

# INSIGHTS

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# INSIGHTS

*The Corporate & Securities Law Advisor*

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## ■ SECURITIES LITIGATION

# Cyan v. Beaver County: Implications Moving Forward

*Commentators have bemoaned the Supreme Court's recent opinion in Cyan, Inc. v. Beaver County Employees Retirement Fund, which likely will force companies to face certain federal securities claims in state court. But the decision may spur companies to act to avoid the state court forum, either by pushing courts to enforce exclusive forum bylaws provisions requiring securities litigation to be filed in federal court, or by lobbying Congress to amend the perplexing jurisdictional provisions of the Securities Act of 1933.*

By Peter L. Welsh, Nicholas M. Berg, Kristi Jobson, and Nick Pisegna

In March 2018, the Supreme Court resolved a long-simmering debate about state court jurisdiction over certain federal securities laws in favor of the plaintiffs' bar. In *Cyan, Inc. v. Beaver County Employees Retirement Fund*, a unanimous Court held that state courts retain jurisdiction to hear cases arising under the Securities Act of 1933 (Securities Act), and that defendants subject to such suits in state court may not remove them to federal court.<sup>1</sup> Counsel to the plaintiffs-shareholders heralded the decision as “a victory for investors,”<sup>2</sup> while the defense bar warned of an imminent rise in state-court claims. But filing numbers suggest that the influx in state court claims may be minimal. More impactful, perhaps, will be litigation regarding the proper standards and rules applicable to securities claims brought in state court, and pending actions regarding the enforceability of exclusive federal forum bylaws

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adopted by corporations that could allow companies to skirt *Cyan's* holding altogether.

### The Statutory Framework

The statutory regime that underlies the dispute concerning state court jurisdiction over federal securities claims is rooted in the Securities Act and the Securities Exchange Act of 1934 (Exchange Act). The Securities Act governs the initial issuance and sale of securities, while its counterpart, the Exchange Act, governs trading of securities on the secondary market. Congress enacted the pair of statutes in the wake of the Great Depression to “promote honest practices in the securities market,” and created a private right of action under each statute to allow citizens to assist in the regulation of the securities industry.<sup>3</sup>

While the statutes share a coherent goal, Congress, for reasons unknown, created separate jurisdictional schemes for each Act.<sup>4</sup> Federal courts have “exclusive jurisdiction” to hear claims brought under the Exchange Act.<sup>5</sup> By contrast, state and federal courts enjoy concurrent jurisdiction to hear Securities Act claims.<sup>6</sup> And, once a plaintiff chose a state forum in a Securities Act case, the parties were stuck with it: Congress barred removal of actions brought under the Securities Act from state to federal court.<sup>7</sup>

Sixty years later, Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA) in an effort to curb perceived “abuses of the class-action vehicle in litigation involving nationally traded securities.”<sup>8</sup> The PSLRA ushered in both procedural and substantive changes to the Securities and Exchange Acts and, in effect, made it harder for plaintiffs to establish a successful securities claim, particularly if they file in

federal court.<sup>9</sup> But these changes had an “unintended consequence,” as plaintiffs’ attorneys began filing their Securities Act claims in state court to avoid the PSLRA’s “obstacles” for federal securities actions.<sup>10</sup>

In response, Congress enacted the Securities Litigation Uniform Standards Act of 1998 (SLUSA) to stem this “shif[t] from Federal to State courts.”<sup>11</sup> The shift to state courts, Congress found, not only “prevented [the PSLRA] from fully achieving its objectives,”<sup>12</sup> but also created a “ripple effect” that “inhibited small, high-growth companies in their efforts to raise capital, and has damaged the overall efficiency of our capital markets.”<sup>13</sup> SLUSA was meant to even out the imbalance created by plaintiffs flooding state courts with federal securities claims, while also preserving the “appropriate enforcement powers” of state regulators.<sup>14</sup>

In particular, SLUSA made a series of amendments to the jurisdictional framework of the federal securities laws.<sup>15</sup> First, SLUSA disallowed the prosecution of any action alleging violations of state law that overlapped with the scope of the Securities and Exchange Acts. To that end, plaintiffs may not pursue, in either state or federal court, certain “covered class actions”—that is, a lawsuit in which damages are sought (1) on behalf of more than fifty people (defined under SLUSA as a “covered class action”) and (2) *based on state law* concerning the dishonest or fraudulent purchase or sale of a nationally traded security.<sup>16</sup> To ensure that this state-law class-action bar was enforced consistently, Congress amended the Securities Act’s blanket bar on removal to provide for the removal from state to federal court of any action that implicated a “covered class action,” and following removal, dismissal by the federal court.<sup>17</sup>

SLUSA also added the following italicized exception to the general rule that state and federal courts have concurrent jurisdiction over all claims brought under the Securities Act:

The district courts of the United States . . . shall have jurisdiction[,] concurrent with State . . . courts, *except as provided in section 77p [i.e., Securities Act section 16] of this title with respect to covered class actions*, of all suits

brought under the Securities Act. This provision—often referred to as the “except clause”—divided federal district courts for years, and was at the crux of the Supreme Court’s decision in *Cyan*.

## Judicial Disagreement Concerning State Court Jurisdiction

Following SLUSA, state and federal courts disagreed about the effect of the “except clause” on state court jurisdiction over Securities Act claims. The federal district courts split within and even among circuits as judges wrestled with SLUSA’s statutory language and purpose.<sup>18</sup>

Some courts concluded that after SLUSA, the Securities Act no longer authorized state courts to hear any “covered class actions.”<sup>19</sup> *Knox v. Agria Corp.*<sup>20</sup> is typical of this line of cases. In *Knox*, the court reasoned that in the context of a federal-law claim brought under the Securities Act, the “except clause” refers to *only* SLUSA’s definition of “covered class action” contained in Section 16(b), since the other subsections of Section 16 “deal exclusively with state law claims.”<sup>21</sup> Thus, the “except clause” exempts from the Securities Act’s grant of concurrent jurisdiction to state courts all covered class actions that raise a Securities Act claim, and only federal courts retain jurisdiction to hear such claims.<sup>22</sup> The court added that this result comports with the purposes underlying SLUSA, as eliminating state court jurisdiction to hear covered class actions amplifies federal court jurisdiction over Securities Act claims, thereby maximizing the objectives of the PSLRA. Further, *Knox* observed, an alternate holding would create a “jurisdictional anomaly” that “does not make sense”: state courts would have jurisdiction to hear Securities Act claims based on federal law, but not enjoy jurisdiction over its own state’s similar laws.<sup>23</sup>

But other courts concluded that SLUSA did nothing to strip state courts of their jurisdiction to hear certain Securities Act claims. The California Court of Appeal in *Luther v. Countrywide Financial Corp.*,<sup>24</sup> 195 Cal. App. 4th 789 (2011) is one of the

few appellate court decisions (in either state or federal court) to assess the issue. The court in *Luther* found that state courts maintained jurisdiction to hear federal-law Securities Act claims.<sup>25</sup> The rationale in *Knox* and similar cases, the California court reasoned, improperly ignores the full, post-SLUSA text of the Securities Act. According to *Luther's* rationale, the “except clause” cross-references Section 16 *as a whole*, rather than specifying only the definitional provision of the section.<sup>26</sup> Considered in full, Section 16 touches on jurisdiction in subsections (b), (d), and (e).<sup>27</sup> These subsections provide that, subject to a few listed exceptions, no state or federal court has jurisdiction to hear certain covered class actions *based on state law*.<sup>28</sup> As a result, the “except clause” exempts from the Securities Act’s grant of concurrent jurisdiction only the covered class actions listed in subsection (b), *i.e.*, state courts retain jurisdiction to hear covered class actions that are based on federal law.<sup>29</sup> To focus solely on the definitional provisions of Section 16 ignores the “first canon” of statutory interpretation that analysis begins with the clear meaning of the language of the statute: “a legislature says in a statute what it means and means in a statute what it says there.”<sup>30</sup>

### **Cyan Resolves Circuit Split in Favor of State Court Jurisdiction**

The clash in state and federal courts over the effect of the SLUSA’s “except clause” on state court jurisdiction over Securities Act claims seemed destined for Supreme Court treatment. And, in June 2017, the justices granted certiorari on a petition in *Cyan, Inc. v. Beaver County Employees Retirement Fund* to resolve the dispute regarding the reach of state and federal court jurisdiction over Securities Act claims.<sup>31</sup>

*Cyan* represents the typical case concerning jurisdiction post-SLUSA: former investors in *Cyan*, a telecommunications company, had purchased stock in an initial public offering (IPO) and brought suit in state court under the Securities Act after their shares declined in value.<sup>32</sup> The defendants (the company and its officers and directors) moved to dismiss for

lack of subject matter jurisdiction, arguing that state courts no longer retained jurisdiction over Securities Act claims after SLUSA.<sup>33</sup> The California Superior Court disagreed, and the state’s appellate courts denied review.<sup>34</sup>

In a decisive and unanimous opinion, the Supreme Court sided with the California courts and the plaintiffs-shareholders, holding that SLUSA’s “clear statutory language” did “nothing” to disturb state courts’ jurisdiction over Securities Act claims.<sup>35</sup> *Cyan* begins with the “background rule of §77v(a) [*i.e.*, Section 22(a)]”: under the as-enacted Securities Act, state and federal courts enjoyed concurrent jurisdiction to hear Securities Act claims. SLUSA, “read most straightforwardly,” eliminates this jurisdictional grant for select securities actions arising under state law, but “says nothing, and so does nothing, to deprive state courts of jurisdiction over class actions based on *federal* law.”<sup>36</sup>

The opinion hinges on the “except clause” inserted in the Securities Act by SLUSA’s conforming amendments.<sup>37</sup> Justice Kagan’s opinion rejected *Cyan’s* efforts to construe SLUSA’s except clause as a full-on elimination of state court jurisdiction over Securities Act claims. In line with *Knox* and its progeny, *Cyan* argued that the reference to “covered class actions” referred to the definition of that term found in Section 16(f)(2)—that is, any class action seeking damages on behalf of more than fifty class members.<sup>38</sup> That reading would effectively strip state courts of jurisdiction over Securities Act claims, given that most claims related to a public offering will naturally involve more than fifty investors. The Supreme Court dismissed *Cyan’s* argument as a contortion of the statutory language, observing that Congress could have simply inserted an exclusive federal jurisdiction provision into the Securities Act if it had wanted to do so.<sup>39</sup> Indeed, Justice Kagan pointed out, it was unlikely that Congress would have “upended” the Securities Act’s baseline of concurrent jurisdiction by nestling a jurisdictional sea change in a “mere ‘conforming amendment.’”<sup>40</sup>

Finally, the Court turned to the issue of removal, addressing the “halfway-house position” put forth by the Federal Government, acting as *amicus curiae*.<sup>41</sup>

According to the Government, SLUSA did not strip state courts of jurisdiction over Securities Act claims, but *did* alter the removal provision of the Securities Act that permits defendants to remove such claims to federal court.<sup>42</sup> Suffice it to say, the argument failed to convince Justice Kagan, who rejected the Government's removal argument on grounds of precedent and statutory interpretation.<sup>43</sup> Instead, the Court concluded that SLUSA did not alter the baseline rule that defendants could not remove Securities Act claims from state court to federal court. Despite the defendants' and Government's appeals to statutory purpose and legislative history, the Court determined that it had "no license" to distort SLUSA's statutory language simply because the litigants asserted that "Congress simply must have wanted Securities Act class actions to be litigated in federal court."<sup>44</sup> If Congress wanted to clean up its language, Justice Kagan concluded, it was free to do so.<sup>45</sup>

### The Path Forward after *Cyan*

The prevailing wisdom among the defense bar suggests that *Cyan* will spur a flurry of Securities Act actions in state court.<sup>46</sup> For example, plaintiffs have avoided filing Securities Act actions in New York state court, as the New York federal district courts had held that those actions were removable.<sup>47</sup> Logically, then, one might expect an uptick in New York state court filings alleging Securities Act claims and similar changes in other jurisdictions that previously had proved hostile to state court jurisdiction over these actions. In this regard, state courts are often assumed to be more plaintiff-friendly, with a more lenient standard of review and thus a greater likelihood of clearing the motion-to-dismiss hurdle.<sup>48</sup> As state courts hear more Securities Act claims, there is a potential to develop a "multi-track" body of securities case law with different jurisprudence in each forum.

Query, however, whether *Cyan* will usher in a flood of state court Securities Act complaints. In California state court—regarded as the preferred forum for plaintiffs avoiding federal court—an

average of seven Securities Act claims have been filed each year since 2010.<sup>49</sup> Federal numbers also remain low. Last year, plaintiffs filed 432 actions under the Securities and Exchange Acts.<sup>50</sup> But only 25 of those complaints alleged any Securities Act claims—and of those, 10 also contained Exchange Act claims, leaving those plaintiff-shareholders with no choice but to file in federal court (still the exclusive forum for Exchange Act claims, as discussed above).<sup>51</sup> Put differently, over the full 2017 year, only 15 federal court actions were even "*Cyan*-eligible" (i.e., alleged solely Securities Act causes of actions). The year 2017 was not unique—in the three prior years, between 11 and 14 actions filed in federal court asserted *only* Securities Act claims. By contrast, 201 cases filed in federal court in 2017 alleged Rule 10b-5 violations (the typical Exchange Act claim).<sup>52</sup>

Even assuming that all *Cyan*-eligible complaints end up in state court, it seems hyperbolic to characterize another dozen cases as a tsunami. Consider the number of IPOs occurring in each state. California, Massachusetts, and Texas regularly beget the largest number of companies "going public" each year—and even before *Cyan*, federal courts in each of those states already had held that state courts retained jurisdiction over Securities Act cases.<sup>53</sup> Even if each IPO drew a Securities Act action in state court, that may not change the game on the ground, particularly given that plaintiffs filing actions in many "hot spot" IPO jurisdictions already had the option of filing in state court pre-*Cyan*.

Indeed, *Cyan* may have a larger impact on plaintiffs firms than on Securities Act defendants. A plaintiff bringing an Exchange Act action in federal court may include a Securities Act claim in order to stay in the driver's seat and avoid competition between plaintiffs pursuing similar claims against the same defendants in two actions. Conversely, a plaintiff seeking the benefits of state court jurisdiction may race to file a Securities Act claim as soon as a claim becomes ripe in order to shut out plaintiffs who might file a combination action in federal court. Intra-forum tensions and skewed incentives could become a hallmark of the Securities Act space.

Whatever the trends in filing, it is safe to say that some number of state courts will begin grappling with federal securities law after *Cyan*. As those cases work through the system, expect litigation about the applicability of the PSLRA to state court actions. Justice Kagan's opinion placed the PSLRA's reforms in two categories, distinguishing between "procedural" provisions only applicable in federal court, and "substantive" provisions that are applicable in state and federal court alike.<sup>54</sup> Some provisions in the PSLRA may be self-evidently "substantive" (e.g., safe harbor for forward-looking statements) or obviously "procedural" (e.g., settlement agreements may not be filed under seal). Others exist in a gray area. Moving forward, defendants subject to suit in state court may attempt to invoke certain PSLRA protections as "substantive" provisions applicable to defendants in state as well as federal court. In particular, the PSLRA's automatic stay of discovery could emerge as a battleground. At least two state court decisions have assumed that the stay of discovery applies to Securities Act claims filed in state court.<sup>55</sup> But discovery provisions arguably fall into a "procedural" rather than "substantive" bucket under the dichotomy set out in *Cyan*.

Meanwhile, companies may take matters into their own hands by adopting "exclusive federal forum" bylaw provisions designating federal district courts as the exclusive forum for Securities Act disputes.<sup>56</sup> If widely adopted, this option could provide a straightforward (and low-cost) mechanism for companies to skirt the unpredictable nature of a state court suit—provided, of course, that courts deem exclusive federal forum designations enforceable. In fact, two federal courts in California already have ruled that such provisions are invalid,<sup>57</sup> while Delaware's Court of Chancery is set to review the enforceability of these bylaws provisions soon. The pending Delaware action challenges exclusive federal forum provisions in the bylaws of three companies that recently completed IPOs.<sup>58</sup> The Delaware complaint argues that if companies are permitted to close the state courts to Securities Act plaintiffs via bylaws, corporate counsel will begin pushing for bylaws

designating arbitral tribunals as the exclusive forum for securities actions—effectively ending all judicial oversight over federal securities laws.<sup>59</sup>

Finally, there is always a chance that Congress will accept Justice Kagan's implicit invitation to amend SLUSA to eliminate state court jurisdiction over Securities Act class actions. Even assuming that Congress intended to do so when it passed SLUSA, it is unclear whether there is any appetite for such a step twenty years later. And, of course, any push to revise the statute may depend on the results of this year mid-term Congressional elections.

## Conclusion

The relative paucity of *Cyan*-eligible actions suggests that the decision may not lead to a massive increase in state court filings. To be sure, the decision opens up filing opportunities for plaintiffs in jurisdictions like New York, which sees a large number of IPOs each year but previously rejected attempts to file Securities Act claims in its state courts. In other jurisdictions, notably California, very little may change after *Cyan*. As *Cyan*'s impact plays out, advocates should pay particular attention to the exclusive federal forum bylaws litigation winding its way through the Delaware courts—if enforceable, many corporations will jump to include these provisions in their bylaws, especially if Congress does not act swiftly to overturn *Cyan* by legislation.

## Notes

1. *Cyan v. Beaver Cty. Emps. Ret. Sys.*, —S. Ct.—, 2018 WL 1384564, at \*17 (Mar. 20, 2018).
2. Darren J. Robbins *et al.*, *After Cyan: Creative Lawyering Can't Displace Clear Statute* (Mar. 26, 2018), available at <https://www.law360.com/articles/1026008/after-cyan-creative-lawyering-can-t-displace-clear-statute>.
3. See Securities Act § 12(a)(1) (providing for a private right of action); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 n.4 (1975) (detailing the private civil remedies provided for in the Securities Act and Exchange Act).
4. Studies of the limited legislative history underlying the Acts suggest that the grant of exclusive

jurisdiction under the Exchange Act was the result of “pure happenstance.” Charles Alan Wright, Arthur Miller, *et al.*, *Exclusive Federal Court Jurisdiction*, 13 Fed. Prac. & Proc. Juris. § 3527 n.19 (3d ed. 2017) (citing American Law Institute, Study of the Division of Jurisdiction Between State and Federal Courts, Official Draft § 1311(b) at 183–84 (1969)); *The Securities Exchange Act and the Rule of Exclusive Federal Jurisdiction*, 89 YALE L.J. 95, 109 n.58 (1979) (citations omitted) (summarizing the Exchange Act’s legislative history and noting that “[n]either Senate nor House document indicates any reason for the election of Exchange Act exclusive jurisdiction”). One secondary source has theorized that the grant of exclusive jurisdiction was “a deliberate concession to the securities industry governed by the new legislation.” Matthew J. Press, *Arbitration of Claims Under the Securities Exchange Act of 1934: Is Exclusive Jurisdiction Still Justified?*, 77 B.U. L. Rev. 629, 630, 634, 636 n.39 (1997) (highlighting the securities industry’s “propaganda” campaign to Congress leading up to the enactment of the Acts).

5. Exchange Act § 27(a) (“The district courts of the United States . . . shall have exclusive jurisdiction” over ‘34 Act claims).
6. Securities Act § 22(a) (“The district courts of the United States . . . shall have jurisdiction [over Securities Act claims] concurrent with State and Territorial courts.”).
7. Securities Act § 22(a).
8. The House Conference Report that accompanied the PSLRA noted that plaintiffs were using the Securities and Exchange Acts to harm “the entire U.S. economy” via “nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and manipulation by class action lawyers of the clients whom they purportedly represent.” *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81 (2006) (quoting H.R. Conf. Rep. No. 104–369 at 31 (1995)).
9. Certain changes, *e.g.*, the “safe harbor” from liability for “forward-looking statements” made by company officials, applied to claims brought in either federal or state court. Securities Act § 27A; Exchange Act § 21E. Other amendments apply only to claims brought under the Exchange Act, *i.e.*, only to certain claims brought in federal court. These added safeguards that apply only to claims brought in federal court include (i) a heightened pleading standard applies to claims brought in federal court; Exchange Act § 21D(b)(1) (making clear that claims brought “under this chapter,” *i.e.*, under the Exchange Act, are subject to the heightened pleading standard); (ii) a federal complaint must be filed with a “sworn certification” stating, *inter alia*, that the plaintiff had not purchased the relevant security “at the direction of plaintiff’s counsel”; Securities Act § 27(a)(2)(A)(ii); (iii) a prohibition on bounties to class representatives, as, instead, class members must receive the same pro rata amount of any final judgment; *id.* § 27(a)(4); (iv) a restriction on any award of attorneys’ fees and expenses to a “reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class”; *id.* § 27(a)(6); and (v) settlement agreements in federal cases generally cannot be filed under seal, and all meaningful information concerning a proposed settlement must be disclosed to class members, *id.* § 27(a)(5), (7).
10. *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 82 (2006). Indeed, as Congress noted after enacting the PSLRA and prior to enacting SLUSA, state-court class actions involving nationally traded securities “were virtually unknown [but] they are brought with some frequency now.” S. Rep. No. 105-182 at 4 (May 4, 1998).
11. SLUSA § 2 (setting forth the Congressional findings and objectives underlying SLUSA).
12. SLUSA § 2(3). In the legislative history for SLUSA, the Committee on Banking, Housing, and Urban Affairs explained the problematic rationale underlying the shift as follows: “First . . . plaintiff’s counsel file state court complaints when the underlying facts appear not to satisfy new, more stringent federal pleading requirements, or otherwise seek to avoid the substantive or procedural provisions of the Act. Second plaintiffs appear to be resorting to increased parallel state and federal litigation in an effort to avoid federal discovery stays or to establish alternative state court venues for settlement of federal claims.” S. Rep. No. 105-182 at 3 (May 4, 1998).
13. S. Rep. No. 105-182 at 3 (May 4, 1998).
14. SLUSA § 2.
15. *See* SLUSA § 2. As the Supreme Court noted in *Cyan*, while SLUSA also amended portions of the Exchange



- Act, it did not alter the Exchange Act's exclusive federal jurisdiction provision. 2018 WL 1384564, at \*5.
16. Securities Act § 16(b).
  17. *Id.* § 16(c).
  18. Courts divided over whether the “except clause” exempted from the Securities Act's grant of concurrent jurisdiction to state courts *all* covered class actions, or just those listed under Section 16(b), *i.e.*, covered class actions brought under state law concerning dishonest or fraudulent purchase or sale of a nationally traded security. *Compare, e.g., Rovner v. Vonage Holdings Corp.*, No. 07-178 (FLW), 2007 WL 446658 (D.N.J. Feb. 5, 2007) (finding that, following SLUSA, state courts did not have jurisdiction to hear covered class actions based on federal or state law under the Securities Act); *Wunsch v. Am. Realty Capital Props.*, No. JFM- 14-4007, 2015 U.S. Dist. LEXIS 48759 (D. Md. Apr. 14, 2015) (same); *In re King Pharms., Inc.*, 230 F.R.D. 503 (E.D. Tenn. 2004) (same), *with, e.g., Fortunato v. Akebia Therapeutics, Inc.*, No. 15-13501-PBS, 2016 WL 1734073 (D. Mass. Apr. 29, 2016) (finding that, following SLUSA, state courts maintained concurrent jurisdiction to hear covered class actions based on federal law under the Securities Act claims); *Bernd Bildstein IRRA v. Lazard Ltd.*, No. 05 CV 3388 (RJD) (RML), 2006 WL 2375472 (E.D.N.Y. Aug. 14, 2006) (same); *Niitsoo v. Alpha Natural Res., Inc.*, 902 F. Supp. 2d 797 (S.D. W. Va. 2012) (same). *See also* Petition for Writ of Certiorari at Appendix F, G, *Cyan*, No. 15-1439 (U.S. May 24, 2016) (collecting cases on either side of the judicial split).
  19. *See also, e.g., supra* note 18 (collecting cases finding that SLUSA stripped state courts of concurrent jurisdiction to hear covered class actions under the Securities Act).
  20. 613 F. Supp. 2d 419 (S.D.N.Y. 2009).
  21. 613 F. Supp. 2d at 424.
  22. *Id.* at 425.
  23. *Id.* at 423.
  24. 195 Cal. App. 4th 789 (2011).
  25. *See also, e.g., supra* note 18 (collecting cases finding that, following SLUSA, state courts maintained jurisdiction to hear covered class actions based on federal law under the Securities Act claims).
  26. Securities Act § 22(a).
  27. Securities Act § 16. Subsection (d) provides an exception to subsections (b) and (c), and notes that certain covered class actions based on state law, like those based on the law of the state of the issuer's incorporation, can still be brought in state courts. *Id.* § 16(d). Subsection (e) includes another exception, allowing state securities agencies to bring enforcement actions. *Id.* § 16(e).
  28. *See id.* § 16.
  29. As the Supreme Court held in 2006, subsection (c) also supports the conclusion that the except clause's cross-reference to Section 16 implicates only certain covered class actions that are based on state law, as subsection (c)— which concerns removal—applies to the exact same universe of actions as those that fall under subsection (b)—which precludes certain covered class actions that are based on state law. *Kircher v. Putnam Funds Trust*, 547 U.S. 633, 643-44 (2006). Under *Kirchner*, since covered class actions based on federal law that are brought in state court cannot be removed to federal court, state courts arguably retain concurrent jurisdiction to hear these federal-law claims. *See id.*
  30. *Id.* at 794 (quoting *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992)).
  31. Interestingly, the petition had been pending for thirteen months and distributed for conference three times by the time of the cert grant. *See* Supreme Court Docket, *Cyan*, No. 15-1439 (U.S.).
  32. *See Cyan*, 2018 WL 1384564, at \*7.
  33. *Id.*
  34. *Id.*
  35. *Id.* at \*8.
  36. *Id.*
  37. *Id.* at \*7 (citing Securities Act § 22(a)).
  38. *See id.* at \*8.
  39. *Id.*
  40. *Id.* at \*9 (citation omitted). The Court memorably summarized the general rule as follows: “Congress does not ‘hide elephants in mouseholes.’” *Id.* (citation omitted).
  41. *See id.* at \*14.
  42. *Id.*
  43. *See generally id.* at \*14-16.
  44. *Id.* at \*16.
  45. *See id.*
  46. *See, e.g., Supreme Court Allows Securities Act Class Actions to Remain in State Court*, Cooley LLP (Mar. 27,

2018), available at <https://www.cooley.com/news/insight/2018/2018-03-27-supreme-court-allows-securities-act-class-actions-to-remain-in-state-court> (arguing that Cyan will lead plaintiffs to file more Securities Act class actions in state court); Boris Feldman & Ignacio Salceda, *After Cyan: Some Prognostications* (Mar. 23, 2018), available at <https://www.law360.com/articles/1025703/after-cyan-some-prognostications> (same); U.S. Supreme Court Holds that SLUSA Did Not Eliminate State Court Jurisdiction, Goodwin Procter LLP (Mar. 21, 2018), available at [https://www.goodwinlaw.com/publications/2018/03/03\\_21\\_18-us-supreme-court-holds-that-slusa](https://www.goodwinlaw.com/publications/2018/03/03_21_18-us-supreme-court-holds-that-slusa) (same).

47. See Effect on non-removal of Securities Act claims, 4C N.Y. Prac., Com. Litig. in New York State Courts § 90:13 (4th ed. 2017) (noting that the U.S. District Court for the Southern District of New York maintained that only federal courts had jurisdiction to hear Securities Act claims).
48. See, e.g., Douglas H. Flaum et al., *Why Section 11 Class Actions Are Proliferating in Calif.* (Apr. 27, 2015), available at <https://www.law360.com/articles/647708>.
49. Cornerstone Research, *Securities Class Action Filings—2017 Year in Review*, at 18 (Jan. 2018).
50. NERA Consulting, *Recent Trends in Securities Class Actions Litigation: 2017 Full-Year Review*, at 5 (Jan. 29, 2018).
51. *Id.*
52. *Id.*
53. E.g., *Electrical Workers Local #357 Pension and Health & Welfare Trusts v. Clovis Oncology, Inc.*, No. 16-cv- 00933-EMC, 2016 WL 2592947 (N.D. Cal. May 5, 2016); *Fortunato v. Akebia Therapeutics, Inc.*, No. 15-13501-PBS, 2016 WL 1734073 (D. Mass. Apr. 29, 2016); *In re Waste Mgmt. Inc. Sec. Litig.*, 194 F. Supp. 2d 590 (S.D. Tex. 2002).
54. *Cyan* at \*10.
55. *Milano v. Auhll*, No. SB 213476, 1996 WL 33398997, at \*2-3 (Cal. App. Dep't Super. Ct. Oct. 2, 1996); *Shores v. Cinergi Pictures Entm't Inc.*, No. BC149861, Notice of Ruling 2 (Cal. Super. Ct. L.A. Cnty. Sept. 5, 1996).
56. These so-called "Grundfest clauses" (named after the Stanford professor who proposed this idea) typically use this or similar language:
 

Unless the Company consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall be the exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933.
57. See Compl. ¶ 46, *Sciabacucchi v. Salzberg et al.*, No. 2018-0931, 2017 WL 6815531 (Del. Ch. Dec. 29, 2017) (filing suit against companies attempting to implement the "Grundfest Solution," and explaining that Professor Grundfest proposed the exclusive federal forum bylaw at a May 6, 2016 presentation at the Rock Center for Corporate Governance); Priya Cherian Huskins, *How IPO Companies Are Adopting Choice of Forum Bylaws to Avoid Section 11 Suits in State Court*, Woodruff Sawyer & Co. (May 23, 2017), available at <https://wsandco.com/do-notebook/ipo-companies-adopting-choice-forum-bylaws/> (detailing the "Grundfest Solution"); Kevin LaCroix, *Delaware Chancery Court Action Challenges Federal Forum Bylaws*, The D&O Diary (Jan. 7, 2018), available at <https://www.dandodiary.com/2018/01/articles/director-and-officer-liability/delaware-chancery-court-action-challenges-federal-forum-bylaws/> (same).
58. *Clayton v. Tintri, Inc.*, No. 17-CV-05683-YGR, 2017 WL 4876517, at \*2 (N.D. Cal. Oct. 30, 2017) ("[D]efendants cite no authority for the proposition that corporate bylaws can preempt federal securities law."); see also Minute Order, *Iuso v. Snap, Inc.*, 17-cv-7176-VAP-RAO (C.D. Cal. Nov. 21, 2017), ECF No. 50 ("[T]he bylaws of Snap's corporate charter cannot overcome federal securities statutes and regulations."). Interestingly, the same law firms that squared off in *Cyan* represented the litigants in *Tintri*.
59. See generally *Sciabacucchi* Compl. *supra* note 52 (seeking declaratory judgments that the exclusive federal forum provisions for Blue Apron Holdings, Stitch Fix, Inc. and Roku, Inc. are invalid under Delaware law).

## ■ EXECUTIVE COMPENSATION

# Top Ten Emerging Trends in Pay Ratio Disclosure

*Preliminary trends are emerging from the pay ratio disclosures filed by U.S. public companies in 2018: few companies are using statistical sampling to identify their median employee; companies are relying on the de minimis exemption, but not the data privacy exemption; companies are excluding employees acquired in acquisitions; and very few companies are using supplemental pay ratios.*

By Christina F. Pearson, Brian M. Wong, and Jessica Lutrin

The 2018 proxy season is in full swing and, since the beginning of 2018 through March 16, 2018, 739 U.S. companies have made public disclosures of the ratio of the annual total compensation of their chief executive officer (CEO) to the median of the annual total compensation of all employees (referred to as the pay ratio) as required by Item 402(u) of Regulation S-K, which was added by the Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>1</sup>

Below is a list of the top ten emerging trends that we identified based on our review of the proxy statements and Form 10-Ks for 45 U.S. public companies that are large accelerated filers with a market capitalization of at least \$25 billion filed between January 1, 2018 and March 16, 2018. As companies continue to disclose their pay ratios, we expect trends to evolve.

**Christina F. Pearson and Brian M. Wong** are partners, and **Jessica Lutrin** is counsel, at Pillsbury Winthrop Shaw Pittman LLP. The authors wish to thank Julie Park and Charmaine D.V. Lindley for their contribution to this article.

### Pay Ratio Ranges

The 45 companies in the data set represent eight industries. The range of pay ratios differs by industry, with companies in the Industrial & Manufacturing and Wholesale & Retail industries having the highest pay ratios and companies in the Financial & Insurance industry having the lowest pay ratio.

Industry	No. of Companies	Low-end of Pay Ratio Range	High-end of Pay Ratio Range
Energy & Natural Resources	6	72:1	935:1
Financial & Insurance	14	1.87:1	575:1
Healthcare & Pharmaceuticals	3	251:1	313:1
Industrial & Manufacturing	8	32:1	2,526:1
Services	2	274:1	439:1
Technology & Telecommunications	3	148:1	341:1
Utilities	2	80:1	102:1
Wholesale & Retail	7	230:1	1,353:1

### Emerging Trends

#### Placement of Pay Ratio Disclosure

The Securities and Exchange Commission (SEC) does not require that the pay ratio disclosure be included in the Compensation Discussion and Analysis (CD&A) or otherwise in the executive compensation section of a company's proxy statement or

Form 10-K. Therefore, companies have flexibility in terms of where they place their pay ratio disclosures.

The overwhelming majority of companies that we reviewed—22 companies (or 49 percent)—placed their pay ratio disclosures at the end of the “Potential Payments Upon Termination or Change in Control” table after all the compensation-related tables in the proxy statement. The remaining 23 companies placed their disclosures in a variety of other locations in their public filings, including in the CD&A and among the executive compensation-related tables.

### Use of Disclaimers

Companies are allowed to provide a disclaimer statement in their pay ratio disclosure that, given the different methodologies used by public companies to determine an estimate of their pay ratio, the estimated pay ratio should not be used as a basis for comparison between companies. Thirteen companies (or 29 percent) included a disclaimer statement in their pay ratio disclosures.

### Supplemental Pay Ratios

The pay ratio rules allow companies to make supplemental disclosures, including additional ratios if desired. Supplemental pay ratios may provide helpful context for investors, especially for those companies with pay ratios on the higher end of the range. Only two companies (or 4 percent) provided supplemental pay ratios:

- A company in the Healthcare & Pharmaceutical industry with a pay ratio of 313 to 1 included a supplemental pay ratio of 223 to 1, which excluded the CEO’s special one-time performance-based incentive award.
- A company in the Energy & Natural Resources industry with a pay ratio of 935 to 1 included a supplemental pay ratio of 156 to 1, which excluded approximately 32,000 retail employees from its pay ratio calculation.

### Description of Median Employee

The pay ratio rules require that only the median employee’s annual total compensation be disclosed,

and the rules do not require that any identifying features of the median employee be disclosed. However, companies may voluntarily disclose such features.

Nine companies (or 20 percent) included a description of their median employee in their pay ratio disclosure. Of the nine companies, six companies disclosed the employee’s location, three companies disclosed the business segment for which the employee worked, two companies disclosed whether the employee was part- or full-time and one company disclosed whether the median employee received a special pay component.

### Consistently Applied Compensation Measure

In determining the median employee, companies may rely on a consistently applied compensation measure (CACM), such as total cash compensation or total cash and equity compensation. The three primary types of CACMs used by the companies that we reviewed were:

- total cash compensation (base salary or wages plus cash bonuses or commissions)—17 companies, or 38 percent;
- taxable income as reported on Form W-2 for 2017—12 companies, or 27 percent; and
- base salary or wages only—nine companies, or 20 percent.

### Statistical Sampling

As an alternative to a CACM, companies may use statistical sampling to identify their median employee. Only four companies (or 9 percent) used statistical sampling to identify their median employee. In addition, one company disclosed that it hired an audit firm which used statistical sampling to confirm that the company had identified correctly its median employee.

### De Minimis Exemption

In determining the median employee, a company may exclude non-U.S. employees if they account for 5 percent or less of the company’s total employee

population (including those excluded on the basis of the data privacy exemption, described below).

Twenty companies (or 44 percent) relied on the *de minimis* exemption to exclude non-U.S. employees. Notably, one company in the Services industry relied on the exemption to exclude approximately 22,000 non-U.S. employees in 70 countries.

### Data Privacy Exemption

In determining the median employee, a company may exclude non-U.S. employees if obtaining the information required to comply with the pay ratio rules would violate a non-U.S. jurisdiction's data privacy rules. We note that the SEC has set the hurdle very high to rely on this exemption. None of the 45 companies disclosed that they relied on the data privacy exemption.

### Acquisition Exemption

A company may omit employees from its pay ratio calculation if the employees were added to the company's workforce as a result of an acquisition or business combination for the fiscal year in which the transaction becomes effective, but the company must disclose the approximate number of employees that are omitted.

Six companies (or 13 percent) disclosed that they relied on this exemption. There is no cap on the number of employees that may be omitted from the calculation using this exemption. Notably, one company in the Industrial & Manufacturing industry omitted approximately 40,000 employees acquired in 15 corporate transactions in 2017 from its pay ratio calculation.

### COLA Adjustment

Companies may determine their median employee by adjusting the compensation of their employees to the cost of living in the CEO's jurisdiction. None of the 45 companies disclosed that they made a cost-of-living adjustment.

### Conclusion

Based on the trends discussed above, we think that companies will spend most of their time determining their CACM and median employee. Once the median employee has been identified, a company may rely on that determination for three years unless there has been a change in the company's employee population or compensation arrangements that it reasonably believes would result in a significant change to its pay ratio disclosure. Because this determination can be onerous, it is unlikely that companies will make significant changes to their pay ratio calculations in 2019. Additionally, companies should consider the best location for their pay ratio disclosure, whether to add a disclaimer and whether any of the exemptions are available. Finally, it seems unlikely that companies will elect to provide supplemental pay ratios, take advantage of the statistical sampling alternatives, use the data privacy exemption or provide a COLA adjustment.

### Notes

1. For a detailed summary of the pay ratio disclosure requirements, see our article "Brace for 2018: The SEC's Pay Ratio Rule" (<https://www.pillsburylaw.com/en/news-and-insights/brace-for-2018-sec-pay-ratio-rule.html>).

## ■ CORPORATE GOVERNANCE

# The Delaware Supreme Court Provides Guidance on Directors' Fiduciary Duty of Disclosure

*In reversing a Court of Chancery decision, the Delaware Supreme Court has provided a reminder that while Delaware law gives significant weight to the stockholders' expression of their will, it is only to the extent that decision is made on a fully informed basis.*

By John Mark Zeberkiewicz and Stephanie Norman

In *Appel v. Berkman*,<sup>1</sup> the Delaware Supreme Court reversed the Delaware Court of Chancery's dismissal of claims relating to the merger of Diamond Resorts International, Inc. ("Diamond"),<sup>2</sup> finding that the stockholders of Diamond were not fully informed when they tendered their shares in a first-step tender offer followed by a back-end merger under Section 251(h) of the Delaware General Corporation Law (DGCL). In reversing the Chancery Court, the Supreme Court held that Diamond's failure to disclose the specific reasons for which its founder and chairman had abstained from approving the transaction rendered the disclosure document materially misleading.

### Background

In early 2016, Diamond commenced a process to review its strategic alternatives, establishing a strategic review committee to oversee that effort.

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In April 2016, at the first stage of the process, Diamond received indications of interest ranging from \$23 to \$33 per share. Over the ensuing weeks, Diamond's management conducted due diligence with potential bidders, leading ultimately to a bid from Apollo Global Management LLC of \$30.25 per share. In late June, Diamond's board met to consider Apollo's bid. In the two meetings of Diamond's board leading to its approval of the transaction, Stephen Cloobek, Diamond's founder and chairman as well as its largest stockholder, indicated that he was not supportive of the transaction. The minutes of those board meetings reflected his disappointment with the price (including his disappointment with the management team for failing to operate the business in such a manner to command a higher price) as well as his view that it was not the appropriate time to sell Diamond. On that basis, he abstained from voting for the transaction.<sup>3</sup>

After the transaction was announced, but before its consummation, the plaintiff made a demand to inspect Diamond's books and records under Section 220 of the DGCL, giving it access to, among other things, minutes of meetings of the Diamond board. On September 2, 2016, Apollo acquired Diamond for \$30.25 per share pursuant to a tender offer in which more than 80 percent of Diamond's shares were tendered for purchase followed by a merger without a vote of stockholders under Section 251(h) of the DGCL.<sup>4</sup> Two months later, the plaintiff brought suit challenging the process that the Diamond board and Stephen Cloobek followed in negotiating and approving the transaction and alleging that Diamond's board failed to disclose all material information to stockholders with respect to the transaction.<sup>5</sup>

## The Chancery Court's Opinion

The director-defendants and Mr. Cloobek (as a director and as chairman) moved to dismiss plaintiff's claims, arguing that, since the holders of a majority of Diamond's outstanding shares had tendered their shares in the offer on a fully informed and uncoerced basis, the transaction was subject to review under the deferential business judgment rule.<sup>6</sup> Pointing to the Delaware Supreme Court's holding in *Corwin*, the Chancery Court noted that, "when a transaction not subject to the entire fairness standard" ab initio, as was the case with the acquisition of Diamond, "is approved by a fully informed, uncoerced vote of the disinterested stockholders," the stockholders' vote has the effect of restoring the presumption business judgment rule.<sup>7</sup> The Court further reviewed its own precedent to the effect that, in the context of a two-step transaction under Section 251(h), the stockholders' tendering of their shares into a first-step tender offer has the same effect as a vote at a meeting.<sup>8</sup>

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*"Delaware law does not require 'that individual directors state . . . the grounds of their judgment for or against a proposed shareholder action.'"*

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Under *Corwin*, once the presumption of the business judgment rule has been restored, the plaintiff's price and process claims will be dismissed unless it is able to show that the transaction constituted waste.<sup>9</sup> In order to avoid dismissal under *Corwin*, a plaintiff challenging a transaction must show that the vote or tender, as the case may be, was not fully informed (in the sense that the stockholders were not apprised of all information material to their decision whether to vote their shares in favor of the transaction or tender their shares

in the offer, as applicable) or was coerced (in the sense that the stockholders' decision was not based solely on the merits of the transaction and there were no exogenous factors effectively driving their decision whether to vote or tender their shares in a particular manner).<sup>10</sup>

As more than 80 percent of Diamond's outstanding shares had been tendered in the offer and the plaintiff had pled neither waste nor coercion, the plaintiff could only avoid a dismissal of his claims by showing that the stockholders' decision whether to tender was not made on a fully informed basis.<sup>11</sup> To that end, the Chancery Court addressed the plaintiff's principal disclosure claim—namely, that Diamond's Schedule 14D-9 omitted disclosure regarding the reasons underlying Mr. Cloobek's alleged "disappointment" with the transaction's process and the ultimate price<sup>12</sup>—which claim hinged almost entirely on the Chancery Court's 1992 opinion in *Gilmartin v. Adobe Resources Corp.*<sup>13</sup> In *Gilmartin*, the Court found that the proxy statement was materially misleading to the extent it conveyed to the target preferred stockholders that the merger consideration they were to receive was fair

without an additional simultaneous, "tempering disclosure" that two of the target corporation's directors believed that it was the wrong time to sell and had expressed that view to their fellow directors. That those two directors were also the target corporation's two most senior executives would have, according to the *Gilmartin* Court, given the omitted disclosure "heightened credibility."<sup>14</sup>

While recognizing the *Gilmartin* Court's opinion, the Chancery Court in *Appel* decided instead to follow more recent precedent suggesting that the omitted facts were not material. Specifically, the Chancery Court cited *Newman v. Warren* for the proposition that "Delaware law does not require 'that individual directors state (or the corporation state for them) the

grounds of their judgment for or against a proposed shareholder action.”<sup>15</sup> and catalogued the numerous opinions that followed the *Newman* Court’s reasoning.<sup>16</sup> The Chancery Court found that the Schedule 14D-9 had accurately summarized the Diamond board’s action with respect to the approval of the transaction, noting that it expressly stated that Mr. Cloobek had abstained from voting for the transaction and clearly disclosed that he had not determined whether to tender his shares. The Chancery Court then noted that the plaintiff had not pointed to an instance in which the Schedule 14D-9 inaccurately characterized Mr. Cloobek’s vote or his intentions. Ultimately, the Chancery Court stated that the plaintiff had not persuaded it that the reasons for Mr. Cloobek’s abstention were material, given “the significant weight of twenty-five years of Delaware authority.”<sup>17</sup>

## The Supreme Court’s Reversal

In its opinion reversing the lower court, the Supreme Court stated that the “sole issue” on appeal was whether the Chancery Court’s ruling rejecting plaintiff’s disclosure-based claims surrounding the basis for Mr. Cloobek’s abstention, along with its related ruling that the stockholders’ overwhelming support of the tender offer restored the presumption of the business judgment rule, was correct.<sup>18</sup> The Supreme Court indicated that, as a result of *Corwin* and its progeny, the Delaware courts will give significant deference to the will of stockholders, but only to the extent the stockholders’ decisions are made on a fully informed basis. In the Supreme Court’s view, in light of Mr. Cloobek’s role as the founder and chairman of Diamond, his

views regarding the wisdom of selling the company were ones that reasonable stockholders would have found material in deciding whether to vote for the merger or seek appraisal, and the failure to disclose them rendered the facts that were disclosed misleadingly incomplete.<sup>19</sup>

The Supreme Court’s analysis proceeded from the basic premise that, whenever they are seeking or recommending stockholder action, directors have a fiduciary duty to disclose all information material to the stockholders’ decision. It then recited the familiar test that information is material if there is a “substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote” and that “disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.”<sup>20</sup>

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### *Directors have a fiduciary duty to disclose all information material to the stockholders’ decision.*

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In holding that the omitted disclosure was material, the Supreme Court rejected defendants’ argument that Mr. Cloobek’s views as to the appropriate time to sell Diamond were only his opinions and thus were not facts required to be disclosed.<sup>21</sup> The Supreme Court stated:

proxy statements seeking approval of major transactions are filled with statements of fact about opinions, in the sense that they recount why fiduciaries and their advisors took certain actions and why they believed the transaction was in the company’s best interest.<sup>22</sup>

The Supreme Court then cited the portions of the Schedule 14D-9 expressing the reasons for which Diamond’s board supported the transaction, stating that, when viewed in light of the many factors favoring the transaction, disclosure regarding Mr. Cloobek’s concerns “would catch a reasonable stockholder’s attention and ‘significantly alter[] the total mix of information’” regarding the stockholders’ decision. Specifically, the Supreme Court stated that the Schedule 14D-9 could have referenced—but did not—Mr. Cloobek’s views in the description



of the risk factors relating to the merger, including that the stockholders would not participate in any future potential upside and that the Company's performance could exceed its forecasts. The Supreme Court found that the Schedule 14D-9's disclosure to the effect that the Diamond board's determination that the company's strategic alternatives were not as favorable as the transaction was at odds with Mr. Cloobek's view and that the statement regarding the fairness of the price stockholders would receive for tendering their shares, without "additional simultaneous, tempering disclosure" regarding Cloobek's reasons for abstaining, was materially misleading.

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### *Stockholders are entitled to rely on the views of the fiduciaries they have elected to serve their interests.*

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Although citing favorably to the Chancery Court's opinion in *Gilmartin*, the Supreme Court did not purport to overturn *Newman* or its progeny. The Supreme Court expressly rejected any reading of *Newman* that would suggest that a director's basis for abstaining or dissenting from a decision could never be material,<sup>23</sup> indicating that any such reading would subvert basic fiduciary principles, given that stockholders are entitled to rely on the views of the fiduciaries they have elected to serve their interests.<sup>24</sup> Nevertheless, the Supreme Court recognized that, as is often the case in any review of fiduciary conduct, there is little sense in adopting *per se* rules. Thus, while it declined to hold that a director's opinions or bases for rejecting or abstaining from a decision could never be material, it likewise found that the omission of that information would not always be material. Instead, the Court reiterated that it would "adhere to the contextual approach that has long been Delaware law," requiring inquiry into whether the statement or omission of a fact would affect the total mix of information, or whether additional disclosure would be required to ensure that the other disclosures are not materially misleading.

As the Chancery Court's dismissal of the claim was based on its finding that Diamond stockholders had tendered their shares on a fully informed, uncoerced basis, the Supreme Court's holding that the Schedule 14D-9 was materially misleading precluded the *Corwin*-based invocation of the business judgment rule, resulting in the case being remanded for further proceedings.

## Conclusion

In providing for the business judgment rule to apply to third-party merger transactions that are approved by fully informed, uncoerced and disinterested stockholders (whether through a vote or a tender of their shares), Delaware law gives significant weight to the stockholders' expression of their will. The Supreme Court's opinion in *Appel* serves as a reminder that the Delaware courts will defer to the stockholders' decision regarding their own fate only to the extent that decision is made on a fully informed basis. Under Delaware law, there are no bright-line rules regarding whether a particular fact is material. Rather, corporations and practitioners must consider the materiality of any fact in light of the particular context in which it arises and in light of Delaware's common law.<sup>25</sup>

## Notes

1. *Appel v. Berkman*, — A.3d —, 2018 WL 947893 (Del. Feb. 20, 2018).
2. *Appel v. Berkman*, 2017 WL 6016571 (Del. Ch. July 13, 2017).
3. *Appel*, 2018 WL 947893, at \*1.
4. *Appel*, 2017 WL 6016571, at \*1.
5. *Id.*
6. *Id.*
7. *Id.* (citing *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304, 309 (Del. 2015)).
8. *Appel*, 2017 WL 6016571, at \*1 (citing *In re Volcano Corp. S'holder Litigation*, 143 A.3d 727, 747 (Del. Ch. 2016), for the proposition that the same public policy underpinning the holding in *Corwin* recognizing the cleansing effect of a fully informed, uncoerced vote of

stockholders applied in the context of a two-step transaction under Section 251(h), where the stockholders' tendering of their shares serves effectively serves as the manifestation of their approval of the transaction).

9. *Singh v. Attenborough*, 137 A.3d 151, 151–52 (Del. 2016).
10. See *Sciabacucchi v. Liberty Broadband Corp.*, 2017 WL 2352152, at \*15 (Del. Ch. May 31, 2017). In *In re Saba Software, Inc. Stockholder Litigation*, 2017 WL 1201108 (Del. Ch. Mar. 31, 2017), the Court identified circumstances under which a vote would be found not to be uncoerced for purposes of *Corwin's* cleansing effect. In that case, a few years before its acquisition, Saba Software, Inc., through two of its former executives, had engaged in a fraudulent scheme to overstate its earnings. As a result, the Securities and Exchange Commission (SEC) required it to restate its financial statements. Despite providing the SEC repeated assurances that it would do so, Saba failed to effect the restatement, which led ultimately to its delisting. When faced with the decision whether to approve the merger at \$9 per share, which was well below historical averages, or continue to hold shares that, due to the delisting, had become illiquid, the stockholders approved the merger. Due to the impact of the delisting on the stockholders' decision, the Court found that the plaintiff had pled facts allowing a reasonable inference that the vote was not uncoerced and, accordingly, refused to allow the invocation of the business judgment rule under *Corwin* and allowed the plaintiff's claims to proceed. *Id.* at \*1.
11. *Appel*, 2017 WL 6016571, at \*2.
12. *Id.* The plaintiff also made allegations regarding the disclosure surrounding Diamond's financial advisor, including with respect to its relationships with the buyer, as well as a Diamond board member with ties to the buyer. The *Appel* Court dispensed with those claims, and they were not addressed by the Supreme Court in its opinion on appeal. See *Appel*, 2018 WL 947893.
13. 1992 WL 71510 (Del. Ch. Apr. 6, 1992).
14. *Id.*
15. *Appel*, 2017 WL 6016571, at \*2. (citing *Newman v. Warren*, 684 A.2d 1239, 1246 (Del. Ch. 1996)).
16. The Court in *Appel* cited the following opinions as ones adopting the reasoning in *Newman: In re Williams Cos., Inc. S'holder Litig.*, 2016 WL 197177, at \*2 (Del. Ch. Jan. 13, 2016); *Dias v. Purches*, 2012 WL 4503174, at \*9 (Del. Ch. Oct. 1, 2012); *In re Sauer–Danfoss Inc. S'holders Litig.*, 65 A.3d 1116, 1130 (Del. Ch. 2011). See *Appel*, WL 2017 6016571, at \*2. The Chancery Court cited *Huff Energy Fund, L.P. v. Gershen*, 2016 WL 5462958, at \*15 (Del. Ch. Sept. 29, 2016), for the proposition that the *Newman* Court's reasoning was extended to apply to directors' abstentions from voting.
17. *Appel*, 2017 WL 6016571, at \*2.
18. *Appel*, 2018 WL 947893, at \*1.
19. *Id.* In this regard, the Supreme Court noted that in Diamond's most recent proxy statement it had stated that Mr. Cloobek has a "unique understanding of the opportunities and challenges that we face and ... in-depth knowledge about our business, including our customers, operations, key business drivers and long-term growth strategies, derived from his 30 years of experience in the vacation ownership industry and his service as our founder and former Chief Executive Officer." *Id.* at \*3.
20. *Id.* at \*3.
21. *Id.* at \*4.
22. *Id.*
23. *Id.* at \*5.
24. *Id.* In expressing its view, the Supreme Court also made the following observation that illustrates its views of corporate governance generally: "Accepting the notion that board disclosures should portray boards of directors as monolithic bastions of groupthink, within which no good faith back-and-forth occurs and no differences of opinion about important issues exists, would do little to breed respect for director decision-making. And it would adopt a vision of stockholders as immature and incapable of considering the pros and cons involved in important transactions. Full and fair disclosure involves giving stockholders a picture that is materially accurate, and in which the imperfections and inconsistencies are not airbrushed away."
25. Although focused primarily on the disclosure of fairness opinions, the following articles provide an overview of the basic principles of Delaware's fiduciary-duty based disclosure regime: Blake Rohrbacher & John Mark Zeberkiewicz, *Fair Summary: Delaware's Framework for Disclosure of Fairness Opinions*, 63 Bus. Law. 881 (2008), and Blake Rohrbacher & John Mark Zeberkiewicz, *Fair Summary II: An Update on Delaware's Disclosure Regime Regarding Fairness Opinions*, 66 Bus. Law. 943 (2011).

## IN THE COURTS

### Delaware Court of Chancery Issues Important Decisions Addressing Stockholders' Agreements

By Amy L. Simmerman, Todd C. Carpenter, and Craig E. Sherman

The Delaware Court of Chancery has issued two important decisions addressing the interpretation and effects of stockholders' agreements. In *Schroeder v. Buhannic*<sup>1</sup>, the Court of Chancery refused to interpret a stockholders' agreement in a manner that would allow a corporation's common stockholders to remove the chief executive officer. In *Southpaw Credit Opportunity Master Fund, L.P. v. Roma Restaurant Holdings, Inc.*,<sup>2</sup> the Court of Chancery held that a corporation's purported restricted stock issuances were invalid, where the corporation failed to comply with provisions governing stock issuances in a stockholders' agreement to which the corporation was a party.

These two decisions are noteworthy statements of both the potential limitations and potency of stockholders' agreements. As often occurs, these decisions also both arose in the context of disputes between factions of stockholders over control of the company—an important reminder about the implications of these types of issues.

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**Amy L. Simmerman, Todd C. Carpenter, and Craig E. Sherman** are partners at Wilson Sonsini Goodrich & Rosati. The views expressed in this article are those of the authors and are not necessarily those of Wilson Sonsini Goodrich & Rosati or its clients.

#### *Schroeder v. Buhannic*

In this case, two stockholders holding a majority of a corporation's common stock delivered a stockholder written consent attempting to remove the corporation's CEO both from his position as CEO and from his seat on the board of directors and to replace him with a new designee. After the corporation rejected this attempt, the stockholders brought a claim under Section 225 of the Delaware General Corporation Law (DGCL), which allows the Court of Chancery to decide disputes over director and officer elections and removals on a relatively rapid basis.

A central issue in the litigation was a provision in a stockholders' agreement, which provided that the stockholder parties agreed to vote in a manner that would ensure, among other things, that the board of directors included "three (3) representatives designated by the holders of a majority of the Common Stock, one of whom shall be the Chief Executive Officer of the Company." The stockholders argued that this language should be read to mean that the board could only maintain in office a CEO whom a majority of the common stock supported as one of their designees—with the implication that they therefore could remove the CEO as well. The corporation, by contrast, contended that this provision merely requires that the subject stockholders must vote to ensure that the corporation's CEO, selected by the board of directors, is one of the three common designees.

Vice Chancellor Travis Laster of the Court of Chancery, in an 11-page order, agreed with the corporation and rejected the stockholders' argument. The Court determined that although both interpretations potentially were reasonable, on balance, the corporation had the correct reading when the stockholders' agreement was examined as a whole. In particular, the Court noted that provisions of the agreement governing the other board seats clearly

provided certain classes or series with a number of designees and then limited, or put parameters around, who those designees could be. Importantly, the Court also noted that even if the stockholders' agreement should be read contractually in the manner the common stockholders desired, such interpretation would conflict invalidly with Section 142(b) of the DGCL, which provides that, unless otherwise properly limited in a corporation's certificate of incorporation or bylaws, a corporation's officers are to be elected and replaced by the board of directors.

### ***Southpaw Credit Opportunity Master Fund, L.P. v. Roma Restaurant Holdings, Inc.***

This case arose in a dispute over control of the corporation's board of directors, also brought under Section 225 of the DGCL. Leading up to the dispute, a stockholder group owning a 48.8 percent stake in the company acquired additional shares in a secondary transaction and thereby took a majority position. Immediately afterwards, the board of directors, which intermittently had considered adopting a new employee equity compensation plan over the preceding several months, adopted a plan and issued enough restricted stock under it to dilute the stockholder back down below a majority stake. The record reflected that the board had expressed concern over whether the diluted stockholder would try to change the board's composition. The diluted stockholder maintained that the incremental dilutive issuances were invalid and ultimately attempted in an action by written consent to remove and replace a majority of the board. The company contested that attempt in court, and another faction of stockholders representing the alleged "new" majority of stock—friendly to the prior board—attempted to reinstall the prior directors.

Vice Chancellor Tamika Montgomery-Reeves of the Court of Chancery, noting that the restricted

stock issuances suffered from "multiple problems" in the board's process, concluded that the issuances were invalid. The Court's specific analysis was that the board of directors had violated the company's stockholders' agreement, which contained a voluminous number of governance provisions and provided that all new stockholders must sign a joinder to the stockholders' agreement before the company could properly issue stock to them.

The specified form of joinder, which had to be "substantially" agreed to, stated, among other things, that the stockholder had reviewed the stockholders' agreement, understood the agreement, had an opportunity for counsel to review the agreement, and agreed to be bound by the terms of the agreement. Importantly, the stockholders' agreement provided that stock issued in violation of the joinder requirement was "null and void *ab initio*." The relevant restricted stock award agreements provided only that the stock would be "subject" to the stockholders' agreement and that the recipient stockholders would agree to execute all required instruments, but the recipients never executed joiners. All parties in the litigation conceded that the stock issuances were flawed, but the company argued that the stock issuances were "voidable"—meaning that the board could ratify the stock issuances under common law and treat them as valid—whereas the diluted stockholder argued that the stock issuances were "void" and incapable of such a cure.

The Court agreed with the stockholder, concluding that the issuances were void. The Court relied on the "express" language of the agreement and the penalty it imposed, citing prior case law that it is the "court's job to enforce the clear terms of a contract." The Court also relied on case law indicating that stock issuances undertaken in violation of statutory law and "governing instruments" are void. The Court noted in a footnote that the defendants failed to contest that the stockholders' agreement rose to the level of a "governing instrument" and thus waived

any such argument. Finally, the Court noted that the outcome was equitable because the board had acted with entrenchment motives and had engaged in gamesmanship in the litigation.

## Takeaways

These new decisions highlight several key themes. First, the terms and the drafting of stockholders' agreements can be critical and should be approached carefully. In the *Schroeder* decision, the meaning that the common stockholders wanted to give the stockholders' agreement violated the boundaries of Delaware corporate law regarding the removal of CEOs. In the *Southpaw* decision, the company

violated the express terms of the stockholders' agreement, resulting in invalid stock issuances, given the language of the agreement and the arguments before the court. We expect that the specific lessons from these cases will come up in practice. In addition, the decisions, consistent with many prior Delaware cases before them, highlight that technical requirements and considerations very often get tested in the context of disputes over control of the company. It is therefore important to approach stockholders' agreements and other similar issues carefully at the outset.

## Notes

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1. C.A. No. 2017-0746-JTL (Del. Ch. Jan. 10, 2018).
2. C.A. No. 2017-0059-TMR (Del. Ch. Feb. 1, 2018).

## STATE CORNER

### 2018 Proposed Amendments to the General Corporation Law of the State of Delaware

By John Mark Zeberkiewicz and Stephanie Norman

Legislation proposing to amend the General Corporation Law of the State of Delaware (DGCL) has been released by the Corporate Council of the Corporation Law Section of the Delaware State Bar Association and, if approved by the Corporation Law Section, is expected to be introduced to the Delaware General Assembly.<sup>1</sup> If enacted, the amendments would, among other things: (1) amend Section 262 to apply the “market out” exception to the availability of statutory appraisal rights in connection with an exchange offer followed by a back-end merger consummated without a vote of stockholders pursuant to Section 251(h); (2) clarify and confirm the circumstances in which corporations may use Section 204 to ratify defective corporate acts; (3) allow nonstock corporations to take advantage of Sections 204 and 205, including for the ratification or validation of defective corporate acts; (4) revise Section 102(a)(1) to provide that a corporation’s name must be distinguishable from the name of (or name reserved for) a registered series of a limited liability company; and (5) make other technical changes.

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If enacted, the amendments to Section 262 (relating to statutory appraisal rights) would be effective only with respect to a merger or consolidation consummated pursuant to an agreement entered into on or after August 1, 2018; the amendments to Section 204 (relating to defective corporate acts) would be effective only with respect to defective corporate acts ratified or to be ratified pursuant to resolutions adopted by a board of directors on or after August 1, 2018; the amendments to Section 102(a)(1) (relating to the requirements of the corporation’s name) would be effective August 1, 2019; and all other amendments would be effective August 1, 2018.

#### Appraisal Rights

##### Application of the “Market Out” Exception to Intermediate-Form Mergers

The proposed amendments would amend Section 262(b) of the DGCL to provide that the “market out” exception to the availability of statutory appraisal rights will apply in connection with an exchange offer followed by a back-end merger consummated without a vote of stockholders pursuant to Section 251(h). As currently drafted, Section 262(b)(3) provides that appraisal rights will be available for any “intermediate-form” merger effected pursuant to Section 251(h) unless the offeror owns all of the stock of the target immediately prior to the merger.<sup>2</sup> Practically speaking, under existing Section 262(b)(3), holders of shares of stock of a target corporation that are listed on a national securities exchange are entitled to appraisal rights in an “intermediate-form” stock-for-stock merger in which they receive only stock listed on a national securities exchange even if they would not be entitled to appraisal rights in a comparable “long-form” merger as a result of the “market out” exception set forth in subsections (b)(1) and (b)(2) of Section 262.

To address the incongruity between long-form and intermediate-form mergers with respect to the availability of appraisal rights in stock-for-stock mergers, the proposed amendments to Section 262(b)(3) provide that, in the case of a merger pursuant to Section 251(h), appraisal rights will not be available for the shares of any class or series of stock of the target corporation that were listed on a national securities exchange or held of record by more than 2,000 holders as of immediately prior to the execution of the merger agreement, so long as such holders are not required to accept for their shares anything except (1) stock of the surviving corporation (or depository receipts in respect thereof), (2) stock of any other corporation (or depository receipts in respect thereof) that at the effective time of the merger will be listed on a national securities exchange or held of record by more than 2,000 holders, (3) cash in lieu of fractional shares or fractional depository receipts in respect of the foregoing, or (4) any combination of the foregoing shares of stock, depository receipts and cash in lieu of fractional shares or fractional depository receipts. Accordingly, if the proposed amendments are enacted, exchange offers followed by a merger under Section 251(h) will receive the same basic treatment as long-form mergers requiring a vote of stockholders with respect to the availability of appraisal rights.

### Appraisal Statement

The proposed amendments would effect a technical change to Section 262(e) to clarify what information must be included in the statement required to be furnished by the surviving corporation under that subsection in cases where the merger was effected without a vote of stockholders pursuant to Section 251(h). Section 262(e) currently requires the surviving corporation to provide, upon request and subject to specified conditions, a statement to dissenting stockholders setting forth the aggregate number of shares that were not voted in favor of the merger or consolidation and as to which demands for appraisal have been received, and the aggregate number of holders of such shares.<sup>3</sup> Given that no shares are

“voted” for the adoption of an agreement of merger in a transaction under Section 251(h), the proposed amendments to Section 262(e) clarify that where the statement is given in the context of an intermediate-form merger, it must set forth the relevant shares not purchased in the tender or exchange offer for which appraisal rights were demanded, rather than the shares not voted for the merger for which appraisal rights were demanded.

### Ratification and Validation of Defective Corporate Acts

The proposed amendments would effect several changes to Section 204 of the DGCL, which deals with the ratification of defective corporate acts, primarily to confirm the circumstances in which it is available for use.

First, the proposed amendments to Section 204(c)(2) would confirm that Section 204 may be used in circumstances in which there is no valid stock outstanding, even if the ratification of the underlying defective corporate act would otherwise require stockholder approval under Section 204(c). As originally drafted, and as further clarified in amendments that became effective in 2015, Section 204 specifies that whenever a vote of stockholders is required to ratify a defective corporate act, only the valid stock (which is generally defined as stock that has been issued in accordance with the DGCL) is entitled to vote on the ratification of a defective corporate act.<sup>4</sup> The proposed changes are intended to confirm that where there are no shares of valid stock outstanding, either because no shares (valid or putative) have been issued or because all of the shares are putative stock, a corporation may take advantage of Section 204, even if a vote of stockholders otherwise would be required to approve the ratification.

Second, the proposed amendments to Section 204(d) would specify the holders to whom notice of a ratification of a defective corporate act must be given. Currently, under Section 204(d), where a vote of stockholders is required to approve the ratification of a defective corporate act, notice of the meeting at which the proposed ratification will be considered

must be given to the holders of valid stock and putative stock, whether voting or non-voting, as of the record date for notice of the meeting as well as the holders of valid stock and putative stock, whether voting or non-voting, as of the time of the defective corporate act. The corporation need not provide such notice to holders of valid stock or putative stock at the time of the defective corporate act if their identities or addresses cannot be determined from the records of the corporation.

In many cases, the time of the defective corporate act differs from the original record date that was fixed for purposes of determining the stockholders entitled to vote or provide consent on the authorization of the original act, or the record date fixed for another purpose in relation to the defective corporate act. For example, where a reverse stock split is the defective corporate act to be ratified, the time of the defective corporate act would be the date on which the reclassification of the outstanding shares pursuant to a certificate of amendment to the certificate of incorporation becomes effective. The stockholders' authorization of such amendment, however, in many cases will have been given at a meeting held weeks in advance of such effective time by stockholders of record as of a date preceding the date of the meeting.

Experience has shown that many corporations, particularly public corporations, are far more likely to have a list of stockholders as of a particular record date than they are to have a list of stockholders as of the time of a defective corporate act where such act did not occur on the record date for determining stockholders entitled to vote on the authorization of the defective corporate act. Accordingly, the changes to Section 204(d) provide that in cases where a vote of stockholders is being sought for the ratification of a defective corporate act at a meeting of stockholders, the notice that is required to be given to holders of valid stock and putative stock as of the time of the defective corporate act may be given, in circumstances where the defective corporate act required the establishment of a record date for voting, consent or for another purpose, to the holders of valid stock and putative stock as of the record date established

for determining stockholders entitled to vote on or provide consent with respect to the authorization of the defective corporate act or the stockholders as of the record date fixed for such other purpose. Section 204(g) also is being amended to provide that public companies may give such notice through disclosure in a document publicly filed with the Securities and Exchange Commission pursuant to Sections 13, 14 or 15(d) of the Securities Exchange Act of 1934.

Third, the proposed amendments to Section 204(h)(1) would clarify and confirm that any act or transaction within a corporation's power under subchapter II of the DGCL may be subject to ratification under Section 204. Subchapter II of the DGCL is broadly enabling, empowering Delaware corporations to engage in all categories and classes of activities, with very few exceptions.<sup>5</sup> As originally drafted, Section 204 was designed to enable Delaware corporations to ratify any act or transaction taken by or on behalf of the corporation so long as the act was one involving a power not specifically denied to corporations generally under the DGCL, such as engaging in a banking business or conferring honorary degrees.<sup>6</sup>

In *Nguyen v. View, Inc.*, the Court of Chancery arguably adopted a different reading of the statute.<sup>7</sup> Specifically, the Court indicated that because an arbitrator had ruled that a stockholder whose vote was required to approve an amendment to the certificate of incorporation specifically had revoked his prior consent, the subsequent ratification of the amendment had to "be viewed in light of that operative reality."<sup>8</sup> The Court held that the corporation, in proceeding with a financing transaction that relied for its effectiveness on the stockholders' approval of the amendment, "did so notwithstanding that the majority common stockholder had deliberately withheld his consent for the transaction—consent that was required for the transaction to be valid as a matter of law." Therefore, the Court found, "at the time the defective corporate acts . . . the [corporation at issue] did not have the power to take these acts. . . ."<sup>9</sup>

The proposed amendments to Section 204(h)(1) would overturn any implication from the *View*



opinion that an act or transaction may not be within the power of a corporation solely on the basis that it was not approved in accordance with the provisions of the DGCL or the corporation's certificate of incorporation or bylaws. Indeed, defective corporate acts require ratification because originally they were not so approved. The amendments attempt to clarify that the failure to approve an act in accordance with the DGCL or the certificate of incorporation or bylaws may not, of itself, serve as a basis for excluding the act from the scope of the statute.

The proposed amendments to Section 204(h)(1), however, would not disturb the Court's power to decline to validate a defective corporate act under Section 205 on the basis that the failure of authorization that rendered such act void or voidable involved a deliberate withholding of any consent or approval required under the DGCL, the certificate of incorporation or bylaws. Notably, Section 205 of the DGCL provides the Court broad power, upon application of various parties, to validate or decline to validate (or grant other relief) in respect of acts that have been ratified in accordance with Section 204 as well as acts that have not been ratified.<sup>10</sup> In resolving matters brought under Section 205, the Court is expressly directed to consider, among other things,

[w]hether the defective corporate act was originally approved or effectuated with the belief that the approval or effectuation was in compliance with the provisions of [the DGCL], the certificate of incorporation or the bylaws of the corporation.<sup>11</sup>

Finally, the proposed amendments to Section 204(h)(2) would clarify that the failure of an act or transaction to be approved in compliance with the disclosure set forth in any proxy or consent solicitation statement may constitute a failure of authorization. The amendment to Section 204(h)(2) would confirm that any act that is alleged to be defective due to deficiencies in the disclosure documents pursuant to which the vote or consent of stockholders was sought may be cured through ratification pursuant to Section 204. By way of example, the amendments

make clear that a corporation may use Section 204 to ratify an amendment to the certificate of incorporation that is alleged to be defective due to a misstatement in the proxy statement regarding the vote required for its adoption.

## Application of Sections 204 and 205 to Nonstock Corporations

The proposed amendments also would revise Section 114 of the DGCL to enable nonstock corporations to take advantage of Sections 204 and 205. In 2010, Section 114 was added to the DGCL to apply (or preclude the application of) other sections of the DGCL to nonstock corporations by translation.<sup>12</sup> As noted above, in 2014, Sections 204 and 205 were added to the DGCL. Those sections originally were designed primarily to cure defects in capital stock.<sup>13</sup> As a result, and because nonstock corporations are inherently more structurally flexible than their stock corporation counterparts (thus allowing greater opportunity for "self-help" fixes to defective acts), Section 114 initially excluded the application of Sections 204 and 205 to nonstock corporations. Experience has shown, however, that Sections 204 and 205 have wide-ranging applications and could offer nonstock corporations a means of fixing otherwise intractable problems. Although Section 114 will not operate to translate every term in Sections 204 and 205 with literal precision, consistent with ordinary principles of statutory construction, the as-translated statutes should be construed in such a way as to give effect to the underlying intent of enabling nonstock corporations to take advantage of the procedures for ratifying or validating defective corporate acts.<sup>14</sup>

## Corporate Name

The proposed amendments also would revise Section 102(a)(1) to provide that a corporation's name, as included in its certificate of incorporation, must be such as to distinguish it upon the records of the Division of Corporations in the Delaware Department of State from any name reserved for

or name of any registered series of a limited liability company. Currently, Section 102(a)(1) requires a corporation to include its name in its certificate of incorporation and, with limited exceptions, specifies that the name must be such as to distinguish it upon the records of the office of the Division from the names that are reserved on such records and from the names on such records of each other corporation, partnership, limited partnership, limited liability company, or statutory trust organized or registered as a domestic or foreign corporation, partnership, limited partnership, limited liability company, or statutory trust under Delaware law. The revisions to Section 102(a)(1) adding registered series of limited liability companies to the list of entities from which a corporation's name must be distinguished are being proposed in connection with proposed amendments to the Delaware Limited Liability Company Act providing for the establishment of registered series of a Delaware limited liability company, which series would be formed through the filing of a certificate of registered series with the Delaware Secretary of State.

### Forfeiture of Charter

The proposed amendments would clarify that the Attorney General of the State of Delaware has the exclusive authority to seek the revocation of a charter pursuant to Section 284 of the DGCL, and that the Court of Chancery may appoint a trustee to wind-up the affairs of a corporation whose charter has been revoked. The proposed amendments thereby would clarify the procedures applicable in situations in which a corporation's charter is revoked due to a clear abuse of its privileges and franchises, such as grievous criminal violations perpetrated by or in the name of the corporation.

### Exempt Corporations

Finally, the proposed amendments would effect a technical change to Section 313(b) of the DGCL to reflect the Delaware Secretary of State's current practice regarding the filing of certificates of revival for exempt corporations. Corresponding amendments

are proposed to be made to Section 502 of Title 8 of the Delaware Code to reflect the Secretary of State's practice regarding exempt corporations' filing of annual reports.

### Conclusion

The 2018 amendments to the DGCL make several important changes, continuing Delaware's commitment to updating its corporate law annually to address issues affecting corporations and practitioners.

### Notes

1. The proposed legislation has not been introduced to the Delaware General Assembly at the time of writing. A copy of the proposed legislation is available at [http://www.rlf.com/files/15699\\_Proposed%20Amendments%20to%20the%20General%20Coporation%20Law%20of%20the%20State%20of%20Delaware.pdf](http://www.rlf.com/files/15699_Proposed%20Amendments%20to%20the%20General%20Coporation%20Law%20of%20the%20State%20of%20Delaware.pdf).
2. See 8 Del. C. § 262(b) (2017). Section 262(b) currently provides, in relevant part, that "[a]ppraisal rights shall be available for the shares of any class or series of stock of a constituent corporation in a merger or consolidation to be effected pursuant to § 251 (other than . . . , subject to paragraph (b)(3) of this section, § 251(h) of this title)." Section 262(b)(1), in its current form, then provides the "market out" exception denying appraisal rights to holders of shares listed on a national securities exchange or held of record by more than 2,000 holders, while Section 262(b)(2) then restores appraisal rights for such holders if they are required to receive anything other than the types of consideration specified therein. *Id.* Paragraphs (1) and (2) of Section 262(b) are currently not applicable to intermediate form mergers effected under Section 251(h). *Id.* Those mergers are dealt with under paragraph (3) of Section 262(b), which provides, in relevant part, that if "all of the stock of a subsidiary Delaware corporation party to a merger effected under § 251(h) . . . is not owned by the parent immediately prior to the merger, appraisal rights shall be available for the shares of the subsidiary Delaware corporation." *Id.*

3. 8 Del. C. § 262(e) (2017).
4. See C. Stephen Bigler & John Mark Zeberkiewicz, *Restoring Equity: Delaware's Legislative Cure for Defects in Stock Issuances and Other Corporate Acts*, 69 Bus. Law. 393 (2014) (hereinafter "Restoring Equity"). In describing the manner in which a hypothetical defective corporate act would be ratified under Section 204 as originally adopted, the authors noted that the resolutions of the board of directors ratifying the act "would be submitted only to the holders of [specified] shares, since they constitute the only shares of valid stock." *Id.* at 427. The authors further noted that the shares of putative stock in their hypothetical "would not be included in that vote." *Id.* In 2015, Section 204 was amended to clarify that, where a defective corporate act requires stockholder approval under Section 204, only the valid stock is counted for quorum and voting purposes. The synopsis to the legislation effecting such clarifying change stated: "Section 204(d) has been amended to clarify that the only stockholders entitled to vote on the ratification of a defective corporate act, or to be counted for purposes of a quorum for such vote, are the holders of record of valid stock as of the record date for determining stockholders entitled to vote thereon. It does so by confirming that shares of putative stock will not be counted for purposes of determining the stockholders entitled to vote or to be counted for purposes of a quorum in any vote on the ratification of any defective corporate act." S.B. 75, 149th Gen. Assem. (Del. 2015).
5. Subchapter II of the DGCL consists of Sections 121 through 127. 8 Del. C. §§ 121–127. Sections 121 through 123 are broadly enabling empowering statutes, see *id.* §§ 121–123, and Section 124 deals with "ultra vires" acts, *id.* § 124. Sections 125 through 127 are the provisions that primarily impose restrictions on a corporation's power. *Id.* §§ 125–127. Section 125 restricts a corporation's power to confer academic or honorary degrees, subject to certain conditions, *id.* § 125; Section 126 specifically prohibits corporations from engaging in a banking business, *id.* § 126; and Section 127 requires a private foundation that does not opt out of that section in its certificate of incorporation to act or refrain from acting in specified ways, *id.* § 127.
6. See generally Bigler & Zeberkiewicz, *Restoring Equity*, at 402–03.
7. 2017 WL 2439074 (Del. Ch. June 6, 2017).
8. *Id.* at \*9.
9. *Id.*
10. See 8 Del. C. § 205(a) & (b).
11. *Id.* § 205(d)(1).
12. 77 Del. Laws ch. 253 (2010).
13. See generally Bigler & Zeberkiewicz, *Restoring Equity*.
14. See John Mark Zeberkiewicz & Blake Rohrbacher, *A New Day for Nonstock Corporations: The 2010 Amendments to Delaware's General Corporation Law*, 66 Bus. Law. 271, 282 (2010) (noting, in reference to the operation of the "translator" provision, that "[p]ractitioners should be aware . . . [that] each of the four translator guides in subsections 114(a)(1)–(4) uses the terms "references" and "deemed to refer to," which were intended to show that the nonstock translations are concept-based, not merely word-based" and that, accordingly, "some translations may not be verbatim and may require some rewording."

## CLIENT MEMOS

*A summary of recent memoranda that law firms have provided to their clients and other interested persons concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of the listed memoranda should contact the firms directly.*

### **Andrews & Kurth LLP Houston, TX (713-220-4200)**

#### **Director Equity Award Limit in LTIPS (March 2018)**

A discussion of the need to address limitations in grants to non-employee directors in long-term incentive plans this proxy season.

### **Arnold & Porter Kaye Scholer LLP Washington, DC (202-942-5000)**

#### **SEC Approves Proposed NYSE Rule Changes regarding the Physical Delivery of Proxy Materials (March 7, 2018)**

A discussion of SEC approved amendments proposed by the New York Stock Exchange to its rules pertaining to the physical delivery of hard copies of proxy materials.

### **Baker & Hostetler LLP Denver, CO (303-861-0600)**

#### **2017 Year-End Securities Litigation and Enforcement Highlights (March 7, 2018)**

A discussion of significant developments, including Supreme Court cases, securities law cases, investment adviser and hedge fund cases, commodities and future regulation cases and securities policy and regulatory developments.

### **Bryan Cave LLP St. Louis, MO (314 259 2000)**

#### **FINRA Explores Options Aimed at Encouraging the Payment of Arbitration Awards and Settlements (March 19, 2018)**

A discussion of FINRA's release of statistics on unpaid arbitration awards, as well as Regulatory Notice 18-06 proposing various changes to its rules in an effort to ameliorate the unpaid awards.

### **Cadwalader, Wickersham & Taft LLP New York, NY (212-504-6000)**

#### **Under Advisement: The SEC Scrutinizes Wealth Management Industry (March 21, 2018)**

A discussion of the SEC's increased regulatory focus on the conduct of investment professionals in the wealth management industry, including inadequate fee disclosure, dubious sales practices and inappropriate steering to unsuitable strategies and products.

#### **A Trio of Delaware Decisions Discount Deal Price in Appraisal Litigation (March 26, 2018)**

A discussion of a trio of Delaware appraisal decisions in which the courts declined to use the deal price as the best evidence of fair value, instead using discounted cash flow analysis and the unaffected market price to determine fair value below the merger consideration.

### **Cleary, Gottlieb, Steen & Hamilton LLP New York (212-225-2000)**

#### **Enforcement Activity in the SEC's Newly Created Cyber Unit (March 30, 2018)**

A discussion of SEC enforcement activity in the first six months since creation of a Cyber Unit within the Enforcement Division and how these early actions, along with SEC public statements and commentary, are likely to translate into additional enforcement activity.

**Davis Polk & Wardwell LLP  
New York, NY (212-450-4000)****SEC Announces Self-Reporting Initiative for Rule 12b-1 Fee Disclosures (March 15, 2018)**

A discussion of the SEC Division of Enforcement announcement of a new initiative to redress “potential widespread violations” by encouraging investment advisers to self-report situations in which an adviser does not disclose adequately that it receives compensation for purchasing or recommending a client purchase mutual fund shares of a share class that pays fees under Rule 12b-1 when a less expensive share class is available and appropriate for the client.

**Drinker Biddle & Reath LLP  
Philadelphia, PA (215-988-2700)****SEC Proposes Changes to Public Liquidity Risk Management Disclosure (March 22, 2018)**

A discussion of SEC proposed amendments to its liquidity management rules that would modify the disclosure requirements for certain open-end investment management companies.

**Eversheds Sutherland LLP  
Washington, D.C. (202-383-0100)****Considerations for the 2018 Proxy Season (March 7, 2018)**

A discussion of matters for companies to consider in preparing for their annual shareholder meetings, including new SEC requirements, guidance from Institutional Shareholder Services and Glass Lewis and activist shareholder concerns.

**Fredrikson & Byron, P.A.  
Minneapolis, MN (612-492-7000)****M&A Diligence Checklist: Don't Forget Website and App Accessibility (March 23, 2018)**

A discussion of the need for potential buyers and their mergers and acquisition legal counsel to consider measures to avoid unintentionally acquiring a website

or app that is a vulnerable target for accessibility/Americans with Disabilities Act litigation.

**Fried, Frank, Harris, Shriver & Jacobson LLP  
New York, NY (212-859-6600)****SEC Announces New Guidance for Public Company Disclosures on Cybersecurity Risks (March 26, 2018)**

A discussion of guidance issued by the SEC on public companies' disclosure obligations regarding cybersecurity risks and incidents.

**Gibson, Dunn & Crutcher LLP  
Los Angeles, CA (213-329-7870)****D.C. Circuit Holds That Witnesses in PCAOB Investigations Have the Right to a Technical Expert (March 26, 2018)**

A discussion of a decision of the U.S. Court of Appeals for the D.C. Circuit vacating an SEC order upholding sanctions issued by the Public Accounting Oversight Board (PCAOB) against a petitioner because he was deprived of his right to counsel as a result of the PCAOB denying his request that a technical expert be present while he gave his testimony to the PCAOB.

**Hunton & Williams LLP  
Richmond, VA (804-788-8200)****Whistleblower Awards for Securities Violations (March 2018)**

A discussion of the SEC's award of its highest-ever whistleblower awards under the Dodd-Frank Act and the SEC's whistleblower program more generally.

**Jenner & Block LLP  
Chicago, IL (312-222-9350)****Amid Increased Enforcement Activity, SEC Reportedly Issues Cryptocurrency Subpoenas (March 8, 2018)**

A discussion of news reports that the SEC has issued subpoenas to as many as 80 entities and

individuals involved in the virtual currency space over the last several months.

**K&L Gates LLP  
Pittsburgh, PA (412-355-6500)**

**Less Form, More Substance: The SEC Staff's Recent Functional Approach to Section 3(c)(5)(C) (March 14, 2018)**

A discussion of a SEC staff no-action letter to Great Ajax Funding LLC permitting an issuer to rely on Section 3(c)(5)(C) of the Investment Company Act of 1940 to acquire assets integral to a vertically integrated real-estate finance business even though the issuer itself did not purchase “mortgages and other liens on and interests in real estate.”

**KattenMuchinRosenman LLP  
Chicago, IL (312-902-5200)**

**Blockchain Technology May Enable Tracing in Securities Act Litigation (March 22, 2018)**

A discussion of Delaware legislation to permit companies registered in the state to issue and trade shares on a “distributed electronic network” and the fact that issuers who take advantage of this run the risk of exposing themselves to increased potential liability under the Securities Act of 1933 (Securities Act). This is because it will enable the tracing of beneficial ownership, undermining what has been a significant defense to private claims brought under the Securities Act.

**Latham & Watkins LLP  
Los Angeles, CA (202-637-2200)**

**SEC's Recent BitFunder Charges and Statement on Digital Asset Trading Platforms (March 12, 2018)**

A discussion of SEC enforcement actions and public statements that illustrate the agency's views on how the federal securities laws apply to crypto or digital asset trading platforms.

**Private Equity Fund Managers: Annual Compliance Reminders and New Developments (March 26, 2018)**

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**Wilmer Hale LLP  
Washington, DC (202-663-6000)****SEC Proposes Transaction Fee Pilot for NMS Stocks (March 27, 2018)**

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