Securities and Corporate Governance Litigation Quarterly

Decisions of Interest for Corporate and Transactional Lawyers

By Matthew I. Hafter, William L. Prickett, Philip M. Smith, Christopher F. Robertson, William J. Hanlon and Dallin R. Wilson

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

Lazard Technology Partners, LLC v Qinetiq North America Operations LLC: An Earn-Out That Didn't Pay

The Delaware Supreme Court recently addressed issues of "good faith" in an earn-out provision in *Lazard Technology Partners, LLC v Qinetiq North America Operations LLC* (available *here*).

In *Lazard*, the buyer paid $40 million at closing and agreed to pay another $40 million after closing if the acquired business' revenue achieved specified targets. This type of post-closing payment, known as an "earn-out," requires the seller to rely on the buyer to manage the acquired business in order to achieve the performance thresholds entitling the seller to the earn-out payment. At the same time, however, the buyer may desire to operate the business in a way that minimizes the amount of post-closing earn-out payments it is obligated to pay — whether motivated purely by a desire to actually pay a lower purchase price, or as a result of the buyer's business judgment on how it manages its own businesses, allocates resources or responds to changes in circumstances after the closing.

With this dilemma in mind, during negotiations the seller in *Lazard* tried to get the buyer to agree that it would act in good faith to maintain levels of business activity existing at the closing, to increase the chances that the level of revenue to achieve the earn-out would be met post-closing. The buyer refused to agree to these affirmative obligations and, instead, agreed only that it would not "take any action to divert or defer [revenue] with the intent of reducing or limiting the Earn-Out Payment."

After closing, revenues did not reach the levels needed to generate the earn-out payment. Seller filed suit for breach of the express obligation not to take action intended to limit the earn-out and for breach of the implied covenant of good faith and fair dealing. As to the first claim, the Court concluded that the contract provision prohibiting intentional acts was to be given its plain meaning —essentially, that intent was a person's design, resolve or determination to act and cause a particular result. The Court rejected the seller's claim due to insufficient evidence of the buyer's improper intent. The court observed that the seller "seeks to avoid its own contractual bargain by claiming that [the earn-out provision] used a knowledge standard, preventing the buyer from taking actions simply because it knew those actions would reduce the likelihood that an earn-out would be due. As [the earn-out provision] is written, it only barred the buyer from taking action specifically motivated by a desire to avoid the earn-out."

The Court also rejected the seller's argument that the implied covenant of good faith and fair dealing prohibited the buyer from taking actions that negatively affected the earn-out. Because the contract specifically provided that the buyer could not act with "intent" to undermine the earn out, and because the seller tried to negotiate for more objective standards — to which the buyer refused to agree — the implied duty of good faith and fair dealing did not inhibit the buyer from conducting its business any way it chose so long as it did not act with the intent to reduce or limit the earn out in violation of the express terms of the negotiated agreement.

Practice Takeaways:

- *Be careful what you wish for…* Without finding that there was any ambiguity in the contract as written, the court looked to extrinsic evidence of the negotiations leading up to the final agreement. The Court took careful note of the earn-out language — proposed in negotiations by the seller but rejected by the buyer — to interpret the scope of the buyer's duties with regard to operating the business after closing. Buyers and sellers should be cognizant that what they propose and reject in negotiations can be held against them in later disputes regarding the meaning of the subject provisions.
- *Subjective earn-out standards favor buyers…* The seller in *Lazard* sought objective standards to govern the buyer's conduct of the business after closing. The buyer was able to limit its obligation to a subjective standard that allowed it to take (or not take) any action it wished provided the action was not specifically *intended* to undermine the earn-out, even if the *effect* of those actions would be to impact the earn-out.
- *Implied obligations of good faith and fair dealing will not save an unfavorable contract provision…* The rule in Delaware is that the implied covenant of good faith and fair dealing cannot be applied to give a party contractual protections it failed to secure in negotiations. Citing prior Delaware cases, the Court stated that the implied obligation of good faith and fair dealing could be invoked by a party "only… when it is clear from the underlying contract that the contracting parties would have agreed to proscribe the act later complained of had they thought to negotiate with respect to that matter." Thus, the implied obligation exists to fill gaps left by the parties, not to grant a party additional protections by "judicial fiat" that the party was unable to negotiate for itself.

Statements of Legal Compliance Require Extra Caution under SDNY's *In re BioScrip* Decision

Although there have been a number of district court decisions applying the Supreme Court's March 2015 *Omnicare* ruling, a recent Southern District of New York decision, *In re BioScrip, Inc. Securities Litigation* (available here), merits special attention.

In *BioScrip*, a purported class of shareholders brought a variety of securities law claims (under both the '33 and '34 Acts) against the company's officers and directors, as well as its underwriters on several stock offerings during the claimed class period. Plaintiffs alleged that the defendants made materially false or misleading statements about two aspects of the company's business. The first related to a purported failure to promptly disclose the company's involvement in a governmental investigation and the second concerned statements about declining revenue in the "PBM Services" segment of the company. The court's analysis of the first set of allegations is, we believe, the most notable one.

In 2011, the government began an investigation of an alleged kickback arrangement between Novartis (who made a drug called Exjade) and BioScrip that was designed to incentivize BioScrip to increase its sales of Exjade, as well as alleged false claims for reimbursement from Medicare. In late 2012, BioScrip received a civil investigative demand (CID) from the government, describing the nature of the investigation and demanding documents from BioScrip. At that time, BioScrip chose not to disclose the fact of the CID or the investigation to investors, and believed that it had not violated any of the various laws prohibiting kickbacks or false claims. In its SEC filings, BioScrip made several statements that were consistent with that belief, including statements that "the Company believes it is in substantial compliance with all existing laws and regulations" and "we believe we are in compliance with the anti-kickback laws." BioScrip also made several statements, again without disclosing the specific investigation or its receipt of the CID, to the effect that although there are various ongoing governmental investigations of various companies and their sales and marketing practices of certain products, "there can be no assurance that we will not receive subpoenas or be requested to produce documents in pending investigations or litigation from time to time."

Applying the Supreme Court's then-recent ruling in *Omnicare*, the court determined that even though these statements were stated as opinions (and those opinions may have been held in good faith), because the defendants did not adequately explain the *basis* for these opinions, the plaintiffs adequately alleged, at least at the pleading stage, that the statements were at least misleading. The court concluded that a reasonable investor could have read BioSrip's statements as suggesting that (a) there was no ongoing investigation of the company, and (b) there was no pending information available to the company which would undermine its belief that it was in compliance with all laws that prohibit false claims and kickbacks. The fact that defendants had received the CID and were therefore aware of the nature of the government's potential claims against the company, provided sufficient conflict with the company's statements of legal compliance for plaintiffs' claims to survive to discovery.

Practice Takeaways:

- As reaffirmed in *Omnicare*, statements of opinion, while generally not actionable simply because they ultimately end up being incorrect, are nevertheless actionable if they are objectively false or are not believed by the speaker at the time they are made.
- Any statements of opinion should be carefully scrutinized based on all available facts to determine whether they should be modified or the bases explained in more detail to provide accurate context for investors.
- In cases like this one, where an issuer determines that it has no duty to disclose the fact of a governmental investigation, consider making no statements, no matter how general and firmly believed, that relate in any manner to the subject matter of that investigation.
- Finally, if faced with a governmental investigation, and the issuer determines to make general statements of belief about its compliance with all applicable laws (either because similar prior disclosures before the investigation would make their absence this time conspicuous or for another reason), consider enhancing the disclosure by describing the basis for the opinions. This may include disclosing the fact of the investigation, whether information was requested by the government and the reasons why the company believes the laws being investigated were not violated.

Delaware Chancery Court Affirms Private Equity Shareholders' Right To Enforce Registration Rights Over Competing Capital Requirements Of Company

The Delaware Chancery Court's decision in *In re Molycorp, Inc. Shareholder Derivative Litigation* (available *here*) is a firm endorsement of the rights bargained for by major investors and an equally firm reminder of the risks of those rights to other investors.

Molycorp is a publicly traded company engaged in the production and sale of rare earth oxides. In 2008, certain private equity investors ("PEIs") participated in the acquisition of a rare earth element mine for Molycorp. In 2010, in preparation for Molycorp's IPO, the PEIs executed a Stockholders Agreement, which gave them the right to appoint directors to the board of Molycorp, and a Registration Rights Agreement, which gave the PEIs the right to have Molycorp register their shares for a secondary offering at any point after the IPO. The PEIs collectively owned 44.1% of Molycorp's shares.

The July 2010 IPO yielded a disappointing $360 million which was less than half of Molycorp's capital budget of $781 million through 2013. Rare earth element prices began to spike in September 2010 following China's limits on exports. Notwithstanding the high rare earth element prices, Molycorp knew by May 2011 that a $280 million loan guarantee from the Department of Energy would not come through as planned and its other financing sources were in danger. At the same time, the PEIs exercised their demand registration rights that gave them priority registration of their shares, subject only to Molycorp's ability to delay action for up to ninety days. The Registration Rights Agreement did not permit any fiduciary to breach its fiduciary duties, and did not preclude an offering by Molycorp itself. However, a simultaneous offering by the PEIs and Molycorp would have tended to decrease the share price realized in both offerings. Molycorp complied with the PEIs' registration demand and the PEIs received $575 million in a June 2011 secondary offering. Molycorp thereafter raised $223 million in a private debt offering but was still short of its operating budget through 2013.

Within a few months of the PEIs' June 2011 secondary offering, prices for rare earth elements plummeted and with them Molycorp's shares. Molycorp raised $350 million in a private offering in February 2012 but that same sale would have raised $248 million more had the offering been made in June 2011 when the PEIs sold in their secondary offering. Shareholders thereafter commenced a derivative action alleging that the PEIs and their nominated directors breached their fiduciary duties in demanding registration rights in priority to Molycorp's capital needs. Their theory was that the PEIs sold their own stock and shut Molycorp out of a sale of its stock at a time when it needed capital, other sources were at risk and everyone knew rare earth element prices would fall eventually. Even assuming the plaintiffs' allegations were true, the Chancery Court dismissed the derivative action on the bases that (1) the Registration Rights Agreement was valid, (2) the PEIs were major investors and bargained for certain rights before the IPO, (3) those rights were fairly extracted and disclosed in public filings, (4) there was no plausible allegation that the PEIs were clairvoyant and knew that rare earth element would plummet before Molycorp could raise capital for its operating needs, and (5) there were no exigent circumstances alleged that would have justified delaying the demand registration. In short, the court found no wrongdoing by the PEIs and their board representatives in pursuing their bargained for rights to sell their shares. The court also observed that to hold otherwise "could discourage would-be investors from funding start-ups for fear that their investment value will not be preserved despite disclosed, carefully negotiated agreements."

Practice takeaways

- Investors who must place a value on their demand registration rights and, on the other hand, companies who must honor them and other shareholders who do not have them, must be mindful that the Delaware courts will not impair those rights unless there is concrete evidence of wrongdoing.
- As the *Molycorp* court observed, "it is not enough to observe that a controller had interests that conflicted with the minority shareholders' interests — to state a claim, one must allege that the controller used her power in an unfair manner."
- A major investor will not impair its demand registration rights or similar rights simply by having board representation; "[a]ppointment by a powerful shareholder does not automatically render a director's decisions suspect."

Ninth Circuit Affirms Insider Trading Conviction and Clarifies the "Personal Benefit" Definition in *Newman*

On July 6, 2015, a panel of the United States Court of Appeals for the Ninth Circuit affirmed the insider trading conviction of Bessam Salman in *United States v. Salman* (available *here*). The opinion was written by Southern District of New York Judge Jed Rakoff, sitting by designation. Notably, Judge Rakoff has written several opinions interpreting and applying the Second Circuit's decision in *U.S. v. Newman*. In *Newman*, the Second Circuit reversed a conviction for insider trading because the lower court did not require the government to prove that the tipper had received a "personal benefit" from the provision of the inside information.

While certain commentators have implied that the *Salman* opinion rejected *Newman*, a close reading of the decision does not support this conclusion. Rather, the case is governed directly by the Supreme Court holding in *Dirks v. SEC*, which originally created the requirement of a personal benefit in connection with tipping liability. What the Ninth Circuit concluded is that if *Newman* could be read to hold that a personal gift of material inside information from a tipper to a tippee with whom he has a close relationship, for the specific purpose of benefiting the tippee, was insufficient to support a conviction, then "we decline to follow it."

As Judge Rakoff noted, however, the facts in *Salman* and *Newman* were quite different. In particular, in *Newman*, the evidence showed no intention by the original sources of the inside information to confer a benefit on a close friend or relative by improperly communicating the inside information. In *Salman*, however, the tipping brother testified "that he gave [his brother] the inside information in order to 'benefit him' and to 'fulfill[] whatever needs he had.'" As the Supreme Court clearly held in *Dirks*, "[t]he elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend." The brother's admission in *Salman* completely distinguished the case from *Newman*.

Importantly, *Newman* did not hold that the "benefit" to the tipper had to take any particular form or even be monetary. Likewise, the *Newman* court never rejected that holding in *Dirks*. Instead, it tried to apply the *Dirks* holding to the evidence presented in *Newman*, which the court found insufficient to show any personal benefit derived by the sources from their "tips" because "the *mere fact* of a friendship, particularly of a casual or social nature" was not enough to prove a intent to benefit the tipper. The *Newman* court found the "circumstantial evidence" in that case "too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips." That is, the simple fact of a relationship or a friendship is insufficient to create an inference of the required "benefit." However, where there is independent evidence of a benefit, which in *Salman* was admitted, that is sufficient even if there is no monetary benefit to the tipper.

The *Salman* decision confirms that *Newman* was not necessarily a dramatic departure from existing insider trading law, but rather a confirmation that there are limits to how tenuous the evidence can be and how far an inference may be taken without hard proof. The *Salman* opinion concludes: "If Salman's theory were accepted and this evidence found to be insufficient, then a corporate insider or other person in possession of confidential and proprietary information would be free to disclose that information to her relatives, and they would be free to trade on it, provided only that she asked for no tangible compensation in return. Proof that the insider disclosed material nonpublic information with the intent to benefit a trading relative or friend is sufficient to establish the breach of fiduciary duty element of insider trading." *Newman* does not lead to any different result on the facts in *Salman*, but instead demonstrates that the specific facts leading to a securities transaction may dictate whether that transaction is a criminal violation.

Based on *Salman* and *Newman*, those under investigation for insider trading should expect a very focused inquiry into all aspects of the relationship between the suspected tipper and tippee. For example, in several recent cases, the SEC has sought to establish the existence of a personal benefit through any form of assistance, such as finding a relative employment, use of personal property, providing any form of services or assistance, and other aspects of personal or family relationships that may not involve a transfer of money.

Practice Takeaways

- Tipper liability still requires a "personal benefit" to the tipper.
- The required personal benefit does not necessarily need to be monetary, but can be a stated desire to financially assist the tippee.
- Evidence of a friendship or personal relationship alone will not demonstrate the required personal benefit.
- Government investigators will seek documents and testimony in insider trading cases specifically targeted at demonstrating an intended benefit to the tipper, which could include any aspects of the relationship among the parties that might show some benefit conferred from one to the other, or from one family member to another.

Delaware Chancery Court Clarifies When Creditors May Assert Derivative Claims For Breach Of Fiduciary Duty

The Delaware Chancery Court recently tackled a host of standing and enforcement of derivative claims in *Quadrant Structured Products Co., Ltd. v. Vertin, et al* (available *here*) and clarified that creditors gain standing to bring such claims only upon a company's insolvency. The company, Athilon Capital Corp. ("Athilon") became financially distressed after making significant termination payments on several credit default swaps. Two creditors, Quadrant Structured Products and EBF & Associates, subsequently purchased a portion of Athilon's debt and all of its equity. Quadrant purchased Athilon's senior debt, and EBF purchased Athilon's equity and the lowest tier of Athilon's three-tier debt. Because it purchased all of the equity, EBF controlled Athilon's board. Depite Quadrant and EBF's infusions of capital, however, Athilon remainded insolvent.

Quadrant later brought a derivative suit against the members of Athilon's Board and EBF, alleging breach of fiduciary duty. Quadrant alleged that while the company was insolvent, the EBF-controlled board transferred value from Athlion to EBF in three ways: first, by making interest payments on junior debt owned by EBF that the board had authority to defer; second, the board paid excessive fees to an EBF affiliate; and third, the board changed Athlion's business model to make speculative investments that would benefit EBF while Quadrant and other senior creditors bore the risk.

Quadrant's Standing to Bring Derivative Claims

The Chancery Court affirmed that Quadrant had standing to bring a derivative suit against a board of directors for breach of fiduciary duty upon Athilon's insolvency. Although the precise test for insolvency in Delaware is unsettled, the court in *Quadrant* applied the "traditional balance sheet test," meaning that its liabilities exceeded the reasonable market value of its assets. The court also observed that insolvency could be shown by the "cash flow test" although the court did not elaborate on what that means under Delaware law. Therefore, after *Quadrant*, a creditor could show standing under the "traditional balance sheet test" but it is less clear a creditor could do so under another insolvency standard.

In a solvent corporation, only stockholders have standing in equity to bring claims derivatively on behalf of the corporation because they are the ultimate beneficiaries of the corporation's value. However, upon insolvency, creditors gain standing to bring derivative claims for breach of fiduciary duty because their rights then become senior to the stockholders. The court clarified that this standing occurs upon insolvency and not merely when the corporation is within the "zone of insolvency." The fiduciary duties that directors owe to creditors upon insolvency are no different from those owed to stockholders during solvency; they are the same "duties that directors owe to the corporation to maximize its value for the benefit of all residual claimants."

Standards for Board Behavior

The court applied the entire fairness standard, Delaware's most onerous standard of review, to Quadrant's allegations regarding the board's payment of (a) interest to the junior "out of the money" bonds held by EBF and (b) excessive fees to EBF's affiliate. As owner of 100% of Althion's equity, the affiliate and the junior debt, and board control, EBF stood on both sides of the transactions. Quadrant's claims survived dismissal and the court's ruling placed the burden of proving fairness on EBF.

On the other hand, the court applied the business judgment rule, Delaware's more lenient default standard, and dismissed Quadrant's claims that the board breached its fiduciary duty when it altered Althion's business plan to include riskier investments. Where the board of an insolvent corporation acts with due diligence and good faith in pursuing a strategy that it believes will increase the corporations value, the directors are protected by the business judgment rule. Even where board members have conflicting interests with large stakeholders, the business judgment rule applies where the board pursues a more risky business strategy to the benefit of the all stakeholders, so long as the transaction appears rationally designed to increase the value of the firm as a whole.

A Return to Solvency Does Not End The Suit

In a matter of first impression, the Court also held in a later opinion (available *here*) that Delaware law does not impose a continuous insolvency requirement for a creditor to maintain standing. A creditor must only establish that the corporation was insolvent at the time suit was filed. However, a creditor would lose standing if it no longer holds a debt claim against the corporation. The court also clarified that a company is insolvent if it has liabilities in excess of a *reasonable market value* of assets — the so-called "traditional balance sheet test."

Practice Takeaways

- Directors have the duty of attempting to maximize the economic value of corporate assets.
- Directors' fiduciary duties do not change when a corporation enters the "zone of insolvency" or insolvency. Actual insolvency is the relevant transitional moment when a creditor gains standing ahead of stockholders.
- Upon insolvency, creditors gain standing to bring derivative claims for breach of fiduciary duty against a board of directors. The creditor must plead insolvency that meets the "traditional balance sheet test."
- Creditors maintain standing in a derivative lawsuit even if the corporation returns to solvency. The creditor must hold a debt claim throughout the proceedings. Payment of a debt to a creditor deprives the creditor of standing.
- Directors of insolvent corporations are protected by the business judgment rule when they engage in transactions that may benefit one residual claimant over another, as long as the transaction appears rationally designed to increase the value of the company as a whole.

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William L. Prickett is Chair of Seyfarth's Securities & Financial Litigation Practice Group, and a partner in the Boston office. *Christopher F. Robertson* and *William J. Hanlon* are partners in Seyfarth Shaw LLP's Boston office. *Philip M. Smith* is a partner in the firm's New York office. *Matthew I. Hafter* is a partner in the Chicago office. *Dallin R. Wilson* is an attorney in the firm's Boston office.

If you would like further information, please contact a member of the *Securities & Financial Services Litigation Practice Group* of Seyfarth Shaw LLP, William L. Prickett at *wprickett@seyfarth.com*, Kevin J. Lesinski at *klesinski@seyfarth.com*, Christopher F. Robertson at *crobertson@seyfarth.com*, William J. Hanlon at *whanlon@seyfarth.com*, Philip M. Smith at *pmsmith@seyfarth.com*, Matthew I. Hafter at *mhafter@seyfarth.com* or Dallin R. Wilson at *drwilson@seyfarth.com*.