2019 YEAR IN REVIEW – SECURITIES LITIGATION

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MEET THE AUTHORS

DAN GOLD is Chair of the firm's Securities and Shareholder Litigation group and former Chair of the Securities Section of the Dallas Bar Association. Among other recent matters, Dan obtained dismissal of shareholder derivative litigation against the Board of Tenet Healthcare, obtained dismissal of a securities class action against Supreme Industries, defended Goldman Sachs in a securities class action, and is defending AT&T, Exxon, and other companies in securities and shareholder litigation. He also regularly advises companies and investment funds on fiduciary duty and indemnification issues.

KIT ADDLEMAN chairs the firm's national Securities Enforcement Defense group and is a member of the Investment Funds Practice group. Kit defends companies, executives and directors against government charges of misconduct, particularly investigations and litigation by the SEC and DOJ. Many of her matters involve allegations of accounting and financial fraud, insider trading, hedge fund and advisor fraud, and Foreign Corrupt Practices Act violations. Prior to joining Haynes and Boone, Kit was the regional director of the SEC's Atlanta Regional Office and spent more than 20 years prosecuting matters in four SEC offices around the country.

THAD BEHRENS is Chair of the firm's Class Action Defense practice. He has a vibrant securities litigation practice, having been recognized by Chambers USA for his excellence in defending companies, directors, officers and underwriters in securities class actions and derivative suits. His recent experience includes obtaining a dismissal of a securities class action for Tenet Healthcare, defending Goldman Sachs & Co. and the underwriting syndicate in a securities class action, and defending Huntsman Corporation in state and federal securities class actions. Thad is a past president of the Dallas Federal Bar Association, and has been recognized as a *Texas Super Lawyer* and a *Best Lawyer in Dallas*.

EMILY WESTRIDGE BLACK focuses her practice on defending clients in high-stakes cases, including securities litigation, class actions, and complex commercial disputes. She also has extensive experience conducting internal investigations arising from allegations of corruption, fraud, and securities law violations. She honed her common-sense, business-oriented approach to legal work during her time working in-house for one of the world's largest pharmaceutical companies. Emily's creative and tenacious approach to client advocacy was recently recognized by *Texas Lawyer*, which selected her as the 2019 Attorney of the Year.

MEET THE AUTHORS

CARRIE HUFF is a partner with 30 years of experience in class action, shareholder and fiduciary litigation. A major part of her practice is advising attorneys on ethics issues, and Carrie is an assistant general counsel of the firm. She also has represented the trustees of family trusts involved in a high-profile, multi-court dispute, and has secured favorable rulings by the Fifth Circuit affirming the comprehensive settlement of the dispute. Carrie is AV® Peer Review Rated Preeminent by *Martindale-Hubbell® Law Directory*.

TIM NEWMAN represents clients in government enforcement actions and complex litigation. He has extensive experience representing organizations and executives under investigation by the SEC, DOJ, FINRA, and state regulators and conducting internal investigations related to suspected accounting fraud, offering fraud, insider trading, and other securities law violations. Tim has been named a "Rising Star" by the *Texas Super Lawyers* directory, Thomson Reuters, the last four years.

MATT McGEE is Counsel in the firm's Dallas and Charlotte offices and has nearly a decade of experience representing companies, directors, and officers in complex business litigation, class action defense, shareholder derivative suits, securities class actions, and M&A litigation. Among other recent matters, Matt obtained dismissal of a securities class action against Supercom, Inc., defended Goldman Sachs in a securities class action, and is defending a public company in one of the first federal securities class actions in Texas state court.

ODEAN VOLKER is Chair of the firm's International Arbitration Practice, and previously served as Co-Chair of the Litigation Department. His practice includes securities and complex litigation, and domestic and international commercial arbitration. He has extensive experience in conducting internal investigations and addressing governance issues for public and private companies. Odean is a Fellow of the Chartered Institute of Arbitrators, and is AV® Peer Review Rated Preeminent by *Martindale-Hubbell® Law Directory*. He was named a Texas Super Lawyer, Thomson Reuters, 2012-2017 and recognized by *The Best Lawyers in America*, Woodward/White, Inc., in Arbitration, 2015-2020.

SPECIAL THANKS to the following attorneys and staff for their contributions and assistance: Carrington Giammittorio, Benjamin Goodman, Kathy Gutierrez, Casey McGovern, William Marsh, and Noor Wadi.

Clients and Friends,

2019 was another busy year in the world of securities litigation and SEC enforcement. Federal securities class actions continued at record levels, and SEC enforcement activity was up after a slowdown in 2018.

Our **2019 Year in Review** focuses on significant securities-related decisions by the Supreme Court and federal appellate courts, key developments in SEC enforcement, and significant selected rulings in state law fiduciary litigation against directors and officers of public companies.

We begin with a discussion of the Supreme Court's decisions in ***Lorenzo*** regarding "scheme liability" and fallout from the ***Cyan*** decision allowing public offering federal securities claims to be maintained in state courts. There was notable activity at the Circuit Courts of Appeals on key issues of scienter and materiality. Last year also saw important Delaware decisions on director liability and interesting developments in the area of SEC enforcement.

The Haynes and Boone team spent 2019 winning early dismissals and representing clients in securities, fiduciary duty and SEC enforcement matters. Among other highlights, we obtained dismissal of a shareholder derivative suit against the Board of Tenet Healthcare; obtained dismissal of securities class actions against Supreme Industries and Exxon; defended underwriters, companies and executives in securities cases across the country; and helped companies and executives in SEC enforcement and internal investigations.

If you have any questions about the issues covered in this 2019 Review, or about our practice, please let us know. We look forward to working with our friends and clients in 2020.

Dan Gold
Chair, Securities and Shareholder Litigation Practice Group
Haynes and Boone, LLP

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I. The Supreme Court's Decision in *Lorenzo*: the Return of Scheme Liability?

In March, the Supreme Court held in ***Lorenzo v. SEC***, 139 S. Ct. 1094 (2019) that a person can be held liable for fraud under Rule 10b-5 by knowingly disseminating false or misleading information provided by someone else. This decision opens a window for potential liability for misstatements beyond the Supreme Court's prior decision in ***Janus Capital Group, Inc. v. First Derivative Traders***, 564 U.S. 135 (2011), which held that only those who make a misstatement can be held liable under the subsection of the rule that directly addresses false and misleading statements.

In *Lorenzo*, the petitioner sent two emails drafted by his boss that described "layers of protection" on a prospective investment as including $10 million in "confirmed assets." In reality, those assets totaled less than $400,000, a fact which the lower court found was known by the petitioner (which the petitioner did not dispute on appeal). In a 6-2 decision authored by Justice Breyer, the Court held that the act of disseminating those emails, while knowing their content to be untrue, subjected petitioner to primary liability under subsections (a) and (c) of Rule 10b-5. The Court held that liability would attach "even if the disseminator did not 'make' the statements and consequently falls outside subsection (b) of [Rule 10b-5]." *Id.* at 1101. Where an individual disseminates information he "understood to contain material untruths," that individual has "employ[ed]" a "device," "scheme," and "artifice to defraud" within the meaning of subsection (a) of Rule 10b-5, Section 10(b), and Section 17(a)(1). *Id.*

In reaching this conclusion, the majority expressly rejected the petitioner's contention that only those who "make" untrue statements under subsection (b) of the Rule can be primarily liable under the other subsections of Rule 10b-5 in connection with those statements. The court explained that to hold otherwise "would mean those who disseminate false statements with the intent to cheat investors might escape liability under the Rule altogether." *Id.* at 1103.

Lorenzo broadens potential liability for misrepresentations or omissions to individuals who might have previously been able to avoid liability under the *Janus* definition of the "maker" of a statement. A number of courts have relied on *Lorenzo* to reject defendants' arguments that they could not be held liable under Rule 10b-5(a) or (c) because they were not a "maker" of a false statement or there were no deceptive acts distinct from the alleged misstatements. *E.g.,* ***SEC v. Weaver***, 773 F. App'x 354, 356 (9th Cir. 2019).

More interestingly, at least one court has interpreted *Lorenzo* as permitting liability based on a defendant's failure to correct a misstatement. *See* ***Malouf v. Sec. & Exch. Comm'n***, 933 F.3d 1248, 1259-60 (10th Cir. 2019). In *Malouf*, the defendant was responsible for, *inter alia*, reviewing his firm's SEC filings. The firm delegated the preparation of these filings to its Chief Compliance Officer ("CCO") and an outside consultant. The defendant failed to disclose to the CCO and the consultant that he had a conflict of interest with respect to the bids he sought for his clients. Thus, the prepared filings not only failed to disclose this conflict but also contained affirmative misstatements regarding the commissions and fees received by the firm's employees, including the defendant, and regarding the firm's provision of "impartial advice untainted by any conflicts of interest." *Id.* at 1254. The Tenth Circuit relied on *Lorenzo* to reject the defendant's argument that his failure to correct the firm's misstatements did not constitute a violation that was separate from the alleged omissions or misstatements. The *Malouf* court held that a person could incur liability under Sections 10(b) and 17(a) for failing to correct a misstatement or omission even "when the conduct involves another person's false or misleading statement." *Id.* at 1260.

Although the *Lorenzo* decision was rendered in the context of an SEC enforcement proceeding, its rationale conceivably could be read by some courts to apply with equal force in private litigation. This would be significant to the extent it opens an avenue to primary liability for a class of persons who previously may only have faced secondary liability under the statutory "aiding and abetting provision," which contains no private right of action and is therefore only enforceable by the Securities and Exchange Commission. While the requirement of pleading and proving both reliance and scienter (culpable intent) may prove an obstacle in many of those cases, *Lorenzo* may expand the view of the shareholder plaintiffs' bar regarding the potential universe of proper defendants and objectionable conduct.

An early example of *Lorenzo* having an impact (albeit short-lived) in private litigation is ***In re Longfin Corp Sec. Class Action Litig.***, No. 18-CV-2933, 2019 WL 1569792, at *8 (S.D.N.Y. Apr. 11, 2019), *rev'd in part on other grounds*, No. 18-CV-2933, 2019 WL 3409684 (S.D.N.Y. July 29, 2019) ("*Longfin*"). In *Longfin*, an underwriter was sued in connection with an issuer's misstatements in offering documents. The plaintiffs alleged that the underwriter's role in knowingly facilitating a NASDAQ listing of invalidly purchased shares that preceded the offering subjected the underwriter to primary scheme liability for the misstatements in the offering documents. In moving to dismiss the case before *Lorenzo* was decided, the underwriter argued that it could not be held liable because it was not alleged to have made any misstatements (and because the plaintiffs failed to plead scienter). Deciding the motion post-*Lorenzo*, the court held that the underwriter could be "liable [for a 10b-5 violation] regardless of whether it 'made' any misrepresentations or omissions." *Id.* (citing *Lorenzo*, 139 S. Ct. at 1101). The underwriter moved for reconsideration, however, arguing that the plaintiffs failed to plead reliance on its alleged conduct or facts giving rise to a strong inference of scienter. The court granted the motion for reconsideration on scienter grounds and dismissed the claims against the underwriter, without addressing the reliance argument. *Longfin*, 2019 WL 3409684 at *1.

It remains to be seen whether *Lorenzo* will usher in a wave of new "scheme" allegations by private securities class action plaintiffs and how those allegations will fare.

II. Fallout from *Cyan*: Does the PSLRA Discovery Stay Apply in State Court?

In 2018, the Supreme Court issued its ruling in ***Cyan, Inc. v. Beaver County Employees Retirement Fund***, 138 S. Ct. 1061 (2018), allowing securities class action plaintiffs to pursue public offering claims in state courts. In *Cyan*, the Court held that: (i) state courts have jurisdiction to hear class actions brought under the federal Securities Act of 1933 ("1933 Act"); and (ii) the Securities Litigation Uniform Standards Act does not empower defendants to remove class actions alleging only 1933 Act claims from state to federal court. The practical effect of the Supreme Court's decision is that more public offering securities cases are now being litigated in state courts. There has been an uptick in 1933 Act cases in state courts throughout 2019.

The *Cyan* opinion made clear that "substantive" aspects of the Private Securities Litigation Reform Act ("PSLRA") apply in state court but left open the question of exactly which provisions of the PSLRA would be deemed substantive. Disputes over the substantive/procedural divide are emerging battlegrounds in 1933 Act suits in state courts. Perhaps the most important issue for defendants is whether the PSLRA automatic stay of discovery, which stays discovery until a plaintiff's claims survive a motion to dismiss, is applicable in state court. In our view the automatic stay is applicable, although it is being hotly contested, and state courts reached different conclusions on this issue in 2019.

In two well-reasoned opinions, state court judges in Connecticut and New York held that the PSLRA discovery stay applies in 1933 Act cases in state court. In ***City of Livonia Retiree Health and Disability Benefits v. Pitney Bowes Inc.***, 2019 WL 2293924 (Conn. Super. May 15, 2019), the court held that the stay applies under the plain language of the PSLRA. Notably, the PSLRA's discovery stay appears in a section of the statute prefaced with "any private action arising under this subchapter," and it is indisputable that 1933 Act cases arise under the federal statute regardless of whether they are brought in federal or state court. By contrast, a different subchapter—not containing the discovery stay—applies only to cases brought "pursuant to the Federal Rules of Civil Procedure."

The court in ***In re Everquote, Inc. Securities Litigation***, 65 Misc.3d 226 (N.Y. Sup. Aug. 7, 2019) reached the same conclusion that the plain language of the federal statute renders the PSLRA's discovery stay applicable in state court. In addition, the court emphasized that its conclusion was buttressed by the PSLRA's purpose to curtail abusive discovery in securities class actions: "[A] divergence in the application of the [PSLRA] discovery stay in state and federal court would create the undesirable (and unsupported by the text of the statute or its purpose) and absurd incentive for lawsuits brought under the 1933 Act to be brought in state court as opposed to federal court to avoid the very protection supporting the enactment of the [PSLRA] and necessarily confounding Congress' acknowledged intention that the lion's share of securities litigation would occur in the federal courts."

On the other hand, a different judge in New York twice held in 2019 that the PSLRA discovery stay does not apply in state court 1933 Act cases. In ***Matter of PPDAI Group Securities Litigation***, 64 Misc.3d 1208(A) (N.Y. Sup. July 1, 2019) and ***In re Dentsply Sirona, Inc. Shareholders Litigation***, 2019 WL 3526142 (N.Y. Sup. Aug. 2, 2019), the court held with no elaboration that "[a]pplication of the federal PSLRA automatic discovery stay would undermine *Cyan's* holding that '33 Act cases may be heard in state courts." It is not clear how a temporary stay of discovery would "undermine" a plaintiff's ability to bring a case in state court, and the court did not explain its conclusion.

These cases demonstrate that it remains unpredictable whether the stay of discovery while a motion to dismiss is pending will apply in any given state court case. In arguing for a stay of discovery, defendants can point to the more developed reasoning in the cases that have held the stay applies in state court under the plain language of the federal statute. Depending on the state, there may also be state-specific arguments that defendants can use to persuade judges that the PSLRA's discovery stay is substantive law that applies in state court.

In the wake of *Cyan*, one strategy that some public companies have used to try to ensure a federal forum—where the PSLRA stay and other protections unquestionably apply—for 1933 Act cases is to adopt provisions in their governing documents specifying that such claims may only be brought in federal court. However, the Delaware Court of Chancery held in ***Sciabacucchi v. Salzberg***, 2018 WL 6719718 (Del. Ch. Dec. 19, 2018) that forum selection clauses are invalid for federal causes of action. The court reasoned that forum selection clauses are only permissible for claims related to the internal affairs of the corporation and that federal securities claims do not fit within that category. *Sciabacucchi* is now on appeal, and the Delaware Supreme Court is set to decide the issue in 2020. If the court reverses, we can expect to see many public companies adopt federal forum provisions.

The practical effect of the Supreme Court's decision is that more public offering securities cases are now being litigated in state courts.

III. Circuit Court Decisions Pose Challenges to Event-Driven Securities Litigation Based on Generic Statements About Corporate Policies.

The rise of so-called "event-driven" securities litigation has been a hot topic for the past few years. Rather than challenging a company's financial statements, plaintiffs will focus on a negative corporate event that was followed by a stock drop (like an oil spill or contamination of a company's product) and juxtapose a prior public statement from the company that purportedly conflicts with the negative event that ultimately occurred. This year, several circuit court and district court decisions have brought to the forefront a subset of event-driven litigation: actions based on statements regarding corporate policies, such as codes of conduct, codes of ethics, or regulatory compliance policies.

In these cases, plaintiffs sue a company facing regulatory scrutiny and allege that the company's conduct policies had assured the public that it was in full regulatory compliance or had programs to ensure such compliance. Indeed, this year the Second Circuit called these cases "creative attempt[s] to recast corporate mismanagement as securities fraud." ***Singh v. Cigna Corp.***, 918 F.3d 57, 59-60 (2d Cir. 2019).

Key to cases challenging allegedly fraudulent statements about regulatory compliance in corporate policies is often whether the statements were material, as required for securities law violations. Although the proliferation of these cases may be relatively new, the materiality requirement is not—there must be a substantial likelihood that the challenged statements would impact a reasonable person's decision to buy or sell stock. This year, courts specifically grappled with when statements in corporate conduct policies are puffery. Puffery—vague statements of corporate optimism, exaggerated sales pitches, or generic corporate-speak—is too general to cause a reasonable investor to rely on it and, thus, immaterial and not the proper basis of a securities fraud case.

This year, the Second and Eleventh Circuits affirmed dismissals of claims challenging statements about a company's regulatory compliance as immaterial puffery. *See Cigna*, 918 F.3d 57; ***Carvelli v. Ocwen Fin. Corp.***, 934 F.3d 1307 (11th Cir. 2019). Indeed, the Eleventh Circuit in *Ocwen* for the first time applied the puffery concept in a securities-fraud case, recognizing the practice in other circuits and finding it "a particularly good fit" in the securities context. *See* 934 F.3d at 1320.

Each case was based on public statements about corporate conduct. Ocwen stated publicly that it was devoting substantial resources to, and making progress toward, regulatory compliance, and Cigna published a code of ethics touting the importance of regulatory compliance and corporate integrity. *Ocwen*, 934 F.3d at 1321; *Cigna*, 918 F.3d at 61. Each company subsequently faced regulatory challenges that, according to the plaintiffs, proved that their previous statements about compliance were false. Yet both Courts found that a reasonable investor would not rely on the challenged statements as representations of regulatory compliance; instead, they were "textbook" and "quintessential" puffery—*i.e.*, generic declarations of corporate integrity, about having policies and procedures in place, and about allocating resources to compliance, none of which invited investor reliance. *See Ocwen*, 934 F.3d at 1321; *Cigna*, 918 F.3d at 63.

Further, these corporate compliance policies implicitly, if not explicitly, acknowledged the difficulties of compliance and the need to improve. This also gutted the plaintiffs' materiality claims, because the notion that "context matters in the materiality analysis cuts both ways." *Ocwen*, 934 F.3d at 1322 (holding that public statements about devoting resources to and seeing improved regulatory compliance were tempered by acknowledgements that "there is more work to be done"); *Cigna*, 918 F.3d at 64 (holding that public statements explaining the need to allocate resources to compliance and the complexity of applicable regulations suggested caution and desired improvement rather than confidence in effective compliance).

Despite these cases, one should not assume that all statements in corporate conduct policies are immaterial puffery. The Second Circuit suggested as much in *Cigna*, and subsequent district court cases demonstrate that whether a statement in a conduct policy is material often depends on the specificity and detail in the policy. *See Cigna*, 918 F.3d at 63. One court has held that where a corporate conduct policy goes "further than simply touting compliance" or making "fuzzy" claims about integrity and transparency, and instead details "specific guidelines for compliance" with specific laws, it can be material. ***Plymouth Cty. Ret. Sys. v. Patterson Cos., Inc.***, 2019 WL 3336119, at *15 (D. Minn. July 25, 2019) (finding statements in code of ethics material where code "outlines specific guidance for compliance with a specific subset of laws"), *report and recommendation adopted as modified*, 2019 WL 4277302 (D. Minn. Sept. 10, 2019); *Cf.* ***Schiro v. Cemex, S.A.B. de C.V.***, 396 F. Supp. 3d 283, 298 (S.D.N.Y. 2019) (finding statements about regulatory compliance in code of ethics immaterial puffery where code explained "guidelines" or used "aspirational language" and did not make statements of fact or of actual compliance). Of course, a plaintiff would still need to plead that these more specific statements were false when made, not merely that the company was out of compliance.

Cases like *Cigna* and *Ocwen* highlight the need for careful drafting of SEC filings and other public statements describing a company's corporate conduct and compliance policies. They also pose challenges to plaintiffs seeking to base securities fraud cases on later events that purportedly contradict a company's generic statements about such policies.

IV. Pleading Scienter Continues to Pose Challenges for Plaintiffs in Securities Class Actions.

One of the most difficult challenges for securities class action plaintiffs is pleading facts giving rise to a strong inference of scienter, a mental state embracing intent to defraud or at least severe recklessness. This challenge is reflected in 2019 decisions by the First and Fifth Circuits. In ***Municipal Employees' Retirement System of Michigan v. Pier 1 Imports, Incorporated***, 935 F.3d 424 (5th Cir. 2019), the plaintiffs claimed that retailer Pier 1 and its executives made misrepresentations regarding and failed to disclose significant "markdown risk," the risk that the company had so much inventory that it allegedly could not rid of it without dramatically lowering prices. In ***Metzler Asset Mgmt. GmbH v. Kingsley***, 928 F.3d 151 (1st Cir. 2019), the plaintiffs claimed that biotechnology company Biogen made false or misleading statements regarding its multiple sclerosis drug Tecfidera's safety profile and usage rate. In both cases, the court of appeals affirmed the district court's dismissals for failure to plead a strong inference of scienter.

The *Pier 1* and *Biogen* cases illustrate a few recurring themes in securities class plaintiffs' failures to plead a strong inference of scienter:

Allegations must be considered in the context of negative information that was disclosed. In securities class actions, plaintiffs attempt to convince the court that information known to management was inconsistent with the company's positive statements. But this analysis must also take into account any negative information that was disclosed to investors. For example, in *Biogen* the court considered that the company had disclosed a patient death, updated the drug's label to account for the increased understanding of its risk, and disclosed that it expected the drug's growth rate to slow. That context undercut plaintiffs' claim that defendants acted with intent to deceive. *Kingsley*, 928 F.3d at 160-61. Similarly, in *Pier 1* the court evaluated plaintiffs' allegations in light of the company's disclosures regarding its high inventory levels. *Pier 1*, 935 F.3d at 432-33.

Allegations regarding internal reports cannot assume contradictory content. Plaintiffs in securities class actions often point to management's receipt of internal reports or data as supporting a strong inference of scienter. *Biogen* and *Pier 1* both reflect that absent factual details about the content of such internal reports or data, such allegations do not provide a strong basis for inferring that management was aware of information contradicting the company's public statements. *Kingsley*, 928 F.3d at 162 (allegation that "everyone in leadership had access to reporting metrics" and monitored "new start rates" insufficient without allegations of "what [the CEO] learned from such monitoring, and whether what he learned was at odds with any of his" alleged misstatements); *Pier 1*, 935 F.3d at 433-34 (allegations regarding "numerous daily, weekly, and monthly reports on sales figures, inventory figures, and purchases that would increase inventory" insufficient because plaintiffs "do not allege that any of these reports revealed" the allegedly undisclosed information regarding "significant markdown risk").

Confidential Witness allegations must provide a basis to infer company-wide numbers. Plaintiffs in securities class actions often attempt to cast doubt on a company's disclosures by pointing to allegations attributed to anonymous former employees (so-called "confidential witnesses") regarding the purportedly negative results in their division or portion of the company. Prior cases hold, and *Biogen* and *Pier 1* reaffirm, that such allegations do not provide a basis for drawing a strong inference of scienter as to company-wide results or disclosures. In *Biogen*, for example, an allegation that a confidential witness's own sales dropped 25% was insufficient because "the fact that his individual sales experienced a decline does not indicate that he knew that [the CEO's] generalized assessments of the magnitude of the change in discontinuation rates nationally for the company were untrue." *Kingsley*, 928 F.3d at 164-65. Similarly, in *Pier 1* the court held that an allegation of "almost 1,000 trailers full of inventory parked outside Pier 1's Baltimore distribution center … says nothing about inventory problems across Pier 1's other five distribution centers and thousands of stores." *Pier 1*, 935 F.3d at 433.

V. Director Failure of Oversight Claims: Difficult But Not Impossible To Plead.

Delaware law imposes a duty on a corporation's board to exercise oversight. A claim for failure to exercise oversight is commonly referred to as a *Caremark* claim in reference to ***In re Caremark Int'l Inc. Derivative Litig.***, 698 A.2d 959 (Del. Ch. 1996). To sustain a *Caremark* claim, a plaintiff must show either (1) an "utter failure to attempt to assure a reasonable information and reporting system exists" or (2) a "conscious failure" to monitor those systems or address corporate wrongdoing. *Caremark* establishes a high bar for director liability and is described as "possibly the most difficult theory in corporation law" for a plaintiff to succeed. And when a shareholder plaintiff asserts *Caremark* claims derivatively on behalf of the corporation, the shareholder faces an additional hurdle because the plaintiff generally must plead particularized facts showing that a majority of the Board faces a substantial likelihood of liability to have standing to pursue the claims. As a result, courts typically dismiss *Caremark* claims at the pleadings stage. Nevertheless, *Caremark* claims are still commonly brought by shareholder plaintiffs soon after a regulatory enforcement action or other corporate crisis.

In ***Marchand v. Barnhill***, 212 A.3d 805 (Del. 2019), the Delaware Supreme Court reversed the dismissal of *Caremark* claims and emphasized the need for Board oversight in critical aspects of a corporation's operations. In that case, a shareholder of Blue Bell Creameries USA, Inc., a large ice cream manufacturer, brought derivative claims against Blue Bell directors and officers for allegedly failing to exercise oversight over food safety. According to the shareholder, this failure contributed to the presence of listeria in Blue Bell products and caused substantial harm to the company and its customers. The defendants argued that the shareholder could not establish an "utter failure to attempt to assure a reasonable reporting and monitoring system exists" as required under the first prong of *Caremark* because management regularly reported to the Board on "operational issues" and had implemented systems to comply with food safety regulations. The Delaware Supreme Court rejected these arguments, holding that Blue Bell management's "nominal" compliance with food safety regulations and management's reports to the Board on "operational issues" were not enough because the Board itself had a duty to "institute monitoring and reporting systems for the corporation's central compliance risks" at the board level. Instead, the court identified the following particularized facts alleged in the complaint as key: (1) the Board had no committee with oversight responsibility for food safety; (2) the Board had no regular process to consider food safety risks; (3) there was no record of the Board having received reports on serious food safety issues, including those relating to the deaths of three customers; (4) the reports the Board did receive about food safety from management were incomplete; and (5) Board records did not describe any regular discussion of food safety.

Characterizing food safety as "essential and mission critical" to Blue Bell's success, the court stated that if a plaintiff is able to "plead facts supporting a fair inference that no reasonable compliance system and protocols were established as to the obviously most central consumer safety and legal compliance issue facing the company, that the board's lack of efforts resulted in it not receiving official notices of food safety deficiencies for several years, and that, as a failure to take remedial action, the company exposed consumers to listeria-infected ice cream, resulting in the death and injury of company customers, the plaintiff has met his onerous pleading burden and is entitled to discovery to prove out his claim."

While *Marchand* dealt with the first prong of *Caremark*, it has implications for *Caremark's* second prong as well. For instance, in ***In re Clovis Oncology, Inc. Derivative Litig.***, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019), the Delaware Chancery Court held that the shareholder adequately pled that the Board was aware management was reporting incorrect information for clinical trials of a key drug the company was developing, but failed to address the misconduct. The court stated: "As *Marchand* makes clear, when a company operates in an environment where externally imposed regulations govern its 'mission critical' operations, the board's oversight function must be more rigorously exercised." In this case, the court held that the complaint alleged particularized facts supporting a reasonable inference that the clinical trials for the drug at issue

Marchand does show courts may take a closer look at how the Board handles "mission critical" aspects of the business.

were “mission critical regulatory issues” and that “the Board consciously ignored red flags that revealed a mission critical failure” to comply with applicable reporting requirements. The court cited allegations of specific presentations to the Board that suggested management was reporting objective response rate (“ORR”) based on confirmed and unconfirmed responses, despite applicable clinical protocols and FDA regulations that required that calculation of ORR exclude unconfirmed responses. Given the importance of ORR to the clinical trials and the Board’s expertise and experience in the pharmaceutical industry, the court held it was “reasonable to infer the Board would have understood the concept and would have appreciated the distinction between confirmed and unconfirmed responses.” The court also focused on allegations that the Board received specific data from management that conflicted with what management reported publicly.

Marchand does not represent a substantive change to Delaware law or the standards used to evaluate *Caremark* claims at the pleading stage. However, *Marchand* does show courts may take a closer look at how the Board handles “mission critical” aspects of the business. Because shareholder plaintiffs often use books and records requests to meet their elevated pleading burden in derivative cases, boards should ensure not only that reporting and monitoring systems for central compliance risks are in place, but also that they are well-documented. That way, shareholders cannot point to an absence of references to oversight systems or discussions about central compliance issues in board records to support their claims that directors failed to put systems in place.

VI. More Clarity on When Protections for Minority Shareholders Must Be in Place for Business Judgment Review in Controlling Stockholder Transactions.

In ***Kahn v. M & F Worldwide Corp.***, 88 A.3d 635, 639 (Del. 2014) (“*MFW*”), the Delaware Supreme Court provided that a controlling shareholder buyout would be afforded deference under the business judgment rule “if and only if” the deal was conditioned “ab initio” (from the beginning) on dual procedural protections for minority shareholders: (1) approval by an independent, special committee and (2) approval by a fully informed, uncoerced vote of a majority of the minority shareholders. Absent either, the transaction would be judged under the exacting entire fairness standard.

Since *MFW*, the requirement that these protections be in place “ab initio” has been litigated up to the Delaware Supreme Court several times. In 2018, the Delaware Supreme Court clarified in ***Flood v. Synutra Int’l, Inc.***, 195 A.3d 754 (Del. 2018) that “a process meets the ab initio requirement when the controller announces the conditions before any negotiations take place.” In *Synutra*, the controlling shareholder proposed by letter an acquisition of the rest of the company’s stock, but did not condition the transaction on the *MFW* dual procedural protections. However, because the shareholder sent a second letter only two weeks later (and before any substantive economic negotiations took place) requiring that the deal be approved by a special committee and a majority of the minority voting stock, the court held that the business judgment rule still applied.

The Delaware Supreme Court took up the question again this past year in ***Olenik v. Lodzinski***, 208 A.3d 704, 706 (Del. 2019). In *Olenik*, a shareholder of

Earthstone Inc. brought class and derivative claims relating to a merger between Earthstone and Bold Energy III LLC. The shareholder alleged that EnCap Investments L.P. controlled both Earthstone and Bold and the transaction was unfair to Earthstone's minority shareholders. According to the shareholder, Earthstone's CEO explored a merger with Bold and sent the Earthstone Board a letter on April 27, 2016 that described a possible transaction with Bold and his intention to make an offer. Earthstone then initiated discussions with EnCap and Bold, and in May 2016, Earthstone presented initial estimates on a valuation for Bold and shared with Bold's financial advisor a model for the combined companies. Over the next several months, Earthstone and Bold officers discussed a plan for the combined company and conducted due diligence. In July, the Earthstone board formed a special committee whose charter provided that the board would not approve a transaction with Bold without the special committee's recommendation. In August, the special committee authorized Earthstone's CEO to send a formal written proposal to Bold with financial terms and that conditioned the deal on approval of a majority of the minority shareholders. After further negotiations, Earthstone and Bold reached agreement. The special committee approved the transaction, and a majority of the shares held by disinterested shareholders approved the deal. Based on these allegations, the Delaware Supreme Court held that "the well-pled facts in the complaint support[ed] a pleading stage inference that the preliminary discussions transitioned to substantive economic negotiations when the parties engaged in a joint exercise to value Earthstone and Bold in May 2016." In particular, Earthstone allegedly gave two presentations on valuation in this time—the first setting a valuation for Bold at $305 million and the second at $335 million. The court stated that "[b]ased on these facts, it is reasonable to infer that these valuations set the field of play for the economic negotiations to come by fixing the range in which offers and counteroffers might be made." Because the MFW dual protections were not in place until several months after economic negotiations had begun, the court held the complaint should not have been dismissed based on a business judgment standard of review.

Neither *Synutra* nor *Olenik* establish a bright-line rule for when the *MFW* dual procedural protections must be in place to achieve business judgment deference, but together these cases show that the *MFW* protections should be in place as early as possible in controller-led mergers and before any economic negotiations, including formal valuations or due diligence, take place.

VII. SEC Disgorgement Claims Continue to Be Impacted by Supreme Court's *Kokesh* Decision.

The SEC continued throughout 2019 to see consequences from the Supreme Court's unanimous holding in ***Kokesh v. Securities and Exchange Commission***, 137 S. Ct. 1635 (2017), although perhaps less significantly than the SEC initially predicted. In *Kokesh*, the Court held that the SEC's ability to recover funds through disgorgement is subject to a five-year statute of limitations. The Court held that disgorgement is not simply remedial, but rather is a penalty subject to the limitations period in 28 U.S.C. Section 2462.

The Court's holding in *Kokesh* was a major development in the world of SEC enforcement. In its 2018 Annual Report, the SEC Enforcement Division estimated that the decision had forced the agency to forego approximately $900 million in disgorgement that year. Two years later, however, *Kokesh* does not seem to have had a lasting impact on the SEC's ability to obtain disgorgement. In fact, according to the Enforcement Division's Annual Report for fiscal 2019, median disgorgement ordered—among actions in which disgorgement was ordered—was nearly $700,000, up from $450,000 in fiscal 2018. Total disgorgement ordered also increased to $3.248 billion, up from $2.506 billion in 2018. This despite the assertion in the 2019 Annual Report that the financial impact of *Kokesh* now stands at approximately $1.1 billion dollars foregone. Anecdotally, we have seen a more urgent investigative pace from the SEC Enforcement Staff in our practice, and we have received more requests for tolling agreements since *Kokesh*.

The most significant fallout from *Kokesh* may be yet to come. In a footnote in the decision, the unanimous Court noted that the opinion did not address "whether courts possess authority to order disgorgement in SEC enforcement proceedings or [ ] whether courts have properly applied disgorgement principles in this context." That question is now teed up in ***Liu v. SEC***, No. 18-1501. The petitioners/defendants in *Liu* are accused of misappropriating approximately $27 million they raised from Chinese investors under the EB-5 Immigrant Investor Program. The Ninth Circuit affirmed a California federal district court's grant of summary judgment in favor of the SEC, rejecting the defendants' argument, based on the footnote in *Kokesh* discussed above, that the SEC does not have authority to order disgorgement as an equitable remedy. The Supreme Court granted *certiorari* and is scheduled to hear arguments in the case March 3, 2020. Although a decision is not likely until spring or summer 2020, the Court's grant of *certiorari* injects significant uncertainty into all stages of ongoing enforcement proceedings.

Congress has also taken an interest in the SEC's ability to order disgorgement. Both the U.S. House and the U.S. Senate introduced bipartisan legislation in 2019 aimed at reversing the implications of *Kokesh*. The House bill, H.R. 4344 or the Investor Protection and Capital Markets Fairness Act, was passed on November 19, 2019, and would prevent disgorgement from being defined as "a civil fine, penalty, or forfeiture," as well as allow for a 14-year statute of limitations. The Senate legislation—the Securities Fraud Enforcement and Investor Compensation Act—was introduced in March 2019 and has not yet been scheduled for further action. It proposes to amend the text of Section 21(d) of the Securities Exchange Act of 1934 to specifically provide the SEC authority to seek disgorgement in federal court actions.

VIII. Constitutionality of Administrative Law Judges in SEC Matters Remains in Focus.

On June 21, 2018, the Supreme Court held in ***Lucia v. Securities and Exchange Commission*** that the SEC's Administrative Law Judges ("ALJs") are officers under the Constitution's Appointments Clause, and so must be constitutionally appointed rather than hired like other federal employees. The fallout from this ruling continued throughout 2019.

Following the Court's grant of *certiorari* in *Lucia*, the SEC ratified the appointments of all of its ALJs and, following issuance of the opinion, stayed for 30 days all matters currently pending before an ALJ. It later reassigned hundreds of administrative proceedings for rehearing, many of which later settled.

Although there have not been challenges to judgments handed down by SEC ALJ's prior to *Lucia*, the case left open many questions. For example, the Fifth Circuit case of ***Cochran v. SEC et al.***, case No. 19-10396, raises the question whether SEC ALJs' removal protections violate Article II of the Constitution. In 2016, Michelle Cochran appeared *pro se* in an enforcement action before an SEC ALJ where she was fined $22,500 and banned from practicing as an accountant with the right to seek reinstatement after five years. But before the final order was entered, *Lucia* was decided and on August 22, 2018, the SEC issued an order vacating all decisions in pending enforcement matters, including the initial order entered against Cochran, and reassigned those matters to different ALJs.

In January 2019, Cochran filed suit against the SEC in federal district court in Texas, arguing that a second enforcement proceeding before a different ALJ would still be unconstitutional because the SEC's post-*Lucia* ratification of ALJ appointments did nothing to address potential Article II removal issues like those identified in ***Free Enterprise Fund v. Public Co. Accounting Oversight Board***. In *Free Enterprise*, the Supreme Court held limitations on the president's ability to remove inferior constitutional officers —in that case PCAOB officers who could only be removed "for good cause shown"—were unconstitutional and impeded the president's Article II duties.

The district court dismissed Cochran's claim for lack of subject matter jurisdiction, holding that Congress intended to channel constitutional claims like Cochran's through the administrative process. Cochran has appealed to the Court of Appeals for the Fifth Circuit, and on September 29, 2019, the Fifth Circuit enjoined the SEC's administrative enforcement proceeding pending resolution of Cochran's appeal.

The *Cochran* case demonstrates that *Lucia* has left open many questions and challenges related to operational issues for the SEC as well as other federal agencies that rely on ALJs with similar employment protections.

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