SEYFARTH SHAW

Securities and Corporate Governance Litigation Quarterly

Decisions of Interest for Corporate and Transactional Lawyers

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Welcome to the inaugural issue of Securities and Corporate Governance Litigation Quarterly, *Seyfarth's quarterly publication of the Securities & Financial Litigation Group focusing on decisions of interest for corporate and transactional lawyers. Each decision summary below is followed by key practice takeaways.*

Supreme Court to Resolve Circuit Split on Section 11 Liability - Can Liability Be Imposed for Good Faith Opinions?

While the Supreme Court's decision on the fraud-on-the-market presumption of reliance in *Halliburton* garnered most of the attention this summer in the securities area from litigators, politicians and armchair legal prognosticators, the Supreme Court's consideration of Section 11 liability in *Indiana State District Council of Laborer v. Omnicare* next term may be far more important to issuers and their securities lawyers.

Most practitioners have assumed that Section 11 liability for opinions in an offering document is restricted to an opinion that is not only objectively wrong but also *subjectively false, i.e.*, the opinion expressed was inconsistent with the opinion held by the speaker. That has been the prevailing view in the district courts and in the Second and Ninth Circuit Courts of Appeal, where most securities cases are brought, as well as the Third and Tenth Circuit Courts of Appeal. As a consequence, there has been a longstanding understanding that an issuer and its professional advisers could not incur Section 11 liability so long as everyone on the issuer's securities team shared the opinion in good faith. That makes sense, of course. Careful and ethical practitioners strive for complete accuracy, but as a practical matter, the factual underpinnings of some opinions are inherently more difficult to absolutely confirm than others. That is why they are stated as opinions, not facts. It has generally been considered sufficient for the issuer and its legal team to do the best they can to verify all facts that form the basis for the opinion with reasonable diligence in the circumstances.

Last October, however, the Sixth Circuit *Indiana State District Council of Laborer v. Omnicare* declined to follow the Second and Ninth Circuits and held that Section 11 liability could be based on *objective* falsity alone. What that means is that an opinion that turns out to be based on inaccurate facts, no matter how thoroughly vetted and firmly believed by the issuer's securities team, could lead to Section 11 liability. Not surprisingly, the defendants in the Sixth Circuit case sought review by the Supreme Court, which granted cert on March 3rd. In their cert petition, the defendants argued that Sixth Circuit's *Omnicare* decision could have "dangerous and far-reaching consequences" because it "would expose corporations, auditors, underwriters, and other professionals to a sharp increase in the cost of litigation, as certain types of federal securities claims – particularly those under Section 11 – would become far more difficult to resolve at the pleading stage." That is an understatement. Indeed, imposing securities law liability for an opinion that turns out to be inaccurate, regardless of whether it was possible to discover the inaccuracy, does more potential damage than increasing litigation costs; it makes an issuer, its underwriters and potentially other professional advisor insurers against good faith errors and potentially deprives investors of valuable opinions that are helpful to forming investment decisions.

Nonetheless, the Sixth Circuit's opinion is not irrational given that Section 11 imposes strict liability for inaccurate facts. Moreover, the SEC has filed a brief siding with the plaintiffs arguing that an opinion, no matter how honestly held, could result in liability under Section 11 if it "lacked a basis that was reasonable under the circumstances." Until the Supreme Court overturns the Sixth Circuit decision in *Omnicare*, material opinions of any kind are a potential source of liability.

Practice Takeaway: Until the Supreme Court clarifies the standard for Section 11 liability for opinions, practitioners must be wary of offering material opinions if their factual bases are difficult or impossible to establish with certainty. It may not be enough to simply exercise care in drafting them. Most importantly, any opinion should have, as the SEC has argued, a reasonable basis under the circumstances.

Delaware Chancery Court's Decision in Rural Metro - A Cautionary Tale For All Company Gatekeepers

Rural/Metro provides ambulance and firefighting services to about 700 communities in 21 states and was acquired by Warburg Pincus in 2011 for $438 million. After the merger was announced, the inevitable shareholders' actions were commenced against the directors and Rural/Metro's two financial advisors, RBC Capital Markets and Moelis & Co. After the directors and Moelis settled, the claims against RBC were tried before Vice Chancellor Laster who issued a 92-page decision holding RBC liable for aiding and abetting the Rural/Metro directors' breaches of fiduciary duty. VC Laster has not issued a decision on damages yet but they are reported to be between $24 million (RBC's position) and $240 million plus interest (the plaintiff's position).

In holding RBC liable, the Court found that RBC had concluded that if it could lead the sale to Warburg Pincus, it would not only earn its advisory fees from Rural/Metro but also participate in financing the acquisition and potentially earning $60 million in additional fees — a clear conflict in VC Laster's view. That conflict led RBC to (1) favor Warburg Pincus to the exclusion of other potential bidders; (2) fail to provide valuation advice to the board; and (3) issue a skewed fairness opinion from an *ad hoc* fairness committee comprised of lower level bankers. The Court found the directors and its special committee to be guilty of numerous breaches of the duty care, including their own undisclosed conflicts of interests, ceding control of the process to a conflicted (albeit highly competent) board member, pursuing a flawed process that precluded other potential bidders, and approving a merger with limited valuation information, all of which occurred with the "knowing participation" of RBC.

The Court also held that Rural/Metro's exculpatory charter provision under Section 102(b)(7) that precluded personal liability of its directors for beach of their duty of care, did not extend to non-directors such as RBC. Among other things, the Court reasoned that "the threat of liability helps incentivize gatekeepers to provide sound advice, monitor clients and deter client wrongs."

All of this occurred in the context of a deal that represented a 37% premium over the preannouncement share price, which itself was over 400% higher than it was two years earlier. In fact, 72% of the shareholders approved the merger, which closed without court interference. What that proves is there is no magical premium amount that will insulate the directors and advisors from post-closing scrutiny of an arguably flawed sale process.

Practice Takeaways:

- Even an ostensibly "great deal" for shareholders will be put under a microscope and mined by the plaintiff's shareholder litigation bar for any flawed process and advisors will be put under the microscope too.
- Advisors to a target are also "gatekeepers" of the process who must ensure they are free from conflicts and also that the target's board engages in a process that is defensible in every way. That starts with active briefing and consideration by the full board, not just the "deal professionals" on the board.

- The board and its advisors must develop documented processes for maximizing the universe of potential acquirors. That is ***not*** just for public companies. All too often, the business people and bankers have narrowed the universe of potential buyers, even for sound and non-conflicted reasons, without documenting the process. That lack of documentation creates high hurdles in the context of litigation.
- Conflicts and potential conflicts of all board members and their advisors must be scrutinized.
- The board and its advisors must rigorously develop and consider the valuation of the target and fairness of the consideration to be paid.

Delaware Supreme Court Allows Hostile Shareholders To Invade Attorney-Client Privilege

Corporations big and small, public and non-public, receive stockholder document demands seeking information. Some are routine and innocuous but many are the first step towards shareholder litigation. Section 220 of the Delaware Corporations Act entitles a stockholder to examine the corporation's books and records (and those of its subsidiaries) so long as the stockholder states a "proper purpose" for the inspection, under oath. "Proper purposes" are those that are "reasonably related to [the stockholder's] interest as a stockholders," and may include the stockholder's wish to communicate with other stockholders, to investigate wrongdoing by the corporation's officers or directors, and even to investigate whether a pre-suit demand is excused before a derivative action is commenced.

If the corporation fails to adequately respond to a Section 220 demand within five days, the stockholder may commence an action in Delaware Chancery Court to compel inspection of the books and records. The Chancery Court enjoys a great deal of discretion in defining the scope of records to be produced but a demand for a stockholders list is presumptively valid, while the burden is upon the stockholder to demonstrate that other records sought are "necessary and essential" to a "proper purpose."

Are there any limits to what a stockholder may obtain through a simple Section 220 demand or action? Yes. Neither corporations in the ordinary course nor the Chancery Court are going to allow Section 220 to be used for a fishing expedition into non-particularized allegations of wrongdoing. But the Delaware Supreme Court recently held in *Wal-Mart Stores, Inc. v. Indiana Elec. Workers Pension Trust Fund IBEW* that there is no legal limit to what can be obtained in a Section 220 proceeding in a proper case, including attorney-client communications and attorney work product. In *Wal-Mart*, the plaintiff pension fund (IBEW) served a Section 220 demand on Wal-Mart following the publication of an article in *The New York Times* describing an illegal bribery scheme to fast track zoning changes, permits and licenses for new Wal-Mart stores in Mexico and Wal-Mart's board's allegedly inadequate response to damning evidence of wrongdoing. While Wal-Mart provided IBEW with some heavily redacted board minutes and other documents, it refused broader discovery and declined to produce any privileged documents. IBEW was not satisfied and filed a Section 220 action in Chancery Court, which found that IBEW had established a "proper purpose" of investigating wrongdoing on the part of the Wal-Mart board in response to the bribery scheme article and what became known as the WalMex Investigation. The court ordered broad disclosure, including disclosure of privileged attorney-client communication and work product, and ordered IBEW to safeguard the privileged documents it received. The Delaware Supreme Court recently affirmed the Chancery Court's disclosure rulings. The Supreme Court emphasized that whether particular documents are "necessary and essential" to a "proper purpose" is fact-specific and where privileged information is sought a stockholder must show "good cause" and a "obviously colorable" claim.

Practice Takeaway: While the WalMex Investigation was unusual in its scope, publicity, and extent of potential wrongdoing, the Delaware Supreme Court's decision is a landmark reminder that corporations and their management ultimately answer to their shareholders who are entitled in a proper case to all information concerning how the corporation is managed or mismanaged. There are numerous strategies to containing unduly broad shareholder demands, but corporate legal advisors must bear in mind, particularly when investigating potential wrongdoing or advising on material transactions that may attract shareholder scrutiny, that nothing may remain secret from the corporation's stakeholders.

Broker-Dealer Agreements Containing Court Forum Selection Clauses Trump FINRA's Mandatory Arbitration Rule

The Second Circuit Court of Appeals held in the consolidated cases *Goldman, Sachs & Co. v. Golden Empire Schools Financing Authority* and *Citigroup Global Markets Inc. v. North Carolina Eastern Municipal Power Agency* (collectively "*Golden Empire*") that a forum selection clause in Goldman Sachs' and Citigroup Global Markets' brokerage agreements providing that "all actions and proceedings arising out of this Broker-Dealer Agreement or any of the transactions contemplated hereby shall be brought in the United States District Court in the County of New York" trumped FINRA Rule 12200.

Rule 12200 requires a FINRA member (essentially all registered broker-dealers and their associated persons) to arbitrate any dispute requested by a customer. Indeed, Rule 12000 provides that "[i]t may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2010 for a member or a person associated with a member to…fail to submit a dispute for arbitration under the Code as required by the Code." Notwithstanding those seemingly clear mandates to arbitrate customer disputes if that is what the customer wants, the Second Circuit in *Golden Empire* concluded that broker-dealers and their customers are free to agree that disputes will be resolved by courts and not FINRA arbitration. The Second Circuit's ruling followed the same conclusion reached by the Ninth Circuit this year in *Goldman, Sachs & Co. v. City of Reno*, 747 F.3d 733, 736 (9th Cir. 2014).

Last year, the Fourth Circuit came to the opposite conclusion in *UBS Fin. Servs., Inc. v. Carilion Clinic*, 706 F.3d 319 (4th Cir. 2013) when considering the exact same forum selection clause in a UBS brokerage agreement. The Fourth Circuit conceded that broker-dealers and their customers can chose to have their disputes heard by the courts rather than arbitrators, but that choice must be unequivocal in light of FINRA Rule 12200 and the strong judicial presumption in favor of arbitration. The Fourth Circuit held that the phrase "all actions and proceedings" in the UBS forum selection clause did not clearly rule out arbitration because arbitration is not an "action or proceeding" and if the parties meant for the customer to waive its right to arbitrate, the forum selection clause would be expected to mention arbitration. The Second Circuit found that reasoning to be nothing more than a "linguistic trick" and found the same forum selection clauses before it were sufficient to supersede Rule 12200.

Practice Takeaway: While there appears to be a split among the Second and Ninth Circuits on the one hand, and the Fourth Circuit on the other hand, the only real difference is the specificity they respectively require for a forum selection clause to trump FINRA Rule 12200. If the UBS agreement in the Fourth Circuit case simply contained an express waiver of the customer's right to FINRA arbitration, the result would have been the same. The takeaway then is that forum selection clauses that seek to override default arbitration rules should clearly reflect the parties' waiver of any right to arbitrate.

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