INSIGHTS

THE CORPORATE & SECURITIES LAW ADVISOR

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Improved Protection for Independent Directors

RANDALL W. BODNER, JESSE M. BOODOO, and **ELIZABETH D. JOHNSTON** of Ropes & Gray LLP explore a recent Delaware Supreme Court opinion, holding that, even in entire fairness cases, a plaintiff must plead non-exculpated claims to survive a motion to dismiss.

SEC Considers Accredited Investor Definition

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Delaware Supreme Court Significantly Improves Protections for Independent Directors

In its recent opinion in In re Cornerstone Therapeutics Inc. Stockholder Litigation, *the Delaware Supreme Court clarified a long unsettled area of the law, holding that a plaintiff seeking monetary damages from a director protected by an exculpatory charter provision must plead a non-exculpated claim in order to survive a motion to dismiss, no matter what standard of review governs the board's conduct.*

By Randall W. Bodner, Jesse M. Boodoo, and Elizabeth D. Johnston

Under Section 102(b)(7) of the Delaware General Corporation Law, a company may adopt an exculpatory bylaw provision eliminating directors' personal monetary liability for breaches of the duty of care.[1] Such exculpatory provisions offer an important form of liability protection for directors, particularly as mergers and acquisitions (M&A) litigation continues to proliferate, and directors face the near certainty of being sued (and personally named) any time they approve a significant merger.[2] Nearly all Delaware corporations include exculpatory provisions in their charters.

In cases governed by the business judgment rule, Delaware courts have long recognized exculpatory provisions as a complete defense, and have relied on such provisions to dismiss complaints that fail to include well-pled allegations of a breach of the duty of loyalty.[3] In this way, exculpatory provisions have insulated independent directors from the threat of personal liability in many of the routine M&A lawsuits in which they are likely to be named as defendants. But in cases governed *ab initio* by the entire fairness standard—such as challenges to controlling stockholder cash-out mergers[4]—the Delaware Court of Chancery reached differing results as to whether the same rule should apply. One camp treated exculpatory provisions as a complete defense and, just as in business judgment rule cases, readily dismissed claims against independent directors at the outset of the litigation.[5] Another camp ruled that, in entire fairness cases, *no* directors could be subject to dismissal, and forced even independent directors to remain in the litigation until the bitter end.[6]

In its much-anticipated decision in *In re Cornerstone Therapeutics Inc. Stockholder Litigation* (*Cornerstone*)[7] the Delaware Supreme Court resolved this split in the Chancery Court. Coming down firmly on the side of independent directors, the Supreme Court held that, in business judgment rule and entire fairness cases alike, a plaintiff must plead non-exculpated claims in order to survive a motion to dismiss. In so doing, the Supreme Court significantly improved the protections available to independent directors in controlling stockholder cases, and signaled a rejection of recent cases seen by many as having eroded the presumption of director independence traditionally afforded to all directors. The decision is a welcome development not just for independent directors of small, closely-held corporations, but also for the independent directors of the substantial

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(and growing) number of controlled public companies.[8]

The *Emerald Partners* Cases Create Tension in the Chancery Court

The previous uncertainty around the interplay between Section 102(b)(7) exculpatory provisions and the entire fairness standard traces back to the Delaware Supreme Court's last guidance on the issue, decided over a decade ago in the extensive *Emerald Partners* litigation.[9] In *Emerald Partners*, the plaintiffs alleged that a merger between the company and its controlling stockholder was not entirely fair.[10] The director-defendants did not move to dismiss but, instead, moved for summary judgment after discovery. The Court of Chancery granted that motion, concluding that the plaintiffs had only pled an exculpated duty of care claim.[11]

The Delaware Supreme Court reversed, holding that triable issues of fact remained as to whether the director-defendants had also breached their duty of loyalty.[12] In reaching that holding, the Supreme Court laid down the broad principle that would guide (and confound) the Chancery Court and its practitioners in the years to come:

> [W]hen entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only after the basis for their liability has been decided.[13]

Taken literally, this statement seemed to imply that so long as a plaintiff sufficiently alleged facts giving rise to the application of entire fairness, and suggesting that the transaction was not entirely fair, then *all* the director-defendants—including the independent and disinterested directors—would be along for the ride in litigation, and barred from exiting the case on a motion to dismiss or motion for summary judgment based solely on Section 102(b)(7) grounds.

The Chancery Court Splits on the Interpretation of *Emerald Partners*

Particularly within the past two years, the Chancery Court began adopting divergent interpretations of the Supreme Court's decisions in *Emerald Partners*.[14] One group of cases—likely reflecting the majority view of the bench and bar—took the Supreme Court's statements at face value. These cases ruled that, where the entire fairness standard applied, exculpatory provisions could be invoked only after a trial and a determination of whether the transaction was entirely fair.[15] Within this

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group, certain cases embraced the result with notably more enthusiasm than others.

Committee members moved to dismiss by arguing that the plaintiffs had failed to plead non-exculpated claims for breach of the duty of loyalty.

In the Chancery Court opinions in *Cornerstone*[16] and *In re Zhongpin Inc. Stockholders Litigation* (*Zhongpin*),[17] decided by Vice Chancellor Glasscock and Vice Chancellor Noble respectively, the Court applied the language of *Emerald Partners* literally, albeit very reluctantly. In both cases, plaintiffs challenged cash-out mergers proposed by controlling stockholders, which had been negotiated by special committees consisting, in the defendants' view, of disinterested and independent directors.[18] Neither company sought at the outset to condition approval of the mergers on a majority-of-the-minority vote; thus, under the Delaware Supreme Court's decision in *Kahn v. M&F Worldwide Corporation*, the entire fairness standard applied.[19] In both cases, the committee members moved to dismiss by arguing that the plaintiffs had failed to plead non-exculpated claims for breach of the duty of loyalty.[20]

Vice Chancellor Glasscock, while noting that he preferred the defendants' view of the law, and lamenting "[t]he automatic inference that a director negotiating…a transaction with a controller…is a conflicted or disloyal director," determined that his hands were tied by *Emerald Partners*. He therefore denied the motion to dismiss in *Cornerstone*.[21] Vice Chancellor Noble followed suit in *Zhongpin*, also denying the motion in that case and citing Vice Chancellor Glasscock's conclusion that *Emerald Partners* "left [the Chancery Court] with no other choice."[22] In both cases, the Court recommended certification of interlocutory appeals to the Supreme Court to resolve whether *Emerald Partners* really required such a harsh result.

In contrast to the reluctant decisions in *Cornerstone* and *Zhongpin*, Vice Chancellor Laster, in *In re Orchard Enterprises, Inc. Stockholder Litigation* (*Orchard*), offered a strong defense for his interpretation of why *Emerald Partners* required delaying the consideration of exculpatory provisions in entire fairness cases.[23] In *Orchard*, the plaintiff challenged a controller cash-out merger, and certain special committee directors moved for summary judgment on grounds that their conduct amounted, at most, to an exculpated breach of the duty of care.[24] Citing approvingly to *Emerald Partners*, Vice Chancellor Laster denied the motion, and commented that even seemingly independent directors belonged in the litigation due to the inherent "risk of undetectable bias" in controlling stockholder transactions.[25] Taking a somewhat skeptical view of director motives, Vice Chancellor Laster reasoned that delaying the consideration of exculpatory provisions in entire fairness cases serves the salutary purpose of rooting out latent disloyalty, or "situations where facially independent and disinterested directors have failed to act loyally and in good faith…and instead have given in to or favored the interests of the controller."[26]

Even seemingly independent directors belonged in the litigation due to the inherent "risk of undetectable bias" in controlling stockholder transactions.

Unlike the decisions in *Cornerstone*, *Zhongpin*, and *Orchard*, a second and separate group of cases rejected the literal reading of *Emerald Partners*, and readily dismissed independent directors from entire fairness cases where no non-exculpated claim was pled.[27] In the most notable example, Vice Chancellor Parsons, in *DiRienzo v. Lichtenstein*, dismissed claims against independent directors arising from a transaction between a hedge fund portfolio company and its controller.[28] Vice Chancellor Parsons reasoned that the *Emerald Partners* decisions should be limited to their own facts, and that independent directors should be subject to dismissal unless the plaintiff sufficiently "alleges that the committee engaged in non-exculpated behavior such as by acting disloyally or in bad faith."[29]

The Delaware Supreme Court Weighs in with *Cornerstone*

In late 2014, the Delaware Supreme Court agreed to take up the issue, accepting the interlocutory appeals in *Cornerstone* and *Zhongpin* and consolidating the cases for purposes of argument and decision. On May 14, 2015, the Supreme Court—in a unanimous opinion—reversed the Chancery Court's denials of the motions to dismiss, and held that a plaintiff seeking monetary damages

> must plead non-exculpated claims against a director who is protected by an exculpatory charter provision to survive a motion to dismiss, regardless of the underlying standard of review for the board's conduct—be it *Revlon*, *Unocal*, the entire fairness standard, or the business judgment rule.[30]

The Court then remanded each case to the Court of Chancery to determine if the plaintiffs sufficiently pled non-exculpated claims.[31]

Chief Justice Strine, writing for the Court, began by acknowledging that *Emerald Partners* could be read in "two competing but colorable" ways, but clarified that "even if a plaintiff has pled facts that, if true, would require the transaction to be subject to the entire fairness standard of review … the independent directors do not automatically have to remain defendants."[32] The Court distinguished *Emerald Partners* as

> focused on a separate question; namely, whether courts can consider the effect of a Section 102(b)(7) provision before trial when the plaintiffs have [already] pled facts supporting the inference … that each director breached … his duty of loyalty.[33]

In a nod to the long-standing uncertainty sewn by *Emerald Partners*, the Court emphasized that it did not "fault those who read the complicated *Emerald Partners* decisions differently," but was now "giv[ing] those cases the most reasonable reading … based on their full context."[34]

In its analysis, the Court focused on a few central tenets of Delaware corporate law. In particular, the Court looked to the fundamental purpose of Section 102(b)(7)—to "free[] up directors to take business risks without worrying about negligence lawsuits"—and reasoned that requiring independent directors to remain as defendants until the completion of litigation would chill the willingness of independent directors to support value-maximizing transactions, or even serve on special committees in the first place.[35] And this, in the Court's view, would diminish the very the benefits that the General Assembly sought to provide through Section 102(b)(7).[36]

Even in controlling stockholder cases, directors are "presumed to be motivated to do their duty with fidelity."

The Court also focused on the core right of a director "to be considered individually when … fac[ing] claims for damages in a suit challenging board action."[37] Citing its seminal decision in *Aronson v. Lewis*,[38] the Court emphasized the bedrock presumption of independence attaching to all directors, and reiterated that "the mere fact that a director serves on the board of corporation with a controlling stockholder does not automatically make that director not independent."[39]

Repudiating the automatic inference of disloyalty and the "suspicious" approach to independent directors advanced by cases like *Orchard*, the Court underscored that, even in controlling stockholder cases, directors are "presumed to be motivated to do their duty with fidelity."[40] In the Court's view, an automatic inference of disloyalty would not only contravene the presumption of loyalty, but also "create more harm than benefit for minority stockholders in practice," given the well-recognized power of independent directors "to secure transactions with controlling stockholders that are favorable to the minority."[41]

The Upshot of the *Cornerstone* Decision

Following *Cornerstone*, disinterested and independent directors who approve transactions subject to entire fairness review—such as controlling stockholder mergers—will be fully entitled to early dismissal of the claims asserted against them. Plaintiffs may still survive a motion to dismiss by pleading facts suggesting a non-exculpated breach of the duty of loyalty. Given *Cornerstone's* admonitions, however, practitioners should expect the Delaware courts to be more suspect than ever of efforts to impugn the independence, loyalty, or good faith of directors based simply upon their service to controlled companies.

In addition, *Cornerstone* offers several other important takeaways for independent directors and practitioners.

Pre-closing claims are likely unaffected. *Cornerstone*, by its terms, decided only how exculpatory provisions apply to claims for damages. Thus, even where independent directors can rely on an exculpatory provision as grounds for dismissal of a damages action, equitable remedies such as injunctions will remain available to plaintiffs, at least where entire fairness (or other heightened scrutiny) provides the standard of review.[42] *Cornerstone* offers independent directors significantly enhanced protection from personal liability, but will likely offer little or no relief from the headache of expedited pre-close injunction actions so common to M&A litigation.

Plaintiffs will still challenge controlling stockholder transactions. Even after *Cornerstone*, plaintiffs will likely still be quick to challenge controlling stockholder transactions. As the Supreme Court noted:

> Interested fiduciaries, often the proverbial deep-pocketed defendants, will continue to be required to prove that the transaction was entirely fair to the minority stockholders, because the plaintiffs' well-pled claims against the interested parties in a controller transaction cannot be dismissed before trial, regardless of whether the independent directors remain as defendants.[43]

As a result, controlling stockholder mergers approved without the dual procedural protections of *Kahn v. M&F Worldwide* will continue to provide a "free pass to trial" (*i.e.,* low-hanging litigation fruit) for plaintiffs. And, in such cases, the independent directors, though protected from personal liability, will remain a central focus of the litigation, as the strength of their process and bargaining will implicate whether the controlling stockholder or the plaintiffs bear the burden of persuasion.[44]

Independent directors will remain subject to discovery, and subject to being added back as defendants later in the case. Even where independent directors are dismissed, because the spotlight remains on the actions of the independent directors in challenges to controlling stockholder transactions, such directors should expect to sit for depositions and otherwise participate in discovery, such as by producing documents. Insofar as that discovery (or other discovery) may be used to demonstrate a non-exculpated breach of the duty of loyalty, plaintiffs may seek to amend their complaints to add independent directors back into the litigation as defendants. Indeed, the Supreme Court expressly noted this possibility in a footnote to its decision, stating that plaintiffs who

> do not have sufficient evidence to plead non-exculpated claims against the independent directors at the pleading stage…may bring such claims later" if they become able "to bring well-pled claims that the independent directors breached their duty of loyalty within the three-year statute of limitations period.[45]

Thus, though protected from monetary liability at the pleading stage, independent directors and their counsel must maintain a watchful and wary eye over the ongoing litigation.

> ***Directors should expect to sit for depositions and otherwise participate in discovery.***

The presumption of director independence is stronger than ever. Implicit in *Cornerstone* is a resounding reaffirmation of the presumption of director independence, and a rejection of the notion that independent directors in controlled companies should be automatically subject to suspicion and doubt. Building on seminal cases such as *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*[46] and *Kahn v. M&F Worldwide*,[47] *Cornerstone* contains some of the Delaware Supreme Court's most laudatory language in recent memory regarding the presumption of independence and the value-maximizing benefits conferred by committees of independent directors. This praise for the critical role of independent directors in evaluating and negotiating potential transactions, along with the Chancery Court's increasing preference for early dismissal of weak M&A litigation,[48] should position independent directors to be more successful than ever in prevailing on motions to dismiss claims for monetary damages.

Notes

1. Section 102(b)(7) was adopted by the Delaware General Assembly in 1986 following the directors' and officers' liability insurance crisis of the mid-1980s, and the Delaware Supreme Court 1985 decision in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). Animating the adoption was the General Assembly's concern that directors would not be willing to take risks if they faced negligence lawsuits (and potential personal liability) for taking them.

2. *See Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001) (Section 102(b)(7) provisions are intended to "free[] up directors to take business risks without worrying about negligence lawsuits"); Matthew D. Cain and Steven D. Solomon, *Takeover Litigation in 2014*, 3 (February 20, 2015), available at *http://ssrn.com/abstract=2567902* ("In plain English, if a target announces a takeover it should assume that it and its directors will be sued.").

3. *See, e.g., In re Synthes, Inc. S'holder Litig.,* 50 A.3d 1022, 1032 (Del. Ch. 2012) ("Because the directors on the Board are protected by the § 102(b)(7) provision exculpating them for personal liability stemming from a breach of the duty of care, the complaint must be dismissed against the directors unless the plaintiffs have successfully pled non-exculpated claims for breach of the duty of loyalty against them.").

4. In *Kahn v. Lynch Communication Systems*, the Delaware Supreme Court established that "the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating stockholder is entire fairness." 638 A.2d 1110, 1117 (Del. 1994).

5. *See DiRienzo v. Lichtenstein*, 2013 WL 5503034 (Del. Ch. 2013); *Hamilton Partners, L.P. v. Highland Capital Mgmt., L.P.*, 2014 WL 1813340, at *15-17 (Del. Ch. 2014). *See also In re S. Peru Copper Corp. S'holder Derivative Litig*., 52 A.3d 761 (Del. Ch. 2011), *aff'd sub nom., Americas Mining Corp. v. Theriault*, 51 A.3d 1213 (Del. 2012) ("The entire fairness standard ill suits the inquiry whether disinterested directors who approve a self-dealing transaction and are protected by an exculpatory charter provision authorized by 8 *Del. C.* § 102(b)(7) can be held liable for breach of fiduciary duties. Unless there are facts suggesting that the directors consciously approved an unfair transaction, the bad faith preference for some other interest than that of the company and the stockholders that is critical to disloyalty is absent.").

6. *See In re Zhongpin Inc. S'holders Liti.*, 2014 WL 6735457 (Del. Ch. 2014); *In re Cornerstone Therapeutics Inc. S'holder Litig.*, 2014 WL 4418169 (Del. Ch. 2014); *In re Orchard Enters., Inc. S'holder Litig.*, 88 A.3d 1 (Del. Ch. 2014); *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155 (Del. Ch. 2014).

7. 2015 WL 2394045 (Del. 2015).

8. *See* Davis Polk, *Corporate Governance Practices of U.S. Initial Public Offerings*, 1 (October 2011), available at *http://www.davispolk.com/files/uploads/CapitalMarkets/103111_CorpGovPractices_Booklet__Controlled_Included.pdf* (findings that, out of the top 50 IPOs, by deal size, of U.S. companies from January 1, 2009 through August 31, 2011, 28 were controlled companies); IRRC Institute and ISS, *Controlled Companies in the Standard & Poor's 1500: A Ten Year Performance and*

Risk Review, 3 (October 2012) (finding that, in 2002, there were 87 controlled companies in the S&P 1500 and, by 2012, there were 114).

9. *See Emerald Partners v. Berlin*, 840 A.2d 641 (Del. 2003); *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001) [hereinafter *Emerald II*]; *Emerald Partners v. Berlin*, 726 A.2d 1215 (Del. 1999) [hereinafter *Emerald I*]; *Emerald Partners v. Berlin*, 552 A.2d 482 (Del. 1988).

10. *Emerald Partners v. Berlin*, 1995 WL 600881, at *1 (Del. Ch. Sept. 22, 1995).

11. *Id.*

12. *Emerald I*, 726 A.2d at 1223.

13. *Emerald II*, 787 A.2d at 93-94.

14. *See supra* notes 6 & 7 and accompanying text.

15. *See supra* note 7.

16. 2014 WL 4418169 (Del. Ch. 2014).

17. 2014 WL 6735457 (Del. Ch. 2014).

18. In *Cornerstone*, Chiesi Farmaceutici S.p.A. ("Chiesi"), a privately held drug maker acquired all of the stock it did not own in Cornerstone Therapeutics, a public Delaware pharmaceutical company. Prior to the merger, Chiesi was the beneficial owner of 65.4% of Cornerstone common stock. Chiesi's initial offer to acquire all of the outstanding shares of Cornerstone common stock was not conditioned on the approval of a majority of the minority stockholders. In response to the offer, the Cornerstone board formed a special committee of directors which negotiated and unanimously approved the merger agreement. Following the full board's approval and approval by more than 80% of the minority stockholders, the merger was consummated. 2014 WL 4418169, at *2.

In *Zhongpin*, Xianfu Zhu, the controlling stockholder, CEO and Chairman of the Board of Zhongpin Inc., a publicly-traded Delaware corporation engaged in meat and food processing, purchased the outstanding shares he did not own through a going-private merger that closed on June 27, 2013. Before the merger, Zhu owned only 17.3% of the company, but the Court of Chancery determined that the plaintiffs had raised an inference that Zhu held a controlling interest because of his level of control over the management and operations of the company. 2014 WL 6735457, *8.

19. 88 A.3d 635, 644 (Del. 2014) ("We hold that business judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned *ab initio* upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders.").

20. *See Cornerstone*, 2015 WL 2394045, at *3-4

21. *Cornerstone*, 2014 WL 4418169, at *6 ("There is much, in my view, to recommend [a particularized] pleading requirement [for independent directors]. It is consistent with our treatment of directors alleged to have breached duties in non-controller-dominated transactions, where the requirement of specific pleading of non-exculpated breaches of duty allows management of the corporation to proceed unaffected by frivolous litigation and protects the directors' ability to pursue appropriate levels of risk without fear of liability, so long as their actions are consistent with the duty of loyalty.").

22. *Zhongpin*, 2014 WL 6735457, at *11-12.

23. 88 A.3d at 7-8.

24. *Id.* at 31.

25. *Id.* at 36 (quoting *Kahn v. Tremont Corp.*, 1996 WL 145452, at *7 (Del. Ch. 1996)).

26. *Id.* Vice Chancellor Laster advanced a similar rationale for delaying the consideration of exculpatory provisions in entire fairness cases in his decision in *Quadrant Structured Products Co., Ltd. v. Vertin*, 102 A.3d 155 (Del. Ch. 2014).

27. *See supra* note 6.

28. 2013 WL 5503034, at *36 .

29. *Id.* at *10.

30. *Cornerstone*, 2015 WL 2394045, at *1.

31. *Id.* The Court emphasized that, in order to plead a non-exculpated claim, a plaintiff must allege "facts supporting a rational inference that the director[s] harbored self-interest adverse to the stockholders' interests, acted to advance the self-interest of an interested party from whom they could not be presumed to act independently, or acted in bad faith." *Id.* at *5.

32. *Id.* at *1.

33. *Id.* at *9.

34. *Id.* at *10 n.53.

35. *Id.* at *8-9.

36. *Id.* at *9.

37. *Id.* at *7 & n.36.

38. 473 A.2d 805, 815 (Del. 1984).

39. 2015 WL 2394045, at *7.

40. *Id*. at *7 & n.37 (quoting *In re MFW S'holders Litig.*, 67 A.3d 496, 528 (Del. Ch. 2013) ("Although it is possible that there are independent directors who have little regard for their duties or for being perceived by their company's stockholders (and the larger network of institutional investors) as being effective at protecting public stockholders, the court thinks they are likely to be exceptional, and certainly *our Supreme Court's jurisprudence does not embrace such a skeptical view*."), *aff'd sub nom.*, *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (emphasis added). *See also Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004) ("[D]irectors are entitled to a presumption that they were faithful to their fiduciary duties.").

41. *Cornerstone*, 2015 WL 2394045, at *8 & n.44. As the Court noted, a substantial body of academic literature suggests that interested transactions subject to special committee approval are often priced on terms that are attractive to minority stockholders. *Id.* (citing Thomas W. Bates,

Michael L. Lemmon, & James S. Linck, *Shareholder Wealth Effects and Bid Negotiation in Freeze-out Deals: Are Minority Shareholders Left Out in the Cold?,* 81 J. Fin. Econ. 681, 706 (2006) (reporting evidence to support the hypothesis that "active board representation and implicit legal recourse" benefit stockholders in the tender offer context); Guhan Subramanian, *Fixing Freezeouts,* 115 Yale L.J. 2, 25 (2005) (discussing the role of "vigorous bargaining" by special committees in increasing premiums for minority stockholders in merger freezeouts, compared to tender offer freezeouts effected without special committees); James F. Cotter, Anil Shivdasani, & Marc Zenner, *Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?,* 43 J. of Fin. Econ. 195 (1997) (finding that, in the context of a tender offer, the presence of an independent board increases the tender offer bid premium and overall stockholder gains)).

42. *Id.* at *6 n.32. *See Orchard*, 88 A.3d at 38-39.

43. *Id.* at *8 n.40.

44. *See Lynch*, 638 A.2d at 1117 ("The initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction. However, an approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff.").

45. *Cornerstone*, 2015 WL 2394045, at *8 n.40.

46. 845 A.2d 1040 (Del. 2004).

47. 88 A.3d at 635.

48. *See* Paul J. Collins, *The Chancery Court as "Gatekeeper" in M&A Litigation*, Delaware Business Court Insider (August 21, 2013); Fried Frank, *Key Delaware Trend in 2014: Increasing Deference to Directors' Decisions—But Not "Anything Goes"* (January 15, 2015). *See also* J. Travis Laster, *Response: A Milder Prescription for the Peppercorn Settlement Problem in Merger Litigation*, 93 Tex. L. Rev. *See* Also 129, 152 (2015) ("As I *see* it, the major driver of nonsubstantive settlements is the pressure created by expedited discovery and the threat of a preliminary injunction during the preclosing phase. If that pressure is removed and the deal is allowed to close, then the litigation can be dealt with in the ordinary course. Because the vast majority of the ubiquitous challenges to deals are exceedingly weak, in most cases the complaints will be dismissed.").

SECURITIES REGISTRATION

The SEC Considers Updating the Accredited Investor Definition

Pursuant to the mandate in the Dodd-Frank Act, the SEC is reviewing its accredited investor definition. Possible changes include adjusting the financial thresholds, allowing a percentage of income or net worth to be used and adding a category based on financial sophistication.

By Nova D. Harb, David H. Pankey, and David L. Ronn

The accredited investor (AI) definition is an extremely important component of the private placement market. A significant amount of capital is raised using Regulation D, and 89 percent of reported Regulation D offerings from January 2009 through December 2012 involved exclusively accredited investors. (In other words, only 11 percent of reported Regulation D offerings during this period included non-accredited investors.)

The Dodd-Frank Wall Street Reform and Consumer Protection Act requires that the SEC review the AI definition for natural persons beginning in 2014 and every four years thereafter. The SEC has received a significant number of comment letters concerning the AI definition for natural persons and two SEC advisory committees have made recommendations to the SEC on this issue.

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Currently an individual is an AI if that person:

- earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year; or
- has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence, as calculated in accordance with the rule).[1]

These income and net worth tests for individuals were established in 1982. Since then, the only change to these tests was the elimination of the value of a person's primary residence from the net worth calculation, which became effective in 2012.

The SEC staff is also considering the AI definition as it applies to entities. It then will prepare a report to the Commission describing its review of the AI definition. The Commission will then decide whether to make that report public and whether to consider revising the AI definition as a result of the SEC staff review.

Comment Letters

Most of the comment letters the SEC has received concerning the possible revision of the definition of AI are located on the SEC's website under the 2013 Proposed Rules at Release No. 33-9458, September 27, 2013. The relevant comment letters start on February 3, 2014. Comment letters at this location before that date mostly deal with the proposed investor protections for Regulation D. As of April 30, 2015, approximately 320 comment letters dealing with the AI definition had been posted at this location.[2]

A lot of people, including a large number associated with angel investor groups, have recommended that the AI definition remain as is, in other words, that the current AI financial thresholds remain in place. The vast majority of the comment letters received by the SEC take this view.

Angel investor groups have conducted a coordinated comment letter campaign concerning the SEC's consideration of the AI definition. Most of the comment letters in the SEC's public files are from self-described angel investors, or persons or entities that provide services to or are otherwise associated with angel investors, or the letters contain wording that is substantially similar to angel investor letters. Of the approximately 320 letters relating to the AI definition, approximately 280 appear to be from these types of commenters.[3]

While the angel investor community has generated a significant number of comment letters, the SEC staff may be more interested in the concepts being advanced, as opposed to the number of letters supporting a concept.

The discussion in the comment letters, and in the meetings of two SEC advisory committees, has focused on several alternatives, including:

- adjusting the AI financial thresholds;
- allowing a percentage of income or net worth to be used in qualifying private placements; and
- adding a new AI category based on financial sophistication.

Each of these possible approaches is explained below.

Investor protection advocates and others have recommended a variety of other changes to the AI definition, including revising the net worth calculation to exclude retirement assets. Although the SEC has stated publicly that it is considering this potential change, neither of the SEC advisory committees recommended it.

The SEC's Advisory Committees

Two SEC advisory committees have considered and made recommendations concerning possible revisions to the AI definition: the SEC's Investor Advisory Committee (Investor Committee) and the SEC's Advisory Committee on Small and Emerging Companies (Small Companies Committee, and together with the Investor Committee, the Advisory Committees).

The Advisory Committees took different approaches with regard to the financial thresholds themselves. The Small Companies Committee recommended that the financial thresholds be adjusted for inflation on a going-forward basis. The Investor Committee recommended that if the AI definition continues to rely primarily on financial thresholds, a new criterion should be added, such as limiting investments in private placements to a percentage of assets or income or a tiered approach where these restrictions are reduced or eliminated at higher levels of income or assets. Both Advisory Committees have endorsed the concept of adding a financial sophistication criterion that would result in AI status without regard to the financial thresholds.

Each of these recommendations is discussed below.

Possible Adjustment to Current Financial Thresholds

Adjust Financial Thresholds for Historical Inflation

Some of the discussion in the comment letters has focused on whether the AI financial thresholds should be raised. If the financial thresholds were adjusted for inflation, the income threshold would increase to just under $500,000 ($740,000 for a married couple), and the net worth criteria would increase from $1 million to almost $2.5 million. While the data is not entirely clear as to the extent of the impact, it is probable that an increase in the financial thresholds of this magnitude would have a material adverse impact on the private placement market.

Very few people are advocating that the income and net worth thresholds be adjusted for inflation since 1982.[4] Accordingly, it is very unlikely that the SEC will simply increase the AI financial thresholds to adjust for inflation since 1982.

Adjust Financial Thresholds for Inflation Going Forward

The Small Companies Committee recommended that the SEC adjust the AI thresholds according to the consumer price index to take into account the effect of future inflation on a going-forward basis. This approach recognizes that the financial thresholds should be modified to reflect changed macro-economic conditions over time, but has the advantage of avoiding the potentially serious negative impact to the private placement market that could take place if the AI financial thresholds were adjusted for inflation since 1982.

A few comment letters also support this concept. However, some of these comment letters advance this idea as an alternative to adjusting the AI financial thresholds for inflation since 1982 or otherwise increasing the AI financial thresholds at the present time. If the adjustment for inflation since 1982 is not a probable option, as seems likely, these commenters might prefer to see the AI financial thresholds stay the same.[5]

No Change to Financial Thresholds

A substantial number of commenters take the view that the SEC should not change the financial thresholds in the AI definition for individuals. The main argument for this position is that the current definition is working and that changing the income or net worth tests would have a material adverse impact on the private placement market.

Most of the comment letters recommend leaving the AI financial thresholds alone because angel investors take this view and the vast majority of the comment letters have been posted by persons associated with or providing services to, or otherwise supporting, angel investor groups.

Add Percentage of Income or Net Worth Test

The Investor Committee believes that the current financial thresholds are inadequate.[6] However, the Investor Committee did not recommend simply adjusting the AI financial thresholds for inflation since 1982.[7] Instead, the Committee recommended consideration of a new approach, which would limit investments based on a percentage of income or net worth. This approach would be similar to the investment limitations in the SEC's proposed crowdfunding rule.[8]

The Investor Committee recommended that the SEC consider alternatives to these thresholds such as the following if the SEC decides to continue with an approach that relies exclusively or mainly on financial thresholds:

- limiting investments in private offerings to a percentage of assets or income; or
- a tiered approach, which would allow some investments in privately placed securities once a person reaches an initial threshold based on a percentage of income or assets, with these restrictions being reduced and then eliminated as income or assets rise.

As an example of this type of tiered approach, the Investor Committee stated that the SEC could retain the current income and net worth thresholds as the base value for the AI definition, but restrict individuals who meet these thresholds to investing up to 10 percent of their income or net worth in private offerings, in the aggregate, in a 12-month period. At the same time, the SEC could use the thresholds, as adjusted for inflation, to define the level above which private offering investments would not be subject to any limits. However, the Investor Committee noted this possibility for purposes of illustration only, and specifically stated that it was not advocating this approach.

The recommendations of the Investor Committee include the following statements explaining these concepts:

> Leaving aside the question of whether the financial thresholds are currently set at an appropriate level, the basic "on/off switch" approach seems illogical. A more sensible approach might be to allow some investments in private securities once a person reaches an initial threshold, based on percentage of income or assets, with restrictions being reduced and then eliminated as income or assets rise…
>
> Properly structured, such an approach to setting the accredited investor definition could significantly reduce the likelihood that investors would suffer unaffordable losses without shrinking the pool of accredited investors in the way that simply adjusting the thresholds for inflation would be likely to do.

In addition, the Investor Committee believes these approaches could work on a stand-alone basis or in combination with a sophistication or experience criteria, as discussed below. The main disadvantage of this approach is its potential complexity.

If the concept were used to expand, rather than restrict, the AI class, it might garner support.

A few other commenters also have supported this kind of approach.[9] If this type of test was implemented in a way that would permit investments as an AI where an individual did not otherwise meet the AI financial thresholds, many commenters probably would support it.[10] In other words, if the concept were used to expand, rather than restrict, the AI class, it might garner support from a wider group of interested persons.

Add New Financial Sophistication Component

Many commenters recommend that the SEC add a new way for individuals to be treated as AIs without regard to their income or net worth: financial sophistication. Both Advisory Committees, as well as a large number of angel investors, have recommended that the AI definition be expanded to include a new category of AI based upon "sophistication." By "sophistication," these commenters mean that a person could qualify as an AI without regard to the financial thresholds if that person had knowledge or experience that indicated financial literacy. Various ways have been advanced to implement this concept, as explained in more detail below.

The SEC staff has stated publicly that it is considering this concept. Because of the rather broad support for the addition of financial sophistication as a factor that results in AI status, there is a realistic chance that the SEC staff will recommend that the SEC consider this kind of change. The more difficult part will be how to structure the new financial sophistication component in a practical sense.

Many suggestions have been made concerning the criteria that should be used for this purpose, including:

- professional credentials or professional experience;
- investment experience; or
- passing a test demonstrating financial knowledge.

Professional Qualifications and Designations

Some commenters believe that several types of professional qualifications would necessarily result in sufficient financial literacy to be considered an AI. Commenters have recommended several criteria, including the following:

- advanced degrees—individuals holding advanced degrees in business or law, such as an MBA, J.D., or a master's or doctorate in finance, economics or business;
- professional designations—individuals with professional designations such as CPA, CFA or CISP; or
- securities licenses—individuals who hold securities licenses (Series 7, Series 63, etc.)

Some of these criteria seem a lot closer to the mark than others.

The Investor Committee notes that two credentials are commonly mentioned as satisfying the AI standard:

- Series 7 securities license; and
- Chartered Financial Analyst designation.

The question is where to draw the line; in other words, if the SEC takes this approach, will the SEC limit the criteria to situations that very clearly demonstrate depth of financial understanding?

Professional Experience

In addition to professional credentials, the Investor Committee supports the use of professional experience to establish AI status.

People who are involved in the investment activity of private investment vehicles are treated as "knowledgeable employees" and are permitted to invest in those private funds without satisfying certain regulatory requirements otherwise associated with those private funds. A knowledgeable employee can invest in a private fund exempt from registration as an investment company under Section 3(c)(1) (3(c)(1) Funds) of the Investment Company Act of 1940 (ICA)—a fund which cannot have more than 100 beneficial owners—without being counted as a beneficial owner. A knowledgeable employee also can invest in a collective investment vehicle that is exempt from registration as an investment company under Section 3(c)(7) of the ICA (a QP Fund), without meeting the financial tests imposed on other investors in a QP Fund. However, currently, these "knowledgeable employees" are not treated as AIs unless they meet the AI financial thresholds. This disconnect results in the very strange result that a person can be treated as financially sophisticated under the ICA rules for 3(c)(1) Funds and QP Funds, but not for purposes of the AI definition. Representatives of the private funds industry have been trying to get this result changed for a long time.

In effect, the Investor Committee has advocated this change and suggested that the knowledgeable employee concept be used as a model for an additional AI category.

Investment Experience

Commenters also have recommended that the SEC consider a new category of AI based on an individual's investment experience. They have advanced the idea that an individual who has a sufficient level of investments should be considered financially sophisticated and qualify as an AI. The Investor Committee supports this concept.

The SEC has used this logic before. The SEC proposed a comparable standard as an alternative method of qualifying as an AI in 2007, but did not adopt the proposal. The proposal would have required $750,000 in investments, and that standard would have been an alternative to the income and net worth tests for individuals.

The ICA contains a very similar concept. A QP Fund is exempt from registration as an investment company under the ICA if all outstanding securities are owned by "qualified purchasers." An individual who holds $5 million or more in specified types of investments is considered a qualified purchaser. In the 2007 AI proposal, "investments" meant essentially the same types of investments as are required to be a "qualified purchaser" in a QP Fund, although at a lower total amount.

Angel Investors

One of the goals of the angel investor community is to have the AI definition revised so that participation in an angel investor group would automatically result in AI status.

The Investor Committee noted that participation in an angel network, in and of itself, may not serve as an adequate measure of financial expertise or experience. However, the Investor Committee stated that it might be possible to develop an acceptable approach to qualifying as an AI based on participation in an angel group that follows best practices with regard to due diligence and that includes financially sophisticated members. The Investor Committee did not provide specifics as to how this type of arrangement would work in a practical sense.

Passing a Test

Some commenters have recommended that AI status should be available to people who pass a test that demonstrates financial literacy. Many believe that testing should deal with financial literacy in a general sense while others argue that testing would need to be very specific, *i.e.*, test knowledge concerning the industry in which the proposed investment would be made. There also has been discussion about how to design and administer this kind of test.

The Investor Committee noted that it would be possible, at least in theory, to develop a test that individuals could take to qualify as AIs. Such a test could be developed either by the regulators themselves—the SEC working in conjunction with the state securities regulators and FINRA—or it could be developed by an independent party.

One commentator suggested that the SEC should administer the test and keep a central registry of people who have passed it. Many commenters have recommended that the test would need to be acceptable to, and approved by, the SEC.

Acting through a Registered Investment Advisor or Broker-Dealer

Some commenters have recommended AI status for an individual who has consulted a licensed investment expert and acts in accordance with its recommendations.[11]

Notes

1. *See* Regulation D, Rule 501(a).
2. There are also a few comment letters relating to the potential change of the AI definition on the SEC's Spotlight page for the Investor Committee (six letters) and the SEC Spotlight page for the Small Companies Committee (seven letters).
3. These figures include form letters supporting angel investor advocated positions relating to the AI definition. The SEC file identifies these form letters by type (Type C, Type D and Type E) and records the total number of letters in each group/type that the SEC received as follows:

- Type C Letters—48 letters from members of the Angel Capital Association;
- Type D Letters—109 letters expressing agreement with the comment letter by Kiran Lingam at SeedInvest; and
- Type E Letters—47 comment letters from members of Golden Seeds, an angel group dedicated to evaluating, funding and helping companies with at least one woman in a management role.

Each of the letters in each identified group/type is exactly the same as every other letter in that identified group/type. Type C, D and E letters support leaving the income and net worth tests alone and the Type C and D letters recommend adding a sophistication component.

4. The Investor Committee included in its recommendations an illustration of a potential approach that included adjusting the financial thresholds for inflation, but was not advocating this illustration as a specific proposal.

5. See, for example, Fred Bryant, co-founder and COO, Wealthforge, September 23, 2014 and Randal Klein, Streamline Consulting LLC, June 18, 2014.

6. The Investor Committee believes that the current definition's financial thresholds do not adequately reflect investor sophistication, access to information, and ability to withstand losses because:

- non-financial assets (other than the primary residence) are included in the net worth test, and as a result the current AI net worth definition does not guarantee that the individual AI will have sufficient liquid financial assets to ensure either that they can hold privately placed securities indefinitely or that they can withstand a significant loss on those investments;
- many individuals who meet the net worth threshold will do so based on a retirement nest egg that will need to *see* them through retirement; and
- the income test by itself does not assure that individuals will have significant financial assets and the ability to withstand the potential risks of private offerings; the ability to withstand the potential risks will vary greatly based on a number of factors not addressed by the current AI definition.

7. The Investor Committee stated that it did not recommend adjusting the AI thresholds for inflation because:

- it is not clear that the SEC set the initial financial thresholds at the right levels in 1982;
- adjusting the AI definition thresholds for inflation would significantly restrict the pool of capital available for private offerings; and
- raising the AI financial thresholds would not resolve the shortcomings in the current AI definition.

8. *See* Release No. 33-9470, October 23, 2013.

9. See, for example, Marilyn Mohrman-Gillis Esq., Managing Director of Public Policy and Communications, Certified Financial Planner Board of Standards Inc., December 19, 2014, and Mitch Ackles, President, Hedge Fund Association, October 6, 2014.

10. *See* Eric L. Dobson, Ph.D., Chief Executive Officer, Angel Capital Group, July 22, 2014.

11. See, for example, Joanna Schwartz, CEO, Early Shares.com Inc., August 4, 2014, and Jerry Verseput, CFP, NAPFA, July 11, 2014.

DIRECTOR LIABILITY

New Delaware Court of Chancery Opinion Provides Guidance for Director Compensation Practices

A recent opinion of the Delaware Court of Chancery, Calma v. Templeton, *has brought renewed attention to the issue of director compensation. The opinion holds that director compensation decisions may not be subject to the presumption of the business judgment rule, but may instead be reviewed under the entire fairness standard. However, it also addresses the circumstances under which stockholder ratification of director compensation decisions may restore the presumption of the business judgment rule.*

By John Mark Zeberkiewicz and Stephanie Norman

Because the amount of compensation paid to non-executive directors on an annual basis tends not to be extraordinary, directors' decisions on the matter frequently go unchallenged. When ordinary director fees are coupled with restricted stock or other equity incentive awards, however, the fees may become sufficiently substantial to precipitate a derivative suit. Despite the directors' statutory authority to fix their own compensation,[1] the decision is one on which the directors stand on "both sides" and, if challenged, may be subject to review under the entire fairness standard, making it difficult to dispense with the plaintiffs' claims at an early stage of the proceeding. A recent opinion of the Delaware Court of Chancery, *Calma v. Templeton*,[2] provides significant guidance to corporations and practitioners in structuring non-executive director compensation plans such that compensation decisions made in compliance with the plan will be more likely to avoid review under the onerous entire fairness standard.

Background

In *Calma*, the stockholder plaintiff claimed that the restricted stock units awarded to Citrix System, Inc.'s non-employee directors under its 2005 Equity Incentive Plan (Plan) were excessive. Through the suit, the plaintiff sought recovery, derivatively on behalf of Citrix, against the defendant directors under theories of breach of fiduciary duty, waste and unjust enrichment. Relying principally on a ratification defense, the defendants moved to dismiss, arguing that any awards would have to be reviewed under a waste standard because stockholders had adopted the Plan.[3]

The plaintiff did not dispute that stockholders had adopted the Plan, nor did he allege that the stockholders' vote was ill-informed. Instead, he claimed that, because the Plan contained no "meaningful limit" on awards to directors, any grant made under it was a discretionary decision on the part of directors to compensate themselves and was therefore subject to entire fairness review. Although the Plan included a limit on the number of shares or RSUs that could be awarded, the total number—1 million—equated to approximately $55 million in Citrix stock at the time the action was filed.

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Analysis of the Court of Chancery

Availability of the Business Judgment Rule

Noting that all of the members of Citrix's compensation committee that had approved the RSU awards were themselves recipients, the Court found that the plaintiff had rebutted the presumption of the business judgment rule.[4] Citing the Delaware Supreme Court's opinion in *Telxon v. Meyerson*,[5] the Court stated that "director self-compensation decisions are conflicted transactions that 'lie outside the business judgment rule's presumptive protection, so that, where properly challenged, the receipt of self-determined benefits is subject to an affirmative showing that the compensation arrangements are fair to the corporation.' "[6] The Court distinguished the approval of the RSU awards at issue from cases where "disinterested directors approved the compensation of other directors."[7]

The receipt of self-determined benefits is subject to an affirmative showing that the compensation arrangements are fair to the corporation.

In making this distinction, the Court cited to *California Public Employees Retirement Systems v. Coulter*.[8] In that case, the stockholder plaintiff challenged, among other things, the decision made by two employee-directors to reprice options held by outside directors under circumstances where the employee-directors were benefitting from a similar repricing of employee options. Explaining that the plaintiff had failed to allege sufficient facts to show that the employee-directors repriced the options of outside directors as a *quid pro quo* for the repricing of their own options, the *Coulter* Court found that the plaintiff had not alleged "that any director participated in the repricing of his own options and was therefore 'interested' as analyzed under the first prong" of the *Aronson* test for showing demand futility in a derivative action.[9]

The *Calma* Court also cited to *Tate & Lyle v. Staley Cont'l, Inc.*,[10] which involved a challenge to the full board's decision to establish a trust to fund compensation plans that benefitted both management and non-management directors upon a change of control. Evaluating each plan that would benefit from the trust, the *Tate* Court distinguished the retirement plan approved by the full board, providing for the compensation of directors upon their retirement or upon a change of control, from the compensation packages of certain executives and other employees that were approved by the compensation committee consisting of independent directors. The *Tate* Court explained that the decision to approve the retirement plan likely would not be protected by the business judgment rule as it would, upon a change of control, "immediately benefit the same directors who proposed its adoption."[11] By contrast, the *Tate* Court explained, with respect to the officer and employee compensation packages, that "compensation decisions are generally the sole prerogative of the directors" and that such packages would likely be afforded the protection of the business judgment rule because they were approved by a committee of disinterested directors.[12] Ultimately, because the purpose of the trust was to fund all compensation plans, including the retirement plan in which the directors had a direct personal interest, the *Tate* Court held that the plaintiffs had shown a reasonable probability of success on the merits that the creation of the trust would be subject to entire fairness review.[13]

Stockholder Ratification

After describing the basic standard of review applicable in the first instance to director compensation decisions, the *Calma* Court addressed defendants' ratification argument. Undertaking a comprehensive survey of Delaware's jurisprudence on common law ratification, the Court noted that the "principle of 'ratification' stems from the law of agency," and that, "[i]n the corporate law context, stockholders (as principals) can, by majority vote, retrospectively and, at times, prospectively, act to validate and affirm the acts of the directors (as agents)."[14] The Court first described the defense of ratification as applied in *Kerbs v. California Eastern Airways, Inc.*,[15] which involved a challenge to a stockholder-approved plan that provided for option awards to be granted to named executives in specified amounts on the basis that the corporation had not received adequate consideration. Although a majority of the directors who had approved the plan were also beneficiaries under the plan, the *Kerbs* Court found that the stockholders' prior adoption of the plan, after full disclosure, would operate to ratify the consideration received by the corporation in respect of the option awards to the executives, thus requiring the plaintiff to demonstrate that the awards were fraudulent or *ultra vires* or constituted waste.[16] (Interestingly, the *Kerbs* Court found that the grants did constitute waste, as the plan contained no measures reasonably designed to ensure that the corporation received the bargained-for benefit.)[17]

The *Calma* Court also addressed the Delaware Court of Chancery's opinions in *Steiner v. Meyerson*,[18] *Lewis v. Vogelstein*[19] and *In re 3COM Corp. Shareholders Litigation*.[20] The *Calma* Court stressed that in each of these cases, the plan at issue imposed "meaningful" substantive limits on the directors' authority to grant awards. Those limits, according to the Court, were critical to the earlier findings that stockholder approval of the plan required the plaintiffs to demonstrate waste.

The Court next reviewed the defense of stockholder ratification as raised in *Kaufman v. Shoenberg*.[21] In that case, the plan at issue did not specify the amount of awards to be granted to specific directors, but provided that it would be administered by a committee of directors who were not entitled to receive awards under it. Because key features of the plan, including the limitations on awards and the standards governing the committee's determinations, had been disclosed to stockholders before its adoption, the stockholders' "ratification" of the plan was sufficient to restore the presumption of the business judgment rule to the committee's decisions.[22]

Ideally, non-executive director compensation would be covered in a separate plan, rather than included in an omnibus plan.

The Court then compared these cases to those in which the directors' ratification defense was not sufficient to restore the presumption of the business judgment rule. The Court pointed to *Sample v. Morgan*,[23] where the two non-employee directors constituting the compensation committee awarded 200,000 shares to the three management directors under a stockholder-approved incentive plan that contained no provisions specifying (or imposing a limitation on) awards to directors. The *Calma* Court's key takeaway from *Sample* was that

> because the stockholders … merely voted in favor of the broad parameters of the plan—and had not voted in favor of any specific awards under the plan—the defendants could not show that stockholders had ratified the decision to grant all of the 200,000 shares authorized under the plan to just the three employee directors. Thus, the directors' conduct would be reviewed under ordinary principles of

fiduciary duty and not limited to a waste standard.[24]

Following this line of reasoning, the *Calma* Court held that the facts before it were most analogous to those in *Seinfeld v. Slager.*[25] As with *Calma*, the plan at issue in *Slager* did not specify the amounts of awards or impose a "meaningful" limit on awards to directors. Instead, the plan imposed a "generic limit" under which directors could have received north of $20 million in stock in a particular year.

The *Calma* Court stated that its reading of *Slager* was that, because the plan imposed nothing more than a generic limit, as opposed to a limit in a specified and fairly narrow range, the defendants were not entitled to a ratification defense. Accordingly, the *Calma* Court rejected the defendants' ratification argument and held that the decision of Citrix's compensation committee to award the RSU to all directors was subject to entire fairness scrutiny.

Key Takeaways

In light of *Calma*, corporations that have incentive plans that do not currently provide specific grant amounts (or narrow ranges) for non-executive directors should consider amending their existing plans or adopting new plans. Ideally, non-executive director compensation would be covered in a separate plan, rather than included in an omnibus plan that also addresses grants to executive officers and other employees. The incentive plans, as amended or newly adopted, should provide for grants to directors in specified amounts (or in narrow specified ranges) or with specified value thresholds. In addition to stock options, restricted stock and other equity-based awards, boards should consider including cash consideration amounts (or narrow ranges) in such plans.[26] If approved by a majority of the disinterested stockholders after full disclosure, the directors' decisions in compliance with those plans should withstand challenge—and any claim should be dismissed at an early stage of the proceeding—except in the most extraordinary circumstances.

Boards should, retain a qualified and experienced independent compensation consultant to advise with respect to such decisions.

In addition, because director-compensation decisions made by the board of a corporation that does not have such a plan in place may be subject to review under the entire fairness standard, the board should ensure that the process by which such decisions are made is thoughtful, deliberate and reasonably designed to result in the corporation obtaining a fair exchange of services for compensation. Boards should, among other things, retain a qualified and experienced independent compensation consultant to advise with respect to such decisions. With input from the compensation consultant, boards also should see that they have selected an appropriate peer group for purposes of determining whether their compensation packages are not off-market. Specifically, boards should be wary of including in any such peer group companies with considerably higher market capitalizations, revenue or net income.[27] As with all important decisions, the board should see that the minutes of its proceedings reflect the bases for its decision, including, if applicable, the advice it received from outside experts.

Notes

1. Section 141(h) of the General Corporation Law of the State of Delaware provides that, "[u]nless otherwise restricted by the certificate of incorporation or bylaws, the board of directors shall have the authority to fix the compensation of directors." 8 *Del. C.* § 141(h). In *Cambridge Retirement System v. Bosnjak*, 2014 WL 2930869 (Del. Ch. June 26, 2014), the Delaware Court of Chancery found that the legislative intent of Section 141(h) was to overturn early case law questioning

the directors' power to set their own compensation, but not to affect the standard by which the decision would be reviewed.

2. --- A.3d ----, 2015 WL 2265535 (Del. Ch. Apr. 30, 2015).

3. Defendants also moved to dismiss on the grounds that plaintiff had failed to make a pre-suit demand on Citrix's board under Court of Chancery Rule 23.1, but the Court found that plaintiff had adequately demonstrated that demand was futile under the so-called *Rales* test, noting that all three of the directors on the compensation committee that had approved the awards were also beneficiaries. *Id.*

4. 2015 WL 2265535, at *8.

5. 802 A.2d 257 (Del. 2002).

6. 2015 WL 2265535, at *8.

7. *Id.*

8. 2002 WL 31888343 (Del. Ch. Dec. 18, 2002).

9. *Id.* at *10 n.26.

10. 1988 WL 46064 (Del. Ch. May 9, 1988).

11. *Id.* at *7.

12. *Id.*

13. *Id.* at *8.

14. *Calma,* 2015 WL 2265535, at *9.

15. 90 A.2d 652 (Del. 1952).

16. *Id.* at 655-56 ("The interested character of the directors who voted for the stock option plan makes their action voidable only and thus subject to stockholders' ratification. The attack, therefore, of the defendant upon the stock option plan is limited to the question of whether or not it constitutes a gift of corporate assets to executives.") (citations omitted).

17. *Id.* at 656-58.

18. 1995 WL 441999 (Del. Ch. July 19, 1995). In *Steiner*, a stockholder challenged a stock option plan that provided for, among other things, the grant to each non-employee director of an option to purchase 10,000 shares on the anniversary of such director's election to the board. Relying on *Kerbs*, the *Steiner* Court held that, because the plan had been approved by the stockholders after full disclosure, the stockholder plaintiff was required to show that the directors' approval of the plan was *ultra vires*, illegal or fraudulent or that the approval of the plan constituted a gift of corporate assets or waste. *Id.* at *7.

19. 699 A.2d 327 (Del. Ch. 1997). Although the plan at issue in *Vogelstein* was slightly different from the plan at issue in *Steiner* in that the plan provided for, among other things, an annual grant of *up to* 10,000 options per year, the Court held that a stockholder-approved rights plan was subject to review under the waste standard. *Id.* at 336.

20. 1999 WL 1009210, at *1-3, n.9 (Del. Ch. Oct. 25, 1999) (holding that "[d]ecisions of directors who administer a stockholder approved director stock option plan are entitled to the protection of the business judgment rule, and, in the absence of waste, a total failure of consideration, they do not breach their duty of loyalty by acting consistently with the terms of the stockholder approved plan" and noting the various limitations of the board's authority under the plan at issue, explaining "[i]t is implicit that the Board may only exercise discretion within these parameters and is free to award as many options as the Plan permits or as few as zero options").

21. 91 A.2d 786 (Del. Ch. 1952).

22. *Id.* at 790.

23. 914 A.2d 647 (Del. Ch. 2007).

24. *Calma*, 2015 WL 2265535, at *13.

25. 2012 WL 2501105 (Del. Ch. June 29, 2012).

26. *Steiner*, 1995 WL 441999, at *7 (Del. Ch. July 19, 1995) (indicating that the cash component of director compensation would also be subject to the waste standard if paid in accordance with a plan validly adopted by a fully informed and disinterested stockholder vote).

27. *Calma*, 2015 WL 2265535, at *18.

IN THE COURTS

The Death of the Dead-Hand Poison Put?

By William M. Lafferty, John P. DiTomo, and Mac Measley

On May 8, 2015, Vice Chancellor J. Travis Laster of the Delaware Court of Chancery approved a settlement of a stockholder class action (*Healthways II*) challenging a so-called "dead hand proxy put" provision in a credit agreement between Healthways, Inc. and a syndicate of lenders, including SunTrust Bank.[1] The validity of such provisions had been the subject of previous decisions by the Court of Chancery,[2] including *Pontiac Gen. Employees Retirement Syst. v. Ballantine*, (*Healthways I*).[3] *Healthways II* re-visits the prior ruling in *Healthways I*,[4] a ruling the Court characterized as one of his "more frequently misrepresented or misunderstood," and provides important guidance in this evolving area of Delaware law.

Challenges to Proxy Puts Are on the Rise

Over the course of the last 6 to 10 months, there have been at least 6 complaints filed in the Delaware Court of Chancery and numerous demands for books and records made pursuant to Section 220 of the Delaware General Corporation Law, all geared toward challenging "Proxy Put" provisions in credit agreements. A "Proxy Put" is a colloquial term used to describe provisions that allow a lender to put outstanding debt to the borrower for immediate repayment upon a change in the composition of a board of directors.[5] Such provisions have the potential to create financial risk for the company in proxy contests, as the provisions are often triggered when a majority of a board of directors will be replaced by individuals nominated as part of an actual or threatened proxy solicitation.

Proxy Puts often contain continuing director exceptions that disarm the Proxy Put if a majority of the old board approves the new slate of directors. More recent iterations of the Proxy Put—so called "dead-hand" Proxy Puts—have excluded the continuing director exception thereby removing the old board's discretion to approve the competing slate. Given concerns of entrenchment, Proxy Puts litigation raises complicated issues of fiduciary duty as well as potential liability for lenders who insist on placing (or keeping) Proxy Puts in their credit agreements. Dead-hand Proxy Puts in particular have been, and will continue to be, targeted by the stockholder plaintiffs.

Healthways I: Dead-Hand Proxy Put May Subject Lenders to Aiding and Abetting Liability

In *Healthways I*, the Proxy Put provision in the SunTrust Credit Agreement was amended in 2012 to remove the incumbent board's right to approve the insurgent stockholder nominees as continuing directors (the "dead hand" feature). The plaintiff alleged that the amendment was made after the company's stockholders had voted to de-stagger the board in response to a stockholder proposal. It was further alleged, based on documents produced in response to a books and records demand, that the board negotiated the amendment without receiving significant value

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in return. Healthways stockholders challenged the validity of the dead hand provision, alleged that the Healthways directors breached their fiduciary duties in approving the credit agreement, and that SunTrust aided and abetted the alleged breach. The director defendants moved to dismiss the complaint on ripeness grounds, arguing that the provision could not be triggered until the Company's 2015 annual meeting, which was expected to occur approximately 12 months from the date of the filing of the complaint, and SunTrust moved to dismiss the aiding and abetting claim for failure to state claim.

In a bench ruling issued on October 14, 2014, the Court denied the defendants' motions (*Healthways I*).[6] Rejecting the ripeness argument, the Court observed that because dissident directors are deemed non-continuing directors under the credit agreement's "proxy put," Healthways stockholders may be "suffering a distinct injury" from the deterrent effect such a provision has regardless of the timing of the annual meeting. With respect to SunTrust, the Court observed that there was "ample precedent" "that [Proxy Put] provisions… [are] highly suspect and could potentially lead to a breach of duty on the part of the fiduciaries who were the counter-parties to a negotiation… ."[7] Analogizing to the third-party deal cases, the Court stated:

> The acquirer is perfectly able to negotiate for the best deal it can get, but as soon as it starts offering side benefits, entrenchment benefits, other types of concepts that create a conflict of interest for the fiduciaries with whom it's negotiating, that acquirer is now at risk. Is the acquirer necessarily liable? No. But does that take the acquirer out of the privilege that we afford arm's-length negotiation? It does.[8]

Thus, because SunTrust was "a party to an agreement containing an entrenching provision that create[d] a conflict of interest on the part of the fiduciaries on the other side of the negotiation" and due to the context in which the provision arose and the prior precedent from the Court of Chancery, the Court ruled that the plaintiff sufficiently alleged facts for pleading-stage purposes to create an inference of a "knowing" participation in the fiduciary's alleged breach of duty.[9]

Healthways II: Assuaging Concerns Raised By *Healthways* I

After the motions to dismiss were denied, plaintiffs and defendants agreed to a settlement which, among other things, required that the credit agreement be amended to delete the dead hand proxy put language. In approving the settlement at a hearing on May 8, 2015, Vice Chancellor Laster sought to dispel what he characterized as "an alarmist view that liability, in fact, was established" by his prior ruling.

First, the Court emphasized that his denial of the motions to dismiss was not a finding of liability or a grant of final relief. Rather, Vice Chancellor Laster stated that it

> was a determination, under the reasonably conceivable standard that applies in this situation, that given the facts surrounding the timing of the adoption of the proxy put [i.e., after the adoption of a proposal to destagger the board], as well as the prior case law regarding these provisions, it was reasonably conceivable that the plaintiffs could prevail on their claims.

Such a finding, the Vice Chancellor emphasized, "certainly holds out the possibility that on the merits it may be proven otherwise and that the pleadings-stage determination could be wrong."

Second, Vice Chancellor Laster stated the "general view[]" of his prior ruling as applying to "any change-in-control provision in any loan agreement" was "specious." Rather, the Court stated that his prior ruling

> addressed a dead hand proxy put, adopted in the shadow of a proxy contest. It didn't address things like other acceleration rights that might be triggered by breaches of debt covenants or similar lender-protective provisions that do not affect the stockholder franchise.

Third, the Court stressed again that there was no "finding of liability on the aiding and abetting claim against any lender who at any point for any company or for any issuer put one of these things in place."

Finally, the Court emphasized that the "plaintiffs might well not prevail on their claims" absent the settlement. The Court stated that, although the claims were meritorious when filed, they were claims that could be contested. Specifically, the Court noted that any claim for monetary damages would have been subject to Section 102(b)(7) and Section 141(e) defenses, and that there would have been factual disputes regarding the degree to which SunTrust knowingly participated in the alleged underlying misconduct.

Practical Implications

Although lenders initially resisted removing so-called dead-hand proxy put provisions, following the aiding and abetting ruling in *Healthways I*, the trend appears to be for lenders to more readily consider agreeing to the amend the poison put provision to remove its dead-hand feature. Based on this change, and the challenges faced by a company in defending such a provision, in most cases, a company with a dead-hand proxy put provision in a credit agreement is best served by assessing with counsel whether such a provision should be amended or removed. In recent examples, lenders have been willing to amend dead-hand provisions after litigation was commenced thereby mooting the claim, but also triggering the payment of mootness fees that have ranged from \$300,000 to \$500,000. Proactively identifying and, if appropriate, removing (or amending) such provisions before receiving a Section 220 demand or the filing of a class action complaint will avoid a demand for the payment of attorneys' fees.

Notes

1. Pontiac Gen. Employees Retirement Syst. v. Ballantine, C.A. No. 9789-VCL (Del. Ch. May 8, 2015). (Healthways II).
2. *See San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc.*, 983 A.2d 304 (Del. Ch. 2009)) and *Kallick v. SandRidge Energy, Inc.*, 68 A.3d 242 (Del. Ch. 2013).
3. C.A. No. 9789-VCL (TRANSCRIPT) (Del. Ch. Oct. 14, 2014) .
4. *Pontiac Gen. Employees Retirement Syst. v. Ballantine*, C.A. No. 9789-VCL (TRANSCRIPT) (Del. Ch. Oct. 14, 2014).
5. In that regard, in *Healthways II*, the Court stated: "I know many object to [the "dead hand proxy put"] term, because they want to make sure everyone understands it is only an acceleration of the debt that happens to be triggered by specific circumstances. But economically that's a put, and because the put is on debt that involves money, there is no difference between an acceleration right conceptually and a put. So I personally am not terribly offended by this term."
6. *Id.*
7. *Id.* at 80.
8. *Id.* at 79.
9. *Id.* at 80-81.

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.

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

Some Observations Concerning the SEC's Proposed Pay-Versus-Performance Disclosure Rules (May 29, 2015)

A discussion of the SEC's proposed rules to implement Section 953(a) of the Dodd-Frank Act, highlighting issues and suggested clarifications or changes that should be made. In addition, the memorandum provides sample disclosure approaches, discusses some results that might arise from use of different methods and identifies some challenges that issuers will face in providing clear disclosure about pay and performance alignment as required by the proposed rules.

Dechert LLP
Philadelphia, PA (215-994-4000)

IPOs—Attractive Exit Alternatives for Financial Sponsors (May 8, 2015)

A discussion of new and innovative transaction structures, such as the so-called umbrella partnership C-corporation structure, that have provided financial sponsors with attractive, flexible tax structures to consider in evaluating whether to test the public markets.

Drinker Biddle & Reath LLP
Philadelphia, PA (215-988-2700)

SEC Answers Money Market Reform Questions (April 30, 2015)

A discussion of the SEC response, through a frequently asked questions format, to industry questions regarding its 2014 money market reform rules. The 15-page release answers 53 questions on various topics.

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

New (Albeit Limited) Judicial Guidance on Adjustments to the Merger Price (May 19, 2015)

A discussion of the Delaware Court of Chancery decision in *Merlin v. Autoinfo* (April 30, 2015), in which the court, for the third time, used the merger price as the primary or sole factor in determining "fair value" in an appraisal case.

Gibson, Dunn & Crutcher LLP
Los Angeles, CA (213-329-7870)

Delaware Court of Chancery Clarifies Director and Officer Advancement Rights (June 1, 2015)

A discussion of a Delaware Court of Chancery decision, *Blankenship v. Alpha Appalachia Holdings, Inc.,* clarifying and strengthening the rights of a former director and officer to receive mandatory advancement under a corporation's charter.

Orrick, Herrington & Sutcliffe LLP
San Francisco, CA (415-773-5700)

Institutional Shareholder Voting Guidance (May 8, 2015)

A discussion of how companies should address a "no" recommendation from either Institutional Shareholder Services or Glass Lewis on their say-on-pay and incentive plan proposals.

Paul Hastings LLP
New York, NY (212-318-6000)

Private Company M&A: The Recent Delaware Case Trifecta (May 2015)

A discussion of three Delaware court decisions addressing some key, customary features in private company mergers and acquisitions: (1) waiver of appraisal rights (*Halpin v. Riverstone,* Feb. 29, 2015); (2) limitations on the covenant of good faith and fair dealing (*Nationwide v. Northepoint,* Mar. 18, 2015); and (3) binding minority stockholders to indemnification and releases (*Cigna v. Audax*, Nov. 26, 2014).

Pillsbury Winthrop Shaw Pittman LLP
New York, NY (212-858-1000)

Can Regulation A+ Succeed Where Regulation A Failed? (May 6, 2015)

A discussion of the impetus for and most important provisions of Regulation A+, as well as the possible implications of the final SEC rules.

Simpson, Thacher & Bartlett LLP
New York, NY (212-455-2000)

SEC Awards Maximum Allowable Whistleblower Payment in Its First Case Involving Alleged Retaliation Against a Whistleblower (May 6, 2015)

A discussion of the SEC's announcement of its award of the maximum allowable amount to a whistleblower under the Dodd-Frank whistleblower program in its first case, *In the Matter of Paradigm Management, Inc. and Candace King Weir,* involving alleged retaliation by an employer against an employee who reported suspected misconduct to the SEC.

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

Spin-Off Guide (May 2015)

A guide intended to help navigate the spin-off process, from the preliminary phases through completion of the transaction.

Delaware Court of Chancery Revisits Creditor Derivative Standing (May 11, 2015)

A discussion of a Delaware Chancery Court decision, *Quadrant Structured Prods. Co. v. Vertin* (May 4, 2015), rejecting several proposed limitations on the ability of creditors to maintain derivative suits following a corporation's insolvency. However, the court reaffirmed the deference owed to a board's decisions, regardless of the company's financial condition, and the high hurdles faced by creditors in seeking to prove a breach of fiduciary duty.

INSIDE THE SEC

The SEC's Division of Enforcement Provides Guidance on Forum Selection

By Marc J. Fagel and Amy Mayer

One of the most profound developments at the Securities and Exchange Commission (SEC) in recent years has been the agency's increased use of its administrative forum rather than federal district courts for contested enforcement actions. The shift stems primarily from the 2010 passage of the Dodd-Frank Act, which broadened the SEC's authority to seek civil money penalties from defendants in administrative proceedings (APs). Prior to Dodd-Frank, penalties could be sought in APs only from regulated entities, such as brokers and investment advisers. Dodd-Frank extended this authority to all manner of cases, from public company accounting fraud cases to insider trading actions, which had previously been litigated primarily in federal court.

The SEC's Division of Enforcement under its current leadership has publicly embraced its new authority, bringing far more litigated APs against a wider array of defendants than ever before. The trend has drawn significant public commentary, and criticism, given the substantial procedural differences between federal trials and SEC APs. Among other things, parties to APs have no right to a jury trial; limited discovery rights (including the inability to take witness depositions); and a much quicker path to trial. Moreover, individuals or companies who lose at hearing must appeal the decision to the SEC itself, the same 5-member body which authorized the Division of Enforcement to file charges in the first place. Some commentators have questioned the fairness of the process, pointing out that the Division of Enforcement had a perfect win-loss record in 2014 in contested APs, while faring more poorly in court trials.[1] The move to APs also has generated a number of constitutional challenges, though to date these challenges have been largely unsuccessful.[2]

The May 2015 Guidance

In light of the controversy, even some within the SEC have called for greater transparency around the Division's increased reliance on APs. SEC Commissioner Michael Piwowar stated in a February 20, 2015 speech:

> To avoid the perception that the Commission is taking its tougher cases to its in-house judges, and to ensure that all are treated fairly and equally, the Commission should set out and implement guidelines for determining which cases are brought in administrative proceedings and which in federal courts.[3]

The Division of Enforcement heeded these calls, and on May 8, 2015, released written guidance addressing the factors considered when determining whether a litigated action will be instituted in an AP or federal district court. The guidance provides four general parameters considered by the Division when contemplating where a case will be brought. However, the Division cautioned that these factors are not exhaustive and "in some circumstances, a single factor may be sufficiently important to lead to a decision to recommend a particular forum."[4]

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The four factors are as follows.

- *The availability of the desired claims, legal theories, and forms of relief in each forum.* In some instances, the cause of action, legal theory, or desired remedies to be pursued by the Division may only be available in a particular forum.
- *Whether any charged party is a registered entity or an individual associated with a registered entity.* The SEC may only obtain suspensions and industry bars of brokers and advisers in an AP, and such actions will thus continue to be pursued primarily in the administrative forum.
- *The cost-, resource-, and time-effectiveness of litigation in each forum.* The much quicker pace of APs may give the SEC an impetus to proceed administratively. Conversely, the need for additional discovery may weigh in favor of a court action, as may the desirability of resolving certain legal claims through a summary judgment motion. The SEC also will consider whether some parties may only be reached in one forum or the other, with a bias in favor of bringing a single action against all defendants where possible.
- *Fair, consistent, and effective resolution of securities law issues and matters.* Matters raising complex or novel securities law issues may be pursued administratively because of the technical expertise of the SEC and the administrative law judges. Consideration also may be given to whether similarly situated parties have been charged previously in the same forum.

Assessment of the Guidance

The May 8 guidance is an important step in the right direction for the SEC. At least implicitly acknowledging some of the concerns voiced not just by industry participants and the defense bar, but also by members of Congress, the judiciary, and even its own Commissioners, the Division of Enforcement has provided some transparency to the enforcement process. At the very least, the factors shared by the Division give the Commissioners a basis to evaluate the staff's charging decisions before authorizing an enforcement action, and potentially provide the courts with a means to evaluate whether the SEC is being consistent and fair in its forum selection decisions.

Nonetheless, the guidance does not go far enough in addressing some of the key concerns about the increased use of APs by the SEC. While the guidance offers baseline considerations for the staff in deciding which forum to select, it does not address the inherent limitations of APs which are at the heart of some critics' concerns. For example, the guidance acknowledges the need in certain cases for discovery not available in APs, yet at the same time emphasizes the obligation of the staff to turn over to defendants the contents of its case file, including materials to which defendants may not be entitled in civil actions under the Federal Rules of Civil Procedure. This analysis fails to take into account the fact that the investigative file is developed wholly by the enforcement staff. Witnesses whom the staff does not call for testimony during its investigation, and documents the staff does not collect, will not be part of that file. Moreover, defendants do not have the same ability to proactively obtain such evidence as they would in civil discovery.

In order to truly address concerns about whether an AP presents an appropriate forum for the resolution of complex securities law cases, the SEC would be well-served to more broadly revisit its Rules of Practice governing APs, such as the limitations on discovery. The SEC's general counsel acknowledged as much in June 2014, suggesting it might be time to update the Rules, but there has been no official word from the agency since then.[5]

Other limitations of the administrative forum which play into fairness concerns, such as defendants' limited appeal rights, also merit greater consideration by the SEC. A losing defendant must take his or her appeal first to the SEC, which has already in some sense ruled against the party in authorizing the enforcement action, and only after that may appeal to a federal Court of Appeals. Moreover, federal appellate courts generally give much greater deference to the rulings of administrative agencies than they do to federal district court decisions. One could argue that, in the cases with the highest stakes or broadest policy repercussions, the scrutiny of the federal courts is particularly warranted, and should weigh against the SEC instituting an AP. By suggesting that cases involving emerging areas of law should be brought before an administrative law judge, the guidelines are arguably the opposite of reasonable expectations.[6]

To be sure, contentions that administrative proceedings are rigged against the defendants (particularly in light of the staff's recent 100 percent win rate) may be unfounded.[7] But as a public agency, the SEC understands the importance of being perceived as fair. To that end, while the new guidance at least provides some transparency into the agency's decision-making process, continued expansion of the Division of Enforcement's use of APs warrants additional action to level the playing field for all litigants.

Notes

1. *See* U.S. District Court Judge Jed S. Rakoff, PLI Securities Regulation Institute Keynote Address: "Is the S.E.C. Becoming a Law Unto Itself?" (Nov. 5, 2014), available at *securitiesdiary.files.wordpress.com/2014/11/rakoff-pli-speech.pdf.*

2. This string of unsuccessful charges came to an unexpected end on June 8, 2015, when an Atlanta federal district court became the first to enjoin a pending SEC administrative proceeding. The court held that the defendant in the AP, who had filed a federal lawsuit against the SEC, had shown a likelihood of successfully demonstrating that the administrative forum was unconstitutional based on the manner in which SEC administrative law judges were appointed. The court stayed the SEC proceeding pending an evidentiary hearing on the constitutional claims. *Hill v. SEC*, No. 1:15-CV-1801-LMM (N.D. Ga. June 8, 2015).

3. Michael S. Piwowar, Remarks at the "SEC Speaks" conference 2015: "A Fair, Orderly, and Efficient SEC" (Feb. 20, 2015), available at *www.sec.gov/news/speech/022015-spchcmsp.html.*

4. The guidance itself, a relatively brief read at just four pages, can be found on the SEC's website at *www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf.*

5. Stephanie Russell-Kraft, Attys Ready To Pounce On SEC's Outdated Admin Rules, Law360 (June 18, 2014).

6. Judge Jed Rakoff of the Southern District of New York, who has been particularly outspoken on the issue of APs (as he has on other SEC-related topics), has argued that much securities law jurisprudence has been developed through judicial case law, such as the law governing insider trading, and is thus better suited for federal courts than APs. *See* supra note 2.

7. *But see* Jean Eaglesham, SEC Wins With In-House Judges, Wall St. J. (May 6, 2015) (publishing allegations by a former SEC administrative law judge that she was pressured to rule in favor of the Division of Enforcement). The article was recently cited by the SEC in an order "inviting" a sitting administrative law judge to "submit an affidavit addressing whether he has had any communications or experienced any pressure similar to that" alleged in the *Wall Street Journal* article. *In re Timbervest*, Order Concerning Additional Submission, Admin. Proc. File No. 3-15519 (June 4, 2015).

INSIGHTS

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