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Supreme Court rules on drug firm's duty to disclose 'adverse events'

A pharmaceutical company should disclose to investors so-called "adverse event reports" linked to its product when a "reasonable shareholder" would want to know the reported information, a unanimous Supreme Court has ruled.

Matrixx Initiatives Inc. et al. v. Siracusano et al., No. 09-1156, 2011 WL 977060 (U.S. Mar. 22, 2011).

Adverse event reports are user complaints of harm caused by a pharmaceutical product.

The ruling affirms a 2009 decision by the 9th U.S. Circuit Court of Appeals in a securities fraud lawsuit involving Zicam, an over-the-counter cold remedy marketed by defendant Matrixx Initiatives Inc. *Siracusano v. Matrixx Initiatives*, 585 F.3d 1167 (9th Cir. 2009).

REUTERS/Molly Riley

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Delaware court uses minority freeze-out principles to analyze reverse stock split

Robert Reder, David Schwartz and Nehal Siddiqui of Milbank, Tweed, Hadley & McCloy say a recent Delaware Chancery Court decision indicates that unless they see the use of procedural safeguards to protect minority shareholders, state court judges will require controlling stockholders to show that their reverse stock split was entirely fair to the minority that it froze out.

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COMMENTARY

High court's *Siracusano* decision reaffirms materiality depends on context of what defendant says

Morrison & Foerster corporate law attorneys Erik J. Olson, Stephen Thau and Stefan J. Szpajda analyze the U.S. Supreme Court's recent *Siracusano* decision, advising companies to map out a strategy for disclosing information on adverse events before bad news lands on the doorstep.

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Delaware court uses minority freeze-out principles to analyze reverse stock split

By Robert Reder, Esq., David Schwartz, Esq., and Nehal M. Siddiqui, Esq.
Milbank, Tweed, Hadley & McCloy

In *Reis v. Hazelett Strip-Casting Corp.*, the Delaware Chancery Court was asked to review a reverse stock split used by a control stockholder to freeze out minority stockholders.[1] The court, in selecting the "entire fairness" standard of review, emphasized that the burden of proving the entire fairness of such a transaction remains with the control stockholder and board of directors unless they *either* form a special board committee or permit a majority-of-the-minority stockholder vote to approve the transaction.

The court also indicated that a business judgment rule analysis would have been applicable if *both* of these mechanisms had been employed.

BACKGROUND

Hazelett Strip-Casting was formed by brothers Bill and Dick Hazelett to manufacture casting machines for the production of aluminum, zinc, lead and related products. Prior to 2002, Bill owned 800 shares, representing a 69.57 percent equity interest, while Dick owned the remaining 30.43 percent with his 350 shares. Dick died in 2002 and, in his will, bequeathed his 350 shares to 169 people, "consisting primarily of past and present company employees." Ginette Reis is one of those employees.

Bill and his son David, both members of Hazelett's five-person board of directors, "did not relish the prospect of Dick's shares being distributed to 169 individuals." In this regard, they cited several concerns, including that the new stockholders would interfere with management of the business. To address these concerns, characterized by the court as "heartfelt, but incorrect," Bill proposed that Hazelett purchase the 350 shares from Dick's estate for $1,500 each. This price apparently was "just pulled out of the air" by Bill.

When the executors of Dick's estate (who included Reis) objected, Bill "sweetened the offer" to $1,500 per share in 2005 plus another $1,500 in 2010 "if the company had the ability to pay the additional amount at that time." If the company failed to make the second payment, the beneficiaries of Dick's estate would be entitled to retain all their shares as well as the initial $1,500-per-share payment.

When the executors continued to resist, the estate's attorney suggested to Bill that "a reverse stock split could be used to bypass the … [executors] and achieve the same result as a purchase." The Hazelett board acted on this suggestion by unanimously approving a reverse split in which "every outstanding share would become a 1/400 fractional interest," leaving the estate with only a fraction of a share. This fraction would be redeemed "promptly following the corporation's receipt of a stock valuation study." A limited partnership formed by Bill to hold his shares voted to approve the reverse split at a stockholder meeting held in November 2005.

Next, the board retained Sheldrick, McGehee & Kohler to determine the value of the estate's fraction of a share. SMK ultimately opined that each 1/400 fractional interest was worth $1,595 and, accordingly, the board approved an aggregate cash payment of about $558,300 in payment for the estate's fractional interest.

Dissatisfied with this valuation, Reis brought suit in the Chancery Court, arguing that the reverse split

- Constituted a breach of fiduciary duty by the control stockholder and the board.
- Was effected in violation of Section 155(2) of the Delaware General Corporation Law.

The defendants moved for summary judgment on the fiduciary duty claim, "arguing that their actions were protected by the business judgment rule" and that Reis "should be relegated to a statutory claim for 'fair value' under Section 155(2)."

Vice Chancellor J. Travis Laster denied this motion and, following a hearing, awarded damages to the estate based on its own valuation of the company.

THE COURT'S ANALYSIS

Reverse stock splits are authorized by Sections 242 and 155 of the DGCL, with Section 155(2) providing that a corporation engaging in a reverse stock split may, in lieu of issuing fractions, "pay in cash the fair value of fractions of a share as of the time when those entitled to receive such fractions are determined."

Although the term "fair value" also appears in DGCL Section 262 (the appraisal statute governing the treatment of dissenting shares in mergers), the court did not find this statute to be analogous from a procedural perspective because Section 155(2) "does not contain anything remotely similar to the mechanisms" found in the appraisal statute. Rather, under Section 155(2), "[r]esponsibility for determining fair value is allocated to the corporation," a determination that ultimately "rests with the board."[2]

Moreover, whereas the only relief available in a DGCL Section 262 appraisal action "is a judgment against the surviving corporation for the fair value of the dissenters' shares," an action challenging a board action such as a reverse stock split "affords an expansive remedy and is brought against the alleged wrongdoers to provide whatever relief the facts of a particular case may require."

EVALUATING DIRECTOR DECISIONS

The court next explained that when "evaluating director decision-making," a court must choose among Delaware's three tiers of review: "the business judgment rule, enhanced scrutiny, and entire fairness." Because the court viewed the Hazelett reverse stock split as "an end-stage transaction for those stockholders being cashed out of the enterprise," the business judgment rule was not applicable.

Moreover, because the other four directors were "beholden to" Bill and the transaction was, in effect, "the 'functional equivalent' of a cash-out merger" led by a control stockholder "to freeze out minority stockholders without

any procedural protections," the court applied an entire-fairness review.[3]

The court put the burden of proving entire fairness on "the defendant fiduciaries" because neither of the available "procedural protections" — formation of a "duly empowered and properly functioning special committee" or a "majority-of-the-minority [stockholder] vote" — was employed to shift the burden of proof to plaintiffs.

The court also noted that if *both* of these protective devices had been used, the transaction would have received the benefit of the business judgment rule.[4]

TWO-PRONGED ANALYSIS

To analyze the two prongs of an entire fairness review, *fair dealing* and *fair price*, the court turned to the facts before it:

- As to *fair dealing*, the court found "no dealing in this case that could be called 'fair.'" Indeed, the court noted, "[p]rocedural protections were not implemented, and no one bargained for the minority." When Reis demurred from the price offered to the estate, the *estate's* own counsel suggested that the company "bypass" Reis, and the board took up this strategy. Moreover, to further their agenda, Bill and David made "threats to the effect that the minority would never receive any dividends, that Hazelett … would never pay a higher price and that the Hazelett family would never sell its shares." In the court's view, "[t]hreats of this nature by a controller are evidence of unfairness."
- As to *fair price*, the court found that Hazelett "did not make any effort to determine the 'fair value' of the fractional interest." For this purpose, the court explained, "[t]he value of a corporation is not a point on a line but a range of reasonable values." The remedy, moreover, "is not necessarily limited to the difference between the price offered and the 'true' value as determined under the appraisal proceedings," but a court has the power to award "damages designed to eliminate the possibility of profit flowing to defendants from the breach of the fiduciary relationship." In this connection, a court can consider "[f]actors such as coercion, overreaching, the misuse of confidential information, or secret conflicts … to award a monetary remedy in an entire-fairness action that differs from what appraisal would generate."

In this case, however, the court did not believe that the facts called for "a remedy other than an award of fair value" because "the defendants did not set out to extract value rapaciously from the minority, nor did they freeze out the minority to capture the value of opportunities that the corporation was on the verge of achieving."

In short, this was a case "where the fair-price analysis and remedial determination coincide," resulting in "the same essential inquiry as in an appraisal, albeit with more leeway to consider fairness as a range and to consider the remedial objectives of equity."

Ultimately, the court preferred the methodology used by the plaintiffs' experts, while factoring in its "concern that the company's earnings have been depressed because the owners have taken their returns in the form of compensation and equipment lease payments," to arrive at a valuation more than *double* the amount paid in the reverse stock split.

CONCLUSION

The *Reis* decision is noteworthy for its application to a reverse stock split of principles generally used in selecting the appropriate judicial standard of review and assigning the burden of proof in minority buyout transactions. Moreover, Vice Chancellor Laster reiterated his approach developed last year in *CNX Gas* that a minority buyout may be entitled to the benefits of a more deferential business judgment analysis if *both* of the recognized procedural protections — formation of a special board committee *and* a majority-of-the-minority vote stockholder vote — are utilized.[5]

While we await Delaware Supreme Court affirmation of this approach, dealmakers have several alternatives to consider in structuring minority buyouts, whether effected via a merger or a reverse stock split. WJ

NOTES

[1] No. 3552-VCL, 2011 WL 303207 (Del. Ch. Jan. 21, 2011).

[2] In contrast, DGCL Section 262 "allocates the task of determining 'fair value' [in an appraisal proceeding] to the Court of Chancery." In a Section 262 appraisal, which is available to stockholders dissenting from a merger but not to those challenging a reverse stock split, "both sides have the burden of proving their respective valuation positions by a preponderance of evidence" and, if "both sides fail," the court "must make its own valuation determination."

[3] The court also indicated that if a "disinterested and independent" board had made the decision to conduct the reverse stock split rather than a board controlled by Bill, a less intrusive "enhanced scrutiny" of the reasonableness of the transaction would have been appropriate.

[4] Vice Chancellor Laster first discussed this approach to reviewing minority buyout transactions in *In re CNX Gas Corp. Shareholders Litigation*, 4 A.3d 397 (Del. Ch. 2010). For a discussion of the CNX Gas decision, please see our Client Alert titled, "Delaware Vice Chancellor Applies 'Unified Standard' in Reviewing Minority Freeze-Out By Controlling Stockholder," from June 22, 2010.

[5] CNX Gas, 4 A.3d 397.

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High court's *Siracusano* decision reaffirms materiality depends on context of what defendant says

By Erik J. Olson, Esq., Stephen Thau, Esq., and Stefan J. Szpajda, Esq.
Morrison & Foerster

The U.S. Supreme Court decided *Matrixx Initiatives Inc. v. Siracusano*, No. 09-1156, 2011 WL 977060, March 22. The court concluded unanimously that "the materiality of adverse event reports cannot be reduced to a bright-line rule." (Slip Op. at 1-2.)

BACK TO *BASIC*

To evaluate materiality, the Supreme Court returned to the rule previously announced in *Basic v. Levinson*, 485 U.S. 224 (1988). "In *Basic*, we held that this materiality requirement is satisfied when there is 'a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." (Slip Op. at 9-10) (quoting *Basic*, 485 U.S. at 231-32.) Thus, materiality will depend on the context in which a statement was made. This includes an evaluation of the connection between the company's actual statement and the quality and nature of the information about adverse events that is omitted.

The court did not adopt the rule proposed by the defendants, which would have required that plaintiffs demonstrate that the omitted adverse events showed a statistically significant connection to a drug or medical device in order to state a claim. While the degree of statistical significance continues to be relevant to the analysis, this factor alone is not determinative, and courts can evaluate statistical significance and many other factors to determine whether omitted information causes a company's statement to be materially misleading within the meaning of the securities laws.

NOT ABOUT SILENCE

At the same time, the Supreme Court issued a strong reminder that securities fraud is about speech, not silence. The court wrote:

> Moreover, it bears emphasis that Section 10(b) and Rule 10b-5 do not create an affirmative duty to disclose any and all material information. Disclosure is required under these provisions only when necessary 'to make … statements made, in the light of the circumstances under which they were made, not misleading. 17 C.F.R. § 240.10b-5(b); *see also Basic*, 485 U.S. at 239, n. 17 ("Silence, absent a duty to disclose, is not misleading under Rule 10b-5"). Even with respect to information that a reasonable investor might consider material, companies can control what they have to disclose under these provisions by controlling what they say to the market. [Slip Op. at 16]

> The court concluded unanimously that "the materiality of adverse-event reports cannot be reduced to a bright-line rule."

THE TOTAL MIX

Consistent with this position, the Supreme Court also emphasized that information on adverse events did not need to be routinely disclosed.

"Application of *Basic*'s 'total mix' standard does not mean that pharmaceutical manufacturers must disclose all reports of adverse events." (Slip Op. at 15) "[T]he mere existence of reports of adverse events — which says nothing in and of itself about whether the drug is causing the adverse events — will not satisfy this standard. Something more is needed, but that something more is not limited to statistical significance, and can come from 'the source, content and context of the reports.'" (Slip Op. at 16).

The determination whether to provide information on adverse events must be decided in context. Statistical significance will be one factor, but not the only factor, that must be considered when making the judgment.

After a discussion of the legal principles summarized above, the court conducted its own evaluation of the context of Matrixx Initiatives' statements and omissions. The court looked in detail at the facts asserted about the alleged connection between the use of Zicam and loss of patients' sense of smell (anosmia), which was the side effect at issue in the case. In light of the scientific evidence, the scope of the company's own research, the importance of Zicam to the company, and the timing and content of the company's statements, the court concluded that omitted information on reported cases of anosmia following use of Zicam were material in light of Matrixx Initiatives' public statements, particularly its statements that public reports that Zicam caused anosmia were "completely unfounded and misleading" and that "the safety and efficacy of [Zicam] … have been well established." (*See* Slip Op. at 17-19). The court went on to conclude that the facts alleged in the complaint were sufficient to satisfy the pleading requirements for demonstrating *scienter* in the present case.

LESSONS LEARNED

Life sciences companies and other public companies can learn at least two lessons from the decision.

First and foremost, be careful what you say. As the court emphasized, the securities laws focus on false or misleading speech. "[Companies can control what they have to disclose under these provisions by controlling what they say to the market." (Slip Op. at 16). Rash or categorical comments are far more likely to form the basis of a lawsuit than measured, careful statements about the facts.

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Rash or categorical comments are far more likely to form the basis for a lawsuit than measured, careful statements about the facts.

Second, life sciences companies should consult carefully with lawyers regarding specific disclosures and policies and practices for disclosing adverse events. The strategy for each company will differ based on the products they produce, the status of Food and Drug Administration approval, the type and number of adverse event reports, whether the adverse events were statistically significant, and a variety of other factors.

Companies are certain to receive an ongoing stream of adverse events reports from clinical trials or public use.

Identifying in advance a strategy for when and how information about those adverse events might be disclosed is likely to help prevent future lawsuits. Moreover, adherence to such a strategy may both prevent future lawsuits and assist in their defense should they arise. WJ

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Case against Cadant directors cut off too soon, 7th Circuit says

A new trial is the only remedy after a judge prematurely let Cadant Inc. directors off the hook for self-interested financing deals that led to the tech firm provider's bankruptcy, according to a federal appeals court in Chicago applying Delaware law.

CDX Liquidating Trust v. Venrock Associates et al., No. 10-1953, 2011 WL 1125815 (7th Cir. Mar. 29, 2011).

Renowned jurist Richard Posner, writing for a panel of the 7th U.S. Circuit Court of Appeals, said the trial judge who granted judgment to the defendants after the plaintiff shareholders presented their case should have waited for the jury to decide whether the directors breached their duty.

Judge Posner reversed the dismissal after finding the deals the directors made with two venture capital groups would not pass Delaware's exacting "entire fairness" test, but said that since the directors won judgment as a matter of law, the trial has to start over again with a new judge.

Since the directors of Cadant personally benefited from bridge loans they arranged with the venture capitalists, they should have been required to prove that both the price and the negotiation of those loans were entirely fair to the shareholders, Judge Posner held.

REUTERS/Sue Ogrocki

"There's enough proof that the alleged misconduct caused loss to Cadant's shareholders to make the issue of causation one for the jury no matter which side has the burden of proof," Judge Richard Posner wrote.

BRIDGE LOAN TO NOWHERE

Cadant, which is incorporated in Delaware, was created in 1998 to develop systems to enable high-speed Internet access for home computers. It ran into financial problems as the dot-com bubble began to deflate after the turn of the century and investors no longer flocked to software and Internet firms.

Venture capital groups Venrock Associates and JPMorgan Chase & Co. supplied financing in the form of a bridge loan and became preferred shareholders.

When Cadant defaulted on a second bridge loan, it sold all its assets to Arris Group in 2002, but the Arris stock it received in return was not worth enough to repay the loan, and Cadant filed for bankruptcy protection.

A suit by the trustee for the bankruptcy estate charged that the Cadant directors disloyally agreed to structure the loans in a way that ensured Venrock and JPMorgan would do much better than the common shareholders.

However, after trustee presented the case for seven weeks in the U.S. District Court for the Northern District of Illinois, the judge granted the defendants' motion for judgment as a matter of law because the plaintiff had not proven its case.

WHICH STANDARD?

On appeal, the plaintiff argued the trial court gave the defendant directors the benefit of the doubt under the business judgment rule, a deferential standard that would have been appropriate only if there was no proof that they personally benefited from the challenged transaction and breached a duty of loyalty to the company.

Judge Posner agreed but noted that judgment for the defendants was premature no matter which standard was used.

"Actually there's enough proof that the alleged misconduct caused loss to Cadant's shareholders to make the issue of causation one for the jury no matter which side has the burden of proof," he wrote on behalf of Judges Joel Flaum and Diane Sykes.

He said there was evidence that a company similar to Cadant was sold at about the same time for more than four times as much as Cadant, which indicates that at least some of the Cadant directors breached their duty by not seeking the best price for the company.

This was especially so for the Cadant directors who were also directors of Venrock, which, as a preferred shareholder, was in effect a lender to Cadant. It was not enough that the directors disclosed their dual roles to the shareholders, the panel said.

"[The directors] persuaded the District Court judge that disclosure of a conflict excuses a breach of fiduciary duty. It does not," Judge Posner wrote. "To have a conflict and to be motivated by it to breach a duty of loyalty are two different things — the first a factor increasing the likelihood of a wrong, the second the wrong itself."

Finally, the judge found that Venrock and JPMorgan were also dismissed prematurely. He said a jury should decide whether they aided and abetted a breach of fiduciary duty.

"We note the questionable wisdom of granting a motion for judgment of law seven weeks into a trial that was about to end because the defendants declared that they were not going to put in a defense case," the opinion says. "Reserving decision on the motion [for judgment] might have avoided a great waste of time, money and judicial resources, as the case must now be retried from the beginning." **WJ**

Attorneys:
Plaintiff: James McGurk, Chicago

Defendants: Thomas Kuhns, Kirkland & Ellis, Chicago

Related Court Document:
Opinion: 2011 WL 1125815

See Document Section A (P. 21) for the opinion.

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Supreme Court

CONTINUED FROM PAGE 1

According to the suit, Matrixx and its top executives knew as early as 1999 of adverse event reports linking the use of Zicam to anosmia, or loss of the sense of smell.

Matrixx and pharmaceutical industry advocates had argued that no duty to disclose the AERs existed because they were not "statistically significant."

> Matrixx had argued it had no duty to disclose that adverse event reports existed because they were not "statistically significant."

But in an opinion written by Justice Sonia Sotomayor, the high court determined that a lack of statistical significance is not necessarily a good reason to withhold otherwise relevant information.

The court said a reasonable investor considers the "total mix" of available information and that the significance of the information depends on its context.

In this case, the context included an allegation that Zicam accounted for 70 percent of Matrixx's sales, the court noted.

"The complaint alleges facts suggesting a significant risk to the commercial viability of Matrixx's leading product," the court said.

The 2004 class-action complaint alleged Zicam's active ingredient, zinc gluconate, could cause anosmia when administered with a nasal spray or gel swab.

The company nevertheless hid the risk and issued a series of public statements between October 2003 and February 2004 touting Zicam's success, the suit said.

A television show reported the risk Feb. 6, 2004, and Matrixx's share price fell nearly 25 percent that day, according to the complaint.

The defendants allegedly violated the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5.

U.S. District Judge Mary Murguia of the District of Arizona dismissed the suit in 2005, ruling that the shareholder plaintiffs failed to establish two key elements of a securities fraud case. *Siracusano v. Matrixx Initiatives*, 2005 WL 3970117 (D. Ariz. 2005).

They failed to show the allegedly false statements were "material" and that the defendants had "*scienter*," or an intent to deceive investors, she said.

Specifically, the judge found that "12 user complaints [were] not statistically significant" and that the defendants' failure to mention them was not a "material omission" from their public statements.

The judge also found the facts insufficient to establish *scienter* because the defendants did not know there was a statistically significant link between Zicam and anosmia.

The 9th Circuit reversed and reinstated the lawsuit.

The panel rejected the "statistical significance" test, ruling that a "reasonable shareholder" would have considered the user complaints to be important information.

The court also found sufficient evidence of *scienter*, noting Matrixx failed to disclose its involvement it an anosmia-related lawsuit during the class period.

The high court sent the case back to the District Court for further proceedings. WJ

Related Court Document:
Opinion: 2011 WL 977060

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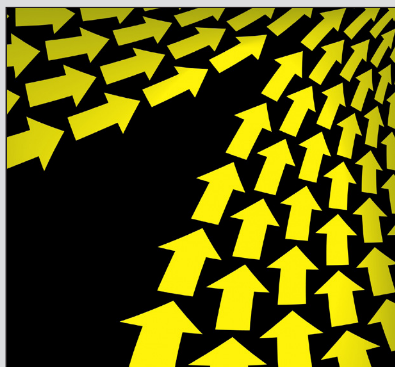

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Suit fails to meet tough *Caremark* pleading standard

Shareholders of Huron Consulting Group picked the toughest task in corporate litigation and failed, according to a federal judge in Chicago who threw out a suit that claimed Huron's massive accounting fraud happened because the directors were asleep at the switch.

Oakland County Employees' Retirement System et al. v. Massaro et al., No. 09 C 6284, 2011 WL 1103779 (N.D. Ill. Mar. 22, 2011).

In dismissing charges of securities fraud, waste of assets and breach of duty with prejudice, U.S. District Judge Elaine Bucklo of the Northern District of Illinois said the plaintiffs did not come close to showing that Huron had to restate four years of its financials because the directors completely failed to supervise the company.

After amending their complaint twice, the plaintiffs had no hope of meeting the tough pleading standards set in the Delaware Chancery Court's seminal *Caremark* decision, which requires proof of "an utter failure to oversee the corporation," Judge Bucklo said. *In re Caremark Int'l Derivative Litig.,* 698 A 2d 959 (Del. Ch. 1996).

THE CAREMARK STANDARD

The *Caremark* decision set a high standard of proof that most courts employ in any case where shareholders allege that they were injured because the directors failed to stop wrongdoing.

Huron, like most of the nation's companies, is chartered in Delaware, where directors have the right to review any suit brought in the name of the company, as was the case here.

To survive a motion to dismiss, a derivative plaintiff must show that the board lacked the independence or objectivity to give the charges a fair review.

That task is particularly difficult where, as here, the plaintiff charges that the shareholders were injured not because of some action, but because of the alleged *inaction* of directors who breached their duty to supervise the company and stop misconduct by officers.

A BLIND EYE?

The plaintiff, the Oakland County Employees' Retirement System, alleged that Huron's directors turned a blind eye to an alleged accounting fraud that inflated earnings from 2006 through 2009.

In 2009 the company was forced to restate its financials for all four years, and the stock price plummeted when investors learned the truth about its fiscal health, the suit said.

The Huron directors asked the court to dismiss the suit because the plaintiff did not give them an opportunity to review the charges and did not show that the majority of the board members were incapable of giving the claims a fair hearing.

The plaintiff argued that the board was not able to objectively review the charges because the crux of the suit was the directors' alleged "sustained and systematic failure to exercise oversight."

A HIGH BURDEN

Judge Bucklo noted that "the plaintiffs' burden is particularly high in this case because … their *Caremark* claim presents possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."

The *Caremark* standard "requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care," she said.

The allegations here fall far short of that standard, the judge ruled, because although they allege a systematic failure to exercise oversight, they cite "only a singular accounting impropriety at the heart of their claims."

WHAT'S A RED FLAG?

In addition, the plaintiff alleges that the directors ignored numerous red flags that warned of an accounting fraud, but this argument "reveals a fundamental misunderstanding as to what constitutes a 'red flag,'" the judge wrote.

The problems the directors allegedly overlooked were more like differences over accounting methods than genuine red-flag warnings of accounting fraud, Judge Bucklo held.

The *Caremark* standard "requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care," the judge said.

"Plaintiffs' allegations that the director defendants failed to detect the company's improper accounting simply do not create a substantial likelihood of personal liability under *Caremark*," she said in dismissing the second amended complaint with prejudice.

Attorneys:
Plaintiff: Adam Levitt, Wolf, Haldenstein, Adler, Freeman & Herz, Chicago

Defendants: Francis Barron, Cravath, Swaine & Moore, New York

Related Court Document:
Opinion: 2011 WL 1103799

See Document Section B (P. 30) for the opinion.

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PRE-SUIT DEMAND

Dillard's directors weren't puppets of controlling family, Arkansas court says

Applying Delaware law, an Arkansas appeals court has refused to revive a Dillard's Inc. shareholder's suit that claimed the directors wrongly rubber-stamped exorbitant compensation for top officers from the department store chain's controlling family.

***Berry v. Dillard et al.*, No. 10-620, 2011 WL 1144697 (Ark. Ct. App. Mar. 30, 2011).**

The Court of Appeals affirmed that the shareholder failed a key procedural test because he did not show that a majority of the directors were so beholden to the Dillard family that they could not give the charges an objective review.

Although it is based in Little Rock, Ark., the venerable Dillard's is incorporated in Delaware, so the Arkansas courts applied the First State's "pre-suit demand" test, which is required for shareholder suits brought on behalf of the company.

> The plaintiff shareholder failed to show that a majority of the directors were so beholden to the Dillard family that they could not give the charges an objective review.

That requirement gives a company's board of directors, as the managers of the company, the right to review such derivative actions and either join in as a plaintiff or seek to have the action dismissed in the best interests of the company.

A shareholder who fails to comply with that requirement must survive a motion to dismiss by showing that the board lacked the independence or objectivity to give the charges an unbiased review.

Plaintiff Billy Berry says the Dillard's directors breached their duty by granting lavish compensation to various top officers despite the company's fiscal problems.

However, the Pulaski County Circuit Court dismissed the suit because Berry failed to show why he should be excused from making a pre-suit demand.

On appeal, Berry claimed he had demonstrated that a majority of the board members were "interested" in the challenged compensation transactions because they had financial ties to the company or the Dillard family.

The appellate panel said the trial court was wrong in finding that director James Freeman was independent even though his entire earnings came from his job as CFO of Dillard's.

But in order to prove that a majority of the board members lacked independence, Berry had to also prove that at least one director was beholden to the Dillard family, Judge Doug Martin wrote for the panel.

While it was true that director Warren Stephens stood on both sides of the compensation transactions and benefited by contracts that Dillard's awarded to a firm he controlled, that is not enough under Delaware law to show that a director lacks independence, the panel said.

"There are no allegations that Stephens, a member of the board's compensation committee, directed the other two members of the committee," Judge Martin wrote. "The complaint also contains no allegations that the transactions between Dillard's and the Stephens entities were not in the best interests of Dillard's."

Berry sought to amend his complaint to cure its defects, but the panel said it was too late because he had already made the choice to appeal, and therefore the suit was rightly dismissed with prejudice. WJ

Related Court Document:
Opinion: 2011 WL 1144697

WESTLAW JOURNAL

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BREACH OF DUTY

Walgreens merger is bad medicine for Drugstore.com, investors say

Walgreens' "hopelessly flawed" offer of $409 million to acquire Drugstore.com is the wrong prescription for the online pharmacy's investors, according to shareholder suits filed in state courts in Washington and Delaware.

Hurlin v. Drugstore.com Inc. et al., No. 11-2-11261, complaint filed (Wash. Super. Ct., King County Mar. 25, 2011).

Halberstam et al. v. Drugstore.com Inc. et al., No. 6328, complaint filed (Del. Ch. Mar. 30, 2011).

Both suits claim that Drugstore.com's directors disloyally agreed to the opportunistic offer at a time when the company's stock price was temporarily depressed.

While the $3.80-per-share offer is double the stock price at the low point it hit the day before the March 24 merger announcement, it drastically undervalues the company's vast potential for future profits, the suits say.

Drugstore.com is based in Bellevue, Wash., but is incorporated in Delaware, giving shareholders the right to sue in either state.

Investor Adrienne Halberstam's class action in the Delaware Chancery Court claims the bid for Drugstore.com is "grossly inadequate" and is really worth only $3 a share when various accounting adjustments are factored in.

For instance, Walgreens will get more than $80 million in tax benefits and net operating loss adjustments as a result of acquiring Drugstore.com, the suit contends.

Halberstam says the directors compounded their breach of duty by agreeing to a plethora of deal-protection devices that will discourage competing bidders.

Shareholder Nicholas Hurlin makes similar claims in his suit in Washington's King County Superior Court.

He says the board breached its duty by agreeing to:

- A no-solicitation clause that prevents Drugstore.com from providing any company information to competing bidders except in extremely limited circumstances.
- A matching-rights provision that lets Walgreens equal or top any competing bid.
- A $15 million termination fee that any successful suitor would owe to Walgreens.

Both suits also allege that the directors breached their duty to disclose all information that would enable investors to decide whether to sell their shares at the price offered.

Both suits claim that Drugstore.com's directors disloyally agreed to Walgreens' opportunistic offer at a time when the company's stock price was temporarily depressed.

The plaintiffs ask the courts to enjoin or rescind the acquisition, find that the directors breached their duty to the class members, and award appropriate damages.

The heads of both companies defended the merger as a win for all shareholders.

"We believe the acquisition of Drugstore.com by Walgreens is a great fit for all of our constituencies," Drugstore.com CEO Dawn Lepore said when announcing the deal March 24. "Drugstore.com benefits from this transaction by joining the largest and most trusted drugstore chain in the U.S."

Walgreens President and CEO Greg Wasson praised the deal in the same announcement.

"Our acquisition of Drugstore.com today significantly accelerates our online strategy to leverage the best community store network in America by becoming the most convenient choice for health and daily living needs whether customers shop online or in our stores," he said. WJ

Attorneys:
Plaintiff (Hurlin): Steve Berman, Jeniphr Breckenridge and Karl P. Barth, Hagens Berman Sobol Shapiro, Seattle

Plaintiff (Halberstam): Ryan M. Ernst, Cross & Simon, Wilmington, Del.

Related Court Documents:
Complaint (Hurlin): 2011 WL 1097224
Complaint (Halberstam): 2011 WL 1213009

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Ex-HP CEO asks court to stay order to unseal letter that led to his ouster

Former Hewlett-Packard chief Mark Hurd has vowed to appeal a court order to unseal a letter about his purported sexual relationship with a company contractor the led to his ouster and has asked a Delaware court judge to stay that ruling in the meantime.

Espinoza v. Hewlett-Packard Co., No. 6000, letter to court filed (Del. Ch. Mar. 23, 2011).

Hurd said he will ask the state Supreme Court to overturn Vice Chancellor Donald Parsons' March 17 decision that an HP shareholder could examine the letter along with other documents to confirm his suspicion that the directors should have fired Hurd instead of giving him a $28 million "going-away present."

Hurd and contractor Jodie Fisher contend that the letter to Hurd, in which Fisher's lawyer requests a settlement of possible sexual harassment charges against him, was confidential and did not become part of HP's corporate documents just because it was brought to the directors.

CONFIDENTIAL?

Vice Chancellor Parsons' 71-page ruling found that not just HP shareholders but the general public had a right to see all court documents unless the parties would be injured by the revelation of sensitive information. *Espinoza v. Hewlett-Packard Co.*, 2011 WL 941464 (Del. Ch. Mar. 17, 2011).

Hurd wrote a March 23 letter to the court concerning two motions that he filed under seal. One asked the judge to stay his ruling, and the other asked for permission to file an immediate appeal of the March 16 decision.

Hurd intervened in a records inspection action filed by investor Ernesto Espinoza, who claims that the Fisher letter, along with HP internal investigative reports and board meeting minutes, will show that the directors wasted company resources by handing Hurd the severance package.

Espinoza's complaint charges that HP has denied him his right as a shareholder of a Delaware-chartered corporation to inspect the company's books and records to confirm suspicions of wrongdoing by officers and directors.

'GOING-AWAY PRESENT'

Hurd left HP last August 2010 after the computer maker conducted an internal investigation of Fisher's allegations. The company found no evidence of harassment but said Hurd abused his expense account and exercised poor judgment in hiding the alleged affair, the suit says.

After the board determined that Hurd should step down, it gave him $12 million in cash and $16 million in stock options. He left and immediately signed on as the co-president of Oracle Corp.

In this case, the legal battle shifted to the revelation of the Fisher letter, with Fisher and Hurd contending that it was always designated as

Former Hewlett-Packard chief Mark Hurd REUTERS/Robert Galbraith

confidential, and Espinoza arguing that it was fair game as soon as it became the basis for Hurd's resignation and severance package.

HP originally agreed to keep the letter confidential at Hurd's request but later said there was no reason to keep it under wraps.

The company has taken no position on the judge's decision.

REASON TO SEAL

In his opinion, Vice Chancellor Parsons said the fact that a document may contain information that is embarrassing to a party is not enough reason to seal it.

"Indeed, if trial courts permit the sealing of disputed documents simply because one of the parties takes an unreasonably broad view of what is confidential, the court risks injuring the public's right of access," the judge wrote.

Vice Chancellor Parsons heard argument March 25 on Hurd's request for permission to immediately appeal the ruling to the state Supreme Court and for a stay order during the appeal. Otherwise, Hurd said, the Fisher letter would become public March 31.

In an order issued March 28, the judge cleared the way for Hurd to get a stay while he appeals the March 17 decision.

In a related order issued the same day, he turned down Espinoza's request for access to a confidential report that a law firm prepared for HP after investigating whether Hurd had violated the company's sexual harassment policy. WJ

Attorneys:
Plaintiff: Norman Monhait, Rosenthal, Monhait & Goddess, Wilmington, Del.

Defendant: Packard: Peter Walsh Jr., Potter Anderson & Corroon, Wilmington

Intervener: Rolin Bissell, Young Conaway Stargatt & Taylor, Wilmington

Related Court Document:
March 17 opinion: 2011 WL 941464

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Shareholder can access info on why Morgan Stanley board refused to sue

A Morgan Stanley & Co. stockholder can review the reasons why the company's directors refused to join the investor's derivative lawsuit over Morgan Stanley's venture into exotic auction-rate securities, a Delaware state court judge has ruled.

Louisiana Municipal Police Employees Retirement System v. Morgan Stanley & Co. Inc., No. 5682, 2011 WL 773316 (Del. Ch. Mar. 4, 2011).

The plaintiff pension fund hopes to use the information it gets in its Delaware Chancery Court books-and-records action to clear a key procedural hurdle in its related derivative suit in New York federal court.

In order to pass that test, shareholders who sue on behalf of the company must either give their directors the opportunity to review the suit's charges or show that the board members lack the objectivity to judge the claims fairly.

REUTERS/Mike Segar

The court limited the information the plaintiffs can inspect to:

- The minutes of board or committee meetings where the litigation demand was discussed.
- The report and presentation of the audit committee's law firm on its recommendation regarding the demand.
- The audit committee's report and presentation to the board on the demand issue.
- Any documents on which the board relied in making its decision on the demand request.
- The report by a law firm hired to look into the alleged wrongdoing that was the subject of the New York derivative action.

THE REASON FOR REJECTION

In the Delaware action, the Louisiana Municipal Police Employees Retirement System said it is entitled to find out why Morgan Stanley's directors rejected the pension fund's demand that the firm join in as a plaintiff in its New York suit against the officers and directors.

Shareholders of Delaware-chartered companies such as Morgan Stanley have the right to inspect the company's books and records if they can show they have a valid purpose such as confirming suspicion of misconduct.

The pension fund said in this action that it needed to access the records to find out if the financial services company's board whitewashed the fund's charges that officers and directors engaged in reckless trading in auction-rate securities from 2006 to 2008 at the expense of investors.

An ARS is a bond or preferred stock that pays interest at rates set at auctions, typically held every seven to 35 days, allowing holders to redeem them for cash much sooner than their long-term maturity dates.

However, the market for those securities collapsed in 2008, helping trigger the Wall Street meltdown.

THE NEW YORK ACTION

The Delaware suit arises from a ruling in the retirement fund's 2008 shareholder derivative lawsuit filed in the U.S. District Court for the Southern District of New York against the Morgan Stanley directors. *La. Mun. Police Employees Ret. Sys. v. Mack et al.*, No. 08-7587 (S.D.N.Y. Aug. 27, 2008).

U.S. District Judge Alvin K. Hellerstein dismissed the complaint in that case in June 2009 because the fund did not show it would have been futile to make a pre-suit demand on the Morgan Stanley board.

The pension fund later made the demand, and the board of directors rejected it.

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Now the retirement fund is asking the Chancery Court to permit it to inspect all the books and records relevant to board meetings and discussions that would disclose the board's reasoning for denying the litigation demand in the New York action.

REASONS REJECTED

Vice Chancellor J. Travis Laster found that "exploring whether a litigation demand was wrongfully refused is a proper purpose" for a records inspection action.

However, Morgan Stanley argued that by making a demand, the plaintiffs conceded the board's independence and disinterestedness and thus had no basis for questioning the demand refusal.

But the court rejected that reasoning because "the Delaware Supreme Court has held that a stockholder who makes a demand does not concede the independence or disinterestedness of the board for purposes of demand refusal (as opposed to demand futility)."

THE ROLE OF EMPATHY

The issue of whether a corporation should sue its directors and senior officers "puts directors in a difficult position where they are subject to potentially subtle influences and pressures," the vice chancellor wrote. "The question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role."

Since the standard for reviewing a demand-refusal decision is highly deferential, "it is critical that an accountability mechanism exist in the form of a limited right to information" in a records-inspection action, to balance out that deference, the court explained.

PROCESS IS NOT ENOUGH

It is not enough that the Morgan Stanley board's demand refusal letter outlined the process used to review and reject the demand, the court said.

"A self-serving letter describing process sans content … would render nugatory the right to use [records inspection] to investigate demand refusal," the vice chancellor wrote in allowing access to all reports and board minutes related to the decision to refuse the demand.

However, the pension fund has not stated sufficient reason to examine all the materials that the company's law firm considered for its report on the wrongdoing alleged in the derivative action, the court said. WJ

Attorneys:
Plaintiff: Robert D. Goldberg, Biggs & Battaglia, Wilmington, Del.

Defendant: Raymond DiCamillo, Richards, Layton & Finger, Wilmington

Related Court Document:
Opinion: 2011 WL 773316

NEWS IN BRIEF

SUIT SAYS STOCK SWAP CHEATS OPTIONSXPRESS HOLDERS

The directors of optionsXpress Holdings Inc. breached their duty to shareholders by selling the company too cheaply to Charles Schwab Corp., according to a suit filed in Delaware state court. The directors allegedly employed an unfair process that produced a stock-swap merger in which Xpress holders will get 1.02 shares of Schwab for each of their shares. The proposed value of Xpress ($1 billion) is far too low, the suit says. Plaintiff Loy Oakes is asking the court to force directors Ned Bennett, Howard Draft, Bruce Evans, David Fisher, Steven Fradkin, James Gray, Michael Soenen and S. Scott Wald to seek a fair price for the company. Oakes seeks a preliminary injunction halting the deal and an order invalidating the deal-protection provisions, which include a $42 million termination fee.

Oakes v. Bennett et al., No. 6314, complaint filed (Del. Ch. Mar. 25, 2011).

WALGREEN–DRUGSTORE.COM MERGER CHALLENGED

Jeffrey Grodko's class action charges the directors of Drugstore.com Inc. with disloyally agreeing to a "hopelessly flawed" merger with rival Walgreen Co. that produced the "grossly inadequate" compensation of $3 per share after accounting adjustments. The board further breached its duty by agreeing to a plethora of deal-protection provisions, such as a termination fee, no-solicitation clause and "last look" option, the suit says. The plaintiff asks the court to enjoin or rescind the transaction and force the individual defendants to account to the class for the damage the deal would cause. The suit says directors Dawn Lepore, Richard Bennett III, Geoffrey Entress, Jeffrey Killeen, William Savoy and Gregory Stanger failed to get the best possible price for the company.

Grodko v. Drugstore.com, No. 6315, complaint filed (Del. Ch. Mar. 25, 2011).

ANIMAL HEALTH BEING ADOPTED TOO CHEAPLY, INVESTOR SAYS

Hilary Kramer's shareholder class-action suit charges that the directors of Animal Health International breached their fiduciary duties by agreeing to a going-private buyout for the unfair price of $4.25 per share from Lextron Inc. The directors never looked for a better price and now are prohibited from doing so by a no-shop provision, one of several deal protections that the directors agreed to, the suit says. The plaintiff asks the court to enjoin the sale, invalidate the deal-protection provisions and award appropriate compensatory damages. He asks the court to hold directors James Robison, Brandon White, Michael Eisenson, Mark Rosen, David Biegler, Ronald Steinhart, Jerry Pinkerton and E. Thomas Corcoran individually responsible for any damages the shareholders may suffer.

Kramer v. Robison et al., No. 6313, complaint filed (Del. Ch. Mar. 25, 2011).

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SUBPRIME/MORTGAGE-BACKED SECURITIES

Merrill Lynch, BofA win dismissal of investor suits

A federal judge in New York has tossed two shareholder suits alleging that former executives of Merrill Lynch, prior to its merger with Bank of America, hurt the company by piling up massive debt backed by subprime mortgages.

In re Merrill Lynch & Co. Securities Derivative & ERISA Litigation, Nos. 07-9696 and 09-8259, 2011 WL 1134708 (S.D.N.Y. Mar. 28, 2011).

U.S. District Judge Jed S. Rakoff of the Southern District of New York said the plaintiffs failed to satisfy the threshold demand requirement on the BofA board of directors.

Merrill Lynch, one of several venerable Wall Street institutions that foundered in the financial crisis, merged with BofA two years ago.

The lawsuit started as a consolidation of various shareholder derivative actions against Merrill officers and directors in 2007.

In a derivative suit, a shareholder's right to sue on behalf of a company derives from the company's primary right to sue directors and officers if they fail to act in its interests.

A shareholder may sue on behalf of the company if the board of directors refuses to do so or if it is futile for the shareholder to demand a suit because the directors would in effect be agreeing to sue themselves.

Judge Rakoff dismissed the suits shortly after the January 2009 merger of BofA and Merrill. *In re Merrill Lynch & Co. Sec., Derivative & ERISA Litig.*, 597 F. Supp. 2d 427 (S.D.N.Y. 2009).

Applying Delaware corporate law, Judge Rakoff ruled the shareholder plaintiffs relinquished their standing by accepting BofA shares for their Merrill shares as part of the merger deal.

BofA shareholders Miriam Loveman, of Maryland, and N.A. Lambrecht, of Florida, revived the suits by filing separate "double derivative" complaints on behalf of BofA against the same former Merrill executives.

Loveman and Lambrecht are former Merrill Lynch shareholders who ended up with BofA shares after the merger.

A double-derivative suit by definition involves the boards of two companies. The shareholders alleged that BofA's directors breached their fiduciary duty by not suing the former Merrill Lynch directors for harming Merrill.

The defendants moved to dismiss the revived complaints, and Judge Rakoff heard argument on the motions Dec. 14.

Addressing Loveman's complaint first, the judge said she had never asked the BofA board to sue the pre-merger Merrill officers and directors.

Judge Rakoff rejected Loveman's contention that any such demand would have been futile.

> One plaintiff failed to explain why the BofA board would be incapable of performing a disinterested assessment of a demand to sue the Merrill Lynch directors for their pre-merger conduct, the judge said.

Loveman claimed that the BofA directors could not make a disinterested assessment of a demand because they purportedly faced a likelihood of liability for events surrounding the merger.

Judge Rakoff said most of Loveman's complaint related to pre-merger activity and that she failed to explain why the BofA board would be incapable of performing a disinterested assessment of a demand to sue the Merrill defendants for their pre-merger conduct.

In Lambrecht's case, she did make demands of the BofA board to sue but said the board wrongfully refused her requests.

Judge Rakoff said a board's decision to reject a demand is entitled to the benefit of the business judgment rule.

The rule presumes that a board makes a decision on an informed basis and in good faith that the action taken was in the best interests of the company.

Lambrecht's contention that the BofA board acted in bad faith and undertook no investigation of her claims is conclusory and insufficient to overcome the business judgment rule, the judge said. WJ

Related Court Document:
Opinion: 2011 WL 1134708

WaMu execs' risky loan strategy led to billions in losses, FDIC says

Three executives of Washington Mutual Bank mismanaged its loan portfolio and caused billions of dollars in losses that led to the largest bank failure in U.S. history, the Federal Deposit Insurance Corp. says in a March 16 lawsuit.

Federal Deposit Insurance Corp. v. Killinger et al., No. 11-CV-459, complaint filed (W.D. Wash. Mar. 16, 2011).

The government is asking the U.S. District Court for the Western District of Washington to hold the executives accountable for WaMu's 2008 closing.

The FDIC says the defendants focused on short-term gains from risky residential mortgage lending while knowing that the bank could not adjust to an inevitable decline in the housing market.

The agency filed the suit in its capacity as the bank's receiver. The complaint names as defendants WaMu CEO Kerry K. Killinger, Chief Operating Officer Stephen J. Rotella and home loans president David C. Schneider.

The officers caused the bank to take on a risky lending strategy in January 2005 in order to obtain significant short-term profits that increased their personal compensation, according to the FDIC.

The agency says the defendants had earned a total of $95 million as a result of the bank's short-term gains by September 2008, when it collapsed under the weight of the plummeting subprime mortgage market.

However, the execs' lending strategy did not take WaMu's long-term safety and soundness into account, according to the government.

The FDIC says the bank made billions of dollars in risky residential mortgage loans while the housing market was doing well.

WaMu also bought loans from third-party sellers and had a portfolio holding over $100 billion in mortgages, the suit says.

The bank made many mortgage loans to borrowers in areas such as California and Florida where housing prices were high and would face an inevitable decline, the agency says.

The government says the defendants made these loans while knowing that WaMu did not have the ability to manage the risks because the bank's technology, controls and data quality were inadequate.

The defendants also knew that when the real estate market declined, many of the mortgages would go into default, the suit says.

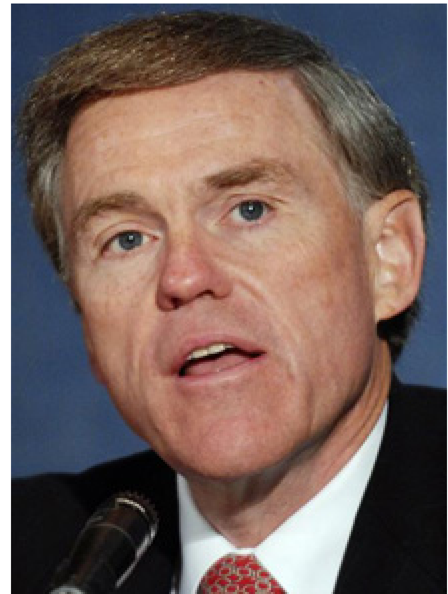
Risky business?

The FDIC says WaMu made several types of risky loans:

- Subprime mortgages to borrowers with poor credit scores
- "Option ARMs," which allowed borrowers to make low payments on adjustable-rate mortgages for a brief period of time
- Home equity lines of credit that left borrowers highly leveraged

The defendant executives compounded the problem by allegedly allowing risky lending involving:

- "Liar loans," where borrowers did not have to provide documentation of income and assets.
- Loans to people with high debt-to-income ratios.
- Mortgages for speculators and buyers of second homes who did not have a personal investment in the property.



REUTERS/Jonathan Ernst

WaMu CEO Kerry K. Killinger is named as a defendant in the suit.

Further, the executives allegedly ignored warnings from bank management about the volatile mortgage and housing markets and the institution's ability to handle the risks.

WaMu began suffering losses as the real estate market declined in 2006 and 2007 and loans went into default. It lost billions before being closed by regulators.

The FDIC says that if the executives had paid attention to risk management, the bank would have been in a better position to weather the collapse of the housing market.

WaMu's losses were the result of the defendants' negligence and breaches of fiduciary duty, the agency says.

The suit further alleges that a month before WaMu failed, Killinger and Rotella took improper actions to shield their personal assets from potential creditors.

The men moved some of their personal assets into their wives' names and created trusts to hold real estate, the suit says.

The FDIC has named the wives as co-defendants in the suit and is seeking a court order declaring that the transfers were fraudulent.

The agency is also requesting that the District Court hold Killinger, Rotella and Schneider liable for an award of unspecified damages, plus interest and costs. WJ

Related Court Document:
Complaint: 2011 WL 910099

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