Securities and Corporate Governance Litigation Quarterly

Decisions of Interest for Corporate and Transactional Lawyers

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Welcome to the second 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.*

Second Circuit Reverses Hedge Fund Insider Trading Convictions - Clarifies Rules Regarding Tippee Liability

On December 10, 2014, the Second Circuit decided *United States v. Newman*, which vacated the convictions against two hedge fund managers — Anthony Chiasson and Todd Newman. In dealing a blow to the government's string of recent insider trading convictions in the industry, the Second Circuit clarified the substantial evidentiary burden needed to convict tippees, especially those who are multiple layers removed from the original tipper. In addition, the court confirmed that the "personal benefit" test for when a tipper breaches a fiduciary duty is still a critical element the government must prove for an insider trading charge. This ruling undoubtedly will have important repercussions for criminal and civil insider trading cases in the Second Circuit, and likely across the country as well.

Background

Chiasson and Newman were both New York hedge fund managers who traded primarily in technology stocks. In 2012, Chiasson and Newman were charged with trading Dell and NVIDIA stock based on material nonpublic information that allegedly originated from insiders at those companies. Their hedge funds were alleged to have reaped $72 million in illicit profits, which made the case one of the largest insider trading prosecutions to date.

At trial, the evidence showed that both Chiasson and Newman traded on non-public information that originated from insiders at Dell and NVIDIA, but that they were many levels removed from the source of the information. The Dell tip originated from an employee in Dell's investor relations department, who disclosed Dell's earnings to an analyst at another investment manager, who in turn provided the information to an analyst at Newman's fund. This analyst then relayed the information to Newman and other analysts, including an analyst at Chiasson's fund, who then shared the information with Chiasson. Thus, Newman and Chiasson were respectively three and four levels removed from the original Dell insider. The NVIDIA information traveled in a similar fashion through several intermediaries before reaching Newman and Chiasson. After trial, the jury returned a conviction on all counts, and Newman and Chiasson were sentenced to 4 1/2 and 6 1/2 years, respectively, as well as substantial monetary penalties.

The Second Circuit Decision

The Second Circuit threw out both convictions, holding that the Government failed to present sufficient evidence that either corporate insider (at Dell and NVIDIA) received a "personal benefit" to trigger a breach of a fiduciary duty. The Court rejected the argument that the "mere fact of a friendship, particularly of a casual or social nature" with the initial tippee is sufficient to show a benefit to the tipper, noting that "[i]f this was benefit, practically anything would qualify." The Court held that there must be a "meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." Though the insider's gain "need not be immediately pecuniary," it must be "of some consequence." The court concluded that the types of benefits that the government introduced at trial, such as "career advice," simply did not rise to the level of a concrete benefit sufficient to support a knowing breach of fiduciary duty sufficient to sustain a violation of the securities laws.

Likewise, the court concluded that the lower court's jury instructions incorrectly permitted conviction without any proof that Chiasson and Newman, as remote tippees, knew that the tip was provided by the insider in exchange for a benefit. Relying upon the seminal decision in *Dirks v. SEC*, 463 U.S. 646 (1983), the court rejected the notion that sophisticated hedge fund portfolio managers like Chiasson and Newman necessarily know that certain types of confidential information "must have been" disclosed in breach of a fiduciary duty, and not for any legitimate corporate purpose. "[T]he Supreme Court [in *Dirks*] affirmatively rejected the premise that a tipper who discloses confidential information necessarily does so to receive a personal benefit." The Court instead found that the evidence demonstrated that Chiasson and Newman did not know about any personal benefit to the insiders at Dell and NVIDIA. The court also noted that there were often legitimate reasons that information is disclosed. "All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders." To prove its point, the Second Circuit noted that the evidence at trial established that both Dell and NVIDIA "routinely 'leaked' earnings data in advance of quarterly earnings." Echoing this sentiment, the Second Circuit disabused the notion that just because a trader has an informational advantage, that trader necessarily violated the law. "[I]nsider trading liability is based upon breaches of fiduciary duty, not on informational asymmetries. This is a critical limitation on insider trading liability that protects a corporation's interests in confidentiality while promoting efficiency in the nations securities markets."

Practice Takeaways:

- In the Second Circuit, insider trading tippee liability requires that the tippee not only know that information is confidential, but that it was also disclosed in breach of a fiduciary duty owed by the insider.
- More than just a social friendship with the tippee is required to establish a personal benefit to the tipper.
- Government cannot assume that all confidential corporate information is necessarily disclosed in breach of a fiduciary duty, nor can it assume that a sophisticated trader or investment professional "must know" that confidential information necessarily was improperly disclosed.
- Simply having an informational advantage is insufficient to create liability; there must be a breach of some duty in connection with obtaining that advantage.

Delaware Vice Chancellor Nixes Deal Protection Devices - A Cautionary Tale For Negotiating Break Up Fees

A number of Delaware decisions over the years have helped carve out generally accepted upper ranges for break-up fees in transactions involving Delaware corporations. For example, in *In re Answers Corp. S'holder Litig.*, (Del Ch. 2011) the Chancery Court noted that a termination fee of 4.4% of the deal's equity value was "near the upper end of a 'conventionally accepted' range." Thus, many practitioners consider a termination fee which significantly exceeds 4-5% of the deal's value to be at risk if challenged by the seller's stockholders.

However, a recent Chancery Court decision (*In re Comverge Inc. S'holder Litig.* (Nov. 25, 2014)) adds a new twist to the equation, by combining the terms of a separate convertible note agreement with the breakup fee amount (and a separate expense reimbursement) in the merger agreement. These combined amounts totaled nearly 13% of the deal value and were therefore too much of an impediment, in the court's view, to a competing bid.

The facts in *Comverge* are somewhat unique, but the court's analysis is nevertheless instructive. In 2012, Comverge agreed to be acquired by HIG Capital for $1.75 per share. (At the time, the stock traded at $1.88 per share). Before announcing the deal, Comverge had, since 2010, been perilously undercapitalized and was actively exploring strategic investors or buyers, including discussions with HIG. At an earlier point in the HIG negotiations, Comverge's board persuaded HIG to raise its bid to $2.15/share – provided Comverge agreed to a 20-day exclusivity period. (During that 20 day period, Comverge received an expression of interest from another potential buyer at over $4.00 per share, to which it could not respond due to the exclusivity restriction). When Comverge later rejected the $2.15 offer as inadequate, HIG was able to purchase a loan previously provided to Comverge (that was in default), which gave HIG new leverage in dealing with Comverge. After that, with the other potential bidder no longer interested, HIG renewed its offer, but this time at $1.75 per share. In addition, HIG offered a convertible note arrangement, which it funded immediately, to help bridge Comverge's cash needs. These notes were immediately convertible into Comverge shares at a significant discount to the proposed deal value. The parties also agreed to a break-up fee of between $1.2 and 1.9 million, the high end of which equaled approximately 6% of the equity value, and an expense reimbursement of up to $1.5 million.

The court dismissed all of the Comverge shareholders' fiduciary duty claims related to the negotiated price and the process followed by the Comverge board. Although Comverge had clearly put itself up for sale (and was thus under *Revlon* enhanced scrutiny), there were no breach of loyalty allegations and the court determined that the breach of care claims could not survive Comverge's exculpatory charter provision under Section 102(b)(7). However, the court refused to dismiss the claims related to the deal protections under the same charter provision. To the surprise of the defendants (and their legal advisors), Vice Chancellor Parsons decided that it was appropriate, at least at the motion to dismiss stage, to combine the effect of the separate HIG note conversion right (which permitted HIG, if it elected, to receive – and another bidder to have to pay – an additional $3 million) with the break-up fee and expense reimbursement amounts to analyze the reasonableness of the deal protections. This combined amount was approximately 13% of the deal's equity value and, at well over twice what was generally accepted as the upper bounds of reasonableness, was "essentially inexplicable on any grounds other than bad faith."

Practice Takeaways:

- While the courts often find ways to accept break-up fees that are on the upper end of the range, there is a limit above which the courts will not go.
- Be careful about additional rights (other than the break-up fee) that are being provided to the proposed buyer (here, the convertible note agreement) which are readily quantifiable and could unreasonably increase the cost for another bidder to make a topping offer.
- This case is another example where the board's duties, in *Revlon* mode, do not require achieving the absolute best price, but rather the best price under the circumstances (which may change during the process, as they did here, despite good faith efforts by the board).

New York Joins Delaware in Holding That Going Private Transactions Can Be Completely Protected by Business Judgment Rule

In a case of first impression in New York, the Appellate Division, First Department held in *In re Kenneth Cole Prods. Securities Litigation*, 2014 WL 6475758 (Nov. 20, 2014) that a going private transaction negotiated and approved by disinterested directors and approved by a majority of the minority of the other public shareholders was immune from dissident shareholder claims under the business judgment rule. Although relying almost exclusively on New York precedents, the Appellate Division's holding in *Kenneth Cole* brings New York in line with the similar holding in Delaware last year in *In re MFW Shareholders Litigation*, 67 A.3d 496 (Del. Ch. 2013), *aff'd, Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

Kenneth Cole owned or controlled 46% of his eponymous company ("KCP") and 89% of the shareholders' voting power. In 2012, Cole proposed taking KCP private and offered a 17% premium over the current market price. He conditioned his offer on the approval of a special committee of four independent directors and the approval of a majority of the minority of the public shareholders. As is typical of many going private transactions, Cole also made it clear that he would not approve any third-party offers to buy KCP. After some negotiation with the special committee, Cole agreed to a slightly higher price. After the deal was announced, the inevitable deluge of shareholder actions were filed and consolidated. The defendants immediately moved to dismiss, arguing that the business judgment rule barred the shareholders' claims.[1]

The lead plaintiff, Erie County Employees Retirement System, made four principal arguments as to why the special committee and Cole had breached their fiduciary duties and why the court should evaluate the entire fairness of the sales process and price rather than defer to the business judgment of the special committee: (1) three of the four directors on the special committee had been elected exclusively by Cole and were controlled by him; (2) the prospectus did not contain adequate disclosures; (3) the special committee failed to solicit third-party offers; and (4) the price was inadequate in light of comments by outside analysts and "plaintiffs' own speculations." The Appellate Division upheld the trial court's rejection of the plaintiffs' first claim noting that it is not enough to charge that the directors were nominated and elected by the controlling shareholder. There were no allegations that the directors on the special committee were in fact self-interested in the sale of KCP to Cole. Second, there were no particularized allegations that the prospectus was deficient. Third, the trial court noted that the law was clear that Cole was entitled pursue his own economic self-interests and to use his controlling interest to block any third-party offers and thus the board's recognition of that right did not breach their fiduciary duty. Finally, the trial court held that absent some showing of specific unfair conduct by the board, the business judgment ruled precluded the court from second guessing the price negotiated the special committee. As a consequence, pre-discovery dismissal of the shareholders' claim was appropriate.

Practice Takeaways:

- New York has illuminated a clear pathway for a successful going private transaction by negotiation and approval by an independent board committee and vote by a majority of the minority.
- Board members may be considered independent even if they were nominated and elected by the majority shareholder.
- The controlling shareholder's instruction to the board that he will withhold support from any competing offer does not infect the process.
- Practitioners must be mindful that the success of this going private method is dependent on a truly independent board committee, arm's length negotiations with the controlling stockholder and adequate disclosures.

[1] Many of the relevant facts are reflected in the trial court's decision (here).

Delaware Supreme Court Reverse Chancery Injunction And Firmly Holds That Revlon Duties Do Not Require A Go-Shop Or Any Particular Market Check In Change of Control

In a sharply worded decision issued December 19, 2014, the Delaware Supreme Court reversed a Chancery Court mandatory injunction that was based on an erroneous finding that *Revlon* required the board of C&J Energy Services, Inc. to shop itself before agreeing to a change of control. The Delaware Supreme Court's decision (here) is less interesting for its central holding that *Revlon* does *not* require a target to shop itself in all cases—the Court had so held on other occasions—than it is for its views on various aspects of the transaction that practitioners will find helpful.

The transaction was somewhat unusual because it began as an effort by C&J Energy to acquire a division of its competitor, Nabors Industries Ltd., that provided completions and productions services ("Nabors CPS"), not an effort to sell itself to Nabors. Nabors was incorporated in Bermuda and the parties quickly came to the conclusion that C&J Energy would enjoy massive tax savings, together with the strategic benefits of the Nabors CPS business, if it merged into a Bermuda subsidiary of Nabors that held the Nabors CPS assets—a "corporate inversion"—rather than acquiring Nabors CPS outright. For the corporate inversion to be effective for tax purposes, however, Nabors would need to own a majority of the new combined company. C&J Energy's founder, CEO and 10% shareholder, Joshua Comstock, and the independent board members recognized that they had backed their way into an effective sale of C&J Energy. Having changed from an asset purchase to a change of control, C&J Energy's board was advised of its *Revlon* duties to obtain the highest reasonable price for the company. (Note: The Delaware Supreme Court assumed without deciding that *Revlon* was invoked in this corporate inversion.) But the strategic attractiveness of acquiring Nabors CPS was dependent upon C&J Energy's management, including Comstock, running the combined businesses. As a consequence, C&J Energy negotiated substantial post-closing protections for its management and shareholders, that included the power to control the board of the combined company with Comstock as chair, restrictions on Nabors' ability to buy and sell its shares in the new company, and a two-thirds vote of the shareholders to change the bye-laws (the Bermudian spelling), sell the company, or issue stock. Both the Chancery and Supreme Courts concluded that those protections were consistent with the board's *Revlon* duties.

Nabors recognized early on that Comstock was controlling the negotiations and should run the new company in any event, and made it clear that it would agree to "aggressive employment agreements" for Comstock and other management. While Comstock and the board were careful to negotiate the terms of Comstock's compensation after agreeing to the terms of the merger, the terms Comstock negotiated were many times the compensation he earned at C&J Energy, *plus* a $173 million severance should he be terminated without cause. The Delaware Supreme Court was nonplussed by those numbers, pointing out that the independent board was apprised of the negotiations and it was non-binding on the new company's board.

The Chancery Court largely focused on C&J Energy's failure to solicit other bids but it is entirely unclear what it expected C&J Energy's board to do bearing in mind that the transaction was designed to combine C&J Energy's business with Nabors CPS, not to sell C&J Energy. In any event, the parties appeared to have anticipated the *Revlon*-based criticism and structured the corporate inversion transaction to mimic a proper change of control transaction by including a reasonable termination fee (2.3% of the deal value), a "fiduciary out" should a superior proposal emerge, a lengthy closing period to allow other proposals to emerge, and a majority of the minority approval provision. The Delaware Supreme Court concluded that these elements were more than sufficient to immunize the board's business judgment from second guessing by the Chancery Court.

Practice Takeaways:

- Corporate inversions, even with extensive voting protections for the shareholders, may be subject to heightened scrutiny under *Revlon*.
- Shopping a company before a corporate inversion or other change of control is not necessary in every circumstance. Indeed, it made little sense for C&J Energy because the purpose of the transaction was essentially to acquire the Nabors CPS assets, not sell C&J Energy. However, allowing enough time after a proposed change of control is announced for competing proposals to emerge and also incorporating appropriately tailored deal protections are pluses when the inevitable shareholder claims are evaluated.
- Generous employment agreements for management will not be criticized so long as the entire transaction is carefully evaluated by a disinterested board. However, *C&J Energy* and other Delaware authorities suggest that the terms of such agreements, particularly with management who are negotiating the terms of the transaction, should be finalized after the other deal terms are negotiated and agreed.

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