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GLOBAL PUBLIC COMPANY ACADEMY

SECURITIES LITIGATION AND EMPLOYEE BENEFITS UPDATES

Michael Blanchard
Laura McNally
Rosina Barker

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EVOLVING ISSUES IN BOARD OVERSIGHT IN THE ERA OF SECTION 220

Stockholder Derivative Litigation And Section 220 Books and Records Litigation

- Section 220 is the "tools at hand" that Delaware has admonished derivative plaintiffs to use before filing a derivative action
- Section 220 permits stockhodlers to obtain corporate "books and records" for a "proper purpose"
- Investigating breaches of fiduciary duty are common proper purposes
- Lowest evidentiary standard known to Delaware law
- Section 220 demands are now routine precursor's to litigation
- "Books and records" can include email and texts where traditional books and records are unavailable – *KT4 v. Palantir*

Caremark

- Utter failure to implement a system of corporate controls
- Knowing failure to respond to red flags – "conscious disregard"
  - Directors knew/should have known the corporation was violating the law, and
  - Directors acted in bad faith by failing to prevent or remedy those violations

Caremark (continued)

- 102(B)(7) requires "bad faith"
- *Caremark* is NOT about effectiveness of controls
- "[G]ood faith, not a good result, is what is required of the board."
- "[T]he most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."

Marchand v. Barnhill

- Monoline company – Ice Cream
- Oversight of food safety was "mission critical"
- Subject to food safety regulation by the FDA
- For several years compliance issues with food safety, never reported to the board –positive tests for Listeria
- By 2015 listeria spread to the ice cream, ultimately killing 3 people
- Chancery Court dismissed the case, holding there was a reasonable reporting system in place
- That system amounted to complete reliance upon management compliance with FDA regulations

Marchand v. Barnhill (continued)

- No board committee addressing food safety
- No protocol requiring management reporting food safety compliance issues
- No regular board consideration of safety risks
- Management received reports (red flags)
- Management received unfavorable reports on food safety, not conveyed to the board

NOT A CHANGE IN THE LAW

- The critical issue, the Supreme Court acknowledged, is not whether "illegal or harmful company activities escaped detection [of the board]"
- *Oversight liability is not about effectiveness*
- The "bottom-line requirement" of *Caremark* is that "the board must make a good faith effort—i.e., try—to put in place a reasonable board-level system of monitoring and reporting" *and then monitor it.*

Clovis Oncology

- A "monoline" biopharmaceutical company with no products, no sales revenue, and only a single promising drug in its pipeline.
- Lung cancer drug entered clinical trials
- Company was reporting on the trials, key metric was the Objective Response Rate –ORR—
- And key to that metric, required by the FDA was "confirmed responses"
- Plaintiffs showed that the board was aware that the ORR that company reported included unconfirmed responses
- SEC investigation, stock drops, securities suits follow

Clovis Oncology (continued)

- "[I]t is appropriate to distinguish the board's oversight of the company's management of business risk that is inherent in its business plan from the board's oversight of the company's compliance with positive law—including regulatory mandates."
- "Delaware courts are more inclined to find *Caremark* oversight liability at the board level when the company operates in the midst of obligations imposed upon it by positive law yet fails to implement compliance systems, or fails to monitor existing compliance systems, such that a violation of law, and resulting liability, occurs."

Section 220 and Takeaways

- Identify critical compliance issues and board committee responsible for oversight
- Establish system for management to report to the board
- Address reported issues
- Document the board's oversight

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SALZBERG V. SCIABACUCCHI MITIGATING THE RISE OF POST-*CYAN* SECURITIES ACT CASES IN STATE COURT?

The Supreme Court's Decision in *Cyan*

- In 2018, the U.S. Supreme Court held in *Cyan, Inc. v. Beaver Cty. Emps. Ret. Fund*, 138 S. Ct. 1061 (2018) that both state and federal courts have concurrent jurisdiction over claims brought under the Securities Act of 1933, as amended (the "Securities Act")—most often misstatements or omissions in registration statements or prospectuses.
- The *Cyan* decision prompted a significant shift in the securities litigation landscape, as plaintiffs increasingly filed Securities Act claims in state court, in part to evade the procedural protections of the Private Securities Litigation Reform Act of 1995 (the "PSLRA").
- Often there are parallel cases brought in federal court against the same defendants based on the same alleged misstatements.

The Delaware Supreme Court's Decision in *Salzberg v. Sciabacucchi*

- In *Salzberg v. Sciabacucchi*, No. 346, 2019 (Del. Mar. 18, 2020) the Delaware Supreme Court rejected a challenge to the validity of the following forum provision adopted in the corporate charters of three Delaware companies prior to their IPOs:
  - "Unless the Company consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall be the exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933. Any person or entity purchasing or otherwise acquiring any interest in any security of [the Company] shall be deemed to have notice of and consented to [this provision]."
- In affirming the facial validity of these exclusive federal forum provisions, the court explained that such a provision could provide corporations with certain efficiencies in managing these claims, including consolidation of multi-jurisdiction litigation and the avoidance of state court forum shopping. There is also merit to the notion that federal courts are best suited to apply federal securities laws, given their expertise and intimate familiarity with this body of law.
- That case provides some relief for Delaware corporations that have recently issued securities, or that plan to do so, if they have federal-forum charter provisions in place.
- The reach of *Sciabacucchi*, and the extent to which section 11 cases continue to be litigated in state court, will depend on a number of factors, most importantly the extent to which states in which these cases are litigated treat federal-form provisions as valid.

Considerations for Incorporating Exclusive Federal Forum Provisions

- Litigating Securities Act claims exclusively in federal court has numerous benefits.
  - Reduced costs and inefficiencies in multi-jurisdiction litigation
  - Avoidance of state court forum shopping
  - Experienced federal forum
  - Forum predictability
- Proxy advisors' positions.
  - Prior to *Salzberg*, Glass Lewis and ISS had mixed views on forum selection clauses, generally reflecting the need for a case-by-case determination.

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ERISA UPDATE: DISCLOSURE OBLIGATIONS OUTSIDE OF SECURITIES LAWS

Company Stock in 401(k) Plans: *Dudenhoeffer* Pleading Standard

- The 401(k) plans of many public companies offer an investment fund primarily invested in company stock
- The company stock fund is subject to ERISA's fiduciary duty of prudence, except its "diversification" prong
- If the company stock price falls, participants might sue the plan's fiduciaries on the basis, among other things, of the fiduciaries' failure to act on negative inside information
- *Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409 (2014)* sets forth what fiduciary breach claims based on inside information must allege to survive a motion to dismiss:
  - Plaintiffs must plausibly allege an alternative action the fiduciary could have taken that (i) would have been consistent with the securities laws and (ii) a prudent fiduciary in the same circumstances would not have viewed as more likely to do harm than good to the fund
- Pleading standard designed to separate the "meritorious sheep from the meritless goats"

Company Stock in 401(k) Plans: *Dudenhoeffer* Pleading Standard (continued)

- *Dudenhoeffer* opinion gives courts three "guidelines" for applying its pleading standard
  1. ERISA's duty of prudence does not require a fiduciary to break the law
     - For example, fiduciary may not divest company stock on the basis of inside information
  2. In evaluating a complaint that a fiduciary failed to take non-prohibited actions in the face of negative inside information (halting new company stock purchases or publicly disclosing negative inside information) the court must consider whether such actions would conflict with securities laws
  3. A complaint that the fiduciary failed to halt new stock purchases or publicly disclose negative inside information must plausibly allege that a prudent fiduciary could not have concluded that this would do more harm than good to the fund by causing a "concomitant" stock price drop.
- Fiduciary breach claims based on inside information have typically failed to meet the "more harm than good" pleading standard.
  - *Whitley v. BP, P.L.C.,* 838 F.3d 523 (5th Cir. 2016)
  - *Rinehart v. Lehman Bros. Holdings Inc.*, 817 F.3d 56, 68 (2d Cir. 2016)
  - *Graham v. Fearon,* 721 F. App'x 429, 437 (6th Cir. 2018)
  - *Martone v. Robb*, 902 F.3d 519, 526-27 (5th Cir. 2018)

Jander v. Retirement Plans Committee of IBM

- Plaintiffs were IBM 401(k) plan participants who allegedly suffered losses from their investments in the plan's company stock fund. Plaintiffs alleged that IBM misrepresented the value of its microelectronics business, artificially inflating the value of company stock, and causing a drop in the stock price when the business was sold
- A securities law fraud suit was brought on substantially similar allegations, and dismissed in *International Ass'n of Heat & Frost Insulators & Asbestos Workers Local #6 Pension Fund v. International Business Machines Corp., 205 F. Supp. 3d 527 (S.D.N.Y. 2016),* holding that plaintiffs had plausibly alleged a GAAP violation, but failed to sufficiently allege scienter as required by the Private Securities Litigation Reform Act.
- *Jander* plaintiffs alleged that the plan fiduciaries, some of whom were insiders with reporting duties, were aware of the alleged fraud, and by failing to disclose the alleged overvaluation breached their fiduciary duty of prudence under ERISA.
- Plaintiffs' ERISA claims were dismissed by the district court. *Jander v. Ret. Plans Comm. of IBM, 272 F. Supp. 3d 444, 451-54 (S.D.N.Y. 2016)*, reasoning that fiduciaries could prudently fear that early disclosure would "spook the market"

Jander v. Retirement Plans Committee of IBM (continued)

- The Second Circuit reversed, holding that plaintiffs' claims satisfied *Dudenhoeffer's* pleading standard: plaintiffs plausibly alleged the plan fiduciaries could not have concluded that a corrective disclosure would do more harm than good to the plan, by alleging the stock price of an "inevitable" disclosure of an alleged fraud generally increases over time. *Jander v. Retirement Plans Committee of IBM*, 910 F.3d 620 (2d Cir. 2018)
- The Supreme Court granted cert. and handed down its decision January 14, 2020. *Retirement Plans Committee of IBM* v. Jander, 589 U.S.___.The Court declined to rule on the merits, and vacated and remanded to the Second Circuit. The Court explained that the plan's fiduciaries and the government argued that fiduciaries have no corporate disclosure duties under ERISA, an argument not before the Second Circuit.
- *Gorsuch* concurrence applies ERISA's two hat doctrine: corporate officers who are also fiduciaries of an ERISA plan do not breach their ERISA duties for actions taken solely in their corporate capacity

Jander v. Retirement Plans Committee of IBM (continued)

- Following remand Second Circuit scheduled briefing in *Jander v. Retirement Plans Committee of IBM*, No. 17-3518
  - Government's brief: Absent extraordinary circumstances, ERISA's duty of prudence requires an ESOP fiduciary to publicly disclose inside information only when the securities laws independently require disclosure.
    - A fiduciary could prudently decide that corporate disclosures not required by the securities laws would do more harm than good to the plan
  - IBM plan fiduciaries' brief: a corporate officer acting as the ERISA fiduciary of a company stock fund has no ERISA duty to make corporate disclosures. Cites Gorsuch concurring opinion and ERISA's two-hat doctrine
- On June 22, 2020, the Second Circuit reinstated its original *Jander* opinion, and again reversed the district court decision
- *Perrone v Johnson & Johnson* (N.D.N.J. 19-cv-00923-FLW, April 29, 2020) dismisses plaintiffs' ERISA claims against fiduciaries of employer stock fund in Johnson & Johnson 401(k) plan
  - Two-hat doctrine: A corporate officer acting as an ERISA plan fiduciary has no ERISA duty to make corporate disclosures
  - A "conclusory" allegation that delayed disclosure does more harm than good to the plan does not satisfy *Dudenhoeffer* pleading standard--disagrees with Second Circuit's *Jander* reasoning, agrees with majority case law

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QUESTIONS?

THANK YOU

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