



Fox Rothschild LLP
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Securities Sit-Down: Confronting Civil Litigation

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I. Securities Litigation

- Securities Fraud Litigation
 - Class Actions
 - Opt-Out Actions
 - Individual Actions
- Derivative and Direct Shareholder Litigation



Regulation of Corporate Conduct

FEDERAL versus STATE LAW

- Federal Law (statutes, regulations and court decisions)
 - Primarily governs disclosures made by a company
- State Law (statutes and court decisions)
 - Primarily governs the conduct of board members and management



Securities Litigation

There are two bodies of law under which securities claims can be brought: (1) Federal law – the laws of the United States; and (2) the laws of the individual states

FEDERAL SECURITIES LAWS

- Securities Act of 1933 – Applies primarily to securities purchased in Public Offerings through a Registration Statement or Prospectus.
- Securities Exchange Act of 1934 (Section 10(b)) – Governs aftermarket trading including purchases and sales of securities on securities exchanges. Resulted in SEC promulgating Rule 10b-5. Virtually all federal securities fraud cases include a claim under Section 10(b) and Rule 10b-5.



STATE SECURITIES LAWS

Each of the 50 states of the United States has its own laws. These laws are both statutory, adopted by the state legislatures, and common law, based historically on English common law.

- Common Law – Every state has common law, which includes bodies of law dealing with fraud and negligent misrepresentation. These laws differ among the 50 states.
- Statutory Law – “Blue Sky Laws” which are essentially their own versions of the federal securities laws. These laws differ substantially among the states, with some laws allowing plaintiffs to sue under the laws while other states, most notably New York, do not.



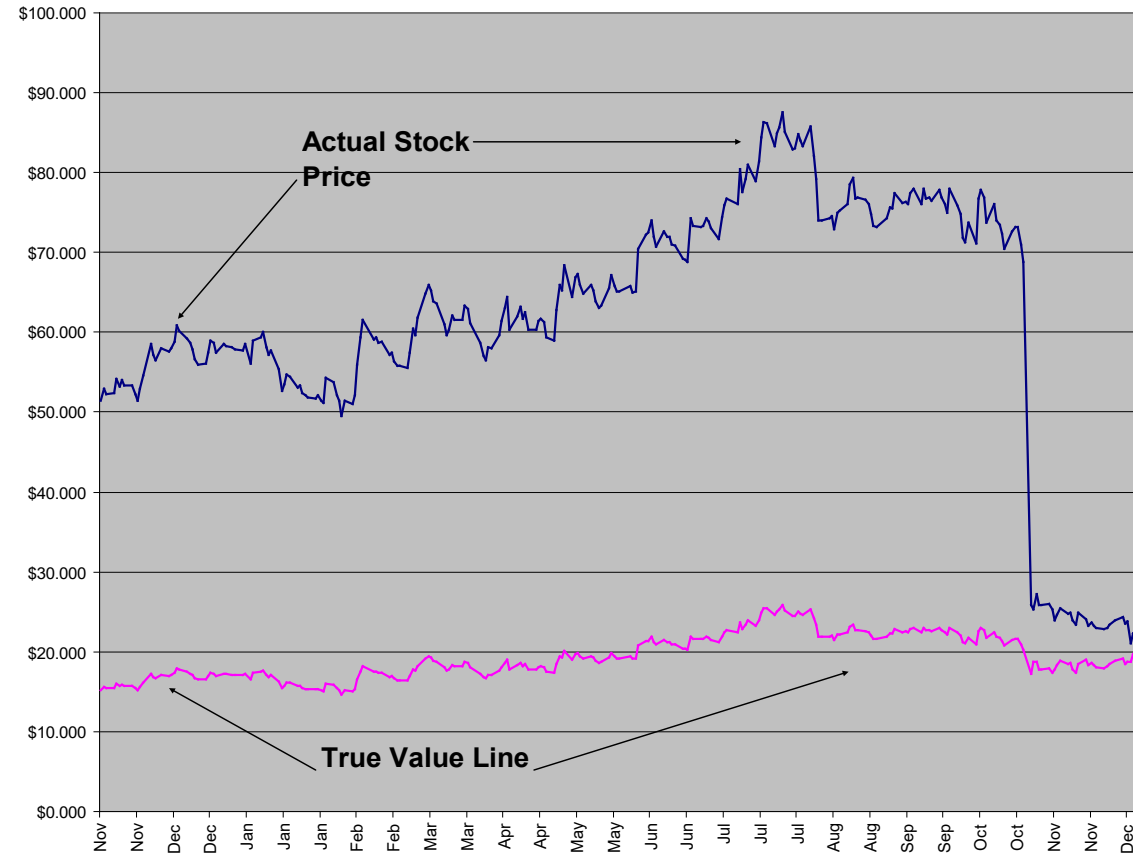
Basic Elements of a Securities Exchange Act Fraud Suit

Whether brought under federal or state law, any lawsuit seeking to assert a claim for fraud has certain basic elements. The goal is to establish that a purchaser of a security suffered damages as a result of a defendant's false statement about a company. The elements of the claim are:

- **Material Misrepresentation** - a defendant must misrepresent a material fact about a company.
- **Scienter** - a defendant must know that the statement was false or must have recklessly disregarded the truth or falsity of the statement. PSLRA – heightened standard – strong interference of scientes.
- **Reliance** – a plaintiff must have relied upon the misrepresentation in making the purchase of the security. In a case under Section 10(b), such reliance can be presumed through a doctrine known as “fraud on the market.” This doctrine sometimes is applicable, and sometimes is not applicable, under state law. An efficient market must exist for the presumption.
- **Economic Loss & Loss Causation** – causal connection between the material misrepresentation and the loss. A decline in a security's price caused by general market factors will not support a fraud claim.



Stock Chart And Value Line



Introduction to Class Actions

- Class Actions are a standard legal procedure used to handle lawsuits in which a large number of people have been injured by a common act or set of actions.
- A Securities Class Action is brought by one or more shareholders (the “Lead Plaintiffs”) and are undertaken on behalf of all shareholders (the “Class”) who have suffered financial losses during the relevant period of fraud/securities law violation (the “Class Period”).
- Shareholders need take no action to participate in the Class as they are automatically included except for filing claim forms when there is a settlement.



Seeking Lead Plaintiff Status In Securities Fraud Class Action Litigation

- Private Securities Litigation Reform Act of 1995 (“PSLRA”)
 - No longer the first to file a lawsuit becomes lead plaintiff
 - Presumption = Shareholder or Group of Shareholders with “largest financial interest” should be appointed Lead Plaintiff(s)
 - Motions for Lead Plaintiff filed 60 days after published notice of first filed class action lawsuit
 - Contemplates court appoints Lead Plaintiff within 90 days of original notice
 - Defendants have no role in Lead Plaintiff battle
 - Discovery Stayed until after decision on motion to dismiss or upon filing of answer



Seeking Lead Plaintiff Status In Securities Fraud Class Action Litigation

- Issues:
 - 5/3 Rule (5 lead plaintiff appointments in 3-year time period)
 - Investment Manager as Lead Plaintiff
 - How to calculate losses (FIFO v. LIFO) (First In First Out vs. Last in First Out)
 - How large a group of shareholders (Multiple shareholders serving as lead plaintiff – how large a group)



Lead Plaintiff(s) File Amended Complaint

- Negotiate Deadlines for Amended Complaint and Response
- (Consolidated) Amended Complaint filed by Lead Plaintiff against originally named defendants and sometimes additional defendants.
- Motion(s) to Dismiss
 - Scierer
 - Materiality
 - Loss Causation



Class Certification

- Class Certification (Rule 23)
 - As soon as practicable
 - Identifiable Class
 - Lead Plaintiff is a member of Class
 - Common Issues of law or fact between Class Members
 - Class Action superior method to adjudicate



Opt-out

1. Primary Considerations:

- Size of Loss
- Nature of Case/Claims

2. Primary Benefits:

- Control Own Case
- Larger Recovery Than Class Members
- Quicker Payment of Settlement Proceeds

3. Primary Drawbacks:

- Pay Costs of Litigation
- Subject to Discovery (Depositions)



Trends

- Total number of securities fraud class actions decreasing
 - 2019 – 427
 - 2020 – 333
 - 2021 - 218
- Significant increase in securities class actions involving Special Purpose Acquisition Company (SPAC)
 - 2019 – 2
 - 2020 – 5
 - 2021 – 32
- Steady number of cases relating to COVID-19
 - 2020 – 17
 - 2021 – 17
- Decrease in number of cases relating to cannabis
 - 2019 – 13
 - 2020 – 6
 - 2021 – 4

* Cornerstone Research



II.

The Tremendous Growth Of SPACs Will Lead To An Explosion Of Litigation

A. What Is A SPAC

- Special Purpose Acquisition Company (a public “blank check” company)
- A method of taking a company public while avoiding the traditional and cumbersome IPO Process
- Once formed primarily by an experienced management teams, but now athletes, politicians, and influencers
- Nominal initial capital investment in exchange for founders shares (approx. 20%)



- 80% held by public through units (common stock and a fraction of a warrant) offered in an IPO
- A SPAC usually has only 18-24 months to:
 - (1) Find a target company and enter into a de-SPAC transaction; or
 - (2) liquidate and return the funds (held in trust) to the investors
 - Founders shares are not redeemable.



- A SPAC's public shareholders may elect to redeem their shares rather than participate in the merged entity.
- In practice, shareholders are allowed to redeem their shares even if they vote in favor of the acquisition (reduce arbitrage/buy below IPO price).
- If the SPAC requires additional funds to complete a merger, the SPAC may issue debt or issue additional shares, such as a private investment in public equity (PIPE) deal.



- The SPAC will solicit shareholder approval for a merger and prepare and file a proxy statement.
- The Proxy, in addition to setting forth the board's position on why the combination should be approved, will advise the public shareholders of their right to redeem shares and at what price.



B. Rapid Growth Of SPACs

- 2019: 59 SPAC IPOs (raised \$13.6 billion)
- 2020: 248 SPAC IPOs (raised over \$80 billion)
- 2021: 613 SPAC IPOs (raised over \$160 billion)

Now everyone from politicians to professional athletes, to influencers are starting SPACs

- More money chasing the same targets with a short deadline to do a deal.
- Non-traditional players (draw attention)
- Betting essentially only on the management team



- **Ripe for Litigation**

- Indeed, SEC has said:

“Any simple claim about reduced liability exposure for SPAC participants is overstated at best, and potentially seriously misleading at worst. Indeed, in some ways, liability risks for those involved are higher, not lower, than in conventional IPOs, due in particular to the potential conflicts of interest in the SPAC structure.”

(John Coates, Acting Director of Division of Corporate Finance)



C. Litigation Risks

- Not surprisingly, the plaintiffs' bar has noticed the tremendous growth in de-SPAC transactions and seized on the opportunity.
- Adopted old methods: File inadequate disclosure cases seeking even more granular financial information and obtain mootness fees once the disclosures are amended.



The structure of SPAC's creates fertile ground for litigation, *e.g.*:

- (1) The founders receive 20% for a *de minimis* investment;
- (2) Founders stand to profit substantially even from a bad (value decreasing) merger; and
- (3) Founders are on the clock to get a deal done or they lose everything.



- That structure has consequences:
 - *In re Multiplan Corp. Shareholders Litig*, 2022 WL 24060 (Del. Ch. Jan 3, 2022)
 - Founders shares created a conflict because they would become very valuable even on a value-decreasing merger that reduced the stock price for the shares held by the public investors. In contrast, the value of the public shares would decrease in value.
 - As a result, the business judgment rule did not insulate defendants. Instead the entire fairness standard applied.
 - The Court held Plaintiffs successfully stated direct claims by alleging that their redemption rights had been interfered with by disloyal disclosures thereby causing damage.
 - Plaintiffs alleged that the directors and the controlling shareholder failed to disclose that the target's largest customer (35%) was preparing to compete with the target.



- Plaintiffs alleged the failure to disclose was a result of the inherent conflict of interest (holders of founders shares and warrants would benefit greatly by even a value decreasing merger)
- Indeed, Klein’s initial investment of \$25,000 was worth \$356 million at closing
- Board lacked independence because Klein (founder) had sole right to appoint and remove; Klein appointed same directors for several SPACs; they had same conflict as Klein; and some had familial relation to Klein.
- SPAC retained Klein Group as its financial advisor
 - Did not retain independent valuation or fairness opinion

- Robust Disclosures Are The Prophylactic
 - The conflict was disclosed as well as the right to redeem.
 - The board, however, needed to have disclosed that the largest customer was preparing to compete. That failure deprived shareholders of the ability to make an informed decision on whether to exercise their redemption rights.
 - De-SPACing agreements typically do not have “fiduciary out” clauses.
 - As a result, the receipt of a “topping bid” may well lead to litigation.



Other areas for potential fiduciary litigation

(1) The oft criticized *Omnicare* requirement for a “fiduciary out” clause—namely, a clause allowing the target board to terminate the deal if a superior offer is received prior to the shareholder vote.



- (2) Inaccurate disclosure of the team's credentials.
- (3) Closing a bad deal as the clock is counting down
(conflicted/disloyal controlling shareholder and board)
 - Conflict
 - So far beyond the bounds of due care that the only explanation is bad faith



D. Other Potential Types of Litigation

- Breach of contract claims between SPAC and target
- Breach of contract claims by investment advisors
- Litigation from a failed deal
 - Investment bank sues target for successful introduction and target sues SPAC
- Appraisal rights of target's objecting shareholders



- With the market falling, you can be sure plaintiffs lawyers are carefully reviewing de-SPACing transactions of the past few years
 - Proxy Statement
 - Registration Statement
- Now plaintiffs will seek damages not merely more robust disclosures and a mootness fee.



III. Fiduciary Duty Litigation

Derivative v. Direct Lawsuits (Tooley Test)

- (1) Who suffered the harm?
- (2) Who receives the benefit?

- Derivative – shareholder asserts claim ***on behalf of the corporation*** seeking to redress harm to the corporation. Any benefit from the litigation will be awarded to the corporation, not the shareholder.
- Direct – shareholder asserts claim for harm done directly ***to the shareholder***. Shareholder and not the corporation is awarded any benefit from the litigation.

Differences Between Derivative and Direct Lawsuits

- Derivative lawsuits require plaintiff to make a **pre-suit demand** on the board of directors.
 - Requirement for pre-suit demand excused only in circumstances in which making a demand on the board of directors would have been futile.



What is the heightened pleading standard in a derivative lawsuit?

- The complaint shall also **allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors** or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.
- The complaint shall allege that the **plaintiff was a shareholder or member at the time of the transaction** of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law.



Types of Derivative Claims

- Claims Against Fiduciaries
 - Breach of Fiduciary Duty
 - Duty of Care
 - Duty of Loyalty
- Claims Against Non-Fiduciaries
 - Negligence
 - Breach of Contract



Duty of Care

- Responsibility to conduct the business and manage the company in a way that comports with the level of attention a reasonably prudent person would give to his or her own affairs.
- Requires directors and officers to be informed of all material information when making decisions for the corporation.



Duty of Loyalty

- Responsibility to act in a manner in which the director believes to be in the best interests of the corporation and its shareholders and not using their authority or their office to benefit themselves.



Duty of Good Faith

- **8 Del. Code, Section 102(b)(7)**
 - Allows companies to include in its certificate of incorporation a provision that exonerates directors from any claim of monetary liability to the company or its stockholders for claims where directors act in bad faith or otherwise in violation of his or her duty of loyalty.
 - Most every public company has such a provision.



Examples of Derivative Claims

- Block transactions between a corporation and insiders that are harmful to the corporation.
- Rescind agreements between corporation and an officer or director that was not fair to the corporation.
- Misappropriation or waste of corporate assets.
- Reforms in executive compensation.
- Usurpation of a corporate opportunity.



Examples of Derivative Claims

- Various provisions in merger agreements that impede the board from complying with its *Revlon* duty (sale process and price).
 - The board of directors owes a fiduciary duty to shareholders to sell the corporation for the highest price possible when a hostile takeover or merger is imminent.
 - “No-shop” provision without a “fiduciary out” clause allowing the board to pursue unsolicited “superior” offers.
 - “Top-up” option
 - Termination fee
 - Matching rights
 - Retention agreements and bonuses
 - Price



The Business Judgment Rule

- Courts will not review actions of board unless violates duties or lack a rational basis
- Presumes the fiduciary used proper business judgment acted:
 - (1) On an informed basis;
 - (2) In good faith; and
 - (3) In the best interest of the corporation.



“Entire Fairness” Standard

- “Entire Fairness” Standard
 - Triggered when a majority of directors are interested, *or* majority stockholder stands on both sides of a transaction.
 - If triggered, board of directors must show that the transaction was **inherently fair** by demonstrating both **fair dealing** and **fair price**.
- If directors involved in transaction are **disinterested** and **independent**, then court may not second-guess their decisions assuming all elements of business judgment rule are met. Independent and disinterested directors are generally in the best position to manage a corporation’s affairs.



Waste Claims

- If plaintiff cannot rebut the presumption of the Business Judgment Rule, then plaintiff cannot recover *unless the challenged action constitutes corporate waste*.
 - “unconscionable cases where directors **irrationally squander** or give away corporate assets.”
- Examples:
 - Transfer of corporate assets that serves no corporate purpose.
 - Overly-generous compensation to executives who do not provide meaningful contributions to corporation.



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