// INSIGHTS

THE CORPORATE & SECURITIES LAW ADVISOR

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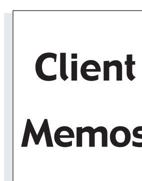

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SECURITIES ENFORCEMENT

2013 Year-End Securities Enforcement Update

The SEC continued its aggressive enforcement program in 2013. It saw not only changes in leadership, but also revision to its settlement policies to require admissions in certain cases. Expectations for 2014 include ramping up of the new accounting fraud task force, continued actions against investment advisers, and brokers and more admissions of liability.

By Marc J. Fagel

2013 proved to be a year of major change for SEC enforcement. Chair Mary Jo White came on board in April 2013, and shortly thereafter named Andrew Ceresney and George Canellos as Co-Directors of the Division of Enforcement. All three are former criminal prosecutors—Chair White served as United States Attorney in Manhattan under President Clinton, and both Ceresney and Canellos were Assistant U.S. Attorneys in her office—and all immediately took steps to embrace an aggressive enforcement program, both in terms of policy and public pronouncements. (Canellos announced his departure from the agency at the beginning of 2014, leaving Ceresney as sole Director.)

The year also has seen a significant number of new appointments at senior levels of the agency. The Chicago, San Francisco, Boston, Denver and Salt Lake City Regional Offices all have new regional directors, over half of whom similarly have experience as federal criminal prosecutors. In addition, new leaders were appointed to several of the Enforcement Division's specialized units.

With so many senior-level changes, it is little surprise that we have seen shifts not just in enforcement policy and priorities, but also in the handling of ongoing investigations. Anecdotally, there is talk in the securities enforcement bar about long-running investigations that were heading for settlement or termination being revisited by the staff; a tentative settlement with the staff appeared to have been scuttled and new, harsher settlement terms proposed (including an admission of liability under the SEC's new policy of demanding admissions in certain cases).

Recognizing that demanding admissions (and tougher sanctions generally) may lead more defendants to take cases to trial, Chair White and others at the agency have embraced a larger litigation docket. In a November 2013 speech, Chair White emphasized the SEC's willingness to try more cases, hailing the importance of trials in fostering legal developments and creating public accountability. That said, the agency's trial record over the past six months has been a mixed bag.

In terms of which cases will draw the attention of an energized Enforcement Division, it is still too soon to tell. 2013 enforcement actions remained consistent with recent years, with a significant number of cases involving investment advisers, fund managers and brokers, and a seemingly endless flow of insider trading cases. The SEC filed a number of cases arising out of the financial crisis, perhaps signaling that the end of the pipeline is approaching. And the Division appears poised to refocus its attention on financial reporting by public companies, an area that continued to see a

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marked decline in enforcement actions, with few meaningful new cases filed in recent months (and almost all of those involving Chinese issuers).

2013 Enforcement Trends: Statistical Overview

While the SEC is taking (and certainly talking) a tougher enforcement approach, the actual number of new cases filed this year showed a noticeable decline. The SEC brought 686 new cases in the fiscal year ended September 30, 2013, down seven percent from last year.[1] After excluding the 132 delinquent filing cases (which actually constituted the highest proportion of the overall enforcement docket since the agency began tracking them), FY2013 turned out to be the slowest year for new cases since 2006.

In addition, according to data released by the SEC to the *Wall Street Journal*, the number of new inquiries opened by the Enforcement Division is also in decline, though the Division attributed some of this to improved triage of incoming tips and complaints.[2] One growth area for the Division was the number of formal orders, which rose 20 percent over 2012.[3] This suggests a continuing trend towards investigations becoming formal (and thus allowing the staff to issue subpoenas compelling witnesses to testify and produce records) on a more routine basis, instigated by the SEC's policy change several years ago delegating formal order authority to senior Enforcement officials. While the increase in formal orders may lead to enhanced discovery burdens for companies and individuals, the issuance of a formal order is arguably no longer symptomatic of an investigation becoming somehow more serious in the eyes of the SEC, but rather just a routine part of any investigative inquiry by the staff.

More telling than the overall number of new cases, however, is how those actions were allocated across subject matter areas. In this regard, the Enforcement program was relatively unchanged from the past few years, with the bulk of cases coming in the investment adviser/investment company and broker-dealer space, while the number of financial fraud/issuer disclosure cases (as well as FCPA matters) continued to decline. Indeed, the SEC filed a strikingly low 68 public company reporting cases, and a mere 5 new FCPA cases. Combined, these cases represented only 13 percent of the enforcement caseload (excluding delinquent filings matters), as compared to the high of 36 percent in 2007. At the same time, cases involving brokers or advisers represented over 47 percent of the docket (versus 28 percent in 2007). Meanwhile, insider trading remains relatively consistent, comprising about eight percent of new enforcement filings in 2013.

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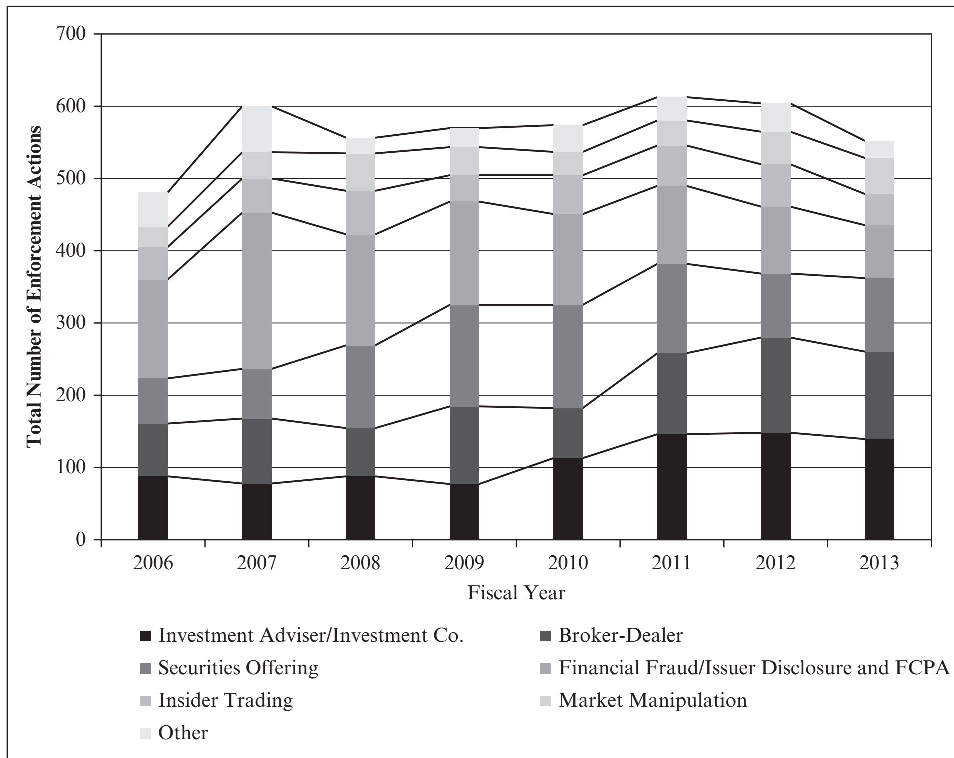
Figure 1: Enforcement Actions Filed by Fiscal Year, 2006–2013[4]



The Return of Financial Fraud (Investigations)

The SEC announced the formation of a Financial Reporting and Audit Task Force in July 2013.[5] The Task Force intends to use qualitative and quantitative analyses of public filings to identify indicia of potential accounting irregularities and other signifiers of fraud. For example, the SEC may compare discretionary accruals reported by peer companies and target outliers to determine whether improper earnings management is occurring. Obviously, given the typical length of a public company reporting investigation, it will be some time before we see whether this initiative is successful in proactively ferreting out financial fraud cases.

In light of the continued decline in the number of SEC financial fraud cases illustrated above, it is an open question whether this trend reflects an absence of improprieties, or simply the agency's lack of focus on the area. While the Division has reallocated significant investigative resources to financial crisis-related investigations, and to its enhanced focus on investment adviser cases, it does not necessarily mean that the agency is "missing" a groundswell of fraudulent reporting—the decline in these cases may very well be the result of improved internal controls and reporting quality post-Sarbanes-Oxley, or market trends diminishing the incentives or opportunities to commit financial fraud (such as a smaller IPO pipeline). Nonetheless, we anticipate that the SEC's public proclamations about enhancing its public company presence, and the freeing up of resources as financial crisis investigations wind down, will lead to the opening of significant financial reporting investigations this year based simply on anomalous metrics in corporate financial statements. A rising number of investigations in this realm is likely to be further exacerbated by the growing

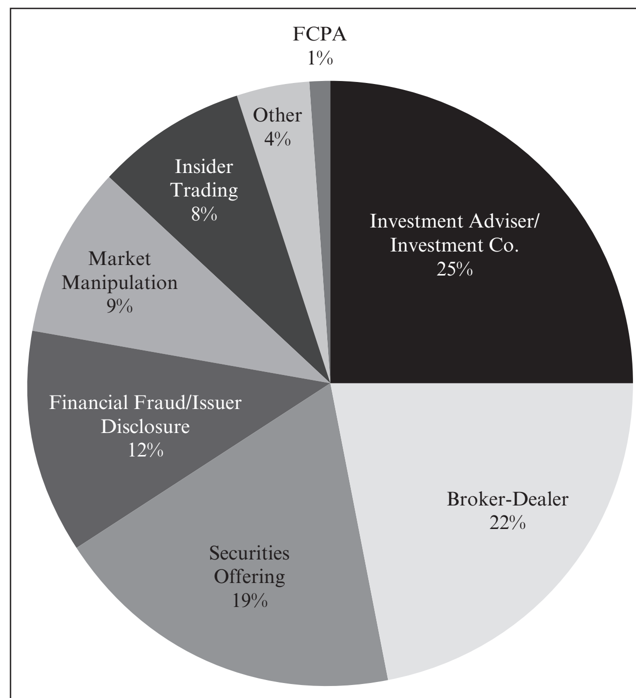
visibility of the SEC's whistleblower program, as discussed below.

The SEC Begins Requiring Party Admissions

After growing judicial and public criticism of the SEC's longstanding policy of allowing parties to settle enforcement cases without admitting or denying the allegations, the SEC announced a new policy in June 2013 requiring party admissions as a condition of settlement in certain cases. While the agency emphasized that most cases would continue to be settled with parties neither admitting nor denying the SEC's allegations, the SEC would break from this practice in cases which involved "egregious intentional misconduct," where the misconduct "harmed large numbers of investors," or where the defendant obstructed the investigation.[6] Chair White reaffirmed the policy in her first public statement of 2014, explaining, "What we are focused on is the enhanced public accountability and the admission of the conduct, the wrongdoing… An apology is easy. We want you to admit what you did."[7]

In the intervening months since announcing the policy, the SEC has only reached two settlements that required admissions. First, in August, the SEC announced a settlement with hedge fund adviser Harbinger Capital Partners and its principal Philip Falcone, in which the defendants admitted to a statement of facts concluding that they acted "recklessly," that Falcone "improperly borrowed" funds from a fund to pay personal tax obligations, and that they selectively agreed to redemption requests by favored customers.[8] The settlement further provided for the payment of $18 million in penalties and disgorgement, as well as a five-year industry bar for Falcone. Notably, despite early assurances that the SEC would not be applying the new policy to cases already in settlement talks,[9] news reports suggest that a tentative agreement (without admissions) had

Figure 2: Breakdown of Enforcement Cases Filed in FY 2013[10]



already been in the works, but was viewed by the Commission as too lax.[11]

More parties will be incentivized to take their chances at trial.

The second settlement under the new policy came a month later, when the SEC settled with JPMorgan Chase over the bank's multi-billion dollar "London Whale" trading loss.[12] As part of the settlement, JPMorgan admitted that the bank misstated financial results, lacked effective internal controls, and misled senior management.[13] A month later, the Commodity Futures Trading Commission announced a settlement with JPMorgan Chase Bank in which the regulator appeared to follow the SEC's lead and required admissions that JPMorgan traders acted recklessly. However, JPMorgan "neither admitted nor denied the CFTC's legal conclusion that there was a violation" of the law.[14] It is unclear to date whether the CFTC will adopt the SEC's admissions policy more broadly or how often the regulator will require admissions as part of a settlement.

Given the paucity of SEC settlements so far including party admissions, it is still too soon to tell how often the agency will invoke the policy, or what fact scenarios are likely to trigger an admission demand by the Enforcement Division. Most practitioners agree that admissions are most likely to be found in high-visibility, publicly scrutinized matters, but the SEC brought a number of high profile cases in recent months (including several stemming from the financial crisis) which continued to be settled on a neither-admit-nor-deny basis. This will be a closely watched area in the months ahead.

The SEC's Mixed Record at Trial

One clear implication of the SEC's move towards requiring some settling parties to admit misconduct, as well as the general trend towards tougher settlements, is that more parties will be incentivized to take their chances at trial. Indeed, the SEC has recognized this likelihood and publicly embraced it. In a November 2013 speech entitled "The Importance of Trials to the Law and Public Accountability," Chair White stated:

> [I]n this age of diminishing trials, we at the SEC may be about to reverse the trend a bit… If, in fact, a result of our change in settlement policy results in more trials, one clear winner will be the administration of justice, which will always fare best in the open for the public to see and to take stock of what a defendant did and what its government is doing.[15]

She called the SEC's 80 percent success rate in trials over the past three years "impressive," especially given the limited trial tools available to the SEC relative to the criminal authorities.

The latter half of 2013 saw a number of significant trial setbacks for the SEC.

Notwithstanding this show of confidence, the latter half of 2013 saw a number of significant trial setbacks for the SEC. The agency got off to a solid start in August, when a federal jury found former Goldman Sachs trader Fabrice Tourre liable on six of seven counts in the closely watched case involving the sale of a collateralized debt obligation.[16] But any celebrating at the SEC was presumably cut short two months later, when, on October 16, a jury found against the agency on all counts in the highly publicized insider trading trial of Mark Cuban.[17] The case may not offer any broader lessons on the SEC's insider trading strategy—the SEC tried the case without its key witness appearing to testify, against a celebrity before a home-town jury, on a legal theory shaky enough that the trial judge had initially dismissed it on the pleadings.[18] But a clear-cut loss in such

a high-profile matter may embolden more defendants to roll the dice and litigate against the SEC.

The Cuban trial was followed by back-to-back defeats in financial fraud cases. In early December, in a case alleging that website design company NIC, Inc. had failed to disclose $1.18 million in perquisites paid to its CEO, a Kansas jury found CFO Stephen Kovzan not liable on all counts.[19] And two weeks later, in a case alleging that water purification company Basin Water Inc. had engaged in sham transactions to boost reported revenue, the court dismissed all claims against the CEO and CFO following an eight-day bench trial. The court held that the SEC had failed to present evidence that the defendants had misled anybody, or that they had acted with scienter.[20] (And, in the first week of 2014, a federal trial judge in Georgia handed another defeat to the SEC in an insider trading bench trial.[21])

It seems unlikely that these recent losses will lead the SEC to soften its settlement posture or refrain from bringing difficult cases. However, the recent trial record may result in the SEC filing more cases as administrative proceedings before an administrative law judge, where the Enforcement Division is perceived to face an easier battle. Dodd-Frank includes provisions allowing the SEC to secure essentially the same relief in an administrative proceeding that it can obtain in a civil court case.[22] The implications of more administrative proceedings—which permit limited (if any) discovery, no jury, a much shorter path to trial, and a more challenging appeal path for respondents—may be significant for parties in the SEC's sights.

The Continuing Ascendance of Whistleblowers

The SEC's whistleblower program, created pursuant to Dodd-Frank and in effect for just over two years, continued to make headlines. After a seemingly slow start, with just two relatively small awards handed out to whistleblowers, the Commission announced on October 1, 2013, that a confidential whistleblower was designated to receive over $14 million after providing tips that helped the SEC quickly investigate and file an enforcement action.[23] Because of the requirement that the SEC maintain the confidentiality of the whistleblower's identity, the agency's announcement provided minimal insight into the underlying case, though it appears likely to have been (like the two earlier cases) a fraud in connection with a securities offering. As whistleblowers are eligible to receive between 10 to 30 percent of the money collected from a successful case, this particular case may involve over $140 million.

Less than a month later, the SEC announced a fourth case in which a whistleblower award had been authorized, this time for $150,000.[24] Once again, the facts were scant, but it appeared to be yet another offering fraud.

In November, the SEC released its second annual report on the Dodd-Frank Whistleblower Program.[25] The report showed a slight increase in the overall number of whistleblower tips, from 3,001 in the 2012 fiscal year to 3,238 in 2013. For the second straight year, "Corporate Disclosures and Financials" was the single largest category of complaints (followed closely by offering fraud and market manipulation claims). Nonetheless, we have yet to see whether the program will lead to enforcement actions involving public companies, or regulated entities such as hedge funds, mutual funds or brokers. Of course, such cases typically take longer than offering frauds to investigate, so there could be cases on the way. And a $14 million payout undoubtedly will generate attention among potential whistleblowers (including corporate insiders who might otherwise be reluctant to come forward), not to mention the plaintiffs' bar.

First Deferred Prosecution Agreement with an Individual

The Enforcement Division has been gradually rolling out its cooperation tools since then-Director Robert Khuzami first began adapting

criminal tools for the SEC's civil program several years ago. The program took another step forward in November 2013, when the SEC entered into its first deferred prosecution agreement (DPA) with an individual. (The SEC has previously reported several DPAs with companies.) The SEC announced it had entered an agreement with Scott Herckis, a former hedge fund administrator whose "voluntary and significant cooperation" enabled the SEC to file an emergency enforcement action alleging that the Heppelwhite Fund's founder and manager had misappropriated more than $1.5 million from the hedge fund and overstated its performance to investors.[26] As a part of the DPA, Herckis admitted that he aided and abetted violations of the securities laws and, as a result, he cannot serve as a fund administrator or associate with any broker, dealer, investment adviser, or registered investment company for a period of five years, and must disgorge approximately $50,000 in fees that he received for serving as the fund administrator.

Given that Director Ceresney, like Khuzami, has background as a criminal prosecutor (as does Chair White), we anticipate that the SEC's use of various quasi-criminal cooperation agreements will continue to expand under the new administration.

JOBS Act Rulemaking

Finally, one additional area to watch in the months ahead will be investigations arising out of securities offerings taking advantage of the 2012 Jumpstart Our Business Startups Act (JOBS Act). In September 2013, certain key provisions of the JOBS Act went into effect, including broadened availability of general solicitations for companies seeking access to the capital markets. The SEC finalized rules addressing reasonable steps issuers must take to ensure that all investors qualify as accredited investors, as well as governing the involvement of certain "bad actors" associated with issuers whose regulatory or criminal history either precludes the company from using general solicitations or requires disclosure to investors.[27] The SEC also proposed rules calling for additional disclosure requirements for companies using general solicitation, as well as initial rule proposals for companies seeking to raise up to $1 million using crowdfunding platforms.[28]

While the JOBS Act provisions are too new to gauge how widely they will be used, the SEC wasted no time in signaling that they will be vigilant in policing potential abuses. In September, shortly before the general solicitation rules became effective, Director Ceresney stated, "We're focused on making sure that we're poised to address any fraud that may occur" under the Act.[29] And in an October speech, Chair White emphasized:

> Contemporaneously with lifting the ban on general solicitation, the SEC staff has undertaken an interdivisional effort designed to monitor how the ability to advertise and "generally solicit" is actually occurring—how companies and hedge funds are taking advantage of the new rule. It includes assessing the impact of general solicitation on the market for private securities and—importantly—on identifying fraud if it is occurring. If it is, we can seek to stop those in their tracks, who would inappropriately take advantage of this new more open environment.[30]

As issuers and funds begin testing the waters of the JOBS Act, we expect the Enforcement Division to be proactive in opening investigations and, down the road, bringing enforcement actions designed to deter abuse of the new rules.

Expectations for 2014

The SEC begins 2014 in a dramatically different place than it began 2013. A new Chair (plus two other new Commissioners), a new Enforcement Director, the majority of regional offices, and

Enforcement units under new leadership—with so many new faces presumably eager to put their imprint on the Enforcement program, it would be a mistake to take too much comfort in the apparent slowdown in new cases last year. Here, then, a few final words on the year ahead:

- The ramping up of the Enforcement Division's accounting fraud task force, coupled with continuing pressure from whistleblowers and the freeing up of resources as the remaining financial crisis investigations wind down, will lead to an expanding number of public company financial reporting investigations. However, with recent statistics suggesting a continuing absence of major fraud on this front, companies could wind up expending significant resources on internal investigations that do not result in actual enforcement actions (or that uncover lesser books and records or internal controls cases that create headaches for companies but do not give the Division major trophies for its efforts).

- The large number of enforcement actions brought against investment advisers and brokers shows no signs of abating. To the contrary, as the SEC's examination program expands its review of hedge funds and private equity funds newly-registered under Dodd-Frank, the enforcement focus on advisers is likely to continue to dominate the docket.

- The SEC will continue to feel pressure to seek more admissions of liability (and to ratchet up settlement terms generally), inevitably leading more defendants to opt to litigate. However, the difficulty in winning complex securities fraud trials, as well as the resource cost to the Enforcement Division of litigating more cases (at the expense of opening new investigations) may ultimately impose a check on the SEC's ability to expand its aggressive settlement strategy.

Notes

1. Year-by-Year SEC Enforcement Statistics, available at *http://www.sec.gov/news/newsroom/images/enfstats.pdf.*
2. Jean Eaglesham, SEC Brings Fewer Enforcement Actions, Slows Early-Stage Probes, Wall St. J., Dec. 17, 2013.
3. SEC Press Release, *SEC Announces Enforcement Results for FY 2013*, available at *http://www.sec.gov/servlet/Satellite/News/PressRelease/Detail/PressRelease/1370540503617.*
4. Note: Data used in chart exclude Delinquent Filings cases.
5. For a more in-depth discussion, *see* Marc Fagel & Leslie Wulff, *Public Companies: Back in the SEC Hot Seat?* Wall St. Lawyer (Sept. 2013), available at *http://www.gibsondunn.com/publications/Documents/FagelWulff-PublicCompanies.pdf.*
6. For a more expansive analysis of the policy change and its implications, *see* Marc Fagel, *The SEC's Troubling New Policy Requiring Admissions*, Bloomberg BNA Securities Regulation & Law Report (June 24, 2013), available at *http://www.gibsondunn.com/publications/Documents/Fagel-SECs-Troubling-New-Policy-Requiring-Admissions.pdf.*
7. Andrew Tangel and Jim Puzzanghera, *SEC's Mary Jo White Wants Companies To Fess Up*, LA Times (Jan. 1, 2014).
8. SEC Press Release, *Philip Falcone and Harbinger Capital Agree to Settlement* (Aug. 19, 2013), available at *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539780222.*
9. Dave Michaels, *SEC Says It Will Seek Admission of Wrongdoing More Often*, Bloomberg Businessweek (June 19, 2013).
10. Note: Data used in chart exclude Delinquent Filings cases.
11. Alexandra Stevenson, An Admission of Wrongdoing As S.E.C. Takes A Harder Line, N.Y. Times (August 20, 2013).
12. SEC Press Release, *JPMorgan Chase Agrees to Pay $200 Million and Admits Wrongdoing to Settle SEC Charges* (Sept. 19, 2013), available at *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539819965.*
13. The SEC also filed a litigated case against two JP Morgan traders in connection with the losses. SEC Press Release, *SEC Charges Two J.P. Morgan Traders with Fraudulently Overvaluing Investments to Conceal Losses* (Aug. 14, 2013), available at *www.sec.gov/News/PressRelease/Detail/PressRelease/1370539776091.* The two were subsequently indicted by the U.S. Attorney's Office in the Southern District of New York. Reed Albergotti, *Two Former J.P. Morgan Traders Indicted for 'London Whale' Trading Loss*, Wall St. J. (Sept. 16, 2013).
14. CFTC Press Release, CFTC Files and Settles Charges Against JPMorgan Chase Bank, N.A., for Violating Prohibition on Manipulative Conduct In Connection with "London Whale" Swaps Trades (October 19, 2013), available at *http://www.cftc.gov/PressRoom/PressReleases/pr6737-13;* Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing

Remedial Sanctions (Oct. 16, 2013), available at *http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfjpmorganorder101613.pdf.*

15. SEC Speech, Chair Mary Jo White, *The Importance of Trials to the Law and Public Accountability* (Nov. 14, 2013), available at *http://www.sec.gov/News/Speech/Detail/Speech/1370540374908.*

16. Susanne Craig and Ben Protess, *Former Trader Is Found Liable in Fraud Case*, NY Times (Aug. 1, 2013). Post-trial motions are pending, including the SEC's motion for more than $1 million in penalties, disgorgement, and interest.

17. Ben Protess and Lauren D'Avolio, *Jury Rules for Mark Cuban in Setback for S.E.C.*, NY Times (Oct. 16, 2013).

18. *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009), vacated and remanded, 2010 U.S. App. LEXIS 19563 (5th Cir. 2010).

19. Mark Davis, Jury Clears NIC Executive Stephen Kovzan After 18-Day Trial, Kansas City Star (Dec. 4, 2013).

20. Stephanie Russell-Kraft, SEC Loses Fraud Claims Against Water Purifier Co. Execs, Law360 (Dec. 12, 2013).

21. SEC V. Schvacho, 1:12-CV-2557-WSD (N.D. Ga. Jan. 7, 2014).

22. For example, Dodd-Frank allows the SEC to seek civil monetary penalties in an administrative cease and desist proceeding. Prior to 2010, with the exception of registered persons such as brokers and investment advisers, penalties could only be obtained in federal court.

23. SEC Press Release, *SEC Awards More than $14 Million to Whistleblower* (October 1, 2013), available at *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539854258; see also* Gregory Wallace, *Whistleblower Awarded $14 million—SEC's Largest Ever*, CNN Money (October 1, 2013), available at *http://money.cnn.com/2013/10/01/news/sec-whistleblower/.*

24. SEC Press Release, *SEC Rewards Whistleblower With $150,000 Payout* (Oct. 30, 2013), available at *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540158194.*

25. 2013 Annual Report to Congress on the Dodd-Frank Whistleblower Program, available at *http://www.sec.gov/about/offices/owb/annual-report-2013.pdf.*

26. SEC Press Release, *SEC Announces First Deferred Prosecution Agreement with Individual* (November 12, 2013), available at *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540345373.*

27. SEC Press Release, SEC Approves JOBS Act Requirement to Lift General Solicitations Ban, available at *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539707782.*

28. *See* Gibson Dunn, SEC Proposes Rules to Implement Crowdfunding Exemption: What Factors Will Affect Its Success?, available at *http://www.gibsondunn.com/publications/Pages/SEC-Proposes-Rules-to-Implement-Crowdfunding-Exemption-What-Factors-Will-Affect-Its-Success.aspx.*

29. Emily Chasan, *SEC's Enforcement Unit Changes Tack*, Wall. St. J. (Sept. 11, 2013).

30. SEC Speech, Chair Mary Jo White, *Hedge Funds—A New Era of Transparency and Openness* (Oct. 18, 2013), available at *http://www.sec.gov/News/Speech/Detail/Speech/1370539892574.*

SECURITIES DISCLOSURE

SEC Commissioner Suggests Disclosure Reform

At the 2nd Annual Institute for Corporate Counsel in New York, NY, on December 6, 2013, SEC Commissioner Gallagher spoke about the need for disclosure reform. In the excerpt of his remarks that appears below, he identified key issues on which to focus, including layering of disclosure, streamlining 8-K disclosure and proxy statements, and reducing redundancy in filings. In addition, Commissioner Gallagher provided the standard disclaimer that his remarks were his own and did not necessarily reflect the views of the Commission or his fellow Commissioners.

By SEC Commissioner Daniel M. Gallagher

* * *

The SEC is first and foremost a disclosure agency. With respect to corporate disclosure, our bedrock premise is that public companies should be required to disclose publicly and in a timely fashion the information a person would need in order to make a rational and informed investment decision. On that foundation, our securities laws and the rules by which we administer them have been built.

And, by now, it's become quite an elaborate edifice. We can't foster capital formation in fair and efficient capital markets through private investment unless the critically important information about public companies is routinely and reliably made available to investors. We need to take seriously however, the question whether there can be too much disclosure. Justice Louis Brandeis famously stated that sunshine is the best disinfectant.[1] As my friend and former colleague Troy Paredes pointed out some years ago, though, it is possible to create conditions in which investors are "blinded by the light."[2] That is to say that from an investor's standpoint, excessive illumination by *too much* disclosure can have the same effect as obfuscation—it becomes difficult or impossible to discern what *really* matters.

* * *

I often hear from investors that disclosure documents are lengthy, turgid, and internally repetitive. In their present state, they are, in other words, not efficient mechanisms for transmitting the most critically important information to investors—especially not to ordinary, individual investors. They are not the sort of documents most people are likely to read, even if doing so is in their financial self-interest. For that reason, today's disclosure documents raise questions of what their purpose actually is and whether they are meeting it.

It is possible to create conditions in which investors are "blinded by the light."

Here, it seems to me, we must acknowledge a dilemma. The good we have done in shaping a detailed disclosure regime to assist and protect investors has, in fact, led to some potential but, I submit, avoidable harm. Corporate disclosure filings didn't naturally evolve into their present convoluted state. Rather, the rules that require periodic corporate reporting and the detailed instructions that implement them, as well as the staff interpretations and guidance that supplement those rules and instructions, have been the principal forces shaping modern corporate disclosure filings.

But other, external forces have played a role as well, most notably the risk of litigation—much of it absolutely frivolous and solely for the benefit of plaintiffs' lawyers, not investors. The failure to disclose anticipatorily is often enough to prompt a shareholder lawsuit based on the assertion of a material omission. It is rational, in other words, for those who prepare corporate disclosure documents, to prepare for the worst, thus perversely prioritizing the need to avoid the penalties that accompany claims of insufficient disclosure, it seems, over rendering the required disclosure in a manner intelligible to the average investor. In sum, the Commission has cause for self-examination where the question of the utility and lucidity of corporate disclosures arises. And in that process we cannot ignore the impact of excessive and frivolous litigation.

* * *

It is rational, for those who prepare corporate disclosure documents, to prepare for the worst.

Here, we come to a fundamental fork in the road. Should we jump in with both feet to begin a comprehensive review and possible overhaul of SEC-imposed disclosure requirements under the securities laws, or should we take a more targeted approach, favoring smaller steps towards our ultimate reforming goals? Ordinarily, I would argue for a comprehensive approach to the solution of almost any problem. Where securities regulation is concerned, we often find that actions we take in one area have unforeseen and unintended effects in others.

However, disclosure reform may be the exception. Although I've publicly called on multiple occasions for a holistic, comprehensive review of market structure issues, I believe, on balance, that with disclosure reform it is better to start addressing discrete issues now rather than risk spending years preparing an offensive so massive that it may never be launched. On this point, I was very pleased to see the recent remarks by Chair White.[3] I hope and expect that, under her stewardship, the Commission will begin to make real headway on disclosure reform. I am genuinely enthusiastic about the prospect of solving some of the real-world problems that have become obvious to all who focus on this area. In short, it's time to get practical and time to get started. *(Editor's note: On December 20, 2013, the SEC issued a staff report to Congress on its disclosure rules for public companies mandated by the Jumpstart Our Business Startups Act. The staff recommended development of a plan to systematically review the Commission's disclosure requirements. It identified two alternative frameworks for structuring such a review, a comprehensive approach and a targeted approach, and recommended a comprehensive review.)*

* * *

Let me give you a few examples of what I believe—based in part on what I'm hearing from market participants—might be good issues on which to focus:

With disclosure reform it is better to start addressing discrete issues now.

The first would be "layering disclosure." The idea of layered disclosure is based on the recognition that some information is inherently material, for instance a company's financial statements. That information should be a focus of any disclosure document. On the other hand, some of the information that must be disclosed is not inherently material, for example the pay-ratio calculation required pursuant to Dodd-Frank section 953(b). Information of that sort is not inherently important to an informed investment decision and should be reported elsewhere—in a separate section or different document. Aside

from the direct benefit to investors in having more readable documents, there are additional benefits to such an approach, such as enabling us to take a critical look at whether liability should attach to particular disclosures and omissions that are *not* inherently material and encouraging issuers to disclose additional information separately by relieving them of some potential non-fraud liability.

Second, we should also look at streamlining 8-K disclosure. Granted, Form 8-K is a document separate from a company's annual and quarterly reports; that's part of the point. Over the years, the categories of information required to be disclosed on Form 8-K have grown considerably. But should each such category of information require almost immediate disclosure on Form 8-K when a change occurs? Is it, for example, really necessary to require immediate disclosure of amended compensation plans of named executive officers, given that this would be reported in the company's upcoming proxy or 10-Q? There has, moreover, been a creeping incursion of financial reporting traditionally made in quarterly and annual reports into Form 8-K filings.[4] The gateway question, in looking at streamlining or curtailing the proliferation of 8-K filings, should be whether investors really need *all* of this welter of immediately updated information in order to know what is material about a company's current condition. So, while acknowledging that the specification of information reportable on Form 8-K implicitly *limits* the types of information that must be disclosed immediately, the question is whether all such categories are of equal importance.

Third, we should have a targeted effort to reduce redundancy in filings. Here, the objective would be to tell issuers, authoritatively and explicitly, where they *must* disclose and where, by contrast, they *need not* disclose particular types of information. This would enable those looking for that information—professional analysts and advisers in particular—either to find it or to identify its absence more easily, while reducing unnecessary repetition within corporate filings. Such authoritative guidance would have the direct effect of enabling corporate filers to eliminate redundancies in their disclosures—surely a service to investors—while significantly reducing the risk of frivolous litigation as a result. For example, we could reduce redundancies between the notes to a company's financial statements and its MD&A disclosure by requiring management only to discuss *material* information, rather than every aspect of a company's financial performance, in the MD&A section—perhaps also suggesting appropriate cross referencing to the financial statement notes.

Over the years, the categories of information required to be disclosed on Form 8-K have grown considerably.

Fourth and more specifically, it's high time that we gave priority attention to streamlining proxy statements. Proxies are the principal means by which public companies communicate with their shareholders with respect to matters of material importance. Their contents should, therefore, be as clear and concise as possible. Inundating investors with charts, tables and torrents of legalese increases the chance that they will miss the forest for the trees. So one potential reform would be to permit some of the tables, say those other than the summary compensation table, to be included in an appendix to the proxy. This would ameliorate the problem of Item 402 disclosure being too dense and unwieldy for most ordinary investors, yet still allow those interested to view the information. The basic corporate information required in annual proxies might also be a good area in which to test a more standardized, online disclosure system that could require one-time online disclosure of basic corporate information and mandate that such disclosure be updated as necessary, with changes tracked, rather than rotely repeated each year.

We should also focus on streamlining registration statements. One idea would be to permit forward incorporation by reference in Form S-1 registration statements. Forward incorporation by reference permits a registrant to automatically incorporate reports filed pursuant to the Exchange Act, such as Forms 10-K and 10-Q, subsequent to the effectiveness of the registration statement. Because this is not now permitted for Form S-1s, registrants must continue to update the S-1 filing after effectiveness either by supplements or post-effective amendments. That such forward incorporation is permitted for Form S-3 registration statements but not for Form S-1s may help explain why issuers and practitioners seem to prefer S-3s for follow-on offerings.

We should have a targeted effort to reduce redundancy in filings.

We should also consider increasing the reliability of SEC guidance by enhancing its *authority* by issuing significant guidance with the Commission's endorsement, rather than by the staff alone. While Commission consideration of draft guidance would take some additional time, there can be little question that an issuer and its advisors would feel more confident, including from a litigation standpoint, in following guidance issued under an explicit Commission *imprimatur*.

We need to renew our focus on the potential of technology to improve corporate disclosure. Here, we must acknowledge that our present corporate disclosure requirements are almost certainly not those we might have devised today in our technology-enabled environment. EDGAR is a simple example, because EDGAR filings are really just electronic shadows of the paper filings they replace. A disclosure system taking full account of the potential of technology might look dramatically different.[5] But our priority at present should be to begin moving in the right direction, rather than swing for the fences. I would therefore be remiss if I did not point to XBRL as an investor-empowering analytic tool. True, XBRL has its limitations. It is a rendering language that does not, in itself, change our system of disclosure, and it does not readily lend itself to describing the nuances of un-structured discussions in disclosure documents. What XBRL *does* do very effectively is ensure that information is disclosed and presented in a manner that promotes ease of analysis and comparison. So, it seems to me, we must recognize that XBRL was and is a major step forward and must fully realize its potential for improving investors' ability to analyze corporate disclosures. We must also acknowledge that we have not yet fully explored the potential technology holds for improving our present disclosure regime. That, too, is an inquiry that calls for your expert attention.

A disclosure system taking full account of the potential of technology might look dramatically different.

Finally, we should treat special, meaning politically-motivated, disclosures as the anomalies they are. We have no reason to expect that Congress will give up issuing specific disclosure requirements any time soon. Indeed, if the recent past suggests anything, it is that we should expect policymakers to continue their efforts to use the securities disclosure regime to further policy objectives fundamentally *un*related to providing investors with information that is material to their investment decisions. With that in mind, I can commend the thinking behind Form SD, despite its adoption as an adjunct to two rules driven wholly by social policy mandates.[6] At the same time, I worry that the existence of Form SD invites more politically-motivated Congressional intervention into our materiality-based disclosure regime. This is a bipartisan problem, something that the Commission must monitor continuously and resist consistently. The Commission should not be put in the position of seeming to pick and choose which disclosure mandates a majority

of Commissioners like. Today's proponents of a special disclosure should keep in mind that they might not be in the majority for the next one. As those of us who have been in Washington a long time know, what goes around, comes around!

* * *

I have no doubt that many of you could readily supplement, revise, or otherwise comment helpfully on this list. I very much hope you will engage in the discussion on disclosure reform. That is very important, because we need to hear directly from the people who are engaged hands-on each day in the business of ensuring that issuers meet their disclosure obligations. Where we see practical improvements we can make to assist ordinary individual investors in identifying and understanding what is truly material in a company's public disclosure documents, making those improvements should be an SEC priority. We should, moreover, resist successive rounds of concept releases and roundtables in areas where such specific problems and practical solutions have already become evident. The Commission should also reward with our priority attention staff initiatives that advance such practical improvements to our system of corporate disclosure.

* * *

Notes

1. Louis D. Brandeis, *Other People's Money* at 92 (1914).
2. Troy A. Paredes, "Blinded by the Light: Information Overload and Its Consequences for Securities Regulation," 81 Wash. U. L. Q. 417 (2003). Available at: *http://digitalcommons.law.wustl.edu/lawreview/vol81/iss2/7*.
3. M.J. White, "The Path Forward on Disclosure," speech to the National Association of Corporate Directors—Leadersip Conference 2013 (Oct. 15, 2013). Available at: *http://www.sec.gov/News/Speech/Detail/Speech/1370539878806*.
4. This is in considerable measure due to the enhanced requirements in Section 401(b) of the Sarbanes-Oxley Act.
5. Professor (and former SEC Commissioner) Joe Grundfest and former SEC Director of Corporation Finance Alan Beller made this point in their 2008 paper, "Reinventing the Securities Disclosure Regime: Online Questionnaires as Substitutes for Form-Based Filings," Rock Center for Corporate Governance, Stanford University, Working Paper Series No. 2 (Aug. 4, 2008). Available at: *http://ssrn.com/abstract=1235082*.
6. The Commission adopted Form SD (17 C.F.R. 249.448), in conjunction with adopting its rule to implement Section 1502 of the Dodd-Frank Act ("Conflict Minerals") (Rel. No. 34-67716 (Aug. 22, 2012)). That same day, the Commission also adopted a rule to implement Section 1504 ("Disclosure of Payments by Resource Extraction Issuers") of that Dodd-Frank Act, to which Form SD also would apply (Rel. No. 34-67717 (Aug. 22, 2012)). Both rules were subsequently challenged in court. The district court upheld the conflict minerals rule; its decision was appealed. The resource extraction rule was vacated and remanded to the Commission.

MERGERS AND ACQUISITIONS

Delaware Clamps Down on Disclosure-Based M&A Litigation

In just over a one-month span in 2013, three members of the Delaware Court of Chancery issued independent rulings decrying the rise in public company deal litigation and calling for reform. Each judge directed his criticism at early-stage, disclosure-only settlements that continue to line lawyers' pockets while offering little-to-no appreciable benefit to stockholders. Such criticism is not entirely unprecedented. However, once-isolated criticism is becoming more widespread, and the Court of Chancery recently has identified specific steps that might alter the incentives driving this trend.

By Peter L. Welsh and Gregory L. Demers

Since the mid-2000s, the Court of Chancery in Delaware has witnessed a surge in M&A litigation, and this past year was no exception. In the first three quarters of 2013, 98 percent of all deals valued at over $500 million resulted in litigation.[1] Given this trend, many stakeholders are now understandably resigned to the fact that deal litigation is a near certainty and view settlement as a cost of doing business. However, recent developments in the Court of Chancery provide Delaware corporations with reason for optimism that a "litigation tax" in every public company M&A transaction is not a foregone conclusion.

The dramatic rise in public company M&A litigation in the last decade has been largely attributable to pre-closing, disclosure-based lawsuits seeking "therapeutic" relief, *i.e.*, "enhanced disclosure." The driving force behind such lawsuits is the high likelihood of extracting a substantial nuisance fee from risk-averse defendants. Increasingly, however, members of the Court of Chancery are demonstrating a greater reluctance to encourage disclosure-only settlements. This trend is manifesting itself in a number of ways, including public reprimands, lower fee awards, and new efforts to prevent plaintiffs from forum-shopping. For example, shortly before year-end, Vice Chancellor Laster criticized a disclosure-only settlement in a stockholder lawsuit against Talbots Inc., stating that "[t]he social utility of cases like this continuing to be resolved in this way is dubious."[2] How these cases will be resolved in 2014 and beyond remains an open question, and it is one that could have a significant impact on public company deal litigation in the years ahead.

The Rise of Disclosure-Based Litigation

Since the mid-2000s, M&A litigation in public company merger transactions has spiked.[3] In 2007, slightly more than half of all transactions valued at over $500 million resulted in litigation; by 2009, that figure had surpassed 90 percent; and today it is approaching 100 percent.[4] These results are not limited to blue chip public company deals. In the past, only larger, more controversial transactions would draw significant stockholder litigation. However, in recent years, plaintiffs broadened their focus and began targeting small-cap and mid-cap companies as well.[5] It appears that any public deal—no matter how modest the transaction, how comprehensive the disclosures, or how fair the terms—is highly vulnerable to litigation. Very few of these cases are fully litigated;

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a substantial majority settle.[6] As a result, some practitioners now view settlement costs, and the inevitable plaintiff attorney's fee claim, as a "litigation tax"[7] attendant to any major transaction, and one that is virtually "inevitable."[8]

A primary factor, if not the primary factor, driving these numbers is the rise in disclosure-based litigation.[9] Settlement terms in M&A litigation have changed significantly over the last decade. Of deal-related stockholder suits filed in Delaware in 1999 and 2000, the majority of settlements involved monetary awards, and 10 percent were disclosure-only settlements, meaning that the only relief obtained consisted of additional disclosures in the target company's SEC filings.[10] Ten years later, those numbers have been turned on their head, with less than 10 percent of all settlements resulting in monetary awards and approximately 70 percent to 80 percent of all settlements resulting in only supplemental disclosures.[11]

It is no mystery why these numbers have shifted so dramatically. On the one hand, lawsuits seeking to enjoin a merger transaction for allegedly misleading disclosure represent a lucrative opportunity for the plaintiffs' bar. A 2012 study found that the median time between the filing of an M&A lawsuit and settlement was 44 days, and the median award of attorneys' fees was between $501,000 and $600,000.[12] Corporations are often under intense pressure to close the deal and avoid protracted litigation. A material misstatement or omission in the target's SEC filings is often argued by plaintiffs to be *per se* irreparable harm, and is claimed by plaintiffs to strongly support an injunction from the court halting the transaction until the disclosure violation is corrected.[13] As a result, this alignment of incentives has caused an explosion of lawsuits seeking "therapeutic" relief—and attorney's fees.

Although a few commentators and observers are supportive of the rise of disclosure-based litigation,[14] many others have decried this trend as an abuse of the judicial system, creating deadweight loss by offering no appreciable benefits to stockholders and serving only to compensate plaintiffs' counsel at the expense of corporate issuers and others.[15] And the Court of Chancery is increasingly clamping down. In a series of recent decisions, several members of the Court have made clear that they will more closely scrutinize the process by which litigants engage in a "kabuki dance" of hurried filings and orchestrated non-monetary settlements of M&A litigation.[16]

The Court of Chancery Weighs In

The first recent shot across the bow came in a March 2013 bench ruling by Chancellor Strine in *Transatlantic Holdings Inc. Shareholders Litigation*.[17] The case arose out of the sale of reinsurer Transatlantic Holdings to specialty insurer Alleghany Corporation. When the merger was announced, in typical fashion stockholders filed suit, asserting class and derivative claims against Transatlantic based on alleged breaches of fiduciary duty—despite the fact that 99.85 percent of voting shares were cast in support of the transaction.[18] The parties reached a settlement whereby Transatlantic would make supplemental disclosures in a proxy statement supplement, but stockholders would receive no other consideration in the settlement.[19]

On March 8, 2013, Chancellor Strine issued a ruling from the bench rejecting the negotiated settlement and leaving no doubt as to his position on makeweight disclosure litigation. The ruling denounced the proposed disclosures as containing only "some rote [facts] about insurance ratios" and "simply parroting, out of context" disclosures made in other cases. The Court concluded that plaintiffs' counsel had failed "to explain in any rational way why the disclosures that they had obtained were in any meaningful way of utility to someone voting on the merger."[20] The Court also expressed concern for the difficult bind that defendants find themselves in when faced with frivolous litigation that threatens to hold up a

major transaction: "I don't fault the defendants, who face an imponderable situation in which the cost of getting rid of non-meritorious claims, you know, on the merits exceeds settling by giving out information which can't—which doesn't possibly impair the vote."[21]

Transatlantic is notable for three reasons. First, it is an example of the quite rare case in which the Court of Chancery has flatly rejected a negotiated settlement between two parties represented by experienced counsel.[22] Second, beyond disapproving the settlement, Chancellor Strine took the unusual step of sympathizing with—lamenting even—the plight of corporate defendants that must pay nuisance fees to put a quick end to frivolous deal litigation. Third, perhaps as a result of this outspoken criticism by the Chancellor, the case garnered significant attention in the Delaware legal community and potentially supported a broader response from the Court to this growing problem.

Less than two weeks after *Transatlantic* was decided, Vice Chancellor Glasscock issued an opinion in another case involving a disclosure-only settlement. In *In re PAETEC Holding Corp.*,[23] the plaintiffs agreed to settle in exchange for additional disclosures in connection with the sale of the company and an agreement by defendants not to oppose a $500,000 fee request. Echoing the concerns expressed in *Transatlantic*, Vice Chancellor Glasscock explained: "There is a risk in any disclosure-only settlement that both the plaintiffs and the defendants have agreed to trivial disclosures as the path of least resistance to a desired end: For the defendants, the release of claims without significant cost, and for the plaintiffs, access to fees and costs."[24] Accordingly, the Court concluded that "close judicial scrutiny of the settlement can be warranted, notwithstanding an uncontested fee request … especially … in the context of merger litigation that produces a disclosure-only settlement."[25] Despite ultimately approving the settlement, Vice Chancellor Glasscock made clear that he too would subject such settlements to heightened scrutiny in the future.

Within less than a month, Vice Chancellor Laster weighed in on the issue as well. In *In re Gen-Probe Inc. Shareholders Litigation,*[26] the Vice Chancellor faced a similar situation in which the parties agreed to a "terribly thin" disclosure-only settlement.[27] In a bench ruling, the Vice Chancellor specifically referenced the *Transatlantic* decision and considered whether to likewise reject the parties' agreed-upon settlement, which provided for "somewhat oblique" and "very soft" supplemental disclosures.[28] Ultimately, the Court approved the settlement, but only after joining Vice Chancellor Glasscock and Chancellor Strine in denouncing this trend.

Invoking a standard that had been established in the Vice Chancellor's *Sauer-Danfoss* bench ruling (and other fee decisions), Vice Chancellor Laster stated that while he preferred to "stick to the ranges" established in other cases—roughly $450,000 to $500,000—he was "starting to think of that range as too high" for disclosure-only cases.[29] He concluded that $500,000 in fees for supplemental disclosures was "excessive particularly when 95 percent of deals get sued on."[30] Most notably, he observed that recent trends in Delaware deal litigation might warrant a modified approach to disclosure-based litigation from the courts: "we now have a sample, which, frankly, didn't exist, really, five years ago to compare these disclosure cases against. And I think the idea that we're giving out, left and right, 500 grand for five [disclosures] … there may need to be a recalibrating of the market."[31]

Given the almost immediate (and fully consistent) reactions by Vice Chancellors Glasscock and Laster, it appears that the concerns articulated by Chancellor Strine in *Transatlantic* were neither fleeting nor idiosyncratic. At year-end, Vice Chancellor Glasscock again weighed in on excessive M&A litigation: "In a universe where litigation resulting from public company mergers

is ubiquitous, it is likely that the Board's awareness of its fiduciary duties would have provided substantial leverage on the Special Committee and the Board to pursue the opportunities that the market, independent of the Plaintiffs' efforts, provided."[32] In a December 2013 ruling, in *In re Talbots Inc. Shareholders Litigation*, referred to earlier, Chancellor Strine reiterated his concerns about disclosure-only deal litigation and "enhanced disclosure settlements," stating that the "social utility of cases like this … is dubious" and suggested that they cannot "continue[ ] to be resolved in this way."[33]

A Shifting View of Plaintiffs' Fee Awards

Given the powerful incentives on both sides to settle as soon as possible, disclosure-based lawsuits rarely are litigated on the merits to a written decision.[34] As a result, courts largely are deprived of the ability to express disapproval of unmeritorious cases in the ordinary course and to provide robust, common law guidance in a written decision around what constitutes a meritorious disclosure-based lawsuit. In addition, courts generally have a strong predisposition toward settlement and are wary of encroaching on compromises reached between parties and counsel dealing at arm's length, making the rejection of negotiated settlements a rare occurrence reserved for the most egregious cases.

The difficulty with much M&A stockholder litigation is not that the parties and their counsel do not deal at arm's length or truly negotiate the specifics of supplemental disclosure or the terms of settlement. Rather, it is that each party (or at least class action plaintiffs' counsel and the defendants) is incentivized to reach settlement on terms that confer little-to-no benefit on stockholders, issuers or the public markets generally. What drives the settlement dynamic is the availability of a significant plaintiffs' fee award in exchange for (at best) modest litigation effort by plaintiffs' counsel and "sleeves off the vest" settlement concessions by defendants.

Recent commentary surrounding attorney's fees in Delaware has focused on a few outsized fee awards that some view as a windfall and a possible harbinger of even larger awards to come.[35] Most notably, in 2011 alone, the Court of Chancery approved fee awards of $2.4 million in *In re Compellent Technologies Inc. Shareholders Litigation*,[36] $22 million in *In re Del Monte Foods Co. Shareholders Litigation*,[37] and $285 million in *In re Southern Peru Copper Corporation Shareholders Derivative Litigation*.[38] However, just as Delaware courts have been increasingly generous with meritorious suits that provide real value to stockholders, they have become increasingly demanding of plaintiffs' lawyers when faced with disclosure-only settlements.

In his widely discussed 2011 *Sauer-Danfoss* opinion,[39] Vice Chancellor Laster reduced a requested fee award from $750,000 to $75,000, which represented the supposed benefit conferred by a single material disclosure.[40] However, the most widely cited portion of the opinion is the Court's compilation of disclosure-only settlements and its conclusion that "[t]his Court has often awarded fees of approximately $400,000 to $500,000 for one or two meaningful disclosures."[41] Interestingly, *Sauer-Danfoss* focused on the importance of creating real incentives (and disincentives) for the plaintiffs' bar: "By granting minimal fees when deal litigation confers minimal benefits, this Court seeks to align counsel's interests with those of their clients and encourage entrepreneurial plaintiffs' lawyers to identify and litigate real claims."[42] The difficulty with such an approach is that it creates a relatively reliable roadmap for plaintiffs' counsel and defendants to follow in order for defendants to get a settlement approved and for plaintiffs' counsel to obtain what it views as an acceptable fee award.

Underscoring this point, Vice Chancellor Glasscock explained in *Dias v. Purches* that "[t]he fact that merger litigation has gone from common to ubiquitous in just a few years suggests that the

current balance of incentives is flawed."[43] He also criticized the growing number of "broad and general" complaints "clad in boilerplate" filed by lawyers "taking a scattershot approach" and warned that "[t]his dynamic obviously creates a risk of excessive merger litigation, where the costs to stockholders exceed the benefits."[44] Because the *Sauer-Danfoss* range would have resulted in a fee award equaling $42,000 per hour for work performed on the plaintiffs' sole meritorious claim, the court reduced the award by one-third, to $266,667.[45]

In his April 2013 decision in *Gen-Probe*, Vice Chancellor Laster appropriately questioned whether the *Sauer-Danfoss* range should be revised in light of the glut of stockholder lawsuits tracking every deal. Accordingly, he reduced a fee award from the requested $450,000 to $100,000.[46] Even more recently, in *In re Complete Genomics, Inc. Shareholder Litigation,* Vice Chancellor Laster again confronted a disclosure-only settlement and again departed from the range established in *Sauer-Danfoss.*[47] For one "meaningful" disclosure, he awarded $300,000, and reduced the total requested fee award from $1.4 million to $315,000.[48]

Significantly, *Complete Genomics* recognized the difficulty in "trying to construct a market proxy for situations that aren't bargained for, that are relatively arbitrarily priced," querying whether the bargained-for disclosure was worth the combined annual household income of ten American families.[49] The Vice Chancellor also stated that he could not "equate the injunctive relief that was made here … with $2.5 million in hard cash money recovery" in a recent case that resulted in a fee award of $500,000, nor could he equate "the amount of effort that went into this injunction proceeding, … [with] the amount of effort that it takes to fully litigate a case through trial, win on the merits, and recover $2.5 million for stockholders."[50] Likewise, juxtaposed against a recent award of $1 million for increasing deal value by $14.15 million,[51] the average fee for disclosure-based suits appears disproportionately large given the benefit conferred.

At the end of 2013, Chancellor Strine went a step further in *In re Talbots Inc.*, a case in which plaintiffs and defendants had agreed upon an award of plaintiffs' attorneys fees of no more than $237,000. In approving the agreed-upon fee award, Chancellor Strine advised plaintiffs' counsel that "I've seen this in many briefs now, this whole idea that if you have a disclosure settlement, you sort of automatically start with 4 or $500,000. That's not the law."[52] He also observed that "most of the cases" coming before the court do not involve material disclosures, and, as a result, he signaled that he would be receptive to a much lower fee in the future: "If it weren't clearly negotiated I could have easily given 50,000, 75,000, 100,000 for this."[53] Chancellor Strine further cautioned that "in the holiday spirit, I am not going to deviate downward. But nor am I going to ever see this cited back as some sort of market indication."[54]

Notably, between 2009 and 2012, average attorney's fees requested in disclosure-only settlements declined for three consecutive years.[55] Although Cornerstone Research has not yet published its annual M&A review for 2013, it is not unreasonable to expect that this trend will continue, especially given the increasing skepticism from various members of the Court. Whether declining fee awards will stem the tide of frivolous deal litigation is another question.

Even if the Court were to cut in half the baseline suggested in *Sauer-Danfoss* for supplemental disclosures—to a range of $200,000 to $250,000—it may not have an appreciable impact on plaintiffs' lawsuits if unaccompanied by additional reforms. For many plaintiff's attorneys, a high likelihood of extracting a modest fee in short order would be worth the upfront investment of time, particularly as disclosure-based M&A litigation has become increasingly routinized over time. One alternative is to expand the range of

awards. For instance, $50,000 could be a reasonable baseline for substantive and helpful, but ultimately immaterial disclosures. On the other hand, $500,000 could be used as a baseline for the very rare case in which plaintiffs' counsel unearth through real litigation effort a very material fact that was not disclosed, or that was disclosed in a materially misleading way, and that significantly altered the mix of information available to stockholders.[56] Dramatically lowering the range of typical fee awards is especially appropriate here, since the usual rationale for awarding significant contingency fees—namely, that plaintiffs bring many cases for which they earn no fee in order to bring the exceptional case where they earn a fee – does not apply currently in disclosure-based M&A litigation.[57]

Another, perhaps complementary, approach is to place more weight on the traditional lodestar method of assessing a plaintiffs' fee petition, coupling a requirement that plaintiffs make a strong showing of real litigation effort together with close scrutiny by the court of plaintiffs' attorneys' time entries and detailed fee backup. It is arguable that, in recent years, too much emphasis has been placed on the amorphous concept of the "benefit" obtained in a disclosure-only settlement, allowing plaintiffs' attorneys to go through the motions of litigating, without actually litigating, and still obtain a fee award. If plaintiffs' attorneys were required to demonstrate sustained, protracted and meaningful litigation effort in order to obtain a fee award, and significant fees were awarded only for significant benefits, the cost-benefit calculation for the plaintiffs' bar of bringing transactional litigation might shift toward investing those significant up-front litigation costs more in meritorious and, therefore, lucrative cases, rather than in routine, predictable disclosure-based cases. A broader spectrum of potential fees, coupled with close examination of the actual work performed by plaintiffs' counsel to justify counsel's fee claim, could better promote incentives to bring meritorious claims while increasing the costs of bringing makeweight M&A litigation and creating a possible deterrent for "raptorious and unblinking" litigators.[58]

Forum-Shopping

An important consideration in reigning in unmeritorious M&A litigation has long been the risk that any concerted judicial reform by the Court of Chancery might drive deal litigation out of Delaware. Recent studies suggest that forum-shopping is on the rise, as entrepreneurial plaintiffs' lawyers seek to evade Delaware courts' growing hostility to contrived stockholder suits.[59] If the ultimate goal is to reduce the overall number of such cases impeding public company transactions—not merely to prevent such cases from being filed in Delaware—then courts will also have to address this multi-jurisdictional problem.

In 2013, the Court of Chancery made progress on this front as well. Specifically, in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.,* Chancellor Strine held that forum-selection clauses in corporate bylaws—an increasingly common response to multi-jurisdictional litigation—are facially valid under Delaware law.[60] However, although *Chevron* represents a significant victory for Delaware corporations, it will not necessarily resolve the issue of forum-shopping, as several uncertainties remain. First, the appeal in *Chevron* was voluntarily dismissed, which means that the Delaware Supreme Court has not yet been called upon to definitely answer this question. Second, it is unclear whether *Chevron* will prompt Delaware incorporated issuers to adopt forum-selection provisions, particularly given the skepticism expressed by institutional investors, as well as Glass, Lewis & Co. and Institutional Shareholder Services. Third, it remains to be seen whether the courts of other states—which must consider the issue in the first instance—will give these provisions effect.[61]

A related concern is the complicity of defendants in this new regime. To the extent that

defendants, like plaintiffs, also desire a court's rubber-stamp for a disclosure-only settlement, the parties may engage in "collusive forum-shopping," thus eliminating any benefit offered by forum-selection clauses.[62] Outside of the courtroom, Chancellor Strine has opined that "the growth in [disclosure-only] settlements … is attributable in material measure to the perverse incentives caused by forum shopping, which … increases the costs and uncertainty of litigation to defendants in a manner that makes [these] settlements more rational than moving to dismiss or otherwise fighting a meritless case."[63]

Looking Ahead

As Chancellor Strine's December 2013 ruling in *Talbots* indicates, a shift is underway in the Court of Chancery with respect to disclosure-based M&A litigation, and while the direction is clear, the destination is not. One apparent take-away is that the recent spate of criticism from the bench is not a passing trend. The Court of Chancery likely will continue to closely scrutinize early-stage, disclosure-only settlements, and will put increasing pressure on plaintiffs and defendants to reach fair terms. Given their growing skepticism, courts may even seek to preempt such suits by more narrowly defining companies' disclosure obligations, which are a creature of common law, not statute.[64]

As defendants get more adept at anticipating disclosure-based lawsuits, plaintiffs' claims will become diluted, which is undoubtedly one factor behind the recent decline. Average fee awards likely will continue their descent. Because, at present, the cost of multi-jurisdictional litigation trumps the expense of nuisance fees, plaintiffs and defendants will make a concerted effort to convince courts that their negotiated settlements are reasonable, and they are likely to prevail. In addition, a sharp pendulum-swing that reduces pre-closing disclosure-based litigation risks an uptick in post-closing damages litigation—which tends to be much more difficult to settle, and which presents the potential for much higher fee awards. Thus, while Delaware courts took important steps over the last year to reign in run-away deal litigation, the alignment of incentives between risk-averse parties will remain a major impediment to widespread reform.

Notes

1. Liz Hoffman, *Delaware's Top Business Judge Lambasts Plaintiffs Lawyers*, Wall Street Journal: Law Blog (Dec. 26, 2013), available at *http://blogs.wsj.com/law/2013/12/26/delawares-top-business-judge-lambasts-plaintiffs-lawyers/*.
2. *In re Talbots, Inc. S'holders Litig.*, No. 7513-CS (Dec. 16, 2013) (transcript).
3. Although most disclosure litigation also includes challenges to the transaction process, the focus in such litigation often very quickly shifts to the disclosures because of the possibility of a disclosure-based injunction and, notably, the relative ease of effecting a disclosure-based settlement.
4. *Id.*; *see also* Robert M. Daines & Olga Koumrian, *Shareholder Litigation Involving Mergers & Acquisitions*, Cornerstone Research Review of 2012 M&A Litigation, p. 1 (Feb. 2013).
5. Steven M. Haas, *The Small-Cap M&A Litigation Problem*, The Harv. L. School Forum on Corp. Gov. & Fin. Reg. (July 31, 2013), available at *https://blogs.law.harvard.edu/corpgov/2013/07/31/the-small-cap-ma-litigation-problem/*; *see also* Dwight W. Stone II, Dennis M. Robinson, Jr., and Patrick D. McKevitt, *Dealing with the Inevitable: Practical Considerations in Defending Merger Objection Lawsuits*, For the Defense, p. 3 (Oct. 2013) (observing that between 2006 and 2009 the median market cap of a target company involved in deal litigation dropped from $1.1 billion to $509 million); Daines & Koumrian, *supra* n.2, at 1 (observing that litigation following transactions valued at more than $100 million accelerated at roughly the same rate as litigation tracking the largest transactions over the preceding three years).
6. Daines & Koumrian, *supra* n.4, p. 6.
7. Haas, *supra* n.5.
8. *See* Stone, *et al.*, *supra* n.5, at 1; *see also Dias v. Purches*, 2012 WL 4503174, at *5 (Del. Ch. Oct. 1, 2012) (describing how lawsuits follow the announcement of M&A transactions "like mushrooms follow the rain").
9. *But see* Steven M. Davidoff, *Debating the Merits of the Boom in Merger Lawsuits*, The New York Times: DealBook (Mar. 8, 2013) (suggesting that a significant factor behind the rise in M&A litigation is new multi-state litigation trend whereby different plaintiffs file suit in multiple jurisdictions concerning the same transaction); Timothy

R. McCormick, Michael W. Stockham, & Mackenzie S. Wallace, *The Aggressive Pursuit of Merger Litigation Outside of Delaware*, In-House Defense Quarterly (Winter 2013) (same).

10. *See* Thompson, Robert B. and Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 Vanderbilt Law Review, 133, 179-81 (2004).

11. Daines & Koumrian, *supra* n.4, p. 6.

12. Robert M. Daines & Olga Koumrian, *Shareholder Litigation Involving Mergers & Acquisitions*, Cornerstone Research Review March 2012 Update, at 7, 12 (Mar. 2012).

13. *See In re Transkaryotic Therapies, Inc.*, 954 A. 2d 346, 360-61 (Del. Ch. 2008).

14. Davidoff, *supra* n.9 ("For [M&A] lawyers to bring good cases … they need to bring bad ones to pay for them.").

15. *See, e.g.,* Haas, *supra* n.5; Andrew Noreuil, Will Recent Delaware Court Decisions Curb Excessive M&A Litigation?, The Harv. L. School Forum on Corp. Gov. & Fin. Reg. (Sept. 18, 2013); Ronald Barusch, Dealpolitik: The Useful Corruption of Shareholder Lawsuits, Wall Street Journal: Blogs (Jan. 13 2011), available *at http://blogs.wsj.com/deals/2011/01/13/dealpolitik-the-useful-corruption-of-shareholder-lawsuits/*; Ann Woolner, Phil Milford and Rodney Yap, When Merger Suits Enrich Only Lawyers, Bloomberg News (Feb. 16, 2012), available at *http://www.bloomberg.com/news/2012-02-16/lawyers-cash-in-while-investor-clients-get-nothing-in-merger-lawsuit-deals.html.*

16. *In re Revlon, Inc. S'holders Litig.*, 990 A.2d 940, 945-46 (Del. Ch. March 16, 2010).

17. C.A. No. 6574-CS, 2013 WL 1191738 (Mar. 8, 2013).

18. *Id.* at *2.

19. *Id.* at *1.

20. *Id*.

21. *Id.* at *2.

22. *See also In re SS&C Tech. Inc., S'holders Litig.*, C.A. No. 1525-N, 2006 WL 3499748 (De. Ch. Nov. 29, 2006); *cf. Scully v. Nighthawk Radiology Holdings, Inc*., No. 5890-VCL (Del. Ch. Dec. 17, 2010)*; In re BEA Sys., Inc. S'holders Litig*., 2009 WL 1931641, at *1 (Del. Ch. June 24, 2009).

23. C.A. No. 6761-VCG, 2013 WL 1110811 (Del. Ch. Mar. 19, 2013).

24. *Id.* at *6.

25. *Id*.

26. No. 7495-VCL, at *36 (Del. Ch. Apr. 10, 2013) (transcript).

27. *Id*.

28. *Id.* at *36-37.

29. *Id.* at *46.

30. *Id.* at *47.

31. *Id*.

32. *In re Quest Software Inc. S'holders Litig.*, C.A. No. 7357-VCG, at *21 (Nov. 12, 2013).

33. *In re Talbots, Inc*., No. 7513-CS.

34. *See* Daines & Koumrian, *supra* n.4, at 5 (demonstrating that, on average, more than sixty percent of deal-related cases settle while less than ten percent are dismissed by the court or reach a judgment).

35. Joe Palazzolo, *Delaware High Court Blesses $300 Million in Attorney Fees*, Wall Street Journal: Law Blog (Aug. 28, 2012), available at *http://blogs.wsj.com/law/2012/08/28/delaware-high-court-blesses-300-million-in-attorney-fees/.*

36. C.A. No. 6084-VCL (Del. Ch. Dec. 9, 2011).

37. C.A. No. 6027-VCL (Del. Ch. Dec. 1, 2011).

38. C.A. No. 961-CS (Del. Ch. Oct. 14, 2011).

39. *In re Sauer-Danfoss Inc. S'holders Litig.*, 65 A.3d 1116 (Del. Ch. 2011).

40. *Id.* at 1140-41.

41. *Id.* at 1136-37.

42. *Id.* at 1141.

43. No. 7199-VCG, 2012 WL 4503174, at *16 (Del. Ch. Oct. 1, 2012).

44. *Id.* at *15.

45. *Id.* at *27. It is worth noting that the actual fee awarded still equaled approximately $28,000 per hour using the court's formula, which could hardly be viewed as a disincentive for plaintiffs' lawyers to bring suit.

46. No. 7495-VCL, 2013 WL 3246605 (Del. Ch. Apr. 10, 2013).

47. *C.A. No. 7888-VCL (Del. Ch. Oct. 2, 2013) (transcript).*

48. *Id.* at *53-60.

49. *Id.* at *54.

50. *Id.* at *53-54.

51. *See In re Quest Software*, C.A. No. 7357-VCG, at *21.

52. *In re Talbots, Inc.*, No. 7513-CS, at *15-16.

53. *Id.* at *15.

54. *Id*.

55. *See* Daines & Koumrian, *supra* n.4, at 9.

56. *See, e.g.*, *In re Del Monte Foods Co. S'holders' Litig.*, C.A. No. 6027-VCL, at *8 (Del. Ch. June 27, 2011) (citation omitted) (observing that plaintiffs' counsel, through an exhaustive investigation, uncovered evidence that financial advisor Barclay's Capital, Inc. had "secretly and selfishly manipulated the sale process to engineer a transaction that would permit Barclays to obtain lucrative buy-side financing fees"). Likewise, while fee awards below $100,000 are uncommon, there is certainly precedent for it. *See* Peter B. Ladig, *The Viability of the Disclosure Only Settlement*, Del. Bus. Litig. Report (May 11, 2011), available at *www.delawarebusinesslitigation.com/2011/05/articles/case-summaries/ma/the-viability-of-the-disclosure-only-settlement/* (discussing three cases relied on by Vice Chancellor Laster in *Sauer-Danfoss* to support a fee of $75,000).

57. *See In re Sauer-Danfoss*, 65 A.3d at 1140 ("Plaintiffs' counsel technically pursued this case on a contingent basis, but disclosure claims … are relatively safe in terms of forcing a settlement. Because disclosure settlements are cheap and easy, and because the defendants like to use supplemental disclosures to resolve deal litigation, entrepreneurial plaintiffs' lawyers do not face significant contingency risk when challenging transactions.") (internal citation and quotation marks omitted).

58. *In re Quest Software*, C.A. No. 7357-VCG, at *22.

59. *See* John Armour, Bernard S. Black, & Brian R. Cheffins, *Is Delaware Losing Its Cases?* (Northwestern Law & Econ. Research Paper No. 10-03, 2012), available at available at SSRN: *http://ssrn.com/abstract=1578404* or *http://dx.doi.org/10.2139/ssrn.1578404* (tracking the migration of public company litigation from Delaware to other states); *see also* Adam B. Badawi, *Merger Class Actions in Delaware and the Symptoms of Multi-Jurisdictional Litigation*, 90 Wash. U. L. Rev. 965 (2013).

60. No. 7238-CS, at *12 (Del. Ch. June 25, 2013); *see also* Federick H. Alexander, *et al.*, *Forum Selection Bylaws: Where We Are and Where We Go From Here*, Insights: The Corporate & Securities Law Advisor, Vol. 27:7, at 2 – 11 (July 2013) (discussing the significance and potential implications of *Chevron*).

61. *See Edgen Group Inc. v. Genoud*, No. 9055-VCL (Del. Ch. Nov. 5, 2013) (declining to enforce a forum-selection clause that would divest a Louisiana court of jurisdiction, despite the "exceedingly weak" nature of the claims, and despite what he characterized as "pathetic representational contortions" by plaintiffs' counsel to avoid personal jurisdiction in Delaware).

62. *See Scully v. Nighthawk Radiology Holdings, Inc.*, No. 5890-VCL (Del. Ch. Dec. 17, 2010) (accusing defendants of being complicit in this scheme and chiding both sides for engaging in "collusive forum-shopping" which "undermines the legitimacy of the entire representational litigation process").

63. Leo E. Strine, Jr. *et al.*, *Putting Stockholders First, Not the First-Filed Complaint*, at 15 n.40 17h25 (Harvard John M. Olin Ctr. for Law, Econ., & Bus., Dis. Paper No. 740, 2013), available at *http://ssrn.com/abstract=2200499.*

64. *See In re Pure Res., Inc., S'holder Litig.*, 808 A.2d 421, 449 (Del. Ch. 2002) (discussing standards of disclosure).

IN THE COURTS

Delaware Courts Interpret Survival Clauses Relating to Contractual Representations

By Kevin R. Shannon and Berton W. Ashman, Jr.

The Delaware Court of Chancery has issued two recent decisions—*GRT, Inc. v. Marathon GFT Technology, Ltd.* and *ENI Holdings, LLC v. KBR Group Holdings, LLC*—holding contract indemnification claims to be time-barred because the litigation was not commenced before the representations at issue terminated.[1] The decisions, which interpreted indemnification and survival provisions similar to those found in many merger or stock/asset purchase agreements, are significant for both deal lawyers and litigators. Among other things, in contrast to some prior cases, the court held that it was not sufficient to provide "written notice" of a claim prior to the termination date. Rather, based on the contract provisions at issue, the court held that a party must commence litigation prior to the termination date of the representations at issue or the claim will be barred.

For deal lawyers, *GRT* and *ENI Holdings* make clear that Delaware courts will respect and enforce the allocation of risk reflected in the parties' agreement, including any shortening of the otherwise applicable limitations period. More importantly, the cases suggest that, absent clear language to the contrary, the court will interpret provisions relating to the termination of representations as the cut-off for filing any claims. Accordingly, it is important that parties attempt to negotiate representations that survive for a sufficient period of time to allow them to discover potential claims, comply with any contractually-mandated dispute resolution procedures, and commence litigation. Alternatively, if the parties intend that they need only provide written notice of a claim prior to the termination date for the representations, the agreement should expressly so state.

For litigators, it is important to recognize that, based on the decisions in *GRT* and *ENI Holdings*, courts may be more likely to determine that providing written notice of a claim prior to the termination date is insufficient to preserve a claim—even when the agreement requires such notice and further requires that the parties engage in certain dispute resolution procedures before commencing litigation. As a result, parties may have a limited period of time to discover, investigate, and file claims in litigation. It is therefore important that parties promptly investigate whether any claims exist because such claims otherwise might not be discovered until after they are time-barred.

GRT, Inc. v. Marathon GTF Technology Ltd.

As Chancellor Strine of the Court of Chancery has stated,

> the shortening of statutes of limitations by contract is viewed by Delaware courts as an acceptable and easily understood contractual choice because it does not contradict any statutory requirement, and is consistent with the premise of statutory limitations

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> periods, namely, to encourage parties to bring claims with promptness ….[2]

One convention interpreted to accomplish this purpose is the inclusion of a survival clause stating that representations and warranties survive only through a specified "termination" date.[3]

In *GRT*, Marathon GTF Technology and GRT, Inc. were parties to a securities purchase agreement pursuant to which Marathon agreed to build an experimental testing facility for GRT to conduct research on certain new technologies. Marathon represented in the agreement that the facility, which was not expected to be completed until after the contract's closing, would be reasonably designed to meet certain objectives, and the contract permitted GRT to inspect the facility following its completion to ensure it was designed as represented.

In the event the facility did not meet the contractual requirements, the agreement provided for a somewhat unique three-part remedial scheme. First, GRT had to "sue and prove" that Marathon had breached the design representations.[4] Second, if a breach was established, the agreement required Marathon to remedy that breach by modifying the facility's deficient design. Third, if Marathon failed to cure the deficiency, GRT could bring suit for Marathon's separate breach of its remedial obligations and seek specific performance. The three-step scheme provided GRT with its "sole and exclusive remedy" for breach of the design representations.[5]

The contract also provided that the design representations would survive for a period of one year after the contract's closing date and thereafter terminate "together with any associated right to indemnification" or other contractual remedies.[6] The court held that this survival clause required that any claims for breach of the design representations be brought before the expiration of the one-year period, opining that "the lifespan of that remedy expressly terminated along with the Design Representations at the end of the Survival Period."[7] Because GRT did not file the litigation until after that period had expired, the court dismissed the claims as time-barred.

In so ruling, the court rejected GRT's argument that the survival clause was intended only to limit the time in which a breach of the representations might occur, rather than shorten the limitations period applicable to claims for any such breach.[8] As the court observed, under Delaware law, claims for breach of contractual representations and warranties accrue at closing—*i.e.*, the representations and warranties "are to be true and accurate when made"—and, therefore, any cause of action for breach of those representations accrues as of that date.[9] Interpreting the survival clause to extend the time in which breach might be deemed to occur, as GRT advocated, would in the court's view extend the date of accrual past the closing, and thus arguably operate also to extend the limitations period beyond the three-year period proscribed by statute, in contravention of Delaware law.[10]

ENI Holdings, LLC v. KBR Group Holdings, LLC

Although the court's analysis in *GRT* was instructive, the impact of the decision was subject to debate given the specific facts and unusual contract provisions at issue. The Court of Chancery's recent, subsequent decision in *ENI Holdings*, which addressed contract provisions that differed in several (arguably material) respects from those in *GRT*, suggests that the analysis in *GRT* may be interpreted broadly to require all claims be filed before the expiration of the survival period. The court in *ENI Holdings* relied heavily on *GRT* to conclude that claims filed after the termination of the representations were timed-barred—even though the agreement at issue appeared to require only that written notice of the claims be provided, and did not expressly require that litigation be commenced, before that date. This holding was

significant because some prior Delaware cases suggested that written notice under such circumstances could be sufficient,[11] and the primary treatise relied upon in *GRT* had noted that, when it comes to "whether the party seeking indemnification merely has to give notice of a claim before the end of the survival period … or whether a lawsuit must have been filed," notice was "the more common formulation."[12]

The dispute in *ENI Holdings* arose from KBR Group Holdings, LLC's December 2010 acquisition of Roberts & Shaefer Co. (R&S) from ENI Holdings, LLC pursuant to a stock purchase agreement (SPA). The acquisition price was subject to potential adjustments based on R&S's working capital at the time of closing and any rights to indemnification for breach of representations and warranties, with a portion of the purchase price escrowed to provide for these potential adjustments. Except for claims of fraud, the sole and exclusive remedy for all claims relating to KBR's acquisition of R&S would be indemnification, as set forth and governed by the SPA.

The SPA provided that, while certain "fundamental" and other representations would survive longer, all "non-fundamental" representations would survive until a specified termination date (Termination Date). The SPA also included the following provision requiring written notice of claims:

> In the event that an Indemnified Party determines that it has a claim for Damages against an Indemnifying Party … the Indemnified Party shall promptly, but in any event within five (5) Business Days of becoming aware of any facts or circumstances that would reasonably be expected to give rise to a claim for indemnification hereunder, give written notice thereof to the Indemnifying Party, specifying, to the extent then known by the Indemnified Party, the amount of such claim, the nature and basis of the alleged breach giving rise to such claim and all relevant facts and circumstances relating thereto ….[13]

If ENI timely disputed the liability asserted in the notice, the SPA required the parties to "engage in good faith negotiations aimed at resolution of the dispute" and, promptly following a final determination of the damages to which KBR is entitled—"whether determined in accordance with [the foregoing negotiations] or by a court"—ENI would be required to pay such damages.[14] The SPA provided for the release of escrowed funds to ENI on the Termination Date, with the exception of any amounts reserved for timely-noticed, but unresolved, indemnification claims.[15]

Alleging breach of various representations and warranties, including non-fundamental representations, KBR provided written notice of certain claims prior to the Termination Date and refused to allow for the release of escrowed funds.[16] ENI subsequently filed suit seeking to require KBR to authorize the release of the escrowed funds, and KBR counterclaimed for breach of representations and warranties, as well as fraud.[17] ENI moved to dismiss on the basis, in part, that certain of the counterclaims arose from non-fundamental representations that terminated prior to KBR's filing its counterclaims and, therefore, were time-barred under the SPA.

KBR responded that the express terms of the SPA required only written notice of the claims, not filing of suit, prior to the Termination Date. Among other things, KBR contended that it could assert a claim for purposes of initiating the parties' dispute resolution procedures by providing written notice, as it had done, prior to the Termination Date, and that the SPA allowed the parties to resolve any such claims either through the negotiations prescribed by the contract or in court. KBR argued that this reading of the contract was consistent with provisions addressing the release of escrowed funds, noting that, "'so long as it initiated the claims process … by giving notice to ENI before the Termination Date,

ENI would not be entitled to the release of the Indemnity Escrow Account until KBR's claims were finally determined' either through inter-party negotiations or a competent court."[18]

Relying primarily on the reasoning in *GRT*, the court rejected KBR's position. In the court's words, it was "not a reasonable interpretation of the SPA that KBR can preserve a lawsuit based on an expired representation or warranty merely by providing notice before the applicable Termination Date."[19] Reading the SPA to allow KBR to provide notice before the Termination Date and file a complaint any time after that date, the court observed, "is neither how a statutory limitations period nor a contractual limitations period operates in Delaware."[20]

Practical Implications

Although the interpretation of a contract necessarily will depend on the specific language at issue, the recent decisions in *GRT* and *ENI Holdings* suggest that, absent unambiguous language to the contrary, Delaware courts likely will interpret termination dates with regard to representations as end-dates for the filing of related indemnification claims. Practitioners should consider these decisions when negotiating survival provisions, and when advising clients regarding the investigation and pursuit of potential indemnification claims.

Notes

1. *GRT, Inc. v. Marathon GFT Tech., Ltd.*, 2011 WL 2682898 (Del. Ch. July 11, 2011); *ENI Holdings, LLC v. KBR Group Holdings, LLC*, 2013 WL 6186326 (Del. Ch. Nov. 27, 2013).
2. 2011 WL 2682898, at *12 n.59. *See also id.* at *3 ("Delaware law does not have any bias against contractual clauses that shorten statutes of limitations because they do not violate the legislatively established statute of limitations, there are sound business reasons for such clauses, and our case law has long upheld such clauses as a proper exercise of the freedom of contract.").
3. *Id.*, at *3 (citing 2 Lou R. Kling & Eileen T. Nugent, Negotiated Acquisitions of Companies, Subsidiaries and Divisions § 15.02[2] n.45 (2011)).
4. *Id.*, at *2.
5. *Id.*, at *7.
6. *Id.*
7. *Id.*, at *4.
8. *Id.*, at *5-6.
9. *Id.*, at *6 (citing *CertainTeed Corp. v. Celotext Corp.*, 2005 WL 5757762, at *4 (Del. Ch. Jan. 24, 2005), 10 *Del. C.* § 8106).
10. *Id.*, at *3 Delaware, like many jurisdictions, does not permit the extension of a statute of limitations by contract. *See id.*, at *15. The court also rejected GRT's argument that parties seeking to shorten a limitations period must use "clear and explicit" language, as required in other jurisdictions such as California and New York. *Id.*, at *11.
11. *See, e.g.*, *Sterling Network Exch., LLC v. Digital Phoenix Van Buren, LLC*, 2008 WL 2582920, at *5 (Del. Super. Ct. Mar. 28, 2008) (claims deemed timely asserted where party provided written notice within the one-year period established by contract's survival clause); *Winshall v. Viacom Int'l, Inc.*, 2012 WL 6200271, at *8 (Del. Ch. Dec. 12, 2012) (suggesting claims would have survived if written notice had been provided prior to the termination date set forth in merger agreement).
12. Kling & Nugent, Negotiated Acquisitions § 15.02[2], at 15-22 (rev. 2012). The most recently revised version of the treatise, which includes a discussion of *GRT*, does not appear to include this comment. In any event, Kling and Nugent strongly caution drafters to be careful to make expressly clear that notice is sufficient to preserve a claim past a termination date, if that is the parties' intention, or else risk the interpretation applied, for instance, in *ENI Holdings*. *See id.* at 15-22.2 (rev. 2013).
13. *ENI Holdings*, 2013 WL 6186326, at *3 (quoting Section 6.08 of the SPA).
14. *Id.*
15. *Id.*, at *2 (quoting Section 6.13 of the SPA).
16. *Id.*, at *3.
17. *Id.*
18. *Id.*, at *10.
19. *Id.*
20. *Id.* (citing *GRT*, 2011 WL 2682898, at *9).

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.

Alston & Bird LLP
Washington, DC (202-756-3300)

The Supreme Court to Revisit the "Fraud-on-the-Market" Theory in *Halliburton* (December 4, 2013)

A discussion of the Supreme Court's decision to hear another appeal from the securities class action pending against the Halliburton Company. Halliburton's petition for certiorari specifically requests that the Supreme Court overrule or substantially modify its holding in *Basic* to the extent that it recognizes a class-wide presumption of reliance derived from the fraud-on-the-market theory.

Cahill Gordon & Reindel LLP
New York, NY (212-701-3000)

PCAOB Reproposes Amendments to Provide Disclosure in the Auditor's Report of Certain Audit Participants (December 9, 2013)

A discussion of reproposed amendments to auditing standards that would require disclosure in the auditor's report of the name of the engagement partner and the names, locations and extent of participation of other independent public accounting firms that took part in the audit.

Chapman and Cutler LLP
Chicago, IL (312-845-3000)

The Corporate Social Responsibility Report: A Key Component of Effective Stakeholder Engagement

A discussion of the importance of stakeholder engagement, corporate social responsibility and the corporate social responsibility report that many companies issue. Such reports typically cover various environmental, social, corporate governance, and economic issues.

Edwards Wildman
Washington, DC (202-478-7370)

Conflict Minerals: Due Diligence and Disclosure Steps Public Companies Should Be Addressing Now (December 2013)

A discussion of steps companies should be taking under the SEC's conflict mineral rules, including finalizing their country of origin inquiry, considering whether due diligence is required and undertaking it if required, preparing to report the results, considering whether an audit is required and making arrangements for it if required, and preparing to file with the SEC and post on the company website the required disclosures.

Faegre Baker Daniels LLP
Minneapolis, MN (612-766-7000)

Delaware Court Clarifies Impact of "Weak" Fairness Opinions (December 9, 2013)

A discussion of the Delaware Chancery Court opinion, *In re BioClinica, Inc. Shareholders Litigation*, curbing the potential for a flood of breach of fiduciary duty claims based on "weak" fairness opinions that could have resulted from the court's 2013 decision in *Koehler v. NetSpend Holdings Inc*.

Fried, Frank, Harris, Shriver & Jacobson LLP
New York, NY 10152 (212-859-6600)

Maintaining Client Confidences During the Holidays: Avoiding Accidental Tipping (December 23, 2013)

A discussion of the need to avoid putting family and friends in danger by inadequately protecting material, nonpublic information entrusted to professionals. The memorandum discusses a number of SEC enforcement cases involving allegations that lawyers told people close to them material, nonpublic information.

Greenberg Traurig LLP
Washington, DC (202-331-3100)

FINRA Again Presses for Expungement Limits Outside of Formal Rulemaking Process (December 24, 2013)

A discussion of FINRA's efforts to describe expungement as "extraordinary" and encourage arbitrators to limit expungement awards to "narrow" circumstances without benefit of a formal rulemaking process.

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

10 MLP Governance Facts

A discussion of the unique governance characteristics of master limited partnerships, which are different than a publicly traded corporation.

Sullivan & Cromwell LLP
New York, NY (212-588-4000)

M&A Executive Compensation Enhancements and Impact on the Say-on-Golden-Parachute Vote (December 17, 2013)

A discussion of a review of 365 merger agreements that were announced during the two years after the "Say-on-Golden-Parachute" vote went into effect on April 25, 2011, and that are subject to the rule. The review found that 39 companies (11percent) substantively enhanced executive compensation arrangements in connection with the transactions.

Sutherland, Asbill & Brennan LLP
Atlanta, GA (404-853-8000)

SEC Order Denying Whistleblower Claim Confirms Prospective Coverage and Limited Discovery in Dodd-Frank Bounty Proceedings (December 9, 2013)

A discussion of a SEC order denying a whistleblower claim, upholding the prospective application and discovery limitations of two of its rules implementing the Dodd-Frank Act provisions for whistleblowers. The order arose in connection with an enforcement action styled *SEC v. Advanced Technologies Group, LTD*, 10-cv-4868 (S.D.N.Y. 2011).

Venable LLP
Baltimore, MD (410-244-7400)

Maryland Trial Court Refuses to Award Plaintiffs' Attorneys' Fees in Post-Merger Litigation (December 19, 2013)

A discussion of a Maryland District Court decision rejecting a request for plaintiff's attorney fees in connection with settlement of a purported class action suit against WSB Holdings, Inc., a Delaware corporation, its directors and Old Line Bancshares, Inc., a Maryland corporation, that was filed shortly after Old Line announced its acquisition of WSB, the parent company of Washington Savings Bank. The Judge "determine[d] that the lawsuit was not meritorious based on the timing of filing and the lack of factual basis for it," and

concluded “There was no benefit conferred … on the shareholders, based on this lawsuit.”

Wachtell, Lipton, Rosen & Katz LLP New York, NY (212-403-1000)

Compensation Season 2014: Shareholder Engagement (December 12, 2013)

A discussion of the current compensation environment, why shareholder engagement has become more important and aspects of such engagement.

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

“Robocop” on the Beat: What the SEC’s New Financial Reporting and AQM Initiative May Mean for Public Companies (December 18, 2013)

A discussion of two initiatives in the SEC Division of Enforcement designed to support the renewed focus on uncovering and pursuing accounting abuses at public companies: (1) the Financial Reporting and Audit Task Force, “an expert group of attorneys and accountants” dedicated to detecting fraudulent or improper financial reporting; and (2) the Center of Risk and Quantitative Analytics, which is dedicated to employing quantitative data and analysis to high-risk behaviors and transactions” in an effort to detect misconduct.

SEC’s Second Annual Report Summarizing Whistleblower Program Shows Little Change (December 3, 2013)

A discussion of the SEC’s second Annual Report to Congress on the Dodd-Frank Whistleblower Program. The memorandum indicates the Report is remarkable for the following reasons: (1) despite significant efforts to publicize the program, the SEC is not seeing a meaningful increase in the number of tips it receives; (2) the Report fails to shed any light on the SEC’s thought process in making awards or how it applies the highly nuanced factors to award decisions; and (3) the Report does not acknowledge that the largest category of tips were in the “other” category which suggests that many of these tips are probably meritless nor does the report illuminate the question of how many tips the SEC receives annually result in meaningful investigations and cases.

INSIDE THE SEC

SEC Proposes Rules to Update Regulation A

By Mark S. Bergman, David S. Huntington, Raphael M. Russo and Hank Michael

On December 18, 2013, the Securities and Exchange Commission (SEC) voted to propose amendments to its public offering rules to exempt an additional category of small capital raising efforts as mandated by Title IV of the Jumpstart Our Business Startups Act (JOBS Act).[1] The SEC has proposed to amend Regulation A to exempt offerings of up to $50 million within a 12-month period, and in so doing has created two tiers of offerings under Regulation A: Tier 1, for offerings of up to $5 million in any twelve-month period; and Tier 2, for offerings of up to $50 million in any twelve-month period. Rules regarding eligibility, disclosure, and other matters would apply equally to Tier 1 and Tier 2 offerings and are in many respects a modernization of the existing provisions of Regulation A. Tier 2 offerings would be subject, however, to significant additional requirements, such as the provision of audited financial statements, ongoing reporting obligations, and certain limitations on sales.

One of the key questions regarding the implementation of Title IV of the JOBS Act has been how the SEC would address the state blue sky issues that have helped make Regulation A unattractive as an offering alternative. Notably, the SEC has proposed a complete preemption of state securities law registration and qualification requirements for securities offered in a Tier 2 offering.

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Background

Section 401 of the JOBS Act created a new subsection (2) to Section 3(b) of the Securities Act of 1933 (Securities Act) that directed the SEC to add a new exemption for offerings of securities up to $50 million within a 12-month period. This new exemption (often referred to as Regulation A+) was intended to build upon Regulation A, an existing but rarely-used exemption from registration for small offerings of securities of up to $5 million in a 12-month period.

Existing Regulation A, originally adopted in 1936, provides for a simplified securities registration process tailored to smaller issuers. It requires companies offering securities under Regulation A to prepare an offering statement, the core of which is an offering circular, which is a disclosure document much like an abbreviated version of a prospectus in a registered offering. However it does not mandate ongoing reporting after the offering is completed. The offering circular must be delivered to prospective purchasers. Offering statements under Regulation A are reviewed by the SEC and must comply with requirements regarding form, content, and process. Regulation A offerings also are subject to state-level registration and qualification requirements.

Regulation A is very rarely used. The commentary to the proposed rule notes that in 2012, there were eight qualified Regulation A offerings for a total offering amount of approximately $34.5 million, compared to approximately 7,700 Regulation D offerings of up to $5 million for a total offering amount of approximately

$7 billion. A number of factors, including the low offering threshold and the absence of a blue sky exemption for securities offered under Regulation A, have contributed to its limited use.

The Proposed Rules

The SEC's proposed rules would update and expand the Regulation A exemption by creating two tiers of Regulation A offerings:

- **Tier 1**, which would include those offerings already covered by Regulation A—*i.e.*, securities offerings of up to $5 million in any 12-month period, including up to $1.5 million for the account of selling securityholders, and
- **Tier 2**, which would include offerings of up to $50 million in any 12-month period, including up to $15 million for the account of selling securityholders.

For offerings of up to $5 million, an issuer could elect to use either Tier 1 or Tier 2.

Eligibility

Regulation A is available to companies organized in, and with their principal place of business in, the United States or Canada. A U.S. or Canadian subsidiary of a foreign multinational company would be eligible to rely on Regulation A if its principal place of business is in the United States or Canada. The SEC requested comment on whether Regulation A should be limited to issuers organized and with a principal place of business in the United States, thereby excluding Canadian issuers, or whether the scope should be expanded to include all foreign private issuers.

The exemption would not be available to SEC reporting companies, certain investment companies, certain development stage companies, or companies that are seeking to offer and sell asset-backed securities or fractional undivided interests in oil, gas, or other mineral rights. Regulation A would be unavailable to issuers delinquent in their Regulation A filings or subject to certain SEC orders. In addition, the requirement that a securities offering be disqualified from relying on Regulation A if the issuer or other covered persons are felons or other "bad actors" would be conformed to the bad actor disqualifications in new Rule 506(d).

The proposed rule would limit the types of securities eligible for sale under both Tier 1 and Tier 2 of Regulation A to the specifically enumerated list of securities in Section 3(b)(3), *e.g.,* equity securities, debt securities, and debt securities convertible or exchangeable into equity interests (including any guarantees of such securities). Asset-backed securities would be excluded from the list of eligible securities.

Modernization of Communications and Offering Process

The proposed rules would update Regulation A to modernize the communications and offering process in Regulation A and to reflect analogous provisions of the Securities Act registration process. Among other things:

- An issuer using Regulation A could obtain indications of interest from potential investors both before and after filing the offering statement, a practice known as "testing the waters." Any solicitation materials would need to be filed with the SEC. Any solicitation materials used after the public filing of the offering statement would need to be preceded or accompanied by a preliminary offering circular or contain a notice informing potential investors where and how the most current preliminary offering circular can be obtained (including by providing a URL link to the offering circular or offering statement on EDGAR).
- The offering statement would be "qualified" only by SEC order (rather than, in the absence of a delaying notation, on the 20th calendar day after filing) so that the SEC has the opportunity to review and comment.

- Confidential submission of draft offering statements and amendments would be permitted, provided the documents were publicly filed no later than 21 calendar days before qualification.
- The preliminary offering circular would have to be delivered at least 48 hours in advance of a sale. A final offering circular would have to be delivered within two business days after the sale in cases where the sale was made in reliance on the delivery of a preliminary offering circular. Issuers and intermediaries would be able to satisfy the delivery requirements for the final offering circular under an "access equals delivery" approach when the final offering circular is filed and available on EDGAR.
- Regulation A issuers would be required to provide updated summary offering information after termination or completion of an offering.
- All filings would be required to be submitted to the SEC in electronic format via EDGAR.

Offering Statement

Under the proposed rule, issuers would continue to be required to prepare an offering statement, including the narrative and financial information required by Form 1-A, the current structure of which would be retained. Proposed Form 1-A would no longer permit disclosure in reliance on the Model A "question and answer" disclosure format currently permitted under existing Regulation A, and would update Model B, which requires various disclosures, including basic information about the issuer; material risks; use of proceeds; an overview of the issuer's business; an MD&A type discussion; disclosures about executive officers and directors and their compensation; beneficial ownership information; related party transactions; a description of the offered securities; and two years of financial statements.

Under the proposed rule, the offering statement would in some instances contain fewer disclosure items than required under existing Form 1-A (for example, proposed Form 1-A would require a description of the issuer's business for a period of three years, rather than five years). In other respects, the offering statement would contain more disclosure (for example, proposed Form 1-A would require a more detailed discussion and analysis in the MD&A of the issuer's liquidity and capital resources and results of operations).

Other Items

The proposed rule would eliminate the existing prohibition on affiliate resales, which prohibits such resales unless the issuer has had net income from operations in at least one of the last two fiscal years. It would not exempt securities sold pursuant to Regulation A from the Section 12(g) Exchange Act registration thresholds, and would add to the list of specific safe harbor provisions subsequent offers or sales made in crowdfunded offerings. The proposed rule also outlines the scope of permissible continuous or delayed offerings under Regulation A.

The proposed rule also notes that while the liability provisions of Section 11 of the Securities Act would not apply to Regulation A offerings, other anti-fraud and civil liability provisions of the securities laws, including Sections 12(a)(2) and 17 of the Securities Act and Rule 10b-5 of the Securities Exchange Act of 1934 would apply.

Additional Requirements for Tier 2 Issuers

In addition to the provisions described above, issuers conducting Tier 2 offerings would be subject to a number of additional requirements under the proposed rules in order to address potential investor protection concerns.

Audited Financial Statements

Unlike Tier 1 offerings, the financial statements included in the offering statement for a Tier 2 offering would be required to be audited in accordance with PCAOB standards.

Ongoing Reporting Requirements

Issuers in Tier 2 offerings would be subject to an ongoing reporting regime and would be required to file various reports, including annual reports on Form 1-K, semi-annual reports on Form 1-SA, current reports on Form 1-U, and special financial reports on Form 1-SA.

Form 1-K would require disclosures relating to: the issuer's business and operations for the preceding three years (or since inception, if in existence for less than three years); related party transactions; beneficial ownership; executive officers and directors; executive compensation; MD&A; and two years of audited financial statements. Form 1-SA and Form 1-U are analogous to Form 10-Q and Form 8-K, respectively, but with scaled disclosure requirements.

A Tier 2 issuer could exit the ongoing reporting regime when it becomes a reporting company under the Exchange Act or by filing a Form 1-Z exit report if there are fewer than 300 record holders of the securities of the class that were offered and the company is current in its Regulation A filing obligations.

Investor Limitation

Investors in a Tier 2 offering would be limited to purchasing no more than 10 percent of the greater of the investor's annual income or net worth, whichever is greater. Tier 2 issuers would be permitted to rely on an investor's representation of compliance with these limitations unless they knew at the time of sale that this representation was untrue.

Interaction with State Securities Laws

Under existing Regulation A, offerings are subject to registration and qualification requirements in the states where the offering is conducted unless a state-level exemption is available. This requirement has been identified by the Government Accountability Office and market participants as one of the main reasons for the limited use of Regulation A. As a result, the SEC has provided in the proposed rules that state securities law requirements would be preempted for Tier 2 offerings, noting that the additional requirements applicable to Tier 2 offerings should provide significant additional investor protection. The proposed rules accomplish this preemption by defining "qualified purchaser" under Section 18(b)(3) of the Securities Act to include all offerees in a Regulation A offering, and all purchasers in a Tier 2 offering.

The North American Securities Administrators Association (NASAA), in correspondence with the SEC, has expressed its vigorous objection to the proposed preemption of state regulation of Regulation A offerings. NASAA has proposed a coordinated review program that would streamline the state filing and review process for Regulation A offerings, whereby a single state "lead" examiner would consolidate comments from other states and serve as a single point of contact with the issuer. In the proposed rules, the SEC indicated that it would monitor the development of the coordinated review program, and solicits comment as to whether it should wait to see if such a coordinated review program can be finalized, adopted and successfully implemented and, if so, whether such a program would sufficiently address current concerns about the costs of blue sky compliance.

Note

1. Release No. 33-9497 (Dec. 18, 2013). Comments on the proposed rules are due 60 days after the release is published in the Federal Register, which had not occured as of January 14, 2014.

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