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 Milbank

# Corporate Governance Group

# Client Alert

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## DELAWARE COURT REFUSES TO DISMISS STATE LAW INSIDER TRADING CLAIM AGAINST DIRECTORS

*Court reaffirms that Brophy remains good law, not pre-empted by federal securities insider trading regime*

In *Pfeiffer v. Toll*,<sup>1</sup> the Delaware Court of Chancery recently refused to dismiss a lawsuit claiming breach of fiduciary duty on the part of members of the board of directors of Toll Brothers, Inc. who allegedly engaged in insider trading. In so ruling, the Court affirmed *Brophy v. Cities Service Co.*,<sup>2</sup> a 1949 case which “recognized the right of a Delaware corporation to recover from its fiduciaries for harm caused [to the corporation] by insider trading” in the corporation’s stock. Rejecting the defendant directors’ argument that the federal securities laws pre-empt a state law claim under *Brophy*, the Court found that the “federal insider trading regime as currently structured rests on a foundation of state law fiduciary duties.”

### **Background**

Toll Brothers, a Pennsylvania-based Delaware corporation whose common stock is traded on the New York Stock Exchange, was founded in 1967 by Robert and Bruce Toll. Toll Brothers “designs, builds, markets, and arranges financing for single-family homes in luxury residential communities throughout the United States.” In 2003 and 2004, the luxury residential market saw “booming growth” and Toll Brothers experienced record financial performance.

<sup>1</sup> CC.A. No. 4140-VCL (Del. Ch. March 3, 2010).

<sup>2</sup> 70 A.2d 5 (Del. Ch. 1949).

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By mid-2005, however, the markets “became worried about a housing bubble . . . and began to question the ability of homebuilders [such as Toll Brothers] to maintain their red-hot performance.” Nevertheless, Toll Brothers, which had historically been bullish on its business and prospects, continued to assure the market that it was on target for net income growth of 20% in both 2006 and 2007. The Company also “rejected the notion that there was a ‘housing bubble’ that was about to pop.” On the contrary, Toll Brothers boasted that “it catered to a niche market of luxury home buyers who were not affected by rising interest rates.” Robert Toll even went so far as to assert in August 2005 that the decline in Toll Brothers’ sales in 2005 was initiated by Toll Brothers itself, in an effort to increase demand and thereby maximize profit. Later that same month, the CFO (also a director) announced in a television interview “that the Company ‘firmly believe[s] that the price of the stock will continue to go up.’”

During this period, Toll Brothers’ common stock significantly outperformed the S&P Homebuilders Index and other peer indices. The stock’s trading price more than doubled from \$28.50 per share in December 2004 to \$58.00 per share in July 2005. And Toll Brothers’ directors profited personally from the strong market in the Company’s stock. From December 2004 through September 2005, and “particularly during the summer and fall of 2005,” the defendant directors collectively sold 14 million shares (in some cases representing over 80% of their individual holdings), generating proceeds of over \$615 million.

It was not until November 2005 that Robert Toll first publicly recognized the “softening demand” in the market and the “increasingly complex regulatory process” for opening new residential communities. One month later, for the first time, Toll Brothers lowered projections for 2006 from net income growth of 20% to growth of only 0.5%. The reaction from surprised investors, analysts and media sources was “profoundly negative,” and the stock price fell dramatically.

In addition to a lawsuit filed under the federal securities laws – which survived a motion to dismiss – a Toll Brothers stockholder, Milton Pfeiffer, initiated a derivative action in the Delaware Court of Chancery alleging, among other things, breach of fiduciary duty under *Brophy* for harm caused to Toll Brothers by the defendant directors’ insider trading. Specifically, plaintiff alleged that “from December 2004 on, the defendants knew their representations about 2006 and 2007 had no reasonable basis in fact,” but nevertheless engaged in sales of stock “while in the possession of material, non-public information about Toll Brothers’ future prospects.” The defendant directors moved to dismiss on the grounds, among others, that (i) a claim for breach of fiduciary duty had not been adequately pled as to Toll Brothers’ outside directors and (ii) “*Brophy* is an outdated precedent that should be rejected.”<sup>3</sup> The Court denied this motion, noting that the directors’ “trades were inconsistent with the past trading patterns and are suspicious in timing and amount.”

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<sup>3</sup> The defendants also premised their motion to dismiss on the alleged failure of the complaint to adequately plead (i) demand futility and (ii) a basis for tolling the statute of limitations. As to the former, the Court concluded that demand on the Toll Brothers board was futile because “[i]n light of the federal securities action, it is not possible for the defendants in this case, who comprised a majority of the Board when the suit was filed, to consider a demand impartially.” As to the latter, the Court concluded that the action was timely filed because “the statute was equitably tolled until December 8, 2005,” the date “that management officially abandoned the projection of 20% growth that forms the centerpiece of the Complaint.”

### *The Court's Analysis*

#### **Adequacy of Breach of Fiduciary Duty Claim**

The Court began its assessment of the adequacy of plaintiff's insider trading claim by noting the two required elements of a *Brophy* claim: "1) the corporate fiduciary possessed material, nonpublic company information; and 2) the corporate fiduciary used that information improperly by making trades because she was motivated, in whole or in part, by the substance of that information." For purposes at least of the motion to dismiss, the Court agreed that both of these elements were satisfied.

##### *Element One: Possession of material, nonpublic information*

While recognizing the "need to distinguish" the information available to outside directors from that available to corporate officers who also serve on a company's board, the Court determined that plaintiff had sufficiently pled "a reasonable basis" from which to infer that Toll Brothers' outside directors possessed material, nonpublic information about the Company. Focusing principally on "the nature of the information in question," and noting that "directors have the statutory power *and responsibility* to direct and oversee the business and affairs of the corporation," the Vice Chancellor recognized that plaintiff's specific allegations did "not contend that outside directors should have uncovered financial fraud, second-guessed technical accounting adjustments, or known about concerns expressed by low-level employees within the organization." Instead, plaintiff's claim "turns on information about the core operations of the Company and the basis for projections that it consistently provided to the markets for over a year." Because the outside directors (two of whom served on the audit committee) possessed and reviewed reports and materials associated with these core operations, the Vice Chancellor observed that "[i]t would afford an ostrich-like immunity to directors not to grant the plaintiff ... [an] inference [for pleading purposes] that Outside Director Defendants knew about core information of this type."

##### *Element Two: Improperly trading on the basis of material, nonpublic information*

The Court regarded "the trades made by the ... [d]efendants as sufficiently unusual in timing and amount to support a pleading-stage inference that the sellers took advantage of confidential corporate information not yet available to the public to unload significant blocks of shares before the market's view of Toll Brothers' prospects dramatically changed." In this connection, the Court rejected defendants' claim that the information was not material, noting that "[t]he Complaint sufficiently alleges that the defendants possessed material information about critical metrics that undercut the projection and indicated that it could not be achieved." The Court also credited the market's adverse reaction when the projections were revised downward. In response to defendants' argument that "if they were seeking to exploit inside information, 'they presumably would have timed their sales to maximize their profits'" rather than selling at a weighted-average price more than 20% below the peak stock price, the Court observed that "[t]he fact that a defendant could have misused inside information more effectively does not defeat an otherwise valid inference of insider trading."

## ***Brophy* Remains Good Law**

The Vice Chancellor fully rejected defendants' characterization of *Brophy* as "a persistent anachronism from a time before the current federal insider trading regime." Rather, the Court pointed out that *Brophy* "was not a one-off decision," but instead built on the "seminal Delaware decision" in *Guth v. Loft, Inc.*<sup>4</sup> In *Guth*, the "Delaware Supreme Court issued its iconic warning to fiduciaries who selfishly misappropriate corporate assets, including confidential information, for personal gain" that "[c]orporate officers and directors are not permitted to use their position of trust and confidence to further their private interests." According to the Vice Chancellor, the *Brophy* Court "relied on these foundational principles" in rejecting the argument that a corporation suffers no harm when a corporate fiduciary engages in insider trading.

The Vice Chancellor cited several factors supporting the continued vitality of *Brophy*:

- *Brophy* addresses "harm to the corporation" as opposed to serving as a device "to recover losses by contemporaneous traders." Such harm is "not measured by insider trading gains or reciprocal losses," but instead by the corporation's "costs and expenses for regulatory proceedings and investigations, fees paid to counsel and other professionals, fines paid to regulators, and judgments in litigation." On this basis, the Vice Chancellor rejected defendants' argument that *Brophy* is a "misguided vehicle for recovering the same trading losses that are addressed by the federal securities laws."
- In response to defendants' argument that the federal securities laws pre-empt an insider trading claim under *Brophy*, the Vice Chancellor rejected "defendants' contention that the federal government has so pervasively regulated insider trading as to crowd out a state law corporate remedy. The history and nature of the federal regime rather supports the conclusion that a breach of fiduciary duty claim for harm to the corporation is preserved."
- Because, as currently structured, "the federal insider trading regime . . . rests on a foundation of state law fiduciary duties," the Vice Chancellor reasoned that "[i]f Delaware were to hold that the fiduciary duties of directors and officers did not limit their insider trading, the cornerstone of the federal system would be removed." Thus, in the Vice Chancellor's view, *Brophy* not only is not pre-empted by the federal insider trading regime, but in fact is necessary to support the continued viability of the private right of action under that regime.
- Finally, the Vice Chancellor stated that "[m]aintaining *Brophy* as a course of action fulfills Delaware's strong public policy of policing against loyalty violations by fiduciaries. . . . Eliminating the remedy would be equivalent to transferring ownership of information from the corporation to its fiduciaries, which is contrary to Delaware law." As such, *Brophy* is "not out of step with federal law."

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<sup>4</sup> 5 A.2d 503 (Del. 1939).

### *Conclusion*

The *Toll* decision preserves a state law claim for stockholders of Delaware corporations whose fiduciaries may have engaged in the trading of the corporation's securities on the basis of material, nonpublic information. As a result, corporate directors and officers engaging in insider trading may face a derivative action under *Brophy* as well as federal securities law claims. More important, this decision illustrates that Delaware courts will not lightly accept an argument that state corporate law is pre-empted by federal law and regulation. It will be interesting to see how this view factors into future debates over whether pending federal financial reform legislation, insofar as it purports to address corporate governance issues, supersedes Delaware corporate law.

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