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COMMENTARY

SEC's final rules implementing Dodd-Frank Act's whistle-blower bounty provisions

With the Securities and Exchange Commission's release of the final rules for the so-called "bounty" provisions for employee whistle-blowers, Steven Pearlman and Christopher Robertson of Seyfarth Shaw outline key aspects of the rules, identify the risks they present to employers and shareholders, and provide a range of steps employers can take to minimize the risk that the rules will encourage employees to bypass internal compliance programs.

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COMMENTARY

Is reverse triangular merger an assignment of target's assets 'by operation of law'?

A recent Delaware Chancery Court ruling is the first to deal with the operation of the "anti-assignment clause" that is a common condition imposed on target companies in "reverse triangular merger" contracts in the burgeoning M&A field, according to Robert Reder, David Schwartz and Alison Fraser of Milbank, Tweed, Hadley & McCloy.

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CHANCERY COURT JUDGES

Chief judge of Delaware Chancery Court to be Wilson Sonsini partner

On the day after he steps down from the vaunted Delaware Chancery Court June 17, Chancellor William Chandler III will step into the role of partner of one of the world's premier corporate defense firms, Wilson Sonsini Goodrich & Rosati.

The firm announced May 19 that the renowned chief judge had accepted the position.

"We are incredibly proud to have such an esteemed member of the judiciary join our firm,"

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Chancellor William Chandler III

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SEC's final rules implementing Dodd-Frank Act's whistle-blower bounty provisions

By Steven Pearlman, Esq., and Christopher Robertson, Esq.
Seyfarth Shaw LLP

On May 25, 2010, the Securities and Exchange Commission released its final rules implementing Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (§ 21F of the Securities Exchange Act of 1934). The rules passed on a 3-2 vote, with the two Republican SEC commissioners in the minority. These rules enable a whistle-blower to obtain a bounty where she or he voluntarily provides the SEC original information that leads to the successful enforcement of a federal court or administrative action where the SEC obtains sanctions exceeding $1 million. Bounties will range from 10 percent to 30 percent of the recovery. This commentary describes the key aspects of these rules, identifies the risks these rules present to employers and shareholders, and provides a range of steps employers may take to minimize the risk that the rules will encourage employees to bypass internal compliance programs.

> The rules enable a whistle-blower to obtain a bounty where she or he voluntarily provides the SEC original information that leads to a successful enforcement action.

ANTI-RETALIATION

The rules protect whistle-blowers against retaliation even where they are not eligible for a bounty, and companies may not hinder a whistle-blower's ability to communicate with the SEC.

The final rules also require a whistle-blower to have a *reasonable belief* that the information she or he is providing relates to a possible securities law violation (or, where applicable, to a violation of the provisions in Section 806 of the Sarbanes-Oxley Act) that has occurred, is ongoing or is about to occur. "The 'reasonable belief' standard requires that the employee hold a subjectively genuine belief that the information demonstrates a possible violation, *and* that this belief is one that a similarly situated employee might reasonably possess." Moreover, the SEC will consider the following in determining whether a whistle-blower has a reasonable belief:

- Whether the information provided to the SEC is specific, credible and timely.
- Whether it is related to a matter that is already under investigation by the SEC but significantly contributes to the investigation.
- Whether it was reported internally and then disclosed by the company (and satisfies either of the foregoing considerations).

IMPACT ON COMPLIANCE PROGRAMS

The SEC will consider whether a whistle-blower complained internally in exercising its discretion to decide on the size of any bounty exceeding 10 percent of the government's recovery. The SEC may decrease an award where a whistle-blower disrupts internal compliance mechanisms.

Also, where a whistle-blower reports original information through a company's internal compliance channels, and the company then reports the information to the SEC, and a successful enforcement action ensues, all the information the company provided to the SEC will be attributed to the whistle-blower. In addition, if a whistle-blower provides information internally to a person with legal, compliance, audit, supervisory or governance responsibilities and then submits the same information to the SEC within 120 days, the agency will consider the whistle-blower to have provided the information to the SEC as of the time he or she made an internal complaint. Thus, the whistle-blower keeps her or his "place in line" through this 120-day "grace period."

ORIGINAL INFORMATION

In order to be eligible for a bounty, whistle-blowers must provide "original information." The rules define "original information" as information derived from the independent knowledge or analysis of the whistle-blower, not already known to the SEC from any other sources, and not exclusively derived from allegations made in a judicial or administrative hearing, government report, hearing, audit or investigation, or from the news media. In addition, "original information" only includes information provided to the SEC for the first time after July 21, 2010 (the date Dodd-Frank was enacted).

INDEPENDENT KNOWLEDGE

As noted, original information must derive from a whistle-blower's "independent knowledge." The rules define "independent knowledge" as factual information in the whistle-blower's possession that is not obtained from publicly available sources (*e.g.,* corporate press releases and filings, media reports, and information on the Internet), and sources that, though not widely disseminated, are generally available to the public (*e.g.*, court filings and documents obtained through Freedom of Information Act requests). This definition does not require that a whistle-blower have direct, firsthand knowledge of potential violations. Rather, the whistle-blower may obtain her or his knowledge from observations, communications and independent analysis of publicly available information.

"Independent knowledge" does *not* include information that is:

- Subject to the attorney-client privilege or learned through legal representation, even if not privileged, unless the disclosure has been authorized.

- Secured through an engagement required under the securities laws by an independent public accountant if the information relates to a violation by the engagement client or the client's directors, officers or other employees.
- Obtained by officers, directors, trustees or partners of an entity who are informed of allegations of misconduct or who learn the information in connection with the entity's processes for identifying, reporting and addressing possible violations of the law (*e.g.*, through a help line).
- Obtained by employees whose principal duties involve compliance or internal audit responsibilities or employees of outside firms retained to perform compliance or internal audit work.
- Obtained in a manner that is determined by a domestic court to violate applicable federal or state criminal law.
- Information that is obtained from a person who is subject to the above exclusions, unless the information is not excluded from that person's use or the whistle-blower is providing information about possible violations involving that person.

There are broad exceptions to the foregoing limitations. In certain circumstances, compliance and internal audit personnel, as well as public accountants, could become whistle-blowers when:

- The whistle-blower believes her or his disclosure may prevent substantial injury to investors.
- The whistle-blower believes that the entity is engaging in conduct that will impede the investigation.
- At least 120 days have elapsed since the whistle-blower reported the information to her or his supervisor or to the company's audit committee, chief legal officer, or chief compliance officer, or at least 120 days have lapsed since the whistle-blower received the information, if the whistle-blower received it under circumstances indicating that the foregoing individuals already are aware of the information.

WHISTLE-BLOWER MISCONDUCT

The rules do not categorically bar all whistle-blowers who engage in misconduct that is the subject of the SEC's action or a related action from recovery. But they impose the following limitations on recovery:

- In determining whether the $1 million threshold is met, the SEC will not include sanctions that the whistle-blower is ordered to pay or that are ordered against an entity whose liability is based "substantially" on conduct that the whistle-blower directed, planned or initiated.
- A bounty will not be awarded to a whistle-blower who is convicted of criminal violations related to the action for which she or he provided information.
- A bounty will not be awarded to a whistle-blower who obtains the information through audits of financial statements required by securities laws and for whom submission would be contrary to the requirements of Section 10A of the Securities Exchange Act.

> The SEC will consider whether a whistle-blower complained internally in exercising its discretion to decide on the size of any bounty exceeding 10 percent of the government's recovery.

VOLUNTARY SUBMISSIONS

A whistle-blower will not be deemed to have voluntarily submitted information to the SEC where:

- She or he is required to report information to the SEC arising out of a pre-existing legal duty; a contractual duty to the SEC, the Public Company Accounting Oversight Board, self-regulatory organizations, Congress, other federal governmental authorities or a state attorney general or securities regulatory authority; or a duty that arises out of a judicial or administrative order to report the information to the SEC.
- She or he provides the SEC with information after receiving a request that relates to the subject matter of the submission by the SEC in connection with an investigation, inspection or examination by the PCAOB or any self-regulatory organization, or in connection with an investigation by Congress, other federal governmental authorities or a state attorney general or securities regulatory authority.

AGGREGATION OF ACTIONS

For purposes of determining whether the $1 million bounty-eligibility threshold is met, the SEC will aggregate two or more smaller actions that "arise from the same nucleus of operative facts." As a practical matter, this will make bounties available in more cases.

IMPLICATIONS

The Dodd-Frank bounty provisions and the SEC's implementing rules give employees an incentive to bypass the internal compliance mechanisms mandated by Sarbanes-Oxley and to complain directly to the SEC. This circumvention of internal compliance mechanisms will make it difficult for companies to promptly address the fraudulent conduct that forms the basis of the whistle-blower's tip to the SEC.

Thus, employers need to strengthen compliance programs and take calculated steps to heighten the likelihood that employees will use internal channels for lodging complaints.

Employers should consider the following range of available measures:

- Create a culture of integrity through top-down transparency and accountability, and continually communicate a commitment to ethics to employees of all levels.
- Train managers to be receptive to and supportive of employee complaints and concerns regarding any perceived improprieties that could amount to fraud.
- Institute help lines (allowing anonymous reports) and multiple other channels for submitting complaints.
- Educate employees through training and widely disseminated and easily accessible policies regarding the available methods of submitting complaints internally.
- Develop and broadly disseminate comprehensive codes of conduct and ethics and related policies that encourage internal complaints and prohibit retaliation.

- Embrace good-faith whistle-blowers as assets who are well-positioned to expose and ferret out potential fraud.
- Reward whistle-blowers for providing the company with information that enables it to identify and address incidents of fraud (myriad types of awards, including monetary and non-monetary awards, may be considered).
- Include the concept of "fostering a culture of ethics and accountability" among the criteria used to evaluate managers' performance. WJ

Steven J. Pearlman (top) is a partner in the labor and employment department in Chicago and co-chair of the national Sarbanes-Oxley Act whistle-blower team at **Seyfarth Shaw**. He can be reached at spearlman@seyfarth.com. **Christopher F. Robertson** (bottom) is co-chair of the national Sarbanes-Oxley whistle-blower team and a member of the complex litigation, securities and investment management practice areas in the firm's Boston office. He can be reached at crobertson@seyfarth.com.

NEWS IN BRIEF

FORMER CFO, SON PLEAD GUILTY TO PONZI SCHEME

Investment company execs Roberto Torres, 76, and his son Alejandro, 39, have pleaded guilty in a New Jersey federal court to securities fraud charges. The older Torres, the CFO of Capitol Investments USA, and his son, an accountant at the company, took part in a Ponzi scheme involving investments in a "fictitious" wholesale grocery distribution company, federal prosecutors said. The scheme involved using money from new investors to pay investment returns to existing investors because the phony grocery company had no actual business operations, the Department of Justice said. Investors lost about $100 million when the Ponzi scheme collapsed in January 2009. Sentencing for the Torreses is scheduled for July 12, and each faces a maximum of 20 years in prison and $5 million in fines.

United States v. Torres, No. 2:11-cr-00199-SDW, guilty pleas entered (D.N.J. Apr. 4, 2011).

TOP EXEC DRAWS HOME CONFINEMENT SENTENCE

Scott Harkonen, the former CEO of InterMune Inc., has been sentenced in California federal court to six months of home confinement for a marketing scheme that cost his company $37 million. The Justice Department said Harkonen was also ordered to serve three years' probation, perform 200 hours of community service and pay $20,000 in fines for his role in making false statements about a drug's clinical test results. Harkonen was found guilty of wire fraud following a seven-week jury trial in September 2009. He falsely represented that clinical trials showed the drug Actimmune helped patients with fatal heart disease live longer even though he knew that the Food and Drug Administration had not approved sales of the drug for such use. The false statements cost InterMune nearly $37 million in criminal and civil penalties.

United States v. Harkonen, No. 3:08-cr-00164-MHP, defendant sentenced (N.D. Cal. Apr. 13, 2011).

MORE SUITS SAY EX-CEO MINED ASSETS FROM PUDA COAL

Puda Coal Inc. shareholder Susan Cittone brings derivative and class-action charges against certain officers and directors for allowing defendant Ming Zhao to transfer the company's assets to himself, leaving it an empty shell. Cittone asks the court to enjoin the directors from breaching their fiduciary duties by accepting an inadequate bid of $12 per share from Zhao to take the company private. The suit, one of many filed in the Delaware Chancery Court against the Puda Coal officials, names Zhao, Liping Zhu, Lawrence Wizel, C. Mark Tang, Yao Zhao, Qiong Wu and Jianfei Ni as defendants. Cittone seeks an injunction barring consummation of the offer, and an order forcing the directors to obtain the best offer available for shareholders and to institute corporate governance and reporting reforms.

Cittone v. Zhao et al., No. 6503, complaint filed (Del. Ch. May 18, 2011).

WARNER MUSIC WILL BE SOLD FOR A SONG, SUITS SAY

Barbara Varipapa's class-action suit accuses the directors of Warner Music Group Corp. of breaching their duty to shareholders by accepting a $3.3 billion offer from Airplanes Music LLC and Access Industries. Although the $8.25-per-share offer is far below the company's value and is the product of an inadequate sale process, the directors agreed to preclusive deal-protection provisions that will deter competing bidders, the suit says. It names William Bronfman Jr., Shelby Bonnie, Richard Bressler, John Connaughton, Phyllis Grann, Michele Hooper, Scott Jaeckel, Seth Lawry, Thomas Lee, Scott Sperling and Airplanes Merger Sub Inc. as defendants. Varipapa seeks an injunction barring consummation of the deal and an order forcing the defendants to exercise their duty to get the best price for the company.

Varipapa v. Warner Music Group Corp. et al., No. 6478, complaint filed (Del. Ch. May 12, 2011).

Is reverse triangular merger an assignment of target's assets 'by operation of law'?

By Robert S. Reder, Esq., David S. Schwartz, Esq., and Alison Fraser, Esq.
Milbank, Tweed, Hadley & McCloy

One of the issues driving the structuring of an M&A transaction is the impact on anti-assignment clauses contained in contracts of the target corporation. Contractual anti-assignment clauses take a variety of forms, including some that require a contracting party's consent before the contract, and the other party's rights and obligations thereunder may be assigned "by operation of law."

> One of the issues driving the structuring of an M&A transaction is the impact on anti-assignment clauses contained in contracts of the target corporation.

A recent decision of the Delaware Court of Chancery in *Meso Scale Diagnostics LLC v. Roche Diagnostics GMBH*[1] leaves unanswered (at least for now) the question whether a reverse triangular merger constitutes an assignment of the target corporation's assets and properties, including its contracts, "by operation of law."[2]

WHAT IS AN RTM?

In a reverse triangular merger, an acquiring corporation forms a new subsidiary for the sole purpose of merging *into the target corporation*, with the target corporation surviving the merger as a wholly owned subsidiary of the acquiring corporation.

In the merger, the target corporation's former stockholders generally receive cash and/or stock of the acquiring corporation in exchange for their target corporation shares. This acquisition structure is often favored because the target corporation does not "incur [] any change in its corporate existence" and, as a result, "the rights and obligations of [the target corporation] … are not transferred, assumed or affected."

Recognizing that Delaware "apparently has not yet confronted this issue," Vice Chancellor Donald Parsons reviewed the current state of Delaware law applicable to various transaction structures in considering whether the reverse triangular merger before him triggered the target corporation's contractual anti-assignment clause.

Stock acquisitions

The vice chancellor explained that a purchase by an acquiring corporation of the stock of a target corporation directly from its stockholders "exemplif[ies] a situation in which a mere change of ownership, without more, does not constitute an assignment as a matter of law." As such, "courts in this state and elsewhere have held that '[w]here an acquirer purchases stock of a corporation, that purchase does not, in and of itself, constitute an 'assignment' to the acquirer of any contractual rights or obligations of the corporation whose stock is sold.'"[3]

Forward triangular mergers

In contrast to a reverse triangular merger, in a forward triangular merger, the target corporation merges *into the acquirer's newly created subsidiary*. Because "the target company is not the surviving entity, and its rights, interests and obligations vest in the surviving entity," Delaware courts have determined that this transaction structure represents an assignment of the target corporation's contracts and other assets by operation of law.

Reverse triangular mergers

Not surprisingly, the vice chancellor did not consider the forward triangular merger decisions to be binding for purposes of reverse triangular mergers. On the other hand, he acknowledged that stock acquisitions are "similar in some respects" to reverse triangular mergers because the acquirer becomes the owner of all the stock of the target corporation.

The vice chancellor was not prepared, however, to conclude that the precedents addressing stock acquisitions necessarily dictate that a reverse triangular merger does not effect an assignment of the target corporation's contracts and other assets by operation of law.

Specifically, the vice chancellor noted that after the merger in question was completed, the target corporation "was gutted and converted into a shell corporation for [the acquirer's] benefit." This alone was sufficient for the vice chancellor to require a hearing on the merits to determine whether the merger "resulted in more than a mere change in control" with respect to which "the parties intended to require [the other contracting party's] consent in this situation by using the term 'by operation of law.'"

UNANSWERED QUESTION

Although the vice chancellor's ruling leaves open the question whether a typical reverse triangular merger constitutes an assignment of a target corporation's contracts "by

> The decision also should serve as a reminder of the care that must be taken, during the due-diligence process, in reviewing anti-assignment clauses in target corporation contracts.

operation of law," it does indicate that an acquirer's post-acquisition actions with respect to the assets of the target corporation could ultimately have a bearing on the issue, making this a case-by-case analysis.

This obviously affects post-closing integration planning and efforts. The decision also should serve as a reminder of the care that must be taken, during the due-diligence process, in reviewing anti-assignment clauses in target corporation contracts, particularly bearing in mind potential acquisition structures under consideration.

NOTES

[1] *Meso Scale Diagnostics LLC v. Roche Diagnostics GMBH,* No. 5589-VCP, 2011 WL 1348438 (Del. Ch. Apr. 8, 2011).

[2] Not addressed by this decision is an even more vexing issue: whether an anti-assignment clause that does not specifically mention either assignments by operation of law or changes in ownership of a contracting party is triggered by a stock sale or a merger, as opposed to a sale of the target corporation's assets (which does require the other party's consent under a typical anti-assignment clause).

[3] Based on this analysis, a stock acquisition presumably also would not trigger an anti-assignment clause that does not specifically mention assignments by operation of law.

Robert Reder (left) has been a consulting attorney for **Milbank, Tweed, Hadley & McCloy** in New York since his retirement as a partner with the firm in March. **David Schwartz** (center) is of counsel, and **Alison Fraser** (right) is an associate in the firm's global corporate group.

Delaware Chancery Court

CONTINUED FROM PAGE 1

law firm chairman Larry Sonsini said in a press release. "During his tenure on the bench, Chancellor Chandler has authored many of the most significant decisions on critical questions of corporate government and the role of directors in managing the corporation."

Chandler, who has headed the five-member Chancery Court since 1997 and presided over some of the most high-profile corporate disputes in the past two decades, said it was "the greatest honor of my life" to lead the nation's foremost business court.

"But I felt that the time was right to take on new challenges," he said in the press release.

"After considerable thought, I believe WSGR is the right place for me to begin my next chapter.

"WSGR has an outstanding legal practice, one of the most enviable client bases in the nation and a roster of attorneys whom I long have considered among the best in the business," Chandler said.

He made the surprise announcement of his departure April 25.

In a phone interview, Chandler said his successor on the court will face challenges including the rapid increase in litigation that has accompanied the recent new wave of mergers, acquisitions and buyouts.

"Along with that uptick in the number of new suits filed, there has been a substantial increase in the amount of expedited merger and acquisition litigation, which puts added pressure on the Chancery Court system … especially if it's one judge down," he said.

Chandler expressed confidence that Delaware's governor will quickly fill the gap he leaves.

He said he believes the remaining four judges are capable of dealing with the new legal issues that he said will inevitably arise in these new M&A cases because "transactional attorneys are very creative about coming up with new twists."

One of those developing problems is the increase in multi-jurisdictional litigation, he noted, which makes shareholder suits more complex and problematic from beginning to end.

Shareholders often file challenges to transactions in Delaware, where most big companies are incorporated, in the company's headquarters state and sometimes in the state where the disputed deals took place.

> Conflicts often arise over which plaintiff attorneys will lead the action, which suits will get the right of way, and the division of settlements and attorney fees at the end, Chancellor William Chandler said.

Conflicts often arise over which plaintiff attorneys will lead the action, which suits will get the right of way to proceed, and the division of settlements and attorney fees at the end, Chandler said.

"In my new role I expect to deal with these and other problems facing major companies but from a different angle," to help them avoid those pitfalls, Chandler said.

He noted that in addition to the growing number of U.S. companies with assets and business deals worldwide, there are more foreign corporations that have incorporated a company in Delaware even though their offices may be oceans away.

Since Wilson Sonsini is a truly global firm, Chandler said, he hopes to help multinational companies deal with a brave new world of legal problems.

Sonsini said Chandler's two decades of judicial experience eminently qualify him to "offer a unique perspective to the boards of directors and management teams of leading public and private enterprises across the globe."

Sonsini noted that Chandler had issued milestone rulings in some of the most contentious and high-stakes corporate law disputes in the country, involving Walt Disney Co., Yahoo, Microsoft, Hewlett-Packard, eBay, Citigroup, Dow Chemical and, most recently, Air Products' yearlong battle to acquire rival Airgas.

Chandler, who joined the Chancery Court in 1989 after four years as a Delaware Superior Court judge, was appointed to a third 10-year term in 2009.

Two-thirds of the nation's Fortune 500 companies incorporate in Delaware, partly because of its corporate law, which balances the interests of management and shareholders, and its expert business court judges, who quickly and consistently resolve business and corporate governance disputes.

A Wilson Sonsini spokeswoman said Chandler would probably spend a significant part of his time working out of the firm's New York office but there are plans to open a small office in Delaware.

According to the firm's website, Wilson Sonsini has grown from roots in California's Silicon Valley to span the world with major offices in New York, Hong Kong, San Diego, San Francisco, Seattle, Shanghai and Washington.

The site says the firm "offers a broad range of services and legal disciplines focused on serving the principal challenges faced by the management and board of directors of business enterprises." WJ

Investors wrongly banked on subprime lender's 'conservative' image, suit says

Wilmington Trust Corp. sold thousands of overpriced shares because top executives convinced investors that the bank holding company was a "conservative" lender even while the officers were up to their necks in subprime mortgage investments, shareholders allege in Delaware federal court.

In re Wilmington Trust Securities Litigation, No. 10-CV-990, amended complaint filed (D. Del. May 16, 2011).

An amended complaint filed by several pension funds acting as lead plaintiffs claims that Wilmington Trust's top officers violated federal securities laws and falsely inflated the company's stock price by hiding its heavy commitment to risky subprime mortgage loans.

Investors learned the truth when WT's share price tanked Nov. 1, 2010, after the company announced an agreement to be acquired by Buffalo, N.Y.-based M&T Bank at a "fire sale" price that was half the stock price that day, the plaintiffs said.

Numerous shareholders filed suits in the U.S. District Court for the District of Delaware that were later consolidated into this action, now led by several public employee pension funds.

An amended class-action complaint filed May 16 alleges defendants former WT CEO Ted T. Cecala, current CEO Donald E. Foley, CFO David Reed Gibson and COO Robert V.A. Harra Jr. participated in a securities fraud scheme.

The defendants allegedly made a series of public statements beginning in October 2009 that exaggerated the value and stability of its commercial mortgage portfolio.

While purporting to have very conservative lending policies, "Wilmington's actual lending and accounting practices were so egregiously deficient and risky that the Federal Reserve Board, Wilmington's primary regulator, placed the bank [on probation]," the suit says.

REUTERS/Brendan McDermid

An amended class-action complaint alleges Wilmington Trust Corp. CEO Donald E. Foley and three others participated in a securities fraud scheme.

As a result of procedures that the regulator imposed on WT, the bank incurred new expenses that dragged the bottom line down even further, and its stock price sank from a high of $20 to a low of $7 by the time M&T made its offer, the suit alleges.

The defendants allegedly made a series of public statements beginning in October 2009 that exaggerated the value and stability of Wilmington Trust's commercial mortgage portfolio.

But the plaintiffs say investors were nevertheless "shocked and alarmed" when M&T offered only $3.84 a share for WT (since shareholders normally get a premium over the current stock price).

The plaintiffs are seeking compensation for a class of investors who bought Wilmington Trust common stock between Jan. 18, 2008, and Nov. 1, 2010. WJ

Attorneys:
Plaintiffs: Pamela S. Tikellis, Robert J. Kriner and A. Zachary Naylor, Chimicles & Tikellis, Wilmington, Del.

Delaware high court won't review $85 million LabCorp merger decision

Delaware's highest court will not immediately review a Chancery Court judge's ruling that Orchid Cellmark shareholders have enough information to decide whether to accept an $85.4 million merger offer from medical testing giant Laboratory Corporation of America.

Delaware Supreme Court building Debbie Zatlokovicz

Silverberg et al. v. Bologna et al., No. 241-2011, 2011 WL 1872207 (Del. May 16, 2011).

A three-justice panel of the state Supreme Court turned down an interlocutory appeal of Vice Chancellor John Noble's May 12 ruling in which he found no need to enjoin LabCorp's $2.80-per-share offer for the genetic testing service company. *In re Orchid Cellmark S'holder Litig.*, No. 6373, *letter opinion issued* (Del. Ch. May 12, 2011).

Dissident Orchid shareholders had sought to hold up the merger and force the company's directors to disclose their efforts to negotiate a better merger offer as well as information on the CEO's opposition to the deal.

A PERSISTENT SUITOR

Several investors filed breach-of-duty actions that were consolidated in Delaware, where both companies are incorporated.

The lawsuits charged that the Orchid board ignored alternative transactions and did not bargain aggressively enough with LabCorp, which had been wooing the company for several years.

The suits claimed that after the board decided to accept LabCorp's offer, it withheld important information from shareholders concerning the merger negotiation process and CEO Thomas Bologna's reluctance to accept LabCorp's offer.

REASONABLE, BUT NOT PERFECT

"There is no single blueprint to follow in reaching the ultimate goal of maximizing shareholder value," Vice Chancellor Noble said in ruling on the plaintiffs' motion for a preliminary injunction.

"The question to be answered by this court is whether the directors made a reasonable decision, not a perfect decision," he said.

The judge found evidence that the board had seriously considered alternatives and conducted a market check that reasonably informed the directors about the company's true value.

"There is no reason to second-guess this board's decision," Vice Chancellor Noble wrote.

He found it was not necessary to tell the shareholders that the board was divided on a preliminary vote on whether to continue negotiations with LabCorp.

SHAREHOLDERS DECIDE

The vice chancellor said there was little chance of success on the merits and a small chance of harm if the deal was not enjoined.

"Maybe the company, as the CEO seems to contend, should be valued more highly," the judge wrote. "That is something for appropriately informed shareholders to decide."

He noted that in situations such as this, "the court should be careful about depriving shareholders of their opportunity to make such a choice."

DISENFRANCHISED?

Two plaintiffs, Herbert Silverberg and Gene Nannetti, got permission from the vice chancellor to seek an immediate appeal of his preliminary injunction ruling.

In their motion for appeal, the appellants argued that the shareholders would be effectively disenfranchised if they were allowed to decide on the offer without all the necessary information.

Writing for the Supreme Court panel, Justice Carolyn Berger said, "The Court of Chancery, in a thorough and detailed opinion, determined that appellants had not demonstrated a reasonable probability of success on the merits, the threat of imminent, irreparable harm or that a balancing of the equities favors the entry of an injunction."

Thus the appeal did not meet the criteria for acceptance of an interlocutory appeal, she said. WJ

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

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

Related Court Document:
Order: 2011 WL 1872207

Preferred shareholders knew of limitations, ThoughtWorks tells Delaware high court

A Delaware judge correctly found that preferred stockholders who financed an expansion of IT firm ThoughtWorks Inc. knew their right to repayment was limited when they bought the stock, the company has told the state's highest court.

SV Investment Partners LLC et al. v. ThoughtWorks Inc., No. 107-2011, answering brief filed (Del. May 18, 2011).

SV Investment Partners, the leader of a group of investors who hold ThoughtWorks preferred shares, is appealing a November Chancery Court decision that found ThoughtWorks is not legally obligated to pay them back by repurchasing those shares if that would leave the company short of operating cash.

In a brief opposing the appeal, ThoughtWorks says its directors are not required to pay the preferred shareholders simply because the company may have a temporary surplus of cash.

The plaintiffs said ThoughtWorks used several excuses over the years to avoid paying them back as the contract governing the preferred shares required.

Preferred shareholders have special contract rights that sometimes put them ahead of other creditors when the company's funds are limited, but differences over the interpretation of these rights can spawn thorny questions concerning the duty of directors to various shareholders and creditors.

Since ThoughtWorks is chartered in Delaware, SVIP and other preferred shareholders sued in the state, seeking a determination that ThoughtWorks had enough assets to redeem the preferred shares but chose to pay other expenses instead.

The plaintiffs charged that ThoughtWorks had used several excuses over the years to avoid paying them back as required under the preferred-shares contract. The contract allegedly allowed them to demand repayment one year after the 2000 investment.

The latest excuse, the preferred shareholders say, was to use a misinterpretation of a "funds legally available" provision, which required ThoughtWorks to redeem the shares unless it lacked the assets to do so without pushing the company into insolvency.

However, in a bench ruling, Vice Chancellor J. Travis Laster said ThoughtWorks' directors were within their rights to decline to redeem the shares because it would make it difficult for the company to meet its bills going forward.

In its brief, ThoughtWorks says SVIP lost in the Chancery Court because it could not prove that the board of directors used bad judgment in deciding to hold on to some cash in order to pay later bills rather than redeem the preferred shares right away.

REUTERS/William Bretzger/The News Journal

Vice Chancellor J. Travis Laster

In addition, Vice Chancellor Laster selected the right definition for "funds legally available," which was the guideline for deciding what money could be used to pay back the preferred shareholders, ThoughtWorks asserts.

"SVIP repeatedly confuses its rights as a preferred stockholder with rights of creditors," the brief says. "SVIP is not a creditor, and its right to cause the company to redeem the stock only out of legally available funds is limited by the bargain it struck." WJ

Attorneys:

Plaintiffs: Martin Lessner, Young, Conaway, Stargatt & Taylor, Wilmington, Del.

Defendant: Kenneth Nachbar, Morris, Nichols, Arsht & Tunnell, Wilmington

REUTERS /Arnd Wiegmann

FRAUD

UBS arm settles SEC municipal-bond fraud suit for $47 million

UBS Financial Services has agreed to pay $47.2 million to settle a Securities and Exchange Commission lawsuit accusing the broker-dealer of fraudulently rigging municipal-bond reinvestment transactions.

Securities and Exchange Commission v. UBS Financial Services Inc., No. 11-CV-2539, complaint filed (D.N.J. May 4, 2011).

UBS, which neither admitted nor denied the allegations, will pay another $113 million to resolve related claims brought by other federal and state authorities, the SEC said in a statement announcing the settlement.

UBS allegedly rigged bids for reinvestment product sellers while acting as a bidding agent for municipal buyers.

The agency filed the suit in the U.S. District Court for the District of New Jersey.

Municipalities seeking to raise funds for capital projects sell tax-exempt municipal securities and then temporarily invest the sale proceeds in reinvestment products, the complaint said.

In order to preserve the tax-exempt status of municipal securities under Internal Revenue Service regulations, the reinvestments must be purchased at fair market value, which typically is established through a competitive bidding process, the agency said.

The SEC alleges that during a four-year period beginning in 2000, UBS rigged at least 100 municipal reinvestment transactions, generating millions of dollars in ill-gotten gains and threatening the tax status of over $16.5 billion in municipal securities.

In particular, the agency alleged, UBS illicitly won bids as a provider of reinvestment products and rigged bids for the benefit of other providers while acting as a bidding agent on behalf of municipalities.

The settlement includes about $9.6 million in disgorgement, $5.1 million in interest and a $32.5 million civil penalty. WJ

Related Court Document:
SEC complaint: 2011 WL 1671627

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

Execs schemed to lure investors and divert funds, SEC alleges

The co-founders of a New York-based beverage-carrier company defrauded investors by falsely hyping the firm while diverting their money for personal use, the Securities and Exchange Commission alleges in a Brooklyn federal court lawsuit.

Securities and Exchange Commission v. Garcy et al., No. 11-CV-2282, complaint filed (E.D.N.Y. May 11, 2011).

The complaint filed in the U.S. District Court for the Eastern District of New York accuses E-Z Media Inc. co-founders George Garcy and Angelo Cuomo of conducting a fraudulent scheme that raised $8 million from at least 200 investors.

From 2003 to 2009 Garcy and Cuomo lured investors by falsely telling them that E-Z Media had contracts to sell its beverage and food carriers to major companies such as Heineken, Anheuser Busch and Aramark Corp., the complaint says.

The defendants also told potential investors that E-Z Media would imminently conduct an initial public offering and that share values would soar, even though the firm took no steps to prepare for a purported IPO, the SEC alleges.

> The defendants allegedly touted to investors nonexistent contracts with major companies, including Heineken, Anheuser Busch and Aramark.

The agency also says the duo misled investors by telling them that the company owned several patents for its carriers. Cuomo and Garcia failed to disclose that the patents were contingent on E-Z Media's payment of $14.5 million to Cuomo and may not ever have been valid, the complaint says.

In addition, the defendants never informed investors that in 1997 the SEC sanctioned Garcy, who also goes by the name Jorge Garcia, for improperly selling another company's stock to the public, the agency says.

The complaint further alleges that Garcy and Cuomo diverted at least $4 million of the investment money for their own benefit, including tuition, mortgages and personal loan payments, and for the benefit of relatives and associates.

The complaint names Cuomo's sons Ralph and Vincent Cuomo, Cuomo's sister Judith Guido, and attorney Joseph Lively as relief defendants for the purpose of recovering assets that may have been fraudulently transferred.

REUTERS/Peter Newcomb

The defendants lured investors by falsely telling them that E-Z Media had contracts to sell its beverage and food carriers to major companies such as Anheuser Busch, the complaint says.

The defendants allegedly violated the Securities Act of 1933 and the Securities Exchange Act of 1934.

The complaint seeks disgorgement from the defendants and relief defendants, injunctions and fines against the defendants, and an order barring the defendants from serving as officers or directors of any public company. WJ

Related Court Document:
Complaint: 2011 WL 1808453

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

Rajaratnam convicted on all insider-trading charges

NEW YORK, May 11 (Reuters) – Hedge fund founder Raj Rajaratnam has been found guilty on all 14 counts of insider trading in a sweeping victory for the government and a vindication of its aggressive use of phone taps to pursue Wall Street crimes.

United States v. Rajaratnam et al., No. 09-CR-01184, verdict returned (S.D.N.Y., Foley Square May 11, 2011).

Rajaratnam, at the center of the biggest insider-trading investigation in decades, sat expressionless as the judge's deputy read the jury's verdict in a hushed New York courtroom. The Galleon Group founder could face at least 15 years in prison when he is sentenced July 29.

The prosecution based its case on evidence that Rajaratnam ran a web of highly placed insiders to leak valuable corporate secrets between 2003 and March 2009, earning an illicit $63.8 million from trading on the information.

The government's unprecedented use of extensive phone tapping in an insider-trading case, which is more often deployed in organized crime and drug trafficking probes, may have marked a turning point in the prosecution of white-collar crimes.

"It's an historic verdict," said Bill Singer, a securities lawyer with Gusrae, Kaplan, Bruno & Nusbaum.

"It will likely set the stage for a dramatic change not only in the way that the Wall Street insider-trader activities are investigated and prosecuted, but most likely this will have a chilling effect on individuals and companies that trade," he said.

Over the course of the two-month trial, the voices of Rajaratnam and his friends and business associates rumbled over courtroom loudspeakers in 46 digital audio recordings at the heart of the government's case. The conversations were occasionally laced with profanity.

In these calls and from trial testimony, the jury learned how Rajaratnam worked his mobile phone even when he was on holiday on a beach in Miami or in Europe, making arrangements to deposit money into accounts for friends who had provided him tips.

The tipsters included executives at major blue-chip companies such as Intel Corp. and Rajat Gupta, who was once head of elite management consultancy McKinsey & Co. and a former Goldman Sachs Group board member.

REUTERS/Brendan McDermid

Galleon hedge fund founder Raj Rajaratnam (left) departs with his lawyer from Manhattan federal court following the guilty verdict May 11.

Gupta's involvement as an unindicted co-conspirator prompted the government to make the unusual move of calling Lloyd Blankfein, Goldman Sachs' chief executive, to testify at the trial. In a fleeting moment during a break in his testimony, Blankfein shook Rajaratnam's hand.

APPEAL LOOMING

What began in October 2009 with Rajaratnam being arrested and frog-marched by FBI agents, and with prosecutors warning hedge fund traders of more arrests to come, ended mid-morning May 11 with jurors slowly filing into the courtroom for the announcement of their verdict.

The jurors, whose jobs include everything from food services to computer graphics, reached their unanimous decision on the 12th day of deliberations, convicting Rajaratnam of five counts of conspiracy and nine counts of securities fraud.

Under federal sentencing rules that are not binding on the judge, Rajaratnam faces between 15 and a half and 19 and a half years in prison, prosecutors said. Securities fraud and conspiracy carry a combined maximum penalty of 25 years' imprisonment.

Chief defense lawyer John Dowd said Rajaratnam, 53, will appeal the case. In particular, he is expected to challenge the use of secret recordings.

"This is only round one. ... We'll see you in the 2nd Circuit," Dowd said, referring to the appeals court in New York.

After the jury was dismissed, Rajaratnam was released until his sentencing by presiding U.S. District Judge Richard Holwell. He is free under a $100 million bail package that will now include an electronic monitoring device and house arrest in his Manhattan apartment.

Reuters graphic/Van Tsui

Rajaratnam's lawyers had stuck consistently to their main theme that his trades were guided by a trove of research and public information. Last November, they lost a bid to suppress the wiretaps after arguing that investigators misled the judges who approved the surveillance.

Galleon had $7 billion under management at its peak in early 2008. It was wound down without losses to investors after the Oct. 16, 2009, arrest of Rajaratnam, a longtime U.S. citizen and the richest Sri Lankan-born person.

The case was the first Wall Street insider-trading trial to draw such wide attention since the mid-1980s scandal involving speculator Ivan Boesky and junk bond financier Michael Milken.

Prosecutors said Rajaratnam traded illegally on at least 15 stocks, many of them technology companies such as Google and chipmakers Advanced Micro Devices and ATI Technologies.

'GREED AND CORRUPTION'

New York's top federal prosecutor, Preet Bharara, who has made insider-trading cases a priority, said in a statement that Rajaratnam "let greed and corruption cause his undoing," echoing a theme pressed by trial prosecutors in their statements to the jury.

"We will continue to pursue and prosecute those who believe they are both above the law and too smart to get caught," Bharara said.

The jurors declined to be interviewed. One alternate juror, who heard all the trial evidence but did not take part in the deliberations, said he was not surprised by the time the jurors took to decide.

"I didn't think it was going to be so open and shut," said Philip Wedo, 35, an unemployed writer and editor, when contacted by phone. "I didn't think they would get him on all 14 counts."

Meanwhile, across the country in Las Vegas, where one of the hedge fund industry's biggest conferences was getting under way, managers and investors buzzed with the news. "Did you hear? Guilty on all charges," one attendee whispered.

Litigation experts said the phone taps strengthened the insider-trading charges, which historically have been difficult to prove because they rely on circumstantial evidence.

Besides wiretaps, prosecutors were armed with testimony of three former friends and associates of Rajaratnam: former McKinsey & Co. partner Anil Kumar, former Intel treasury group executive Rajiv Goel and former Galleon employee Adam Smith.

All three pleaded guilty to criminal charges and agreed to cooperate with the government in the hopes of lighter sentences.

But the recordings provided the prosecutors' best evidence. In potentially one of the most damning exchanges, Rajaratnam was heard discussing information he received from Gupta about Goldman Sachs, including the first quarterly loss in its history in 2008.

Galleon Group hedge fund founder Raj Rajaratnam (right) is shown during the reading of his guilty verdict in a courtroom sketch made during his insider-trading case in New York May 11. REUTERS/Jane Rosenberg

"We will continue to pursue and prosecute those who believe they are both above the law and too smart to get caught," U.S. Attorney Preet Bharara said.

"I just heard from somebody who's on the board of Goldman Sachs, they are gonna lose $2 per share," Rajaratnam was heard telling a colleague on one call. "So what he was telling me was that, uh, Goldman, the quarter's pretty bad."

Rajaratnam is the only one out of 26 people charged in the broad Galleon case to go on trial so far. Twenty-one have pleaded guilty, and one defendant is at large.

(Reporting by Grant McCool and Basil Katz; additional reporting by Jonathan Stempel, Dan Levine, Scot Paltrow, Andrew Longstreth and Svea Herbst-Bayliss) WJ

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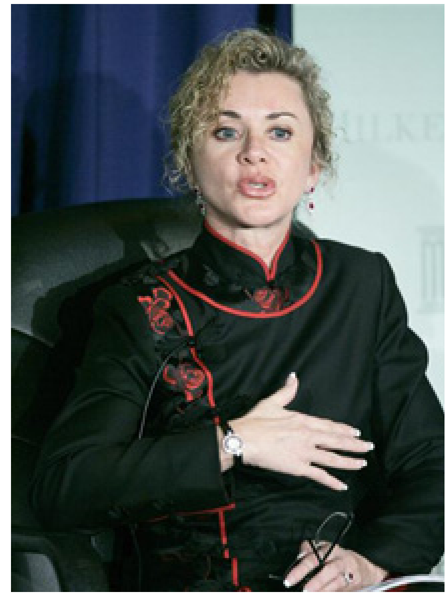
Defendant: John Dowd, Terence Lynam, Jeffrey King and William White, Akin Gump Strauss Hauer & Feld, Washington; Robert Hotz and Samidh Guha, Akin Gump Strauss Hauer & Feld, New York

REGULATORY ACTIONS/STOCK SALES

3 executives charged in $50 million stock sale scheme

The former CEO and two executives of Shanghai-based Xinhua Finance Ltd. have been charged with fraud for allegedly concealing sales of their personally held company stock from the Securities and Exchange Commission.



REUTERS/Fred Prouser

Former Xinhua Finance CEO Loretta Fredy Bush, shown here in 2006, is charged with making false statements, mail fraud and conspiracy to commit mail fraud.

United States v. Singhal et al., No. 1:11-cr-00142-RCL, indictment filed (D.D.C. May 10, 2011).

According to an indictment filed in the U.S. District Court for the District of Columbia, the three defendants did not want the SEC or the public to know they were selling their stock holdings in Xinhua and used various companies or "entities" to hide the transactions. The entities were located in California, Delaware and the Bahamas.

For example, the indictment says Dennis Pelino, 63, of Miami Beach, and Loretta Fredy Bush, 52, of Shanghai, China, allegedly used a California entity to purchase their preferred shares of Xinhua. Pelino served as chairman of Xinhua Finance's finance committee and Bush was the CEO.

Pelino and Bush allegedly failed to report the sales or the $27.7 million in proceeds to the SEC and investors.

In a separate transaction with a different entity, Xinhua audit committee head Shelly Singhal, 43, of Newport Beach, Calif., and Pelino concealed $25 million in proceeds generated through sales of more Xinhua stock, the indictment says.

According to the FBI, Pelino, Bush and Singhal are charged in the indictment with four counts of making false statements, four counts of mail fraud and one count of conspiracy to commit mail fraud. WJ

CFO's $550,000 embezzlement voids commercial crime coverage

The 8th U.S. Circuit Court of Appeals has ruled an insurer can rescind a commercial crime policy after an insured company's CFO repeatedly misrepresented internal safeguards to prevent employee theft while simultaneously embezzling nearly $550,000.

Pioneer Industries Inc. v. Hartford Fire Insurance Co., Nos. 09-3002 and 09-3072, 2011 WL 1328111 (8th Cir. Apr. 8, 2011).

The panel affirmed a Minnesota federal judge's decision that CFO Clinton Harlander's misrepresentations about Pioneer Industries' accounting policies, audit procedures and internal controls materially altered the terms of an insurance policy covering employee theft.

The appeals court therefore held that Hartford Fire Insurance Co. could refuse to pay Pioneer's claim over Harlander's embezzlement of nearly $550,000.

The panel upheld the U.S. District Court for the District of Minnesota's ruling that Minnesota law requires Hartford to prove that Harlander's misrepresentations about Pioneer's bookkeeping practices increased the risk of loss under the policy.

He said Hartford met this burden.

According to the opinion, Harlander completed six insurance applications during the 11 years he served as CFO. In each one submitted from 1987 to 2004, he misrepresented company safeguards to prevent employee theft.

The lack of some of these safeguards facilitated Harlander's embezzlement of nearly $550,000 throughout his tenure until his death in 2006.

"Such misrepresentations are material to coverage for commercial crime insurance, and directly related to the loss involved here," Circuit Judge Kermit Bye wrote for the appeals court.

Therefore, the judge said, Hartford could rescind Pioneer's coverage for Harlander's embezzlement.

The 8th Circuit did agree with the lower court that Hartford could only rescind coverage for claims that occurred since April 1, 2003. Therefore, the insurer could not recover money it paid to Pioneer on a claim for inventory theft in August 2000.

Hartford unsuccessfully argued that the applicable policy went into effect April 1, 2000. This was the last time it issued a new declarations sheet to Pioneer, which indicated the policy was effective until canceled. Therefore, Hartford asserted, the August 2000 theft should not be covered either.

However, the appellate court found it significant that Hartford had sent Pioneer a nonrenewal notice in January 2003 with "express statements of its intent to terminate the policy [effective April 1, 2003], as well as its direct reference to and compliance with the cancellation/nonrenewal conditions of the policy."

At that time, Hartford also requested that Pioneer submit a full application for a new policy rather than a limited renewal application. This conduct "was consistent with an intent to terminate the existing policy," the court added.

The appeals court refused to ignore Hartford's explicit notice that it canceled the policy as well as its later actions that implied the same intent because of the "mere inference created by the lack of a fixed expiration date in the declarations sheet."

"We believe Minnesota law gives more weight to direct expressions of intent than to inferential evidence," the 8th Circuit explained.

Accordingly, the panel confirmed that Hartford's explicit nonrenewal notice canceled the policy in 2003, but that Hartford could only void coverage for the CFO's embezzlement and not the earlier inventory theft. WJ

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Related Court Document:
Opinion: 2011 WL 1328111

See Document Section C (P. 37) for the opinion.

CASE AND DOCUMENT INDEX