INSIGHTS

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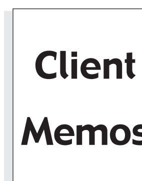

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Practical Strategies for Effective Management of Earnings Calls

Careful planning is important to see that the annual and quarterly earnings calls that accompany a public company's earnings press release comply with legal requirements and adhere to public company best practices. A number of considerations, including the evolving use of social media and the communication of forward-looking guidance, should be front of mind for company counsel in preparations for earnings season.

By Andrew L. Fabens and Sean Sullivan

While historical financial information is not required to be disseminated by public companies until the deadline for the corresponding period's periodic report,[1] most public companies announce selected financial information[2] to the market prior to that time, triggering a Current Report on Form 8-K (Form 8-K) under Item 2.02.[3] Many also hold an earnings call to discuss the company's historical financial performance, and in some cases, give forward-looking guidance.

In preparing for the earnings call and the related earnings press release, company counsel should consider the economic and financial backdrop against which the company's performance will be viewed on the earnings call. Every quarter, company counsel should be actively involved in the review and refinement of the earnings press release and the earnings call script to oversee the clarity and accuracy of the information presented.[4] Many companies also prepare responses to potential questions management could be asked in the question and answer period during the earnings call. Those companies that plan to use social media to convey information during the earnings call should prepare hyperlinks to relevant legends and cautionary statements in advance. In circumstances in which revenue or earnings are expected to be significantly higher or lower than previous periods or previously issued forward-looking guidance, special care should be given to see that the disclosures in the earnings press release and on the earnings call are clear and accurate, and that the disclosure dissemination process is properly observed, given that investor interest and litigation risk could be heightened.[5]

In some circumstances, such as a pending securities offering or management participation in an industry conference, a company may elect to pre-release its earnings results. However, this practice generally should be avoided in the absence of a compelling reason to deviate from a company's established timing for dissemination of forward-looking guidance.

Starting the Cycle: The Announcement Press Release and Earnings Call Preparation

The anticipated date of the earnings press release and the earnings call should be announced a few weeks in advance, using a method that complies with the broad dissemination requirements of Regulation FD. The announcement press release should include:

- specific instructions for how to access the earnings call or view the webcast;[6]

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- the location on the company's website of any accompanying materials, including the slides to be presented during the webcast; and
- the time period during which a rebroadcast of the webcast or replay of the call will be available on the company's website.

While an earnings call can occur at any time during the day, nearly all companies hold calls outside of market trading hours to ensure the information disclosed on the call is fully disseminated before any trading in the company's shares occurs. While the Internet allows for nearly real-time dissemination of information disclosed on earnings calls, as a practical matter, nearly all companies hold their earnings call before or after the trading day to lessen the possibility that a trader or investor listening to the earnings call could buy or sell the company's securities before those not listening to the call become aware of the company's disclosures.

On or before the day the earnings press release is disseminated, the company must file or furnish its Form 8-K,[7] attaching the earnings release as an exhibit. The dial-in information and webcast viewing instructions for the earnings call and the location of any accompanying materials to be discussed on the earnings call should be clearly noted in the earnings press release. Working in conjunction with the company's investor relations staff, company counsel should see that the earnings press release is finalized for timely dissemination over the wires and on the company's website, and that the Form 8-K is filed prior to the earnings call.

During the Earnings Call: Disclosures Made by Management

Once preparations are complete, the focus of company counsel turns to the call earnings itself and supporting the members of the management team speaking on the earnings call. Company counsel should be standing by prior to and during the earnings call for any last minute questions that may arise.

The location on the company's website of the earnings call rebroadcast and accompanying materials should be announced by management during the earnings call. Oral disclosures made during an earnings call generally do not trigger the requirement that an additional Form 8-K be filed or furnished, as long as the earnings press release has been filed or furnished within the 48 hours prior to the earnings call. Item 2.02 of Form 8-K provides a safe harbor for this information. To the extent that supplemental financial or other information is to be discussed on the earnings call but is not included in the earnings press release, this information should be made available

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on the company's website, along with the slides that management will present.[8]

Any presentation of non-GAAP financial metrics in an earnings press release must be accompanied by a reconciliation of these metrics to the most closely comparable GAAP figure.[9] Similarly, any disclosure of a non-GAAP metric orally in an earnings call that is not disclosed in the earnings press release requires reconciliation to the most closely comparable GAAP figures, which must be posted to the company's website prior to the commencement of the earnings call.

Social media practices in the context of the earnings call are evolving.

After the Earnings Call: Access on the Company Website

Following the call, because most companies provide for a rebroadcast of the earnings call via recorded webcast or recorded audio on their websites, company counsel will be faced with the decision of when to remove website access to the rebroadcasts or move the webcast or recorded call to an archive part of the website.[10] A best practice is to allow access to earnings call rebroadcasts for one or two weeks after the earnings call before removing access permanently or moving it to an archive section of the website. A rebroadcast period of this duration allows for full dissemination of the information, but is short enough that it should not result in the company maintaining forward-looking guidance about a given period on its website many weeks into that period. Absent special circumstances, the duration should be consistent from quarter to quarter.

Best Practices for Social Media Use in Connection with the Earnings Call

A small but growing number of companies are using social media platforms, such as Twitter, to "live Tweet" earnings calls.[11] Given the requirements of the securities laws discussed above, the use of the social media in this manner should be considered carefully before implementation. As a starting point, a company should consider its social media communication to be akin to any other disclosure it makes and should see that the disclosure complies with all SEC rules regarding the qualification of such disclosures. However, character-limited social media platforms, like Twitter, present a unique challenge for companies because it is often not possible to fit all required information, legends or disclaimers into a single Tweet. While the SEC has not issued specific guidelines regarding company communications on character-limited social media with respect to financial information, it has issued guidance in another context: disclosures in connection with business combinations in which character-limited social media prevents the full inclusion of a required legend. In recently released guidance with respect to Rule 165 of the Securities Act of 1933, the SEC staff stated that a hyperlink to a legend on a character-limited social media platform that is noted as important to the reader is sufficient to meet the Rule's legend requirement, provided that the destination of the hyperlink prominently conveys the mandated information.[12] By analogy, a company that elects to Tweet financial information during an earnings call could view this guidance as instructive in developing its practices.

Social media practices in the context of the earnings call are evolving. For example, during the earnings call, a company is likely to Tweet three primary types of information: (1) historical GAAP financial information and operational data; (2) historical non-GAAP financial information; and (3) forward-looking guidance. Each category of Tweet warrants different considerations with respect to how the transmitted information is qualified and the type of cautionary language included.[13]

- For historical GAAP financial information and operational data, suggested practice is

the insertion of a hyperlink to the earnings report as a whole.

- For historical non-GAAP financial information, the company should specify that the metric is non-GAAP, include the corresponding GAAP financial metric, and insert a hyperlink directly to the reconciliation contained in the earnings release, which would satisfy the requirements of Regulation G.[14]
- For forward-looking guidance, the company should specify that a statement or series of statements is "forward-looking" at the beginning of the Tweet or series of Tweets and insert a hyperlink directly to the forward-looking guidance disclaimer in the earnings release.

Company counsel should prepare hyperlinks to the relevant information prior to the call for use by the company's investor relations staff.

Companies currently use a variety of practices, as standards in this area are evolving. For example, some companies, such as GM, Boingo, and notably, Twitter itself, place relevant legends and cautionary language in a Tweet at the beginning and/or end of the series of Tweets disseminated during the earnings call. This approach may be based on the view that a series of Tweets relating to and disseminated during the earnings call should be treated as a single communication intended to be read in its entirety. It also reflects the practical reality that inclusion of relevant legends and cautionary language in each Tweet often will leave insufficient room for the information the company seeks to convey. To bolster the "single communication" argument, some of these companies include "hashtags" to distinguish Tweets disseminated during the earnings call, and conclude each of these Tweets with "#XYZearnings" (where XYZ is the company's stock ticker). Another approach, which has been used by companies such as LinkedIn and eBay, is to include a hyperlink to the earnings report in every Tweet disseminated during the earnings call. This practice, however, significantly reduces the number of characters available for conveying information in each Tweet.

The small number of companies currently using limited-character social media communications during their earnings calls may be due, in part, to the regulations governing the dissemination of information and the absence of more specific guidance from the SEC. An added complexity for consideration is that individual Tweets can be "Retweeted," effectively removing them from their original context and from the accompanying Tweets in a series that may contain legends and cautionary language. As a guiding principle, companies seeking to use character-limited social media during earnings calls should balance inclusion of legends and disclaimers relating to the information presented with the practical limitations of the platform as they consider the use and placement of hyperlinks to legends and cautionary language in their Tweets.

Inclusion of relevant legends and cautionary language in each Tweet often will leave insufficient room for the information the company seeks to convey.

Forward-Looking Guidance in the Context of the Earnings Call

A slowly declining, but substantial majority of public companies provide some form of forward-looking guidance,[15] and many present that information on their earnings call. There are many arguments with respect to whether, and to what extent, a company should issue forward-looking guidance on earnings calls and/or in the earnings press release. Forward-looking guidance proponents argue that by providing this guidance, companies increase transparency and reduce uncertainty with respect to future financial

results. Companies that provide forward-looking guidance face specific challenges in managing and appropriately qualifying such disclosures, and it is critical that a company adopt and adhere to a policy that addresses key items, including:

- the scope of forward-looking guidance to be provided (financial, non-financial or both);
- the timing and frequency of forward-looking guidance (quarterly or annual);
- the qualification of forward-looking guidance by citing specific trends or events that could affect the accuracy of the forward-looking guidance;
- the review of the earnings press release and/or earnings call script, including careful review of the "forward-looking statements disclaimer;" and
- the circumstances under which the company will update guidance.

Forward-looking guidance encompasses more than just numerical statements with respect to projected financial performance. Descriptions of future business and industry trends, progress on company strategic initiatives and quotations or commentary discussing the state of the company that are made on the earnings call or in the earnings press release also can be covered by the safe harbor for forward-looking statements.[16] In reviewing each proposed earnings call script, careful thought should be given to any statement that may be construed as forward-looking in nature to see that it is properly presented and that the forward-looking guidance disclaimer is properly tailored to the statements that will be included in that particular earnings call script.

Companies take differing views with respect to the method by which they provide disclosure of forward-looking guidance to the market. Some view the written press release as the clearest and most permanent method of presenting this information, and therefore present the forward-looking guidance in the earnings release and restate the information on the earnings call. Other companies provide forward-looking guidance only orally on the earnings call. However, because the earnings call is available on the company's website for some period of time, and a number of commercial sites and transcription services sell written call transcripts,[17] oral guidance, like written guidance, is readily available long after the earnings call. A best practice is to include forward-looking guidance in the earnings press release, at least in summary form, so that investors, the press and the general public can easily locate the information at the time of the earnings release and in the future.

Forward-looking guidance encompasses more than just numerical statements.

Updating Forward-Looking Guidance

While the earnings press release and earnings call are the primary avenues of communication of the company with the broader investment community, there are occasions in which a company's management may refine or revise guidance that has been previously provided. As a general rule, a company does not have a duty to update forward-looking statements that it has previously made; however, when a company's previous forward-looking statement becomes clearly misleading or inaccurate, a company should consider whether disclosure correcting, revising or updating the prior forward-looking guidance is warranted.[18] Generally, a company may need to evaluate whether to correct or update forward-looking guidance where the company:

- plans to offer securities;
- plans to repurchase its securities or engage in a going-private transaction;
- desires to enable insiders to trade in its securities, subject to the company's insider trading policy and trading windows; or
- desires to manage investor expectations in order to maintain credibility and mitigate unpleasant surprises and litigation risk.

Although court decisions have not consistently identified factors that render forward-looking guidance updates unnecessary, the following circumstances may support a conclusion that no update of the original forward-looking guidance is required or advisable:

- it has not become materially inaccurate;
- it was clearly presented as a forward-looking statement and was accompanied by meaningful cautionary language that identified the risk that caused the guidance to become inaccurate;
- it was clearly phrased to speak only as of the date given;
- a publicly disclosed event, such as a large acquisition or a significant industry development, makes it clear that no reasonable investor would believe that the original forward-looking guidance continues to apply; or
- it explained the assumptions on which it was based, and information widely available to market participants makes clear that the assumptions have not come to pass.

Any update to guidance should be disseminated in a manner that is compliant with Regulation FD and should be filed on Form 8-K as well.

Conclusion

A company's earnings call, and the related earnings release, is one of the most high-profile avenues available to a company to communicate important information to its investors and the public. Careful planning of the earnings call, a thoughtful approach to related social media communications and the proper presentation of forward-looking guidance disseminated on the earnings call can contribute substantially to the smooth and effective execution of the earnings calls.

Notes

1. The Annual Report on Form 10-K is due 60 to 90 days after the end of the corresponding quarter; the Quarterly Report on Form 10-Q is due 40 to 45 days after the end of the corresponding quarter.
2. The release of this material non-public information about the company's financial performance, whether by press release, webcast or conference call, triggers Item 2.02 of Form 8-K.
3. While the Current Report on Form 8-K must be filed or furnished with the SEC within four business days, the market practice for most public companies is to promptly file or furnish it after the announcement of the earnings information.
4. Most companies observe a blackout period, during which officers, directors and certain other insiders cannot trade in company's stock, because these individuals may be in possession of material non-public information about the company and its financial performance. These blackout periods generally end 24 to 48 hours after the company files the periodic report for that period.
5. All parties with knowledge of or access to the draft earnings release, or the financial information and forward-looking guidance contained therein, should be regularly reminded of the importance of maintaining the confidentiality of the information, pursuant to applicable insider trading policies.
6. To satisfy the concept of broad accessibility under Regulation FD with respect to the earnings call, companies typically make the earnings call available in multiple formats, including conference call and webcast.
7. In many circumstances, a company can elect to either file or furnish its Form 8-K with the SEC. When a Form 8-K is filed, the information is incorporated into any Rule 415 shelf registration statements of the company, although incorporation by reference of a furnished Form 8-K is permitted by including a specific reference in the offering document. Absent specific reasons to file Forms 8-K, companies typically furnish them.
8. If *unrelated* material information that would otherwise be required to be disclosed on a Form 8-K is disclosed orally on an earnings call and is not included in either the earnings press release or the materials posted to the company's website in advance of the earnings call, the company should promptly file or furnish that information on Form 8-K.
9. The use of non-GAAP metrics is governed by Regulation G and Item 10(e) of Regulation S-K.
10. Companies often move a webcast or recorded call to an archive portion of their website to maintain the availability of the information in a centralized location while also signaling that the information is dated and does not speak as of the time it is accessed through the archive portion of the website.
11. Twitter is a social media platform in which users can convey messages of up to 140 characters.
12. The SEC issued this Compliance and Disclosure Interpretation (C&DI) on April 21, 2014. CD&Is are available at *http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm*.
13. Under Section 21E of the Securities and Exchange Act of 1934, as amended, forward-looking guidance in the earnings press release and/or the earnings call should be qualified as forward-looking and meaningful

cautionary language should be included with respect to the factors that could cause actual results to materially differ from the forward-looking guidance. The Private Securities Litigation of Reform Act of 1995 (15 U.S.C. § 78u-5) provides a safe harbor for forward-looking statements on condition that the company concurrently supplies such qualifying language. While some companies may use a "boilerplate" formulation of the "forward-looking statements disclaimer," the law requires that the cautions be specifically tailored to the forward-looking statements. Company counsel should review each earnings press release and earnings call script and include tailored and precise disclaimer language.

14. When a company communicates a non-GAAP financial metric, Regulation G requires the company to disclose the corresponding GAAP financial metric and the reconciliation of the two metrics in the same communication.

15. According NIRI Analytics' *Guidance Practices and Preferences 2012 Survey Report*, 88 percent of 2012 survey respondents provide some form of guidance (either financial, non-financial or both), compared to 90 percent in 2010 and 93 percent in 2009. 76 percent of survey respondents report providing financial guidance in 2012, compared to 81 percent in 2010 and 85 percent in 2009.

16. *See* endnote 13.

17. While transcription of earnings calls is common and generally accurate, inaccuracies can occur, including with respect to forward-looking guidance. Company counsel should consider discussing with the company's investor relations staff whether and how it conducts reviews of transcripts of earnings calls.

18. Some courts recognize a duty to correct, where guidance is discovered to have been based on incorrect information, and a duty to update, where circumstances have changed but the guidance has nonetheless remained "alive" in the minds of reasonable investors. *See In re Burlington Coat Factory Sec Litig.*, 114 F.3d 1410, 1432 (3d Cir. 1997) (stating a duty to update may arise if "the projection contained an implicit factual representation that remained 'alive' in the minds of investors as a continuing representation"); *see also In re International Business Machines Corp. Sec. Litig.*, 163 F.3d 102, 110 (2d Cir. 1998); *Winnick v. Pac. Gateway Exch., Inc.*, No. 02-16060, 2003 U.S. App. LEXIS 17030 (9th Cir. August 15, 2003).

CORPORATE LITIGATION

Increased Risk of Post-Closing Damages Litigation on Disclosure Claims

In a recent series of cases, the Delaware Court of Chancery clarified that money damages may be available post-closing to remedy a disclosure violation where there is evidence of a breach of the duty of loyalty by the directors who authorized the disclosures. While it is expected that early-stage, disclosure-only settlements will continue to be the norm in public company M&A litigation, this development may materially alter the way in which such cases are litigated (and settled).

By Peter L. Welsh, Martin J. Crisp, and Timothy V. Capozzi

The ubiquity of public company M&A litigation is well-established, as the overwhelming majority of large and even modest-sized deals now result in multiple stockholder lawsuits. A quick glance at the numbers once again confirms this: for the fourth consecutive year now over 90 percent of public company transactions valued at over $100 million resulted in litigation in 2013, with each deal attracting an average of more than five lawsuits.[1] This sustained spike in lawsuits remains largely attributable to the proliferation of disclosure-based actions seeking "therapeutic relief" in the form of additional disclosures. The incentives favoring the early-stage, disclosure-only settlements that typically resolve such litigation are well known, as corporations face intense pressure to resolve any litigation that may delay or otherwise interfere with a signed deal, and the costs of pre-closing, disclosure-only settlements generally are modest in comparison with the total transaction value.[2] Although the Delaware Court of Chancery has grown increasingly skeptical of such settlements,[3] many disclosure-based stockholder suits continue to be litigated pre-closing with a focus on expedited discovery, the possibility of injunctive relief, and a potential non-monetary settlement at a relatively modest cost to the target company. Absent an injunction or settlement, the general practice was that disclosure-based claims do not get litigated post-closing. Recent developments may signal a change in this practice.

In a series of decisions handed down during the first half of 2014, the Delaware Court of Chancery clarified that, despite the equitable nature of disclosure claims and a general preference that such claims be litigated pre-closing, money damages may be available post-closing to a plaintiff who uses discovery to uncover material, undisclosed facts that implicate a director's fiduciary duty of loyalty. While there remain formidable obstacles blocking the way of a stockholder plaintiff hoping to win post-closing monetary relief on disclosure claims—to prevail at trial, a plaintiff must prove reliance on the alleged inadequate disclosures, causation, and quantifiable money damages—this development has a potentially material impact on the way in which parties will choose to litigate (and settle) disclosure claims in M&A litigations. This impact on litigation strategy may be significant given the potential for a material damages award in a post-closing case, which award may be based on the difference between the court's estimate of the fair value of the target company and the merger consideration.

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The Existing Uncertainty: *In re Transkaryotic Therapies, Inc.*

Until recently, the viability of post-closing disclosure claims was the subject of considerable debate. While some M&A practitioners believed that such claims were proscribed in all instances, others thought that post-closing disclosure claims for money damages could be maintained in certain circumstances. At a minimum, there appeared to be significant obstacles to pursuing such claims. The range of opinions was largely attributable to divergent readings of former Chancellor Chandler's 2008 decision in *In re Transkaryotic Therapies, Inc.*[4]

> ***Until recently, the viability of post-closing disclosure claims was the subject of considerable debate.***

The *Transkaryotic* litigation arose from the strategic merger of two pharmaceutical companies. In the months immediately following the merger, stockholders in the target company filed appraisal actions. Following extensive discovery in the appraisal actions, the stockholders filed a breach of fiduciary duty action, alleging that Transkaryotic's directors breached their duties of care and loyalty by failing to disclose material facts before the stockholders voted to approve the transaction. After the appraisal and fiduciary duty actions were consolidated, several of the directors moved for summary judgment on the disclosure claims, arguing that the alleged non-disclosures were immaterial, and, in any event, the disclosure claims were barred by the 102(b)(7) exculpatory charter provision in Transkaryotic's certificate of incorporation.

Chancellor Chandler granted the directors' motion with respect to the plaintiffs' disclosure claims, concluding that the Court did not need to wrestle with the claimed materiality of the alleged omissions or the application of the exculpatory provision because the stockholders' claims were "barred."[5] He reasoned that post-closing, the Court lacked the tools to redress the stockholders' true injury from alleged material omissions—the infringement of their right to cast informed votes on the transaction. Monetary damages were inadequate because the right to cast an informed vote "cannot be adequately quantified or monetized";[6] equitable remedies were either impractical or pointless—the Court could not unwind the merger because "'the metaphorical merger eggs [had] been scrambled,'"[7] and supplemental disclosures nearly three years after the merger "would be an exercise in futility and frivolity."[8] Having found the Court's remedial options inadequate, the Chancellor held that the Court of Chancery

> cannot grant monetary or injunctive relief for disclosure violations in connection with a proxy solicitation in favor of a merger three years after that merger has been consummated and where there is no evidence of a breach of the duty of loyalty or good faith by the directors who authorized the disclosures.[9]

Underpinning Chancellor Chandler's decision in *Transkaryotic* is the concern that, if the Court permitted post-closing damages actions for disclosure claims, strategic litigants might employ dilatory tactics to win money damages by waiting for a deal to close before bringing their disclosure claims.[10] Such an outcome would not only undermine the Court of Chancery's policy, motivated by the primacy of a fully informed stockholder vote and the irreparable harm to stockholders of a vote without complete and accurate information, of encouraging pre-closing litigation of disclosure claims but also thwart the Court's "clear … desire to avoid entirely the issue of monetary damages."[11] Thus, Chancellor Chandler repeatedly emphasized the nearly three years that had passed between the merger close and the filing of the disclosure claims, at one point attributing the gap to the plaintiffs' delay.[12]

Because of its strong language disfavoring post-closing disclosure claims and its finding that the claims at issue were "barred," some practitioners and litigants not unreasonably understood *Transkaryotic* to have effectively precluded post-closing relief for disclosure claims.[13] Others believed that the decision left some room for a post-closing money damages action for disclosure claims in an appropriate case, highlighting that the Court's holding did not explicitly foreclose such relief where there is evidence of a breach of the duty of loyalty or good faith by the directors who authorized the disclosures.[14] In the years following the decision, the Court of Chancery appeared similarly ambivalent, with individual opinions seemingly supportive of one side of the debate or the other.[15] As a practical matter, that uncertainty only intensified the already strong incentives for early-stage settlement of disclosure claims.

The New Normal: *In re Orchard Enterprises, Inc. Stockholder Litigation*

In February of 2014, some five years after *Transkaryotic* was decided, Vice Chancellor Laster, one of the Court of Chancery's most vocal critics of the early-stage, disclosure-only settlements that have come to predominate the Court's docket in recent years,[16] squarely addressed the issue of post-closing money damages actions based on disclosure claims in his *In re Orchard Enterprises, Inc. Stockholder Litigation* opinion.[17] That opinion, which holds that money damages can be an appropriate remedy for post-closing duty of loyalty disclosure claims, is likely to end the post-*Transkaryotic* speculation and influence Delaware disclosure claim litigation for the foreseeable future.

Orchard involved a deal in which a private equity fund squeezed out the minority stockholders of a digital music and video distributor. After the deal closed, stockholders of the distributor filed an appraisal action. Two months after a ruling in the appraisal action, and over two years after the merger closed, the *Orchard* plaintiffs filed a breach of fiduciary duty action.[18] The director defendants moved for summary judgment, arguing that *Transkaryotic* barred any award of money damages for a post-closing disclosure claim.[19] Vice Chancellor Laster disagreed. He flatly rejected that *Transkaryotic* required the "dramatic result" argued for by the directors.[20] *Transkaryotic*, he explained, was no more than a "straightforward application" of Delaware law, which had long honored a company's ability to shield its directors from personal liability for disclosure violations where the fiduciary breach was not a product of disloyalty.[21] He further stated that *Transkaryotic* did not apply because the *Orchard* squeeze-out transaction, unlike the merger of two pharmaceutical companies at issue in *Transkaryotic*, was not an arm's-length transaction, and, unlike the stockholder plaintiffs in *Transkaryotic*, the stockholder plaintiffs in *Orchard* had identified credible evidence that the director defendants breached their duty of loyalty.[22]

In re Orchard Enterprises, Inc. Stockholder Litigation *holds that money damages can be an appropriate remedy for post-closing duty of loyalty disclosure claims.*

While carefully distinguishing the two cases on their facts, Vice Chancellor Laster did not discount the *Transkaryotic* Court's goal, "consistent with other Court of Chancery decisions," of encouraging plaintiffs to bring disclosure claims before a merger vote, or its proposition that "the equitable remedy of pre-vote relief is superior and preferable."[23] Instead, he rejected the contention that a stockholder that uncovers a material disclosure claim that implicates the duty of loyalty through the discovery process should have no remedy simply because "a monetary

remedy cannot perfectly replicate" the original stockholder vote.[24] He posited that a court confronted with such a scenario could compensate the wronged stockholder, who was forced to vote without adequate information, by returning to the stockholder the fair value of the stockholder's shares less the merger consideration received for those shares.[25] Addressing the *Transkaryotic* Court's implicit concern that stockholders "might too easily obtain a post-closing award of damages for a breach of disclosure" if such damages are made available, Vice Chancellor Laster emphasized that while pre-vote injunctive relief merely requires a showing of a material misstatement or omission, stockholders seeking post-vote monetary relief will need to establish reliance, causation, and quantifiable money damages.[26]

Subsequent Decisions

In the weeks following Vice Chancellor Laster's *Orchard* opinion, the Court of Chancery issued two decisions that suggest that, rather than being an isolated data point for practitioners to consider, *Orchard* seems to have resolved the uncertainty that followed *Transkaryotic*. First, a little over one week after *Orchard*, Vice Chancellor Noble decided *Frank v. Elgamal*, another disclosure case involving alleged unfairness to minority stockholders in a change of control transaction.[27] In *Frank*, which cited *Orchard* twice, Vice Chancellor Noble appears to have presumed that monetary relief for post-closing disclosure claims is an available remedy for stockholder plaintiffs. After surveying the summary judgment record, he concluded that an issue of fact prevented him from determining the adequacy of the disclosures at issue and whether the plaintiffs' disclosure claims implicated the duty of loyalty.[28] As a result, he held that he was unable at summary judgment to determine whether the directors might face monetary liability.[29]

While *Frank* shows that at least one other Vice Chancellor appears to agree that money damages are a possible remedy for post-closing disclosure claims in connection with mergers involving a transaction between a controller and minority stockholders in a squeeze-out transaction, Vice Chancellor Laster's more recent decision in *Chen v. Howard-Anderson* shows that *Orchard* likely will apply beyond this specific context.[30] In *Chen*, which involved the merger of two manufacturers of broadband access equipment, the director defendants argued that no remedy was available to the stockholders because the deal had already closed and the merger did not involve a controlling stockholder.[31] Vice Chancellor Laster, citing *Orchard*, summarily rejected the stockholders' contention as "an incorrect statement of current Delaware law," concluding that money damages could be awarded if the stockholders proved at trial a disclosure violation attributable to a failure to act in good faith.[32]

Stockholders seeking post-vote monetary relief will need to establish reliance, causation, and quantifiable money damages.

Key Takeaways

Over the past few years, the Court of Chancery has become increasingly wary of early-stage, disclosure-only settlements that yield a handsome return for plaintiffs' lawyers, and releases for defendants, but offer no appreciable benefit to stockholders.[33] Until recently, the blame for the dramatic rise in such settlements has fallen primarily on plaintiffs and their counsel, and the Court of Chancery has moved to deter such suits, including by increasing judicial recognition of the validity of forum-selection clauses in corporate bylaws and decreasing attorney fee awards.[34] The Court's recent decision in *Orchard* is notable in that it offers energetic plaintiffs' attorneys the possibility of a meaningful carrot—possible money

damages for post-closing disclosure claims—rather than yet another stick.

While it is uncertain whether the plaintiffs' victories at summary judgment in *Orchard*, *Frank*, and *Chen* ultimately will result in damages awards following trial, the mere possibility of a potentially substantial money damages award (and a corresponding substantial fee award for counsel) is likely to materially alter the complexion of disclosure claim litigation. While early-stage, disclosure-only settlement is expected to remain the norm for the foreseeable future, corporate defendants increasingly my find themselves negotiating with plaintiffs who are willing to spurn early settlement and seek full-blown, post-closing merits discovery, particularly in Delaware and other state courts where discovery often occurs prior to or contemporaneously with defendants' motion to dismiss. In this context, deal participants must re-calibrate to account for the prospect of prolonged litigation and the collateral consequences, including increased discovery costs, the reality that post-closing disclosure claims that survive a motion to dismiss will in most cases require a money payout to settle, and the possibility of directors and officers insurance coverage disputes over the applicability of "bump up" provisions to such settlements.

Notes

1. *See* Olga Koumrian, *Stockholder Litigation Involving Mergers & Acquisitions*, Cornerstone Research Review of 2013 M&A Litigation, p. 1 (2014).
2. *See* Olga Koumrian, *Settlements of Stockholder Litigation Involving Mergers & Acquisitions*, Cornerstone Research Review of 2013 M&A Litigation, p. 3 (2014) (illustrating that the average fee approval in disclosure-only settlements executed in 2010-2013 was $456,000 in Delaware courts and $545,000 in other courts).
3. *See* Peter L. Welsh & Gregory L. Demers, *Delaware Clamps Down on Disclosure-Based M&A Litigation*, Insights: Corporate & Securities Law Advisor, January 2014, p. 16.
4. 954 A.2d 346 (Del. Ch. 2008).
5. *Id.* at 357.
6. *See id.* at 361.
7. *Id.* at 362 (quoting *McMillan v. Intercargo Corp.*, 768 A.2d 492, 500 (Del. Ch. 2000)).
8. *Id.*
9. *Id.*
10. *See In re Orchard Enters., Inc. S'holder Litig.*, C.A. No. 7840-VCL, 2014 Del. Ch. LEXIS 31, at *143 (Feb. 28, 2014) (responding to the *Transkaryotic* Court's seeming concern with "the problem that stockholders might too easily obtain a post-closing award of damages for a breach of the duty of disclosure").
11. *In re Transkaryotic Therapies, Inc.*, 954 A.2d at 360.
12. *Id.* at 366 n.55.
13. *See, e.g.*, Robert S. Reder et al., *DE Court Rules on Deficiencies in Proxy Materials*, The Corporate Counselor, December 2008, *http://www.milbank.com/images/content/1/0/1061/1208-Corporate-Counsel-Reder-Stone-Haddad.pdf* (opining that *Transkaryotic* "will leave plaintiffs without a remedy for legitimate disclosure claims if they neglect to press their claims, or do not discover the deficiencies, until after the transaction has been consummated"); Broc Romanek, *Duty of Disclosure: Delaware Chancellor Further Limits Availability of Damages*, DEALLawyers.com, June 25, 2008, *http://www.deallawyers.com/blog/2008/06/duty-of-disclosure-delaware-chancellor-further-limits-availability-of-damages.html* (asserting that *Transkaryotic* left "very little room for any post-closing remedy" for a duty of disclosure claim).
14. *See, e.g.*, Willkie Farr & Gallagher LLP, *Delaware Chancery Court Limits Damages for Duty-Of-Disclosure Claims; Dismisses Claims Against Directors for Breach of Fiduciary Duty*, June 27, 2008, *http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C2648%5CDelaware_Chancery_Court_Limits_Damages.pdf* (predicting that, after *Transkaryotic*, failure to pursue injunctive relief for disclosure claims would leave future plaintiffs without an effective remedy "absent a showing of bad faith or breach of the duty of loyalty"); Karen L. Valihura et al., *Recent Developments in Delaware Law*, Bloomberg Law Reports—Corporate Law, 2009, *http://www.skadden.com/sites/default/files/publications/Publications1998_0.pdf* (asserting that *Transkaryotic* "appeared to close the door on the availability of monetary or equitable relief for a disclosure violation" where "there was no evidence of a breach of the duty of loyalty or good faith by the directors who authorized the disclosures").
15. *Compare Binks v. DSL.net, Inc.*, C.A. No. 2823-VCN, 2010 Del. Ch. LEXIS 98, at *53 (Del. Ch. Apr. 29, 2010) (dismissing possible disclosure claims and quoting *Transkaryotic* for the proposition that, even if the plaintiffs adequately alleged a disclosure violation, the only available remedy, supplemental disclosure, would "be an exercise in futility and frivolity"), and *In re Countrywide Corp. S'holders Litig.*, C.A. No. 3464-VCN, 2009 Del. Ch. LEXIS 44, at *53 (Del. Ch. Mar. 31, 2009) (citing *Transkaryotic* as support for the proposition that the

plaintiffs' disclosure claims "would likely not support a money damages award now that the merger has closed"), and *In re Alloy, Inc.*, C.A. No. 5626-VCP, 2011 Del. Ch. LEXIS 159, at *48-52 (Del. Ch. Oct. 13, 2011) (noting that the plaintiff stockholders did not refute the defendants' contention that *Transkaryotic* precluded money damages for disclosure violations), with *In re John Q. Hammons Hotels Inc. S'holder Litig.*, C.A. No. 758-CC, 2009 Del. Ch. LEXIS 174, at *50-51 n.49 (Del. Ch. Oct. 2, 2009) (denying defendants summary judgment because, unlike *Transkaryotic*, issues of loyalty were implicated and therefore "this is not a case in which the Court will refrain from granting relief for disclosure violations because the transaction has been completed").

16. *See In re Gen-Probe Inc. S'holders Litig.*, No. 7495-VCL, at 36-37, 46-47 (Del. Ch. Apr. 10, 2013) (transcript) (characterizing a disclosure-only settlement as "terribly thin" and remarking that "there may need to be a recalibrating of the market" in calculating attorney fee awards in such cases).

17. C.A. No. 7840-VCL, 2014 Del. Ch. LEXIS 31 (Feb. 28, 2014).

18. While the merger consideration was $2.05 per share, former Chancellor Strine determined in the appraisal action that the fair value of the common stock at the time of the merger was $4.67 per share. *Id.* at *1-2. The discrepancy related to whether the transaction triggered a liquidation preference in favor of the distributor's Series A convertible preferred stock, ninety-nine percent of which was held by the private equity fund and its affiliates at the time of the squeeze-out. *Id.* at *4, *10-11. The *Orchard* plaintiffs alleged, among other things, that the proxy statement disseminated by the distributor in advance of the stockholder vote on the deal misstated whether the merger triggered the liquidation preference. *Id.* at *29.

19. *Id.* at *136.

20. *Id.*

21. *Id.* at *136-37.

22. *Id.* at *136-38.

23. *See id.* at *136, *142-43.

24. *Id.* at *142.

25. *Id.*

26. *Id.* at *143-44.

27. C.A. No. 6120-VCN, 2014 Del. Ch. LEXIS 37 (Mar. 10, 2014).

28. *Id.* at *117-19.

29. *Id.*

30. C.A. No. 5878-VCL, 2014 Del. Ch. LEXIS 50 (Apr. 8, 2014).

31. *Id.* at *118.

32. *See id.* at *118-19.

33. *See* Welsh & Demers, *supra* n.3.

34. *See id.*

SECURITIES ENFORCEMENT

Imposing *Brady*-Like Obligations on the SEC?

*The SEC currently denies civil defendants one of the most basic protections afforded to every criminal defendant—the right to favorable evidence, or "*Brady *material." Given the "quasi-criminal" punishments the SEC can impose, should the SEC policy be changed?*

By Stephen A. Best, Paul F. Enzinna, and Evan N. Turgeon

In recent years, the SEC has seen its enforcement powers expanded, and has made enforcement a "key priority."[1] The SEC may not imprison individuals, a fact apparently regretted by its current Chair, Mary Jo White.[2] But although Chair White believes they are "too low," the "quasi-criminal" punishments[3] the SEC can impose are significant, and may include large monetary payments and loss of livelihood.[4] Nevertheless, the SEC denies civil defendants one of the most basic protections afforded to every criminal defendant: the right to favorable evidence, or "*Brady* material." The SEC's policy in this regard denies defendants a fair trial, and undermines the truth-seeking function of those trials.

The *Brady* Rule

In *Brady v. Maryland*, the Supreme Court held that the Due Process Clause requires the government in criminal cases to disclosure exculpatory evidence "material to guilt or punishment," which is known to the government but unknown to the defendant.[5] This obligation covers not only evidence supporting the accused's defense, but also information that may be used to impeach government witnesses.[6] Violations of this rule can result in a reversal of conviction and/or a new trial for the accused.[7] The *Brady* doctrine reflects an acknowledgement that when seeking to punish its citizens, the State's interest is not to win the case, but to ensure that "justice shall be done."[8]

However, the *Brady* decision affords these protections only to defendants in criminal proceedings; the Supreme Court has not decided whether *Brady* requires government agencies to make affirmative disclosure of exculpatory material to defendants in civil cases.[9] Instead, it falls to each individual agency to decide whether to follow the *Brady* rule in its civil litigation or administrative actions. The SEC purports to follow the *Brady* rule in administrative proceedings before it.[10] Its rule, however, requires the defendant to request such information, and applies only to certain categories of information, such as transcripts and documents obtained by subpoena.[11] Because the rule imposes no affirmative duty to disclose exculpatory evidence as such, the SEC need not disclose all exculpatory information in its possession, as the *Brady* decision requires. And the SEC has *no Brady* obligation in civil actions it brings in federal court.

A More Significant and Aggressive SEC Enforcement Role

After the 2008 financial crisis, Congress expanded and enhanced the SEC's enforcement powers. The Dodd-Frank Act authorized extraterritorial application of U.S. securities

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laws,[12] authorized nationwide service of process,[13] expanded the SEC's authority to impose quasi-criminal civil penalties in cease-and-desist actions,[14] expanded the reach of aiding and abetting liability,[15] and provided strong incentives and protections for whistleblowers who alert the SEC to securities violations.[16]

Shortly after being named SEC Chair, Mary Jo White, a former criminal prosecutor, stated that the agency, in enforcing the securities laws—which White identified as a "key priority"—the SEC would "deploy[] the full enforcement arsenal," and use "all available means."[17] She promised to be a "tough cop," to be "aggressive and creative," and to "maintain and enhance our ability to win at trial."[18]

Unjust Outcomes

At the same time the SEC seeks to enhance its prosecutorial role, it refuses to provide defendants with the same fairness provided in criminal trials. The SEC's failure to adopt a meaningful *Brady* rule prejudices defendants and produces patently unjust outcomes. It also undermines the ostensible purpose of SEC enforcement actions—to ascertain the truth.

SEC Civil Actions

Having adopted no *Brady* rule in its civil actions, the SEC has no affirmative duty to disclose exculpatory evidence to defendants. While defendants in civil actions may seek discovery under the Federal Rules of Civil Procedure, a defendant who fails to formulate a discovery request that captures a document—which the defendant may not know exists—will never see that document, however exculpatory it is. Nor will the court or jury deciding the case.

Even if *Brady* material is responsive to a discovery request, the SEC may withhold it by claiming that it is immune from disclosure based on privilege or attorney work product protection. In the insider trading suit *SEC v. Cuban*,[19] for example, the SEC sought to withhold attorney notes documenting exculpatory statements that Mr. Cuban made during an interview with SEC attorneys immediately after the trade at issue—classic *Brady* material. Mr. Cuban won access to the notes only after extensive litigation, and even then the SEC filed motions *in limine* and objected at trial in an effort to prevent this evidence from being shown to the jury. The notes eventually were admitted, and the jury acquitted Mr. Cuban of all wrongdoing. But defendants unwilling or unable to engage in such protracted and costly litigation routinely are denied access to material that could prove their innocence.

The rules governing parallel or joint SEC-DOJ investigations add another wrinkle, and create a danger of collusion between the SEC and DOJ that would deny defendants access to *Brady* material in civil and criminal proceedings alike. In the *Gupta* case, the U.S. Attorney's Office for the Southern District of New York and the SEC brought parallel criminal and civil charges against the defendant after a broad insider-trading investigation.[20] As part of the factual investigation, the U.S. Attorney's Office and the SEC conducted joint interviews of numerous witnesses.[21] The SEC attorney who attended the joint interviews prepared memoranda that summarized the portions of the interviews he deemed relevant.[22]

Gupta moved for production of these memoranda on two fronts. Gupta contended that in the criminal case, the U.S. Attorney's Office had an obligation under *Brady* to review the SEC's memoranda and to turn over any exculpatory evidence.[23] He also argued that in the civil action, he was entitled to the material under Federal Rule of Civil Procedure 26(b) as "matter relevant to the subject matter involved in the action."[24] The U.S. Attorney's Office objected on the ground that it had no *Brady* obligation to review or disclose the SEC's materials because the SEC was not an "arm of the prosecutor" or part of a "joint prosecution

team."[25] The SEC argued that the memoranda were entitled to work product protection and exempt from disclosure under Rule 26(b)(3).[26]

The court rejected the government's positions and required the U.S. Attorney's Office to review the memoranda and disclose any *Brady* material to Gupta.[27] The court held that where an investigation includes joint fact-gathering, the government is charged with reviewing all documents and information connected to that joint investigation and disclosing any exculpatory information.[28] The court also rejected the SEC's argument, holding that although the memoranda were "classic work product under Fed. R. Civ. P. 26(b)(3)," that protection was overcome by the defendant's "substantial need" for the material.[29]

Defendants in SEC administrative actions face penalties tantamount to criminal sanctions.

Although Gupta was eventually able to access the *Brady* material he sought, it exposes a very real danger for defendants. Because the SEC is under no *Brady* obligation in civil litigation, the SEC may conduct an investigation independent from the U.S. Attorney's Office, review the material collected, and selectively disclose information suggesting the defendant's culpability to criminal prosecutors while withholding exculpatory material.[30] Prosecutors who "outsource" fact-gathering to the SEC in this way could deny defendants *Brady* material even in criminal prosecutions.

SEC Administrative Actions

Numerous factors make SEC administrative actions the sort of proceedings that warrant meaningful procedural protections. Defendants in SEC administrative actions face penalties tantamount to criminal sanctions.[31] The costs of defending an administrative action can be huge, as can the financial penalties (including punitive sanctions) that the SEC may impose if the defendant loses.[32] And the damage to an individual's reputation or the imposition of a trading ban can further damage or even destroy a defendant's business. Additionally, the SEC's fact-finding power in administrative actions is broad and one-sided. The discovery provisions of the Federal Rules of Civil Procedure do not bind the SEC in such proceedings.[33] Instead, the SEC is bound only by its own discovery rules, which restrict the material available to defendants but grant the SEC wide latitude. Moreover, the SEC gathers large amounts of information from potential defendants in its role as a regulator.[34]

SEC regulations do impose a watered-down, quasi-*Brady* obligation in its enforcement proceedings, where it enjoys "home-court advantage."[35] Rule 230 requires that the Division of Enforcement make available to defendants in administrative proceedings certain documents it obtains prior to the institution of proceedings, including transcripts and documents obtained from persons outside the SEC.[36] The rule permits the Division to withhold from this production certain documents, including those subject to privilege, work-product protection, or the disclosure of which would reveal the identity of a confidential source.[37] The rule states that this power to withhold does not authorize the Division of Enforcement to "withhold, contrary to the doctrine of *Brady v. Maryland*, documents that contain material exculpatory evidence."[38]

But this quasi-*Brady* obligation is insufficient to safeguard defendants.[39] First, *Brady* imposed a rule of disclosure, not a rule of discovery. This means that in criminal proceedings, the *Brady* rule applies whether or not a defendant requests exculpatory information.[40] The SEC rule does not mandate that the SEC disclose anything unless the defendant requests it. In cases where the defendant does not know that exculpatory material exists, and therefore does not request it, the SEC is under no obligation to disclose it.[41]

Second, even where a defendant requests disclosure of information that would be exculpatory, the rule does not require the SEC to produce it unless it fits one of the categories the disclosure of which is mandated. The rule requires the SEC to disclose documents obtained by subpoena and all documents obtained from persons not employed by the Commission, as well as transcripts and transcript exhibits.[42] However, it does not require the SEC to disclose, for example, notes taken by its staff in interviews, such as the exculpatory notes in the *Cuban* case.

Several other agencies have adopted* Brady *rules voluntarily.

Third, the SEC interprets its own *Brady* rule narrowly, that defendants are not entitled to "engage in 'fishing expeditions' through confidential Government materials in hopes of discovering something helpful to their defense"—language quoted regularly in SEC administrative decisions denying defendants access to *Brady* material.[43] The SEC instead requires that a defendant make a "plausible showing" that the information requested is both "favorable and material" to his defense.[44] The SEC's expansive discovery power results in the SEC collecting vast stores of data about prospective defendants, and "[w]ithin the thousands of pages of data reported to these administrative bodies, it becomes difficult for even the most sophisticated defendant to find the information sufficient for exoneration."[45]

Finally, the SEC applies a good-faith exception to its rule; it is intended only to "insure that exculpatory material *known to* the [Enforcement] Division is not kept from the respondent."[46] *Brady* obligations, on the other hand, include no exception for failing to disclose exculpatory information on the ground that prosecutors were unaware of it.[47]

The problem of impotent *Brady* protections in administrative proceedings is all the more pressing given that Dodd-Frank has expanded the categories of cases that the SEC can choose to bring before its internal tribunal. Before Dodd-Frank, the SEC could only bring administrative actions against employees of regulated entities, such as brokerage firms or investment advisers—actions against others were required to be heard in district court.[48] Dodd-Frank, however, removed that restriction, giving the SEC the ability to bring administrative actions and levy fines on even more categories of defendants.[49]

Suggested Reforms

Reforms are needed to protect defendants in proceedings brought by the SEC. These reforms could take many forms. The simplest solution would be for the SEC to abide by the *Brady* rule in its civil litigation, and to adopt a full-fledged *Brady* rule for its administrative actions. The SEC could implement a written, uniform "full-disclosure" policy—which would serve the truth-seeking function of its proceedings—for all enforcement matters.[50] Such a policy would require the enforcement staff to show defense counsel all the evidence it has against the prospective defendant—the essence of due process.[51] Indeed, the Wells Committee in 1972 proposed implementing just such a policy in an era when enforcement proceedings did not carry the severe potential negative consequences and ruinous fines that they do today.[52]

The SEC would not be the only agency with such a policy; several other agencies have adopted *Brady* rules voluntarily.[53] However, in the SEC's case, voluntary reform seems unlikely. The SEC has refused to adopt any *Brady* policy in its civil proceedings, and routinely fights to withhold exculpatory material from defendants, even when the Federal Rules of Civil Procedure require its disclosure.[54]

Reform by legislation is also a possibility. In 2012, the Senate considered the Fairness in

Disclosure of Evidence Act,[55] which would have required that any investigating agency, including the SEC, turn over exculpatory information without regard to its materiality. The bill, however, died in committee.

Finally, the Supreme Court could extend *Brady* protections to defendants in administrative actions and civil litigation brought by the government. Grounding this safeguard in the U.S. Constitution's Fifth Amendment due process protections would ensure that defendants' constitutional rights are honored regardless of the prosecutorial forum.[56] After all, in criminal, civil, and administrative actions alike, "the ultimate objective is not that the Government 'shall win a case, but that justice shall be done.' "[57]

Conclusion

Now more than ever, reforms are needed to render SEC administrative actions and civil litigation fair to defendants. The SEC's increased reliance on administrative actions, the heightened penalties available in such actions, and the SEC's recent push to secure admissions of wrongdoing call for a corresponding increase in procedural protections for defendants. Fairness dictates that civil defendants also receive *Brady* material, which the SEC routinely fights to keep secret. Civil government attorneys and criminal prosecutors serve the same cause of justice and the same public interest, and should be bound by the same procedural rules.[58]

The SEC's Enforcement Division pledges to "act[] honestly, forthrightly, and impartially," and to "assur[e] that everyone receives fair and respectful treatment."[59] Indeed, "fairness" is second only to "integrity" on the Enforcement Division's list of values integral to its mission.[60] The SEC should recognize that true fairness requires more than treating all defendants alike—it requires treating all defendants fairly. That requires the SEC to abide by the *Brady* rule.

Notes

1. Mary Jo White, Chair, Sec. & Exch. Comm'n, Address at Council of Institutional Investors Fall Conference: Deploying the Full Enforcement Arsenal (Sept. 26, 2013), *http://www.sec.gov/News/Speech/Detail/Speech/1370539841202#.U0f7yvldX6M*.
2. *See id.*
3. *See* Oral Arg. Transcript, *Gabelli v. SEC*, No. 11-1274 (Jan. 8 2013) at 24, 32, 35, available at *http://www.supremecourt.gov/oral_arguments/argument_transcripts/11-1274.pdf* (last visited Apr. 25, 2014).
4. *See* Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program,* 13 Ford. J. Corp. & Fin. L. 367, 410 n.197 (2008), *http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=1013&context=jcfl*.
5. *Id.* at 88.
6. *See Giglio v. United States*, 405 U.S. 150, 154-55 (1972).
7. *See Smith v. Cain*, 132 S. Ct. 627 (2012).
8. *Berger v. United States*, 295 U.S. 78, 88 (1935); *see also Young v. United States ex rel. Vuitton et Fils S.A.*, 481 U.S. 787, 803 (1987) (citing American Bar Association, *Model Code of Professional Responsibility* Canon 7, Ethical Consideration 7–13 (1982) ("[t]he responsibility of a public prosecutor differs from that of the usual advocate; his duty is to seek justice, not merely to convict").
9. *See Goldberg v. United States*, 425 U.S. 94, 98 n.3 (1976) (leaving this question open); *see also* Justin Goetz, Note, *Hold Fast the Keys to the Kingdom: Federal Administrative Agencies and the Need for Brady Disclosure*, 95 Minn. L. Rev. 1424, 1430 n.43 (2011) ("Surprisingly, lower federal courts have been reticent to extend the *Brady* rule to civil government prosecutions.") (citing *Demjanjuk v. Petrovsky*, 10 F.3d 338, 353 (6th Cir. 1993)).
10. 17 C.F.R. § 201.230(b).
11. *Id.* § 201.230(a).
12. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 929P(b) (2010).
13. *Id.* § 929E.
14. *Id.* § 929P(a).
15. *Id.* § 929M-O.
16. *Id.* § 922.
17. Mary Jo White, *supra* note 6.
18. *Id.*
19. No. 08-CV-2050-D (N.D. Tex., filed Nov. 17, 2008).
20. *United States v. Gupta*, 848 F. Supp. 2d 491 (S.D.N.Y. 2012); *SEC v. Gupta*, No. 11-civ-07566 (S.D.N.Y. filed Oct. 26, 2011).
21. *Gupta*, 848 F. Supp. 2d at 492-93.
22. *Id.* at 493.

23. *Id.*
24. *Id.*
25. *Id.* at 494.
26. *Id.* at 493.
27. *Id.*
28. *Id.* at 494-95.
29. *Id.* at 496.
30. *See* 17 C.F.R. § 240.24c-1(b)(1) (permitting the SEC to disclose non-public information to any "federal, state, local or foreign government or any political subdivision, authority, agency or instrumentality" thereof).
31. Atkins & Bondi, *supra* note 9, at 410 n.197 ("These consequences at times can be tantamount to criminal sanctions, including large monetary payments and loss of livelihood."); *see also* Sec. & Exch. Comm'n, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, *http://www.sec.gov/about/whatwedo.shtml#.U0gWXPldX6M* (last visited Apr. 14, 2014) ("First and foremost, the SEC is a law enforcement agency. The Division of Enforcement assists the Commission in executing its law enforcement function by recommending the commencement of investigations of securities law violations, by recommending that the Commission bring civil actions in federal court or as administrative proceedings before an administrative law judge, and by prosecuting these cases on behalf of the Commission.").
32. In 2010, the Dodd-Frank Wall Street Reform Act granted the SEC broad authority to impose civil monetary penalties in administrative proceedings, in addition to the cease-and-desist orders previously available to the SEC. *See* Kenneth B. Winer & Laura S. Kwaterski, *Assessing SEC Power In Administrative Proceedings*, Law360 (Mar. 24, 2011), *http://www.law360.com/articles/233299/assessing-sec-power-in-administrative-proceedings*) (citing Section 929P of Dodd-Frank, amended Section 8A of the Securities Act, Section 21B(a) of the Securities Exchange Act, Section 9(d)(1) of the Investment Company Act, and Section 203(i)(1) of the Investment Advisers Act). This is part of a broader administrative agency evolution from formal to informal adjudication, and a corresponding loss of procedural due process rights. Goetz, *supra* note 14, at 1426 n.18 (citing Richard E. Levy & Sidney A. Shapiro, *Administrative Procedure and the Decline of the Trial*, 51 U. Kan. L. Rev. 473, 496-97, 500-02 (2003) (noting the evolution of administrative agencies from formal to informal adjudication, and the concomitant loss of procedural due process rights)). *See also* Jeffrey E. Shuren, *The Modern Regulatory Administrative State: A Response to Changing Circumstances*, 38 Harv. J. on Legis. 291, 298 (2001) ("[A]gency creation and expansion of existing agency authority have tended to occur during periods of national crisis[.]").
33. Goetz, *supra* note 14, at 1425 (citing *Katzson Bros. v. EPA*, 839 F.2d 1396, 1399 (10th Cir. 1988); *Hess & Clark v. FDA*, 495 F.2d 975, 984 (D.C. Cir. 1974) ("Of course, administrative agencies are not bound by the same details of procedure as the courts.")).
34. *Id.*
35. *See* Gretchen Morgenson, *At the S.E.C., a Question of Home-Court Edge*, N.Y. Times (Oct. 5, 2013), *http://www.nytimes.com/2013/10/06/business/at-the-sec-a-question-of-home-court-edge.html?_r=0* ("some legal experts say these proceedings suffer from potential bias because the judges operate within the agency bringing them. The possibility of a home-court advantage or a sympathetic adjudicator, critics say, raises questions of fairness, especially for individuals defending themselves in these matters."); *accord* Sarah N. Lynch, *SEC judge who took on the 'Big Four' known for bold moves*, Reuters (Feb. 2, 2014), *http://www.reuters.com/article/2014/02/02/us-sec-china-elliot-idUSBREA1107P20140202* ("Critics say the internal court system gives the SEC a home-court advantage.").
36. 17 C.F.R. § 230(a)(1).
37. *Id.* § 230(b)(1).
38. *Id.* § 230(b)(2).
39. *See* Atkins & Bondi, *supra* note 9, at 411-12 (advocating for a "written and uniform 'full-disclosure' policy for [SEC] enforcement matters").
40. *See United States v. Agurs*, 427 U.S. 97, 107-10 (1976).
41. *See also* Atkins & Bondi, *supra* note 9, at 380 n.71 ("[t]oday, there are no specific guidelines concerning the amount and type of information that staff must share with a prospective defendant, so practices vary among the staff and across the regional offices").
42. 17 C.F.R. § 230(a)(1).
43. *In re Orlando Joseph Jett*, 52 S.E.C. 830, 830 (June 17, 1996) (continuing, "Unless defense counsel becomes aware that exculpatory evidence has been withheld and brings it to the judge's attention, the government's decision as to whether or not to disclose information is final."). *See*, *e.g.*, Order, *In re Nevis Capital Mgmt., et al.*, S.E.C. No. 3-11201 (Nov. 10, 2003), *https://www.sec.gov/alj/aljorders/2003/3-11201-2.pdf;* Order on Motion to Compel Production of Documents, *In re Bandimere & Young*, S.E.C. No. 3-15124 (Mar. 12, 2013), *http://www.sec.gov/alj/aljorders/2013/ap-759.pdf;* Order Denying Respondent's Motion Requesting Release of Information Without Prejudice, *In re Jantzen*, S.E.C. No. 3-14880 (July 5, 2012), *http://www.sec.gov/alj/aljorders/2012/ap709ce.pdf*.
44. *Jett*, 52 S.E.C. at 831.
45. Goetz, *supra* note 14, at 1425-6 ("This asymmetry of information poses a problem of fundamental fairness for defendants."); *see also* Mark Latham, Environmental Liabilities and the Federal Securities Laws: A Proposal for Improved Disclosure of Climate Change-Related Risks, 39 Envtl. L. 647, 677 (2009) (referencing the SEC enormous amount of data the SEC collects).
46. *In re Warren Lammert*, Release Nos. 33-8833 & 34-56233, 91 S.E.C. 761 (Aug. 9, 2007) (quoting *In re David M. Haber*, Exchange Act Release No. APR-418, 55 S.E.C. 3333, 3334 (Feb. 2, 1994)).

47. *Brady*, 373 U.S. at 87 (enforcing disclosure requirements "irrespective of the good faith or bad faith of the prosecution.").

48. Morgenson, *supra* note 40.

49. *See* Levy & Shapiro, *supra* note 37, at 500-02 (2003) (noting the rise of informal adjudication within administrative agencies and a resulting loss of procedural due process rights).

50. Atkins & Bondi, *supra* note 9, at 411.

51. *Id.*

52. *Id.*; *see also id.* at 411 n.199 (citing U.S. Sec. & Exch. Comm'n, Report of the Advisory Committee on Enforcement Policies and Practices 37 (June 1, 1972), *reprinted in* Arthur F. Mathews et al., Enforcement and Litigation Under the Federal Securities Laws 275 (Practicing L. Inst. 1973).

53. *See*, *e.g.*, Federal Energy Regulatory Commission (FERC) (Policy Statement on Disclosure of Exculpatory Materials, 129 FERC ¶ 61,248 (2009)); Federal Deposit Insurance Corporation (FDIC) (*First Guar. Bank*, No. FDIC-95-65e, 1997 WL 33774615, at *2 (F.D.I.C. Apr. 7, 1997)); Commodity Futures Trading Commission (CFTC) (*First Guar. Metals, Co.*, Nos. 79-55 to -57, 1980 WL 15696, at *9 (C.F.T.C. July 2, 1980)).

54. *See*, *e.g.*, Order on Motion to Compel at 4-5, *SEC v. Pentagon Capital Mgmt., PLC et al.*, No. 1:08-cv-03324 (S.D.N.Y. Oct. 8, 2010); *United States v. Gupta*, 848 F. Supp. 2d 491 (S.D.N.Y. 2012); *SEC v. Cuban*, No. 08-CV-2050-D (N.D. Tex. filed Nov. 17, 2008).

55. S. 2197, 112th Cong. (2012).

56. Goetz, *supra* note 14, at 1430, 1455. Indeed, the few decisions that support extending the *Brady* rule to civil government prosecutions "share the same quality: they blend traditional elements of criminal prosecutions within a civil enforcement context." *Id.* at 1430 n.43 (citing *Demjanjuk v. Petrovsky*, 10 F.3d 338, 353 (6th Cir. 1993)).

57. *Sperry & Hutchinson Co. v. FTC*, 256 F. Supp. 136, 142 (S.D.N.Y. 1966) (upholding the concept of extending the *Brady* rule to civil prosecutions) (quoting *Campbell v. United States*, 365 U.S. 85, 96 (1961)).

58. Goetz, *supra* note 14, at 1455.

59. SEC Enforcement Division, *Enforcement* Manual §1.4.1 (Oct. 9, 2013), available at *http://www.sec.gov/divisions/enforce/enforcementmanual.pdf* (last visited Apr. 23, 2014).

60. *Id.* at 1.

IN THE COURTS

Delaware Court Upholds Poison Pill Defense Against Activist

By Jason M. Halper, William P. Mills, Martin L. Seidel, and Gregory A. Markel

In a May 2, 2014 ruling relating to activist hedge fund Third Point LLC's proxy battle with auction house Sotheby's, the Delaware Chancery Court found that Third Point was not likely to succeed in its argument that the Sotheby's board violated its fiduciary duties when it adopted a two-tiered stockholder rights plan in response to a rapid accumulation of shares by activist funds and later refused Third Point's request for a waiver of the rights plan.[1] While the Court did not address the claims on the merits, the preliminary injunction opinion offers important guidance for boards in deploying a rights plan, particularly one that treats active and passive stockholders differently.

Background

The Sotheby's rights plan contains an increasingly common two-tier structure. The plan is triggered if "active" stockholders who disclose ownership on a Schedule 13D acquire 10 percent of Sotheby's stock or if "passive" stockholders who disclose ownership on a Schedule 13G acquire 20 percent of Sotheby's stock. The plan has a term of one year unless approved by stockholders and also contains a "qualifying offer" clause, which exempts from the rights plan certain offers for all of the company's shares, a feature favored by proxy advisory firms.

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When it adopted the rights plan in October 2013, the Sotheby's board had observed significant share accumulations by several hedge funds, including Marcato Capital, Trian, and Third Point. These accumulations were accompanied by Schedule 13D filings by Third, Point and Marcato disclosing intentions to consider seeking fundamental changes at Sotheby's, including an extraordinary corporate transaction. Third Point later announced that it would run a slate of director candidates at Sotheby's annual meeting and requested that the board waive the 10 percent trigger so that Third Point could acquire up to 20 percent of Sotheby's shares. Sotheby's rejected the waiver request citing, among other things, "the risk that Third Point could obtain 'negative control' or effectively a controlling influence without paying a premium with respect to certain matters if it achieved a 20% stake."

On May 5, 2014, following the decision, Sotheby's and Third Point announced that they had settled the proxy contest and Third Point agreed to withdraw its lawsuit with respect to the rights plan. Under the agreement, Sotheby's will add Mr. Loeb and two other directors nominated by Third Point to the board. Sotheby's will terminate the rights plan concurrent with its annual meeting and Third Point has agreed to cap its ownership at 15 percent.

Takeaways

As is typically the case when Delaware courts evaluate a board's use of defensive measures, the particular facts of the case weighed heavily in the Court's ruling. Nonetheless, the decision is the first by a Delaware court to address the use of a two-tier stockholder rights plan in response to activist activity. It therefore provides important guidance to directors and their advisors in

deploying rights plans in response to stockholder activism.

Effective Negative Control Can Be a Threat Against Which a Board May Deploy a Rights Plan

To pass muster under the *Unocal*[2] standard of review, a board must show that it adopted a stockholder rights plan in response to a reasonably perceived threat to corporate policy and effectiveness, and the plan must be a reasonable and proportional response to that threat. The Court said that whether there was a legally cognizable threat at the time Third Point requested a waiver of the rights plan's 10 percent trigger was "a much closer question" than whether a threat existed at the time of the board's adoption of the plan. Nonetheless, Vice Chancellor Parsons was persuaded that the potential for Third Point to obtain "negative control" posed an "objectively reasonable and legally cognizable threat." The Court found there was evidence that Sotheby's directors had "legitimate real-world concerns" that permitting Third Point to obtain 20 percent as opposed to 10 percent ownership could effectively permit Third Point to "exercise disproportionate control and influence over major corporate decisions."

The Court acknowledged it was breaking new ground because prior Delaware decisions addressing negative control dealt with situations where a person obtains an explicit veto right through contract or otherwise, whereas in this case the Court was addressing "effective" negative control. The Court observed that, at 20 percent, Third Point would "by far" be the largest stockholder and that fact, "combined with the aggressive and domineering manner in which the evidence suggests [Third Point founder Dan] Loeb has conducted himself in relation to Sotheby's," meant that the board could have legitimate concern that Third Point would be able to "exercise influence sufficient to control certain important corporate actions, such as executive recruitment, despite a lack of actual control or an explicit veto power."

The opinion provides a reminder to boards that a decision to maintain a rights plan must take into account the state of play as it exists at the time of the relevant decision.

Rapid Stock Accumulations by Activists Can Be a Threat Against Which a Board May Deploy a Rights Plan

Vice Chancellor Parsons' decision makes clear that rapid stock accumulation by activists, leading to so-called "creeping control," can constitute a reasonably perceived threat to corporate policy and effectiveness under *Unocal*.

When the board enacted the rights plan, several hedge funds were accumulating Sotheby's stock, with Third Point accumulating stock rapidly. The board's advisors informed it that activists commonly formed a "wolf pack" for the purpose of acquiring a large block of shares and, in that circumstance, there is a risk that activists acquire control without paying stockholders a control premium. Taking into account the funds' rapid accumulation of stock and the actions of these funds in other situations, the Court found sufficient evidence that the board made an objectively reasonable determination that Third Point and other funds posed a threat of acquiring creeping control.

A Two-Tiered Rights Plan Might Be a Reasonable Response by a Board

While the Court did not endorse the two-tier structure of the rights plan and noted some concern regarding discriminating against "active" versus "passive" stockholders, the Court also noted that the two-tiered structure

> arguably is a 'closer fit' to addressing Sotheby's needs to prevent an activist or activists from gaining control than a 'garden variety' rights plan that would restrict

the ownership levels for every stockholder, even those with no interest in obtaining control or asserting influence.

The Court highlighted the fact that a 10 percent threshold still allowed an investor to establish a significant stake in the company. Third Point was the company's largest stockholder with just under a 10 percent stake. In contrast, the board collectively owned less than 1 percent of the company. As the Court noted, a trigger level much higher than 10 percent could "make it easier" for Third Point and the other funds to acquire creeping control without paying a premium. The Court also noted that no Schedule 13G filers (which in theory could be more inclined to vote for incumbent directors than would an activist) owned more than 10 percent, which in this case made the question of whether a Schedule 13G filer should be permitted to buy more stock than an activist stockholder "a complete non-issue." It is important, however, to view the ruling in the light of the relevant facts, including a board with a low ownership stake and no passive investor—which would be subject to a higher ownership threshold under the rights plan—in actuality owning more stock than Third Point. It is an open question whether the outcome would have changed had these or other relevant facts been different.

The *BLASIUS* "Compelling Justification" Standard Could Potentially Be Implicated in Judicial Review of a Rights Plan

While *Unocal* is the appropriate standard of review for contested rights plans, the Court explained that it was possible (although not entirely clear) that the *Blasius*[3] standard of review also could be implicated within the *Unocal* framework in the stockholder rights plan context. Under *Blasius*, a board must show a compelling justification for actions it takes with the primary purpose of interfering with the effectiveness of a stockholder vote. In practice, this is a much higher standard to meet than *Unocal*, and courts rarely find that there is a compelling justification for actions that interfere with a stockholder vote.

The Court found that Third Point did not establish a reasonable probability that, by adopting the rights plan and not agreeing to Third Point's waiver request, the Sotheby's board was acting for the primary purpose of interfering with the stockholder franchise. The evidence showed that the board was responding to what it believed to be a threat to the corporation and "any effect of [sic] electoral rights was an incident to that end." Further, as the board was unstaggered and comprised of a majority of independent directors with no material financial interests in continuing to serve on the board, there was no evidence the directors were trying to entrench themselves or acting out of animus towards Third Point.

A Board Must Conduct a Good Faith and Reasonable Investigation into the Threat Posed By Activists

A board attempting to satisfy *Unocal* must demonstrate that its conclusion that there exists a threat to corporate policy or effectiveness is predicated on a reasonable and thorough investigation. If a board is comprised of a majority of independent directors and retains competent outside financial and legal advisors on which it relies, the board will establish a *prima facie* case of good faith and reasonable investigation. Boards should meet frequently with their advisors and request information on the activist landscape, the backgrounds of the activists who are known to be invested in the company's stock, the likely plan of attack by the activists and the company's alternatives and defensive posture. The board's investigation, analysis and conclusions with respect to the threat posed by the activists should be properly documented in the minutes of board meetings.

Boards Should Remember That Private Communications Among Directors May Become Public in Discovery

In the course of discovery for the case, several emails sent among directors became public and the source of media scrutiny. At the preliminary

injunction hearing, Third Point's attorneys highlighted emails from directors claiming that the compensation of the Sotheby's CEO was "red meat for the dogs" and that "[the directors] have handed Loeb a killer set of issues on a platter." While these emails do not appear to have adversely impacted the Court's decision, they did become the subject of several prominent articles in the media and serve as a reminder to boards to exercise discretion in communications, especially when a company is in the midst of a contested proxy solicitation.

A Properly Adopted Rights Plan Remains an Effective Tool for Boards in Combating Stockholder Activists

While the Court found that Third Point was not likely to succeed on its claims, the Court's analysis of the harm likely to be suffered by Third Point if it were successful underscores the effectiveness of rights plans. The Court found that the rights plan would reduce the likelihood of Third Point winning the proxy contest because, in a close contest, Third Point's inability to purchase more shares "substantially reduces its odds of winning." The Court cited an expert's report, which analyzed 34 proxy contests occurring in 2012 and 2013 and concluded that the 10 percent rights plan trigger reduces the probability that Third Point would prevail in the proxy contest by 21-25 percent. According to the Court, Third Point's reduced odds of winning "likely would have qualified as a threat of irreparable harm." However, because Third Point was unable to show a likelihood of success that the board breached its fiduciary duties, it still refused to grant a preliminary injunction notwithstanding the threat of irreparable injury.

Notes

1. *Third Point, LLC v. Ruprecht*, C.A. No. 9469-VCP (Del. Ch. 2014).
2. *Unocal Corp. v. Mesa Petroleum Co*., 493 A.2d 946 (Del. 1985).
3. *Blasius Indus., Inc. v. Atlas Corp.,* 564 A.2d 651 (Del. Ch. 1988).

STATE CORNER

The Uncertain Future of Fee-Shifting Bylaws

By Ronald O. Mueller, Jason J. Mendro and Geoffrey C. Weien

A recent decision of the Supreme Court of Delaware has drawn widespread attention to whether a Delaware corporation may require stockholders who sue it unsuccessfully to pay for the corporation's defense fees and costs. In *ATP Tour, Inc. v. Deutscher Tennis Bund*,[1] the Court held that the directors of a non-stock membership corporation may adopt bylaw provisions imposing such fee-shifting obligations on its members. In the almost immediate aftermath of the *ATP* decision, however, the Delaware State Bar Association proposed an amendment to Delaware law that forbids stock corporations from adopting such provisions in their bylaws or certificates of incorporation, and that proposal is now pending before the Delaware General Assembly. As a result, the continuing significance of the *ATP* decision, at least with respect to stock corporations, is uncertain.

Background

The Supreme Court of Delaware's opinion addressed certified questions from the U.S. District Court for the District of Delaware. The underlying federal litigation involved ATP Tour, Inc. (ATP), which is a non-stock membership corporation that operates a global, professional men's tennis tour. ATP's members are tennis players and entities that own and operate tennis tournaments.[2] By joining ATP, members agree to be bound by its bylaws, which may be amended by its board of directors.[3]

In 2006, ATP's board amended its bylaws to add a fee-shifting provision. The bylaws provide, among other things, that when any member asserts any claim against ATP or another member and "does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought," then the claiming member "shall be obligated…to reimburse [ATP] for all fees, costs and expenses of every kind and description (including, but not limited to, all reasonable attorneys' fees and other litigation expenses)" incurred in connection with the claim.[4]

In 2007, ATP modified its tournament schedule and downgraded certain tournaments to a lower "tier." The affected tournament organizations (ATP members) sued ATP and most of its directors in the U.S. District Court for the District of Delaware, asserting antitrust claims and breach of fiduciary duty claims. After a jury trial, ATP prevailed on all claims.[5]

ATP then sought to recover its legal fees, costs, and expenses under the fee-shifting provision of its bylaws. The district court denied the fee request in light of the plaintiffs' antitrust claims, holding that federal antitrust laws preempted fee-shifting agreements. ATP appealed, and the U.S. Court of Appeals for the Third Circuit held that the district court, before addressing preemption, should have first determined whether the fee-shifting provision in the bylaws was enforceable as a matter of Delaware law. On remand, the district court certified four

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questions of Delaware law to the Supreme Court of Delaware.[6]

Paraphrased, the four questions were:

1. Whether the board of a non-stock corporation may lawfully adopt a fee-shifting bylaw like the one adopted by ATP.
2. Assuming that such a bylaw could not be enforced against a claimant who obtains at least *some* relief, whether such a bylaw might be enforceable against a claimant who obtains *no* relief at all.
3. Whether such a bylaw is unenforceable if it was adopted by directors who intended to deter legal challenges to other corporate action then under consideration.
4. Whether such a bylaw is enforceable against members who joined the corporation before the bylaw was adopted.

The Supreme Court of Delaware's Holding

On May 8, 2014, the Supreme Court of Delaware held that a fee-shifting bylaw provision is not invalid *per se*, even if it is intended to deter litigation. Moreover, such a bylaw provision may be enforceable against members of a corporation who joined the corporation before the bylaw provision was adopted.

As the Court explained, bylaws are presumed to be valid as long as they are consistent with the Delaware General Corporation Law (DGCL), the certificate of incorporation, and other applicable laws. A bylaw does not become "facially" invalid merely because there might be some circumstances in which it would be unenforceable.[7] Moreover, a "bylaw that allocates risk among the parties in intra-corporate litigation" is within the permissible scope of bylaws in general because it relates to "the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers, or employees."[8] Finally, bylaws operate as a contract among a corporation's shareholders, and common law does not prohibit fee-shifting arrangements among contracting parties.[9] Thus, the Court concluded, fee-shifting bylaws are facially valid under Delaware law.[10]

The Court clarified that "[w]hether a specific… fee shifting bylaw is enforceable, however, depends on the manner in which it was adopted and the circumstances under which it was invoked."[11] Even facially permissible bylaw provisions could be unenforceable if they were "adopted for an improper purpose."[12] The Court noted, for example, that it had declined to enforce bylaws that were adopted for the purpose of entrenching directors or obstructing the rights of shareholders to undertake a proxy contest against management. Significantly, the Court held that "[t]he intent to deter litigation … is not invariably an improper purpose."[13] Fee-shifting provisions, the Court reasoned, "by their nature" deter litigation but are not *per se* invalid.[14]

Finally, the Court confirmed that amendments to bylaws generally are enforceable against members who joined the corporation before the bylaws were adopted. The DGCL permits a corporation's certificate of incorporation to empower the directors to "adopt, amend or repeal bylaws" unilaterally, and if the directors are so empowered, "stockholders will be bound by bylaws adopted unilaterally by their boards."[15]

Because the certified questions addressed only principles of law, the Supreme Court of Delaware did not analyze whether ATP's bylaw, in particular, was adopted for a proper purpose and thus enforceable in the circumstances of its case. Furthermore, the Court did not consider the plaintiffs' contention that the federal antitrust laws prohibit fee-shifting based on the particular claims asserted; that issue will be resolved by the federal courts.

Proposed Legislative Response

On May 29, 2014—just three weeks after *ATP* was decided—the Corporate Law Section

of the Delaware State Bar Association approved a proposal to amend the Delaware General Corporation Law to prohibit stock corporations from adopting fee-shifting provisions in their bylaws or certificates of incorporation. The proposal was introduced to the Delaware General Assembly on June 3, 2014, where it is now under consideration. The proposal does not limit *ATP*'s application to non-stock corporations, nor does it prohibit stock corporations from pursuing fee-shifting through means other than bylaw or charter provisions (such as entering into ordinary contracts that contain fee-shifting terms). As currently drafted, the amendments affecting stock corporations would take effect on August 1, 2014.

The proposed amendments to Delaware law contrast with the laws of a sizeable minority of states that have enacted statutes permitting fee-shifting to stockholder plaintiffs, even in the absence of fee-shifting bylaws. For example, California[16] and New York[17] have adopted "security for expense" statutes requiring certain derivative plaintiffs to post a security for the corporation's reasonable defense costs, including attorneys' fees, and authorizing courts to award some or all of the security to the corporation when the litigation concludes. New Jersey law imposes similar requirements on stockholders instituting either derivative actions or class actions, while limiting the circumstances in which fee-shifting may be awarded.[18] Several other states have adopted comparable laws to protect corporations from the cost of meritless stockholder litigation.[19]

Considerations

In light of the pending proposal to amend Delaware law, it is not clear whether *ATP* will have any significance for Delaware stock corporations after August 1 of this year. Corporations interested in adopting such provisions may, therefore, wish to reassess the legal landscape after the Delaware General Assembly has considered this matter. Corporations that adopt fee-shifting provisions before then face the risk that those provisions will be invalidated by statute or possibly face uncertainty over whether any changes to Delaware law will apply retroactively.

Even in the absence of new legislation, corporations should carefully weigh the advantages and disadvantages of fee-shifting provisions, as well as the potential limitations of the *ATP* decision, before amending their bylaws or certificates of incorporation.

A threshold question in interpreting the *ATP* decision is whether it is limited to non-stock corporations, or whether it applies to stock corporations as well. Although ATP is a non-stock corporation and the certified questions were limited to non-stock corporations, none of the statutory provisions or case law the Supreme Court of Delaware cited are limited to non-stock corporations. Indeed, the Court noted that the DGCL applies to non-stock corporations (with some exceptions not relevant here).[20] Because the DGCL governs bylaws for stock and non-stock corporations in the same way, *ATP*'s construction and application of that law also should apply to both. That interpretation appears to be confirmed by the amendments proposed by the Corporate Law Section, mentioned above.

Notably, *ATP* holds that it is permissible for bylaws to provide for fee-shifting in litigation that concerns intra-company disputes. The Delaware Court of Chancery previously has distinguished such suits from those involving "external matters," such as personal injury claims that do not concern shareholder rights.[21] *ATP* does not suggest that corporations could effectively require fee-shifting outside the context of intra-company litigation.

Corporations should be mindful that they may be unable to enforce fee-shifting provisions that are adopted for an improper purpose. Although the purpose of deterring litigation is permissible

in general, purposes directed at a particular shareholder or suit could be deemed inequitable in certain circumstances. Because the "enforceability of a facially valid bylaw may turn on the circumstances surrounding its adoption and use,"[22] a board considering a fee-shifting bylaw should carefully consider and document the proper purposes of its decision.

Corporations also should consider the full range of circumstances in which a fee-shifting bylaw could apply in light of its specific terms. In addition to applying to shareholder suits, a broadly worded fee-shifting bylaw also could apply, for example, to litigation between a corporation and its directors or officers. Corporations should consider whether such broad application is desirable and thoughtfully tailor the terms of the provision to meet the board's intended purpose.

Finally, although fee-shifting provisions may benefit stockholders if Delaware's legislature does not forbid them, some stockholders nonetheless may be wary of such provisions. And although the Supreme Court of Delaware has confirmed that boards may adopt such bylaw provisions without stockholder approval, such unilateral action may be disfavored by some stockholders or their advisors. For example, companies that unilaterally adopt these provisions may receive stockholder proposals requesting the company to repeal the provision or put it to a stockholder vote or even proxy advisory firm recommendations against their directors. Accordingly, in evaluating whether to adopt a fee-shifting provision, corporations should consider engaging with their stockholders to educate them on the benefits of doing so. Boards also should assess their corporation's stockholder base and consult with their investor relations and proxy solicitation advisors as part of that consideration.

Notes

1. No. 534, 2013 (Del. May 8, 2014) ("Op.").
2. *Id.* at 3.
3. *Id.* at 4.
4. *Id.*
5. *Id.* at 4-5.
6. *Id.* at 5-7.
7. *Id.* at 8.
8. *Id.* at 9 (quoting 8 *Del. C.* § 109(b)).
9. *Id.*
10. *Id.*
11. *Id.* at 10.
12. *Id.* at 13.
13. *Id.*
14. *Id.*
15. *Id.* at 14 (citation omitted).
16. Cal. Corp. Code § 800(c), (d). Under California law, the amount of the bond cannot exceed $50,000.
17. N.Y. Bus. Corp. Law § 627.
18. N.J. Rev. Stat. §§ 14A:3-6.7, 3-6.8.
19. *See* Alaska Stat. § 10.06.435(h); Ark. Code § 4-26-714(c); Colo. Rev. Stat. § 7-107-402(3) (authorizes cost-shifting, not including attorneys' fees); Nev. Rev. Stat. § 41.520(3), (4); N.D. Cent. Code § 10-19.1-86(2); 15 Pa. Cons. Stat. § 1782(c).
20. Op. 8 n.10 (citing 8 *Del. C.* § 114).
21. *See Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 952 (Del. Ch. 2013).
22. Op. 12.

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.

Arnold & Porter LLP
Washington, DC (202-942-5000)

Recent Developments in SEC Enforcement: A Review of Mary Jo White's First Year (May 2014)

A discussion of steps that the SEC has taken in Mary Jo White's first year as Chair towards her goal of strengthening the SEC's enforcement program in a way that is "bold and unrelenting."

The Second Circuit Clarifies the Territorial Limits of U.S. Securities Laws (May 2014)

A discussion of a U.S. Court of Appeals decision, *City of Pontiac Policemen's and Firemen's Retirement System v. UBS AG* (2d Cir. May 6, 2014), holding that the Supreme Court's *Morrison* decision precludes claims arising out of foreign-issued securities purchased on foreign exchanges, even if the securities were cross-listed on a domestic exchange. The mere placement of a buy order in the U.S. for the purchase of a foreign security on a foreign exchange is insufficient to establish a "domestic transaction" under the Securities Exchange Act of 1934 (Exchange Act).

Bingham McCutchen LLP
Boston, MA (617-951-8000)

SEC Seeks to Deploy Section 20(b) to Skirt Restrictions of *Janus* (May 5, 2014)

A discussion of statements by the SEC that it is considering whether actions brought under Section 20(b) of the Exchange Act avoid restrictions imposed by the Supreme Court in the *Janus* decision.

Blank Rome LLP
Philadelphia, PA (215-569-5500)

California's Revised Uniform Limited Liability Company Act (April 2014)

A discussion of a new California law governing limited liability companies (LLCs) that became effective on January 1, 2014. It makes significant changes in the rights and responsibilities of members and managers of LLCs. However, most of the provisions are "default" provisions that apply only of the members have not agreed otherwise in a written LLC Operating Agreement.

Cadwalder, Wickersham & Taft LLP
New York, NY (212-504-6000)

Before the Whistle Blows: Understanding and Addressing the Expanding Scope of Whistleblower Protections under Sarbanes-Oxley and Dodd-Frank (May 12, 2014)

A discussion of the whistleblower provisions of the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, particularly those prohibiting retaliation against those who report suspected misconduct. The memorandum suggests practical steps that companies and their advisors can consider in order to be prepared to effectively address whistleblowing activity.

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

Lerner v. Prince: New York Appellate Division Holds No Right to Discovery in Demand-Refused Litigation, Applies Delaware Substantive Law (May 28, 2014)

A discussion of a New York Appellate Division decision, *Lerner v. Prince* (decided May 22, 2014), holding that the plaintiff's right to discovery in a demand-refused derivative action is a substantive rather than procedural, question and thus governed by the law of the state where the corporation is chartered rather than the law of the forum state. The case also recognizes the validity of properly constituted demand committees.

S.E.C. v. Graham: S.D. Fla. Holds That 28 U.S.C. § 2462's Five-Year Statute of Limitations Jurisdictional, Applies to All Forms of Relief (May 16, 2014)

A discussion of a U.S. District Court decision, *SEC v. Graham* (S.D. Fl. May 12, 2014), holding that the general five-year statute of limitations governing civil penalty actions brought by the government jurisdictionally barred the court from considering a complaint brought by the SEC more than five years after the last sale or offering of securities alleged to have violated the securities laws occurred.

Janus Inapplicable to Criminal Cases—Non-"Makers" of Statements Can Still Be Criminally Liable for Violations of SEC Rule 10b-5 (May 9, 2014)

A discussion of a U.S. Court of Appeals decision, *Prousalis v. Moore* (4th Cir. May 7, 2014), holding that the willful creation of a materially false statement of fact, intended to be disseminated in connection with the sale or purchase of a security, can be a criminal violation of SEC Rule 10b-5 even if the creator of the statement was not the one who disseminated it, holding that the Supreme Court's decision in *Janus* did not apply to criminal cases.

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

Highlights of 2013 SEC Enforcement in the Municipal Market (May 29, 2014)

A discussion of a number of enforcement actions brought by the SEC in the municipal market in 2013 that not only reinforced the agency's commitment to regulating the municipal market, but also brought about a number of firsts for the SEC's municipal securities enforcement program.

Cleary, Gottlieb, Steen & Hamilton LLP
New York, NY (212-225-2000)

SEC Director Speaks on Spreading Sunshine in Private Equity (May 7, 2014)

A discussion of a speech by the Director of the SEC's Office of Compliance Inspections and Examinations (OCIE) concerning key issues that OCIE has identified since starting exams of the industry in October 2012. He reported that in over 50 percent if the 150 exams of private equity advisers that have been conducted to date, OCIE identified what it believed to be violations of law or material weaknesses in controls with respect to handling of fees and expenses.

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

Bidder-Activist Collaboration to Buy Allergan Expands Reach of Activists in M&A—Will the Model Be Followed? (May 9, 2014)

A discussion of the collaboration of an activist, Pershing Square, and an operating company, in connection with Valeant's intent to acquire Allergan, and consideration of whether others will follow this model.

Haynes and Boone, LLP
Dallas, TX (214-651-5000)

Directors Beware: ISS Urges Ouster of Target's Director in the Wake of its Data Breach (May 30, 2014)

A discussion of an Institutional Shareholder Services (ISS) report recommending that Target Corporation's shareholders oust seven of the company's directors for "failure to provide sufficient risk oversight" on cybersecurity. The memorandum discusses the ramifications of the ISS report and the steps that directors can take to address the risk of cyber incidents.

Paul, Weiss, Rifkind, Wharton & Garrison LLP
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S.D.N.Y. Dismisses Claim Seeking Short-Swing Profit Disgorgement from IPO Underwriters (May 9, 2014)

A discussion of a U.S. District Court decision, *In re Facebook, Inc., IPO Securities & Derivative Litigation* (S.D.N.Y., May 2, 2014), rejecting the argument that underwriters and stockholders in an IPO should be treated as a "group" for the purposes of the short-swing profit rule as result of "lock-up" agreements temporarily prohibiting shareholders from selling their shares without underwriter permission.

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

Sutherland Annual Study Finds that It Often Pays for Broker-Dealers, Investment Advisers and Their Representatives to Litigate Against the SEC and FINRA (May 14, 2014)

A discussion of an annual survey of litigated actions brought against members of the securities industry. The study of 2013 proceedings demonstrates that it often pays to fight against the SEC or the Financial Industry Regulatory Authority.

Troutman Sanders LLP
Atlanta, GA (404-885-3000)

SEC Guidance—Using Social Media in Registered Securities Offerings (May 5, 2014)

A discussion of recent SEC staff guidance in using technologies, such as social media, to communicate in registered securities offerings. Specifically, on April 21, 2014, the staff issued guidance permitting offering participants to use Twitter or othe similar social media with character limitations to issue Rule 134 offering announcements and Rule 433 free writing prospectuses.

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

Council of Institutional Investors Urges SEC to Require Full Disclosure of Dissident Director Compensation Schemes (May 14, 2014)

A discussion of the request by the Council of Institutional Investors to the SEC calling for shareholder contestants in a proxy contest to disclose any special compensation arrangements with a board nominee.

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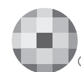
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