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Roundtable Series

SECURITIES

Experts weigh in on the latest trends in securities law.

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Securities

In the securities practice area, Tesla's Elon Musk recently grabbed headlines with his tweet heard 'round the world about taking the company private. The episode culminated in a high-profile settlement with the Securities and Exchange Commission, leaving practitioners to ponder what lessons one should take away from this cautionary tale.

On the litigation front, the U.S. Supreme Court took some practitioners by surprise with its unanimous decision in ***Cyan v. Beaver County Employees Retirement Fund***, concerning whether state courts have jurisdiction to hear class actions alleging only Securities Act of 1933 violations. The High Court also issued its decision in ***Lucia v. SEC***, holding that SEC administrative law judges are "officers of the United States," subject to the Constitution's appointments clause.

Meanwhile, the Delaware Chancery Court's decision in ***Akorn v. Fresenius Kabi AG*** is making waves in M&A litigation, sparking a lively discussion on material adverse effect, the elusive "Delaware tornado" that has officially touched down. Our panel explored these issues as well as the Ninth Circuit's recent ruling in ***Northstar Financial Advisors v. Schwab Investments***—a case 10 years in the making—on the Securities Litigation Uniform Standards Act of 1998's preclusion of state-law class-action claims arising from prospectus disclosures.

Participating in this roundtable were Joshua D.N. Hess and Matthew L. Larrabee of Dechert; Laurie Carr Mims of Keker, Van Nest & Peters; and Peter M. Stone of Paul Hastings.

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Moderated by
DAILY JOURNAL
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DISCUSSION

MODERATOR: What potential issues may arise from Elon Musk's settlement with the SEC over his now-infamous tweet on taking Tesla private? What are the lessons to be learned from the settlement?

HESS: It is an interesting case for many reasons. One, just because it is headline grabbing, and it's a notable case of a statement by a CEO about taking a company private when really there was not much support for everything that was in that statement.

One of the things that strikes me about it is this is really throwing the book at him. It is also amazing to me how quickly the SEC acted on this issue. The statement was on August 7th and the settlement was filed on September 29th. That's a land speed record for an SEC enforcement action.

Overall, I think this is *sui generis*. I tend to think this case is pretty unique and it may be hard to read too much into this as far as what would we likely see from the

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enforcement division in other types of misstatement cases.

MIMS: I agree that what's most notable about the case is how quickly it moved. When I saw how fast it was moving, my supposition was that Tesla and Elon Musk might be driving that speed due to a concern about the overhang of this issue, on top of all of their other current problems—for example, not meeting their projection numbers, among other issues.

The idea that the SEC issued a subpoena within a week of the statement is not that atypical. What's atypical is that Elon Musk sat for a deposition the next week or ten days later. Normally there's much more of a lag time there. The company or the individual would seek time to prepare and to gather the documents in the deposition. So it would be interesting to find out what was driving the speed—it could very well be that it was the board or Elon Musk himself.

STONE: What's notable to me about the decision is how lightly the SEC treated Mr. Musk and Tesla. I disagree with the notion they threw the book at Mr. Musk. He clearly had made a statement that subjected himself and Tesla to a risk of significant regulatory liability. To a multibillionaire, a $20 million fine could well be pocket change. From what I have read, I think the company may have already been reshuffling the board and some board members may already have had a desire to bring in an independent chairman. I will say Mr. Musk and Tesla were very wise to settle because it seems like the kind of thing that really could have distracted Tesla and Mr. Musk and, as Laurie [Mims] said, overhung the company for a long time.

I think it is an unusual case, but in this world where Twitter is becoming more and more a mode of communication—whether it is by the President or by celebrities—it is probably not the last time we are going to see some claim based on a tweet. The cautionary tale for clients is the same as what we have been telling them for many years about email: tweets don't disappear. They are fired off with the same speed as an email and often with the same lack of thought, and they can pose a great risk.

LARRABEE: That to me is a client-advice risk-management issue. If you are going to take a lesson away from this, it is Peter Stone's point. Tesla had designated Musk's Twitter account as a form of corporate communication. I can understand why they might have been doing that, given he is the company and he does communicate by tweeting to people. But the company got dinged for not having, at least in the eyes of the SEC, adequate internal controls over the Twitter account. If that's the standard and you're talking about an entrepreneurial company with a founding entrepreneur like Elon Musk, what is the prudent set of standards for controlling that person's Twitter account? What exactly does that mean? It is not going to be that easy to do, at least for somebody who is

mercurial like Mr. Musk, let alone our President.

HESS: There is a permanent injunction here, too, which I think is the sleeping problem for Tesla and for Mr. Musk with respect to the settlement. If Tesla is unable to get control of the Twitter account, and there is another "oops" moment, then the bricks may really fall down on them. There will probably not be much more they can do about it.

There's one way to view this as an impetuous "oops." It is notable there are no allegations that Mr. Musk had profited from his statement. The statement was false, but the fact that he got hit with a $20 million personal fine and was kicked out as chairman when he never personally profited from the statement, was surprising. That to me indicates they could have a problem if the next impetuous tweet is just simply not fully fact-checked. That potentially could be a new claim stated by the enforcement division.

MODERATOR: Is this an unusual situation?

MIMS: It is not particularly unusual in the sense of a CEO making statements that relate to the stock, particularly the value of the stock—we all routinely see SEC subpoenas, inquiries, and certainly civil cases in such scenarios. What makes this situation unique is, first of all, Elon Musk's celebrity status. Second is the fact that Tesla is suffering from many other issues and was already on the rocks with its investors, and with the SEC to some degree. I do think that the speed was probably just as much on the part of the accused, Tesla and Elon Musk, as it was the SEC. That's, again, just my guess. It sounded like there were settlement talks from the beginning with the SEC, and they wanted to get it resolved as quickly as possible, so that they could move on with their business. That's not going to resolve all of the civil litigation that arises from the same issue, but that's a lower risk than something like the overhang of an SEC investigation.

His punishment seems kind of light in a way—the amount of the fine and the fact that his ability to control the company has not really been changed. It remains to be seen whether the new chairman will exert any real power.

MODERATOR: Might the DOJ pursue this matter?

LARRABEE: Tesla did issue a statement that they got a voluntary request of documents from DOJ, which means they were doing something. But after the SEC settlement, I'd be surprised to see an actual criminal investigation of substance come out of that.

MODERATOR: Let's move on to litigation trends. What are your thoughts on the Delaware Chancery Court's finding of a material adverse effect in *Akorn, Inc., v. Fresenius Kabi AG, et al.*, C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018) (Laster, V.C.)?

STONE: It's an interesting case. Fre-

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Akorn will have impact outside of merger litigation. There are MACs, another shorthand for material adverse effect clauses in financial agreements, including with banks. I could see banks potentially feeling emboldened to invoke a MAC by the findings in this case.

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senius agreed to acquire Akorn for $34 a share after some negotiation and a fair amount of due diligence. Akorn is essentially a genetic drug company; Fresenius is in the pharmaceutical world and a very large player in Germany.

There was a period of time between the merger agreement signing and the close which ultimately lasted a couple quarters. It was always scheduled to last at least a quarter. During that quarter, Akorn's revenue/profit fell off a cliff as compared to its guidance, and that continued ultimately because of competition that it didn't expect, and the cancellation of at least one significant contract.

At the same time, as a part of the pre-closing process, Fresenius developed concerns about Akorn's regulatory compliance, and, in fact, received whistleblower letters from Akorn's current or former employees suggesting that there were significant regulatory compliance problems at several plants.

In the pharmaceutical world, you have to document nearly all the steps of development of a drug. There are strict restrictions on, by way of examples, how lab notebooks are dealt with, compliance with good manufacturing process, and data integrity.

It turned out that Akorn had significant problems in each of those areas, and ultimately had to self-report to the FDA. The FDA over a period of time came to impose increasing sanctions on Akorn. Fresenius got cold feet and did not close the merger and purported to terminate it. Akorn sued to try to force them to close the merger. Fresenius asserted it was a material adverse effect in several respects. They asserted a general material adverse effect in terms of the company's financial performance. That's particularly interesting to practitioners in the M&A world because that comes up across industries. They also asserted a violation of the regulatory compliance, what they called the regulatory MAE. That may be of main interest to the pharmaceutical world.

Then there was also the ordinary course covenant claim that Akorn post-signing had not continued to operate their business in the ordinary course—namely, that Akorn decided to stop much of their remediation work at making sure they were FDA compliant until Fresenius took over.

Vice Chancellor Laster after a five-day trial found that all those claims by Fresenius had merit and that in particular there had been a material adverse effect both in general and as a regulatory matter so he refused to order Fresenius to close the merger.

It is a really interesting case because there haven't been very many, if any, Delaware Chancery Court findings of a material adverse effect. In fact, just a few weeks before the *Akorn* decision, Vice Chancellor Glasscock III in another case had referred to the MAE claim as a Delaware tornado—often discussed, but never seen. We have seen one now, a really big one. I think there's a lot to take away from *Akorn*.

MIMS: I agree with Peter [Stone] that

one of the more interesting pieces, and probably what's going to have a bigger effect on companies outside of the pharmaceutical and biotech life sciences realm, is the ordinary course operating standard. Vice Chancellor Laster found that the financial problems that happened, some of which were due to regulatory compliance issues, but some of which were due to a changed competitive environment, materially affected the progress of the company. He looked at the durational effect.

There was also this unique way of looking at whether a change of 20 percent was enough to be material, and experts looked at different benchmarks. For example, they said a 20 percent drop would be the second largest drop ever in the stock market if that were to happen. So they said, "How can that not be material?" But they also looked at breakup fees, and other negotiated changes in prices that occur.

So I thought that part of the opinion was particularly interesting and more likely to have an impact on both the transactional side (how merger agreements are drafted), and also litigation (which arguments people put forth for trying to get out of a merger). It is quite an opinion.

I have had a case before Vice Chancellor Laster, and I currently have a merger agreement dispute in front of him, and I find that this is his characteristic approach to contracts. He really holds the parties to the contract, and does not allow implied conditions.

One of Akorn's arguments was that Fresenius knew that there were these issues, or certainly should have known based on its due diligence. The Vice Chancellor rejected it, saying there's no reliance requirement for a breach of contract claim. This was a negotiated arm's-length agreement that had representations on both sides, and that's all that we look at. It is not up to the buyer in this case to go and make sure that each of these representations line up with what the buyer has seen in due diligence. If that were the standard, then what's the point of having the representations you are saying are true at the time of the signing and are true at the time of closing? It's quite a lot to get through, but I think that *Akorn* will be cited in many contexts, and outside of Delaware.

LARRABEE: It is a classic Laster opinion in the sense that it is completely committed to freedom of contract. It's fearless analysis of Delaware law wherever it takes him. It is his own intense analysis of the business issues and the finance of the companies that appear before him and has more than two or three quotable quotes. Those characteristics define almost everything he does, and they are rarely short, also.

HESS: The most remarkable thing about this case is that it is the first. Speaking of Delaware tornadoes, this is the first one that's touched the ground. That said, I am not sure how much the ruling changed in terms of the law of material adverse effects in Delaware—if anything, at all. This was an incredibly extreme

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case. This is like fraud. The level of the regulatory failure was breathtaking. The degree of the financial performance miss is enormous. So I think we can confirm that, at least if this is the standard, it is still going to be way out of reach for most people. However, now it is at least something that *could* happen.

It's a little early for M&A practitioners to say general MAE is going to give us a lot more protection. Still, I think looking at good due diligence, good covenants, sandbagging provisions or anti-sandbagging provisions, are the types of things we really should be thinking about.

STONE: To me, this case has two main takeaways from a practice standpoint. One is the finding that the company acted outside the ordinary course in directing, for example, its IT function to put off projects until they were acquired. That's going to cause a lot of pause for sellers. It is not that out of the ordinary to say, "We are going to have new management in. Let's put off these big projects that we were considering until they come in and bless them." Perhaps the solution is to have straightforward communication between the buyer and seller. In this case, if Akorn had said to Fresenius, "We had these computer projects all lined up, we are going to spend a lot of money, do you want us to hold off?" maybe they would have gotten protection just by having that dialogue.

The other main takeaway from the case is the fact you can have a general MAE. Josh [Hess] was right, the facts of this case are pretty extreme in terms of the business falloff. But it is not that unusual to have a company acquire another and over the period of the first year or two—a period that's durationally significant—see a good size fall-off. Sometimes it's due to the merger itself, sometimes it's due to competition. Sometimes people are trying to sell the business because they see the fall off the cliff. It happens for many reasons.

This gives buyers some more protection in the instance where someone is selling a business to get out ahead of a wave that's about to swamp them. I agree with everything Matt [Larrabee] said about the character of the opinion. It is a classic Laster opinion.

MODERATOR: Do you anticipate seeing more MAE cases succeed, or was *Akorn* an outlier?

STONE: It is an important case because it is the first case where the tornado touched down, and it shows that they can. I have always thought that you could prove a material adverse effect on the right set of facts and we now have some guidance as to what those facts look like. I think you'll see other MAE cases succeed in settlement or at trial. But they are, in some ways, few and far between.

LARRABEE: I am guessing we are going to see more cases fail because people will get in situations where all their incentive is to try it. They will point to this decision and say our facts are comparable, and 19

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out of 20 times they won't be comparable and they'll lose. That's the common outcome I expect.

STONE: Do you think there is a difference between people trying to get out of closing a deal or people trying to seek damages after a deal, when they operate the business and it falls off a cliff?

LARRABEE: I think those are good claims. I think post-closing settlements are something viable in Delaware. Depending on the contract language, but the standard is usually lower, right? You get all kinds of breaches of reps and warranty. It is not necessarily an MAE standard. I think that's probably a more available remedy.

MIMS: This case likely will have impact outside of merger litigation. There are MACs, another shorthand for material adverse effect clauses in financial agreements, including with banks. I could see banks potentially feeling emboldened to invoke a MAC by the findings in this case. Certainly the biggest impact will be in the merger context, but there are many other contractual contexts where there are similar material adverse effect clauses.

MODERATOR: What is the anticipated impact of the U.S. Supreme Court's unanimous ruling in *Cyan Inc. v. Beaver County Employees Retirement Fund*, 583 US _ (2018), holding the SLUSA does not strip state courts of jurisdiction to adjudicate class actions alleging only 1933 Securities Act violations, nor does it authorize removing such suits from state to federal court?

HESS: The decision is not that surprising. The fact that it was *unanimous* was quite surprising. I was surprised by the unanimous decision because the statute had really torn apart lower courts other than those cited in the Bay Area. Also, oral argument in *Cyan* was actually quite rollicking, to the point that Justice Alito rather angrily exclaimed that the whole statute was gibberish. There was definitely more volatility in the *Cyan* oral argument than you normally see in other cases. There were clearly many questions surrounding this issue simply because it is not clear in terms of statutory interpretation.

So when the decision came out and it was a unanimous vote, and Justice Kagan was so breezy about it, I was stunned because, frankly, this is a crazy statute. She was basically like, "Well, this is a pretty straightforward reading; no problem; nothing to see here." I was actually quite flummoxed by that. At the end of the day and with the breezy approach of the decision, it still doesn't answer the question of the point of the "except as provided by Section 77p" clause. There's still no real answer for that.

MIMS: I was likewise surprised that the decision was unanimous. It is a situation where the only complete remedy is going to be further legislation. Even with this decision, like Josh [Hess] said, there's not an answer to the critical question of what this language means, and it

must have meant *something*. As far as practical ramifications, it means that we are going to be seeing more plaintiffs back in California state court.

These types of claims are usually brought against companies that have recently IPOed or have done a secondary fundraising round—usually, they are not well-established companies. The burden of having to litigate in state court, without the discovery stay, is a big one and is something that often drives early settlement. This is something that companies that are considering an IPO, or particularly considering a secondary public offering, should keep in mind because basically all that needs to happen is the IPO or the secondary offering, and then a stock drop within a year, and if that happens and the amount is significant, you're likely to see one of these cases.

LARRABEE: The other area where it may have an impact is on people in the mutual fund industry. People in mutual funds have continuous offerings under their prospectus so they have a registration statement that is always effective. As a result, they are subject to the '33 Act every day they go to work. You could see some more activity in that area in state courts as well.

STONE: I wasn't particularly surprised in the outcome. The statute is tremendously unclear, but it is hard to navigate a textual path to federal court. Given the lack of clarity, it is not surprising that the justices would say, "Well, for many, many decades these cases were permitted in state court, so absent a clear sign, why would we change that?"

That leads to two consequences. One is you are going to have judges now dealing with securities cases who are less experienced in securities cases, which means that they will not, perhaps, have the familiarity with items like loss causation. There are very few defenses available on a '33 Act case and very few elements a plaintiff has to prove. You get into a pretty arcane area of the world as a defendant trying to prove a lack of loss causation to a judge that doesn't know how loss causation works. There are judges on the state bench who know about the standards or are absolutely capable of getting up to speed, but there are going to be many cases in state courts where you have judges who are very unfamiliar with the legal concepts.

LARRABEE: Particularly because under the '33 Act, the burden is on the defendant to come forward with the statutory damage form, and any causation defense. So good luck with that.

STONE: You don't have many other places to go. And then, of course, what Laurie [Mims] was saying is absolutely right: absent the judge agreeing with the reasons why there's an automatic stay under the federal securities laws, typically in California you would not have any discovery stay and the pressure that can add will often drive a settlement that would be much different

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than the one you would have if you were in federal court. On the other hand, we did have concurrent jurisdiction for decades and the world didn't end.

HESS: One solution around this is congressional action, but I honestly think that is probably a no-go, even though it would be a simple fix—seven words or less. Still, it is unlikely.

I think the more likely route is a private ordering. Clients who are about to IPO should heavily consider a venue provision not unlike the breach of fiduciary duty claim venue provisions we have been starting to see where the Delaware Chancery Court has made the exclusive venue for breach of fiduciary claims. Those have been upheld. You could do the same thing with respect to Section 11 claims and say any Section 11 claims that are brought with respect to our registration statements must be brought in a federal court of competent jurisdiction or a specific one. That is the kind of provision that is currently being challenged in the Chancery Court. I think oral argument just occurred and clarifies Chancellor Laster on it. I would expect a 250-page opinion about the appropriateness of such a provision under Delaware law, but the provisions about venue selection for breach of fiduciary duty claims have been upheld. I am not sure why there would be a difference with respect to these types of claims.

So if that type of private ordering solution presents itself, it could be a much easier fix that may obviate any need for congressional action and may obviate the issue entirely.

LARRABEE: I think Josh [Hess] got it. The net result of this is private ordering, and this will be something academic and securities law geeks like us will look at. And our clients will have felt very little impact on their lives. That's my guess.

MODERATOR: Since the ruling in *Cyan*, has there been an uptick in state court filings?

LARRABEE: Cornerstone Research says no, the frequency of state court filings hasn't changed pre- and post-*Cyan*.

MIMS: It hasn't been very long since the ruling. After some time, I wouldn't be surprised to see these cases being pursued in other states that like California have more liberal discovery rules generally, and lower thresholds for surviving motions to dismiss or demurrers. Unless, of course, Congress fixes the issue or there is this private ordering solution that's upheld, and then it won't be worth plaintiffs' time.

MODERATOR: What are the takeaways from *Lucia v. SEC*, 585 U.S. ___ (2018), in which the Court held SEC administrative law judges are "officers of the United States," subject to the Constitution's appointments clause?

STONE: The case arises in the securities context, but it is really a

separation of powers or federalism case. The case isn't that surprising to me, and it doesn't seem like it is going to have that much impact at the SEC. There may be some kind of delay and some small effect on cases that were pending, and certainly on the cases that were involved in the appeal.

HESS: The minute *Lucia* was done, the commission issued an order staying every case and then eventually reappointed all of the ALJs. The remedy the Court provided in *Lucia*, which was controversial because Justice Breyer said now we have to provide some kind of remedy, is that you have to start the administrative proceedings all over again and you can't have the same ALJ do it. So you have to reassign it to a different ALJ.

The commission basically said, "Just in case it wasn't clear, I bless you all and you are officially appointed by a commission" and they did the reassignment. That started in September. So that was just a mere speed bump for the current docket in terms of what's going on right now.

MIMS: But it wouldn't apply to cases where there hadn't been a jurisdictional challenge or constitutional challenge or anything that settled, and there's a pretty high statistic of cases that are settled in this context. I don't think it is something that affects what's going to happen going forward, but looking at the last two years, it feels inequitable. Companies or people who have settled have lost this remedy for retrial that these other defendants may be able to take advantage of.

LARRABEE: I am guessing people will move on pretty quickly to other due process challenges, right? In some ways the ruling and the remedy for the ruling make it more apparent that the judge, jury and executioner is an appointee of the prosecutor. There aren't very many justice systems designed in that way. I think people have made arguments that this isn't a system designed to get justice. If you have ever been through one of these proceedings, you would know it is not designed to get justice. I think those attacks are still out there, no matter how well appointed everybody is.

MODERATOR: Moving on to the Ninth Circuit, what are your thoughts on the recent decision in the *Northstar Financial Advisors Inc. v. Schwab Investments et al.* class action—a case 10 years in the making—on SLUSA preclusion of state-law class-action claims arising from prospectus disclosures? How does it square with other circuits' rulings?

MIMS: The reasoning of the majority of the opinion did not seem complicated or novel to me. The reasoning is it should depend on the gravamen of the complaint or the gist as to what caused the harm. That's the typical way that these sorts of provisions are interpreted so that they avoid results by artful pleading.

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HESS: Matt [Larrabee] and I represented the Schwab defendants in *Northstar*. I don't think there is a circuit split. There is a perception of some that there is. The issue in the case was surrounding a falsity element of SLUSA: exactly when does a case state a misrepresentation or omission? Many of the circuits have grappled with this issue. It is a little bit metaphysical. What you have seen are many different rhetorical incantations—the essential element, the gravamen, and so forth.

I for one am maybe not as close of a student of English to appreciate the differences between those words that suggest that there's a circuit split as the dissent in *Northstar* did and another dissent in the Seventh Circuit did.

The position we took and the Ninth Circuit accepted is that simply, if the claim you are bringing is based upon conduct that would be enforceable or actionable under the falsity provisions of the federal securities laws, then it will be precluded under SLUSA.

One of the wrinkles about the *Northstar* case is that it had two different types of claims. One says, "I'm saying something when it is already false." But then there's another that says, "I am saying something before it is false, you buy it, but then it becomes false and I don't correct it." That looks like a holder claim, and they are not actionable by a private party under the federal securities law. I think what troubled the dissent in the Ninth Circuit is the perception that this class doesn't have a remedy. If you take the line of cases in SLUSA and *Dabit* together, it leads you to a potentially harsh result, but that is the result Congress probably intended.

LARRABEE: I think that's the reason this was a hard case. As a matter of statutory interpretation or as a matter of interpreting the Supreme Court's guidance on SLUSA, the answer was pretty straightforward because the plaintiffs in *Northstar*, even on the most difficult issue, were saying, "I bought shares, I bought securities. At the time I bought the securities, the prospectus, the governing document, the offering document, was true. Later the issuer of the governing document changed their behavior and the governing document was false, and that change in behavior caused my damage." That's a fact pattern. To me it is pretty clear that claim depends on a misrepresentation or omission because the conduct that caused the harm deviated from a then-effective prospectus. So that prospectus became false, that was the cause of the harm.

Chief Judge Thomas was very clear at oral argument that what he was worried about was that the net result of SLUSA is there's no class remedy. I argued that case and we made lots of arguments that there is a remedy: SLUSA precludes a class action, but the SEC can help you, you get an individual state cause of action and get 48 of your friends and collectively pursue a state law cause action. There wasn't a person in that courtroom listening to me articulate arguments that wasn't

thinking if SLUSA applies, there's no remedy because there's no holder claim and there's no effective state law remedy, particularly in that case when the plaintiff made a profit. So he didn't even have a claim.

That's why it was hard. That's why Chief Judge Thomas was looking for some reason to get to a different answer. I think that's the same reason we got a hint of a circuit split in the Seventh Circuit case. Josh [Hess] and I have read all these cases on the circuit split. God bless you if you can read those cases and say they are different in terms of outcome. I couldn't.

STONE: Matt [Larrabee] said from his insider's view what I would have said as an outsider to the case: first the statutory interpretation part of it seemed really easy to me; second, really this is all about whether holders have a remedy; and third, *Dabit* decided that. I wouldn't have been particularly troubled by this decision as a judge. There's a strong policy reason not to have holders being able to bring securities claims. It is simply too easy to say, "I would have done something different with the benefit of hindsight."

LARRABEE: That's what the majority was thinking. That's why we got a good ruling, and that's why we got a good holding in a prior case called *Hampton*. I think the Ninth Circuit is very clear where they stand, and it is consistent with the law around the country now.