopted in the certificate of incorporation, allows independent board members greater flexibility to move to dismiss litigation they deem is not in the best interests of the corporation and implements fee shifting and other provisions in the context of derivative and shareholder class action proceedings.
- Amends the Shareholders' Protection Act (SPA) to make all publicly traded New Jersey corporations subject to the SPA and to allow certain business transactions to take place that previously would have been prohibited under the SPA, if the requisite approvals are obtained.
- Amends the dissenters' rights section to provide that such section is the exclusive remedy absent fraud or material misrepresentation.
- Allows remote participation by shareholders in annual or special shareholders' meetings.

Shareholder Derivative and Class Actions

The new statute repeals former N.J.S.A. § 14A:3-6, governing procedural requirements in connection with shareholder derivative actions, and replaces it in its entirety. The statute enhances the substantive provisions of the former statute and makes certain provisions applicable to shareholder class actions. The new statute only applies if so provided in a company's certificate of incorporation.

The new statute is designed to allow New Jersey corporations a more robust ability to dismiss shareholder derivative suits. It provides that a derivative proceeding will be dismissed if the court finds that independent directors, shareholders or court-appointed professionals have determined that the derivative proceeding is not in the best interests of the corporation. In addition, the statute requires the shareholder plaintiff to hold the shares of the corporation not only at the time of the act or omission complained of, but also to continue to hold the shares throughout the derivative proceeding.

The new statute also imposes certain of its provisions upon shareholder class actions arising out of breaches of New Jersey law. One of these provisions is the fee-shifting provision. Under this provision, a court may require a plaintiff shareholder to pay the corporation's expenses in the event the court determines the proceeding was brought without reasonable cause or for an improper purpose.

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The prior statute required shareholders with less than $25,000 in stock holdings to post a bond for potential fee shifting in a derivative suit. For both derivative and shareholder class action proceedings, the value of plaintiffs' shareholdings required to avoid the need to post a bond has been increased from $25,000 to $250,000.

The provisions of new N.J.S.A. § 14A:3-6 apply only if they are expressly made applicable to the corporation by the certificate of incorporation. Accordingly, a corporation seeking to take advantage of this section must submit to its shareholders for approval an amendment making new section 3-6 applicable to the corporation.

Shareholders' Protection Act

This new statute amends certain provisions of the New Jersey Shareholders' Protection Act, N.J.S.A. § 14A:10A-1 *et seq.* to make it applicable to all publicly traded New Jersey corporations and to make it easier in certain circumstances to exempt a board-approved transaction from the SPA. The SPA applies to a corporation only at a time when it has a class of voting stock that is registered with the SEC or traded on a national securities exchange.

Previously, the SPA was applicable to such publicly traded New Jersey corporations that had either their principal executive offices or "significant business operations" in New Jersey. Corporations often had difficulty determining the meaning of "significant business operations." The amendments remove this uncertainty by expanding the scope of the SPA to define a "resident domestic corporation" to include all New Jersey corporations. However, those corporations not previously subject to the SPA (because they do not have either their principal executive offices or "significant business operations" in New Jersey) will be able to opt out of the SPA by amending their bylaws within 90 days of the date of the signing of the amendments or June 30, 2013.

The amendments also make it easier for corporations to exempt board-approved transactions from the scope of the SPA. The SPA prohibits a "resident domestic corporation" from engaging in business combinations with a shareholder that beneficially owns 10 percent or more of the resident domestic corporation's outstanding voting stock ("interested shareholder") for a period of five years from the date the interested shareholder crossed that 10 percent ownership threshold (the "stock acquisition date") unless that business combination was approved by the resident domestic corporation's board of directors before that interested shareholder's stock acquisition date. This provision had proved difficult to navigate because a business combination often would not have been contemplated at the time the stock was acquired by an "interested shareholder" and yet may be considered years later.

Under the amended SPA, a resident domestic corporation may engage in a business combination if the original stock acquisition that made the person an "interested shareholder" (the purchase that brought the shareholder over 10 percent) was approved by the board and the subsequent business combination is approved by (1) the board (or a committee thereof) consisting solely of persons who are not employees, officers, directors, shareholders, affiliates, or associates of that interested shareholder and (2) the affirmative vote of the holders of a majority of the voting stock not beneficially owned by such interested shareholder at a meeting called for such purpose.

Finally, the amendments provide that a beneficial holder of 5 percent or more of the voting power of the outstanding voting stock of the resident domestic corporation 90 days after the effective date of the amended SPA is exempt from the amended SPA if the resident domestic corporation is newly covered—that is, it did not have its principal executive offices or significant business operations located in New Jersey as of the effective date. The effective date is 90 days following enactment. Thus, the amendments exempt

5 percent shareholders who are such 180 days after enactment. The intent of this amendment is to "grandfather" 5 percent shareholders newly subject to the SPA. These holders would be required to report their holdings under the Securities Exchange Act of 1934 by virtue of thier 5 percent ownership and such shareholders would not have expected the SPA to apply to them.

Dissenters' Rights as Sole Remedy

The new statute amends N.J.S.A. § 14A:11-1 to provide that, if a shareholder is entitled to dissent from a corporate action (typically a merger or other acquisition transaction), then that shareholder is prohibited from challenging such corporate action unless the corporate action in question was (1) not effectuated in accordance with the applicable provisions under the NJBCA or the corporation's certificate of incorporation or (2) procured as a result of fraud, material misrepresentation, or other deceptive means. This amendment reflects the belief that dissenters' rights are an adequate protection for shareholders who believe they are not being paid fair value for their shares.

Remote Participation in Shareholders' Meetings

The new statute amends N.J.S.A. § 14A:5-1 to expressly permit shareholders to participate in a shareholders' meeting by means of remote communication to the extent authorized by the corporation's board of directors. This amendment is designed to reflect the fact that much of modern-day communication takes place electronically. Because of our rapidly changing system of communication, the commission, in drafting the legislation, declined to precisely define what constitutes remote communication. Accordingly, participation by remote communication will be subject to guidelines and procedures adopted by the board, provided that each shareholder can see and hear the proceedings contemporaneously and can vote and participate in the meeting.

CLIENT MEMOS

A summary of recent memoranda that law firms have provided to their clients and other interested persons concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of the listed memoranda should contact the firms directly.

Baker & Hostetler LLP
Denver, CO (303-861-0600)

SEC Staff Advises SOX 402 Is No Bar to Proposed Compensation Plan Incorporating Loans to Officers From Independent Lender (March 28, 2013)

A discussion of a SEC no-action letter confirming that an issuer's directors and executive officers may participate in an equity-based incentive compensation program offered by a financial services firm, RingsEnd Partners, LLC, without it being deemed to be extending credit or arranging the extension of credit for purposes of Section 402 of the Sarbanes-Oxley Act.

SEC Releases National Examination Program Priorities for 2013

A discussion of the publication of the SEC Office of Compliance Inspections and Examinations' examination priorities for 2013, including its four program areas: (1) investment advisers and investment companies; (2) broker-dealers; (3) clearing and transfer agents; and (4) market oversight.

Dorsey & Whitney LLP
Minneapolis, MN (612-340-2600)

Delaware Court Authorizes Seizure of Chinese Company's Assets in Books and Records Case (April 10, 2013)

A discussion of a Delaware Court of Chancery decision, *Deutsch v. ZST Digital Networks, Inc.*, holding a Chinese company in contempt of court and granting the US shareholder the right to put his shares back to the company at a price based on book value derived from its SEC financial report for failing to produce corporate books and records pursuant to Section 220 of the Delaware General Corporation Law and appointing a receiver.

Goodwin Procter LLP
Boston, MA (617-570-1000)

Using the Web to Match Private Companies and Potential Investors: SEC No Action Letters Open a Door, but Questions Remain (April 2, 2013)

A discussion of SEC no-action letters in which the SEC staff indicated they would not take action against the operators of the FundersClub website and AngelList website for failing to register as a broker-dealer under the Securities Exchange Act of 1934. The memorandum indicates that the letters are based upon a number if representations that it may be difficult to apply in practice.

Kirkland & Ellis LLP
Chicago, IL (312-862-2000)

Setting the Record (Date) Straight (April 17, 2013)

A discussion of how the record date, often thought of as merely mechanical, can be used tactically and have strategic implications on the prospects for a deal's success.

Latham & Watkins LLP
Los Angeles, CA (202-637-2200)

Encouraging Internal Reporting, and Its Limits (April 26, 2013)

A discussion of how companies can deal with whistleblower risks while avoiding actions that could be reasonably interpreted by the SEC as attempting to obstruct the SEC's whistleblower program, or as illegally retaliating against whistleblowers.

The DOJ's Case Against Standard & Poor's and the Continued Rise of FIRREA as a Tool for Government Enforcement (April 15, 2013)

A discussion of the Department of Justice's civil action against S&P Financial Services LLC and its parent McGraw-Hill relating to S&P's rating of collateralized debt obligations during the onset of the financial crisis. Somewhat overlooked has been the DOJ's use of the Financial Institutions Reform, Recovery and Enforcement Act of 1989. The primary advantages of this Act are a longer statute of limitations, a lower burden of proof and the prospect of significant monetary penalties.

Paul, Weiss, Rifkind, Wharton & Garrison LLP New York, NY (212-373-3000)

The JOBS Act: One Year Later (April 15, 2013)

A discussion of the principal aspects of the JOBS Act, as qualified by SEC guidance.

Schulte Roth & Zabel LLP New York, NY (212-756-2000)

SEC Focuses on Broker-Dealer Registration Issues Facing Private Fund Managers (April 9, 2013)

A discussion of SEC actions that have made broker-dealer registration an area of focus for private fund managers. In March, the SEC filed and settled charges against a private fund manager, one of its senior executives and an external marketing consultant regarding the consultant's failure to register as a broker-dealer, *In the Matter of Ranieri Partners LLC and Donald W. Phillips*, Release No. 34-69091. In April, the Chief Counsel of the Division of Trading and Marketing indicated his views (posted on the SEC website) concerning broker-dealer registration.

Skadden, Arps, Slate, Meagher & Flom LLP New York, NY (212-735-3000)

Getting Back to Basics with Rule 10b5-1 Trading Plans

A discussion of the concerns that have been raised with respect to plans entered into to take advantage of the affirmative defense provided by Rule 10b5-1 under the Securities Exchange Act of 1934 and a recitation of best practices and recommendations for such plans.

Weil Gotshal & Manges, LLP New York, NY (213-310-8000)

M&A Representations and Warranties Insurance: What Every Buyer and Seller Needs to Know (April 15, 2013)

A discussion of how reps and warranties insurance can be used in winning bids and finding means to close deals in today's challenging environment.

A New Playbook: Part 3—Global Securities Enforcement Activity Stepping Up to Meet New Market Challenges (April 2, 2012)

A discussion of the marked increase in global enforcement activities by regulators in the United Kingdom, Canada, and the European Union, which are attempts to give teeth to the global financial reforms each jurisdiction felt necessary to adopt to potentially prevent a repeat of the financial crisis.

INSIGHTS

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