INSIGHTS

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SECURITIES ENFORCEMENT

Supreme Court Upholds SEC Authority to Seek Disgorgement, but Imposes Important Limiting Principles

While the Supreme Court has held that the SEC may seek disgorgement in civil enforcement actions, it did so only when the disgorgement does not exceed a wrongdoer's net profits and is to be awarded for victims. Thus, the decision provides defense counsel with important tools for pushing back against disgorgement remedies that do not satisfy this standard.

By Kristina Bunting, Andrew J. Ehrlich, Alex Young K Oh and Richard A. Rosen

In June 2020, the Supreme Court held that the Securities and Exchange Commission (SEC) may seek disgorgement in civil enforcement actions, at least when the disgorgement does not exceed a wrongdoer's net profits and is to be awarded for victims. In *Liu* v. *Securities & Exchange Commission*, the Supreme Court addressed whether the SEC may seek disgorgement pursuant to its statutory authority under 15 U.S.C. § 78u(d)(5) to obtain equitable relief. In an earlier decision, *Kokesh* v. *Securities & Exchange Commission*, the Supreme Court had characterized disgorgement as a "penalty" under the general federal statute of limitation applicable to the enforcement of penalties.[1] *Kokesh* arguably had called into question whether disgorgement constitutes equitable relief for purposes of the SEC's statutory authority, and thus set the stage for *Liu*.

In *Liu*, the Supreme Court upheld courts' equitable authority to award disgorgement in SEC enforcement actions, but held that to be valid, the awards should adhere to the following principles: (1) the amount disgorged must not exceed the wrongdoer's net profits; (2) the disgorgement must be obtained for the benefit of investors; and (3) a disgorgement order against affiliates may be unjust depending on certain enumerated circumstances. The Court's decision provides welcome guidance in area where there previously was a limited basis for challenging the discretion of the SEC, and provides potential defendants in SEC enforcement proceedings with clear grounds for resisting unreasonable disgorgement demands.

Kristina Bunting, Andrew J. Ehrlich, Alex Young K Oh, *and* **Richard A. Rosen** *are attorneys at Paul, Weiss, Rifkind & Garrison LLP.*

Factual and Procedural Background of *Liu*

The SEC brought a civil enforcement action against petitioners Charles C. Liu and Xin Wang (among others), alleging that they violated the federal securities laws by fraudulently raising approximately $27 million from investors and then misappropriating the funds.[2] A federal district court in California entered summary judgment for the SEC and awarded disgorgement of over $26 million, in addition to other relief.[3] Petitioners objected that the disgorgement award failed to exclude their legitimate business expenses.[4] The district court, however, disagreed; it ruled that the sum was a "reasonable approximation of the profits causally connected to their violation."[5] Under the district court's ruling, petitioners were jointly and severally liable for the full disgorgement award of $26 million.[6]

The Ninth Circuit affirmed. On appeal, petitioners argued that the Supreme Court's intervening decision in *Kokesh* precluded the SEC from seeking

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disgorgement in civil enforcement proceedings.[7] The Ninth Circuit disagreed. As the Ninth Circuit explained, the *Kokesh* Court had declined to address whether the SEC was authorized to seek disgorgement as a remedy. The Ninth Circuit therefore applied the circuit's "longstanding precedent on this subject," which permitted the award.[8] In the Ninth Circuit's view, the "proper amount of disgorgement" was "the entire amount raised less the money paid back to investors."[9]

The Supreme Court granted review to consider

> [w]hether the Securities and Exchange Commission may seek and obtain disgorgement from a court as "equitable relief" for a securities law violation even though this Court has determined that such disgorgement is a penalty.[10]

The Supreme Court's Decision

In an 8-1 decision written by Justice Sotomayor, the Supreme Court rejected petitioners' argument that disgorgement is not a permissible remedy under 15 U.S.C. § 78u(d)(5).[11]

15 U.S.C. § 78u(d)(5) permits courts to award "any equitable relief that may be appropriate or necessary for the benefit of investors" in civil enforcement actions brought by the SEC. Because Congress did not define what remedies constitute "equitable relief," the Court analyzed whether disgorgement was *typically* available in courts of equity. In rejecting petitioners' argument that the SEC has no authority to seek disgorgement under § 78u(d)(5), the Court noted that "[e]quity courts have routinely deprived wrongdoers of their net profits from unlawful activity, even though that remedy may have gone by different names," such as restitution or accounting for profits. The Court further observed that courts sitting in equity generally have awarded profits-based remedies against individuals or partners engaged in concerted wrongdoing, not against multiple wrongdoers under a joint-and-several liability theory.[12] The Court also explained that its decision in *Kokesh* that disgorgement was a "penalty" for statute of limitations purposes under 28 U.S.C. § 2462 had no bearing on whether disgorgement was "equitable relief" under 15 U.S.C. § 78u(d)(5). A disgorgement remedy could, and does, qualify as both.

At the same time, the Court rejected the SEC's argument that it can obtain broad disgorgement remedies unconstrained by traditional equitable principles.[13] The Court observed that, "[o]ver the years . . . courts have occasionally awarded disgorgement in three main ways that test the bounds of equity practice."[14] Specifically, courts have (1) "fail[ed] to return funds to victims," (2) "impose[d] joint-and-several liability," and (3) "decline[d] to deduct business expenses from the award."[15] The Court did not determine whether the disgorgement award below suffered from any of those three deficiencies. The Court instead provided "principles that may guide the lower courts' assessment" of those issues on remand.[16]

First, the Court indicated that "[t]he equitable nature of the profits remedy generally requires the SEC to return a defendant's gains to wronged investors."[17] The Court left open whether depositing the proceeds of disgorgement with the United States Treasury, rather than returning those proceeds directly to victims, might be justified where it is "infeasible to distribute the collected funds to investors."[18] The Court observed that, if the SEC requests an order on remand directing proceeds to the Treasury, "the lower courts may evaluate in the first instance whether that order would indeed be for the benefit of investors," as required by statute.[19] The Court also observed that, "[t]o the extent that feasibility is relevant at all to equitable principles," "lower courts are well equipped to evaluate the feasibility of returning funds to victims of fraud."[20]

Second, the Court raised the possibility that imposing joint and several liability for disgorgement may be impermissible depending on the circumstances. The Court declined "[to] wade into all the circumstances where an equitable profits remedy might be punitive," but it contrasted "equally culpable codefendants" with "more remote, unrelated

tipper-tippee arrangements."[21] With respect to petitioners, the Court identified their marriage and the lack of evidence that they did not commingle funds as facts relevant to whether "petitioners [could] be found liable for profits as partners in wrongdoing or whether individual liability is required."[22] The Court left the task of weighing those and other considerations on remand.[23]

Third, the Court held that "courts must deduct legitimate business expenses before ordering disgorgement under § 78u(d)(5)."[24] It noted that a defendant may be denied "'inequitable deductions' such as for personal services."[25] But "the exception requires ascertaining whether expenses are legitimate or whether they are merely wrongful gains 'under another name.'"[26] As the Court noted, certain of petitioners' expenses went toward items that "arguably [had] value independent of fueling a fraudulent scheme," such as payments for a lease and business equipment.[27] The Court left resolution of whether those expenses should be deducted from the disgorgement amount in this case to the lower courts.[28]

Justice Thomas dissented. In his view, "[d]isgorgement can never be awarded under 15 U.S.C. § 78u(d)(5)" because the SEC may only seek "equitable relief" under that section, and "disgorgement is not a traditional equitable remedy."[29]

Implications of the Supreme Court's Decision

While the Supreme Court held in *Liu* that the SEC may as a matter of principle seek disgorgement under 15 U.S.C. § 78u(d)(5), the decision circumscribes the authority of courts to enter disgorgement awards. After *Liu*, disgorgement generally is permissible only when the award (1) represents the net profits of the wrongdoer, (2) is awarded for the benefit of victims, and (3) is not directed at affiliates of the wrongdoer if an award against the affiliates would be punitive. The decision thus imposes much-needed standards that the SEC must follow in seeking disgorgements and may present opportunities for defendants to challenge disgorgement remedies.

Disgorgement Limited to Net Profits of Wrongdoer

In holding that the SEC is permitted to obtain only the net profits of the wrongdoer, the Supreme Court distinguished between "legitimate expenses," which may be deducted from a disgorgement remedy, and "inequitable deductions such as for personal services."[30] But the Court left open how a district court might distinguish between the two. The Court also did not address which party has the burden of proving whether expenses should be excluded from a disgorgement award. Defendants in civil enforcement actions likely will argue that the SEC has the burden to justify the full amount of its requested disgorgement remedy and that certain expenses are "legitimate business expenses" that should be deducted from the disgorgement amount.

Disgorgement Should Benefit Victims

The Court's pronouncement that any disgorgement generally should benefit victims also left open certain questions, including whether and in what circumstances the decision to deposit disgorged funds in the Treasury would benefit victims of the fraud, as required by statute and equitable principles. It is not clear how this new factor will impact the SEC's efforts to seek disgorgement, and the SEC may issue further guidance as a result. Based on the Supreme Court's statements regarding the return of funds to victims, Defendants may be able to draw on the Supreme Court's statements regarding the feasibility of returning funds to victims to argue that (1) it is the SEC's burden to show that it is infeasible to distribute funds to victims directly, and (2) if funds cannot be returned to victims directly—or if there are no apparent victims to compensate, such as in certain Foreign Corrupt Practices Act (FCPA) and insider trading cases—then disgorgement cannot be ordered at all.

The decision also may assist defendants who are seeking to settle parallel actions by the SEC and private plaintiffs in class or derivative securities actions. With the SEC obligated to disburse disgorgement proceeds to victims, defendants may have a stronger

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argument that any settlement with class or derivative plaintiffs must take into account any disgorgement award entered in the SEC action.

Guidance on Permissibility of Joint and Several Liability for Disgorgement

On the issue of joint and several liability for disgorgement, the Court declined to "wade into all the circumstances where an equitable profits remedy might be punitive when applied to multiple individuals."[31] But it did provide some guidance on the types of factors that lower courts should consider in determining whether to impose disgorgement on affiliates of the wrongdoer. Those factors include: (1) the role of the affiliate in the misconduct forming the basis of the disgorgement award, *i.e.*, whether the affiliate is an active participant or a "mere passive recipient"; (2) whether the finances of the individual wrongdoer and affiliate are commingled, or whether the affiliate did not enjoy the "fruits of the scheme"; and (3) "other circumstances [that] would render a joint and several disgorgement order unjust."[32] The Court did not, however, provide guidance on what such "other circumstances" might be. This raises additional important questions that the SEC will have to consider in deciding whether to seek disgorgement against certain corporate entities, such as whether to seek disgorgement against a parent corporation for the conduct of a subsidiary, or one joint venture partner for the conduct of another joint venture partner. Notably, the Court also hinted that a "more remote, unrelated tipper-tippee arrangement[]" might not support a joint and several disgorgement remedy,[33] which may open the door for some tippers in insider-trading cases to argue that they should not be liable for the profits of tippees. The Court's decision thus provides defense counsel with important tools for pushing back against disgorgement remedies that do not satisfy the *Liu* standard.

Notes

1. Kokesh v. Securities & Exchange Commission, 137 S. Ct. 1635 (2017).
2. Petition for Writ of Certiorari at 4, Liu v. SEC, No. 18-1501, 2020 WL 3405845 (U.S. June 22, 2020).
3. *Id.* at 5-6.
4. Defendants' Memorandum in Opposition of SEC's Motion for Summary Judgement at 25, SEC v. Liu, 262 F. Supp. 3d 957 (C.D. Cal. 2017).
5. SEC v. Liu, 262 F. Supp. 3d 957, 976 (C.D. Cal. 2017), *aff'd*, 754 F. App'x 505 (9th Cir. 2018), *vacated and remanded*, No. 18-1501, 2020 WL 3405845 (U.S. June 22, 2020).
6. *Id.* at 975-976.
7. *See* SEC v. Liu, 754 F. App'x 505, 509 (9th Cir. 2018).
8. *Id.*
9. *Id.*
10. Petition for Writ of Certiorari at i, *Liu*, 2020 WL 3405845.
11. The Court's holding aligns with the focus of the Justices' questions at oral argument. Many of the Justices' questions focused less on whether the SEC lacked any authority to obtain disgorgement and more on the issue of whether disgorgement should be limited to net profits and returned to victims. Oral Argument Transcript at 8:3-11, 9:23-10:8, 8:12-11:21, 34:3-20, 36:11-13, 40:2-5, *Liu*, No. 18-1501 (U.S. Mar. 3, 2020).
12. *Id.* at *7.
13. *Id.* at *8-9.
14. *Id.*
15. *Id.* at *9.
16. *Id.*
17. *Id.*
18. *Id.* at *10.
19. *Id.*
20. *Id.* at *10 n.5.
21. *Id.* at *11.
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*
27. *Id.* at *12.
28. *Id.*
29. *Id.* at *12.
30. *Liu*, 2020 WL 3405845, at *11.
31. *Id.* at *11.
32. *Id.*
33. *Id.*

SECURITIES LITIGATION

Observations on the First Wave of Securities Litigation Amid COVID-19

The changes wrought by COVID-19 and the resulting volatile markets have produced a slew of securities litigation complaints brought by both class-action plaintiffs and the Securities and Exchange Commission. Companies should keep these in mind as they prepare future disclosures.

By Michael G. Bongiorno, Jessica Lewis, Robert Kingsley Smith, and Sierra Shear

The spread of COVID-19 has ushered in rapid changes to the global economy. Almost overnight, some industries, such as hospitality and retail, faced major disruptions as consumers placed their plans and purchases on hold. In others, such as the medical supply industry, natural opportunities arose from the crisis as companies rushed to develop or to sell products used to treat COVID-19. And still other industries, such as parts of the technology sector and retailers with strong supply/delivery chain management already in place, saw an unexpected flood of demand as businesses and consumers rapidly changed their communication and shopping habits.

These changes, and the continuing uncertainty about how the marketplace will respond to and recover from the pandemic, have caused market turbulence and, beginning in mid-February, the largest decline in stock prices since the 2008 financial crisis—followed by the largest single month gain since 1987 in April 2020. As market volatility has continued, it is inevitable that companies now face the prospect of increased securities litigation claims related to COVID-19. So far, a variety of public companies—including those that have faced a steep decline in demand or revenue as a result of this crisis and those that have experienced sudden stock surges in the wake of COVID-19—have faced suit by both class action plaintiffs and the Securities and Exchange Commission (SEC). The following summary of securities litigation complaints related to COVID-19 or filed amid the COVID-19 pandemic provides instructive context and allows preliminary observations for any company navigating economic changes and new market dynamics amid COVID-19.

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Private Securities Class Actions

Class Actions under the Exchange Act

Beginning in early March 2020, class action plaintiffs began filing a first wave of securities fraud complaints under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) asserting that companies made misleading public statements about the impact of COVID-19 on their businesses. Those cases span a number of industries affected in various ways by COVID-19.

Norwegian Cruise Lines. The first putative securities fraud class action related to COVID-19 was filed on March 12, 2020, in *Douglas v. Norwegian Cruise Lines* in the Southern District of Florida. The plaintiffs named Norwegian Cruise Lines and its chief executive officer (CEO) as defendants, alleging that Norwegian's February 20, 2020, Form 8-K and press release failed to disclose known adverse facts about how COVID-19 would affect Norwegian's operations. For instance, the plaintiffs allege that the Form 8-K falsely stated:

> Despite the current known impact from COVID-19 coronavirus outbreak, as of the

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> week of February 14, 2020, the Company's booked position remained ahead of prior year and at higher prices on a comparable basis.

They further allege that Norwegian's Form 10-K, filed one week later, failed to disclose that Norwegian sales representatives were providing customers with unproven or false information about COVID-19 and the company's business in order to encourage customers to book or not cancel cruises.

According to the plaintiffs, the truth was revealed on March 11, 2020, when a *Miami New Times* article reported on leaked emails from a Norwegian employee related to the company's sales practices and statements to customers. The article reported, for instance, that Norwegian employees were instructed to tell potential customers that "coronavirus is not a concern in warm Caribbean climates" and that, contrary to what sales representatives told customers, "sales are at serious lows." The company's shares allegedly fell 26.7 percent that day and a further 35.8 percent the next. Notably, Norwegian's stock price already had declined during the period between the alleged misrepresentations/omissions and the alleged "corrective disclosure"—from $48.51 on February 20, 2020, to $20.50 on March 10, 2020.

Inovio Pharmaceuticals, Inc. Also on March 12, 2020, a putative securities fraud class action was filed suit against Inovio Pharmaceuticals, Inc. and its CEO in the Eastern District of Pennsylvania. The plaintiffs allege that Inovio made false and misleading statements when, on February 14, 2020, it announced on *Fox News* that the company had developed a COVID-19 vaccine "in a matter of about three hours" and planned to begin human testing early this summer. Inovio's CEO repeated the statements on March 2, 2020, in a highly publicized meeting with President Trump, and asserted that the company planned to start US-based trials in April 2020. The company's stock price allegedly "more than quadrupled from $4.28 per share on February 28, 2020, and continued to increase in the following weeks, reaching an intra-day high of $19.36 on March 9, 2020."

Then, on March 9, 2020, an activist short-seller called Citron Research called for a SEC investigation into the company's alleged misstatements. Inovio's stock price subsequently fell to $5.70, which allegedly represented a 71 percent "decline from its Class Period high." A shareholder derivative complaint, which made parallel allegations based largely off the putative securities fraud class action complaint, was subsequently filed against Inovio's board of directors on April 20, 2020, in the Eastern District of Pennsylvania.

Zoom Video Communications. About a month later, on April 7, 2020, a putative securities fraud class action related to COVID-19 was filed against Zoom Video Communications and its CEO in the Northern District of California. The plaintiffs allege that, contrary to Zoom's disclosures about its robust data security, the company failed to employ adequate security and encryption measures.

According to plaintiffs, the truth began to emerge on July 8, 2019, and continued to develop over the following months. But the plaintiffs allege the truth was not "fully laid bare" until the increasing use of Zoom's video communication software during the COVID-19 pandemic resulted in the publication of a series of news articles between March 26, 2020 and April 2, 2020, about flaws in Zoom's security. The articles asserted, among other things, that Zoom's privacy policy did not make clear that Zoom shared some data analytics with a third-party and that Zoom was "under scrutiny by the office of the New York State Attorney General" for data privacy concerns. The company's stock price fell 19.62 percent between March 27, 2020, and April 2, 2020, and another 4.1 percent on April 6, 2020, following the publication of additional news articles and reports concerning alleged data security flaws, including the alleged news that New York City's Department of Education banned the use of Zoom in classrooms.

SCWorx Corp. Approximately three weeks later, on April 29, 2020, a putative securities fraud class action was filed against SCWorx Corp., a healthcare

technology company, and its CEO in the Southern District of New York. The plaintiffs allege that SCWorx made false and misleading statements when it announced in an April 13, 2020 press release that it

> had received a committed purchase order of two million COVID-19 rapid testing kits, "with provision for additional weekly orders of 2 million units for 23 weeks, valued at $35 million per week."

The company's stock price allegedly increased approximately 80 percent, from $2.25 to $12.02, on news of the order.

Then, on April 17, 2020, a third-party research firm published a report calling the deal "completely bogus," citing SCWorx CEO's "checkered past" of pleading guilty to tax evasion and paying judgment in a fraud suit, the "questionable credibility of [SCWorx's] supplier" run by a "CEO … alleged to have falsified his medical credentials," and disclosures by SCWorx's supplier's source that "disavowed any relationship" with SCWorx's supplier. Over the next three trading days, SCWorx's stock price allegedly fell more than 17 percent.

Elanco Animal Health Inc. On May 20, 2020, a putative securities fraud class action was filed against Elanco Animal Health Incorporated, an animal health company, and its CEO in the Southern District of Indiana. The plaintiffs allege that Elanco made false and misleading statements by providing overly optimistic revenue guidance in public statements and SEC filings beginning in January 2020. For instance, in a March 24, 2020 press release, Elanco disclosed that it was withdrawing previously announced 2020 revenue guidance due to COVID-19, while stating that the company "had not experienced any supply disruptions" and continued to advance critical projects in its pipeline. The plaintiffs further allege that Elanco failed to disclose that its revenue was likely to decline due to its distributors lacking sufficient demand for its channel inventory.

Then, on May 7, 2020, Elanco announced its first quarter 2020 financial results, disclosing that revenue had declined due to a reduction in demand "driven by factors resulting from the COVID-19 pandemic." On an earnings call that same day, Elanco's CEO also reported that distributors were "managing their inventory more tightly" due to financial pressure from COVID-19. That day, Elanco's stock price fell more than 13 percent.

Forescout Technologies, Inc. Two days later, on May 22, 2020, an amended complaint was filed in a putative securities fraud class action filed against Forescout Technologies, a cybersecurity company, and its CEO in the Northern District of California. The plaintiffs allege that Forescout made false and misleading statements when, beginning in February 2019, the company provided "extraordinarily bullish guidance for the full fiscal year of 2019" and throughout 2019 issued partial disclosures stating that the company would not meet prior revenue guidance. The complaint alleges that while the company publicly assured investors that its sales pipeline and rate of closing deals "remained 'very strong'" and that the company was "'hiring like crazy,'" the company failed to disclose that its inability to meet guidance was due in part to weakness in the company's sales and deal pipeline and a declining number of sales representatives. According to the plaintiffs, in January 2020, Forescout again issued overly aggressive guidance, this time for the first quarter of 2020, and included the guidance in a March 2020 definitive proxy statement filed with the SEC that sought approval of the acquisition of Forescout by another company.

Then, on May 11, 2020, Forescout disclosed in its first quarter Form 10-Q that its revenues "for the first quarter of 2020 were $57 million, or $5 million less" than the company projected in its March 2020 proxy statement. The complaint alleges that Forescout "conveniently blamed the global pandemic" for its failure to meet revenue projections, even though a global pandemic was not declared until March 11, 2020 and many of Forescout's "peer" companies beat guidance for the first quarter of 2020. Forescout's stock price allegedly fell nearly 5 percent on May 12, 2020. One week later, on

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May 18, the company issued a press release stating that acquisition of Forescout would not proceed. Following that release, the company's stock price allegedly declined by nearly 24 percent.

Sorrento Therapeutics, Inc. On May 26, 2020, a putative securities fraud class action was filed against Sorrento Therapeutics, Inc., a biopharmaceutical company, and its CEO in the Southern District of California. The plaintiffs allege that Sorrento made false and misleading statements on May 15, 2020 when the company announced that it had "discovered an antibody that had 'demonstrated 100% inhibition of SARS-CoV-2 virus infection.'" The complaint further alleges that on *Fox News* that same day, the company's CEO falsely referred to the company's breakthrough as a "'cure.'"

Then, on May 20, 2020, a third-party issued a research report referring to Sorrento's claims as "'sensational,'" "'nonsense,'" and "'too good to be true,'" and quoting medical researchers as describing Sorrento's disclosure as "'very hyped.'" While that same day Sorrento's CEO appeared on Yahoo! Finance to allegedly defend the company's claims, Sorrento's stock price declined 43 percent from its "Class Period high" by the close of trading. Two days later, on May 22, 2020, *Biospace* published a May 21, 2020 interview with Sorrento's CEO allegedly stating that the CEO "'insist[ed] that they did not say [Sorrento's breakthrough] was a cure.'" Sorrento's stock price allegedly declined on that news, closing approximately 49 percent below the "Class Period high."

Carnival Corp. Finally, a putative securities fraud class action was filed on May 27, 2020, against Carnival Corporation, a leisure travel and cruise company, and its CEO in the Southern District of Florida. The plaintiffs allege that beginning in its January 28, 2020 Form 10-K, Carnival made a series of false and misleading statements about its adherence to its health and safety protocols and its compliance risk management program, while failing to disclose increasing incidents of COVID-19 on the company's ships, violations of "port of call regulations" resulting from "concealing the amount and severity of COVID-19 infections" on Carnival's ships, the company's failure to follow its health and safety protocols, and that the company was continuing to operate and spread COVID-19 at "various ports throughout the world," negatively impacting its business prospects.

Then, on April 16, 2020, a business magazine published an article allegedly stating that "Carnival's ships have become a floating testament to the viciousness of the new coronavirus and raised questions about corporate negligence and fleet safety," asserting that Carnival allegedly ignored early warning signs and failed to take action after being informed of the spread of COVID-19 on its ships. Carnival's stock price allegedly fell over 4 percent on that news. Approximately two weeks later, on May 1, 2020, *The Wall Street Journal* published an article allegedly describing how cruise ships, including Carnival ships, "facilitated the spread of COVID-19," describing additional early warning signs about the spread of COVID-19 aboard cruise ships that Carnival ignored, and noting that the House Committee on Transportation and Infrastructure had requested documents from Carnival related to "COVID-19 or other infectious disease outbreaks aboard cruise ships." Carnival's stock price allegedly fell another 12 percent that day.

Class Actions under the Securities Act

Class action plaintiffs also have filed complaints alleging violations of Sections 11, 12(a), and 15 of the Securities Act of 1933 (Securities Act) amidst COVID-19 related to market volatility, appearing to take advantage of the rescissory nature of Securities Act damages. Only one Securities Act complaint focuses its allegations on COVID-19. Complaints filed against at least two other issuers that went public in the months preceding COVID-19 allege losses that appear to be based on stock drops that occurred during the COVID-19-induced market decline.

Phoenix Tree Holdings. On April 24, 2020, the first and only Securities Act suit filed to date that directly relates to the COVID-19 crisis, was filed against Phoenix Tree Holdings, a China-based real estate company that went public on January 17,

2020, and its underwriters in the Southern District of New York. The plaintiffs allege that Phoenix failed to disclose the volume of complaints made by residents of its apartment buildings and did not warn of the potential impact of COVID-19 on its business. The complaint asserts that at the time Phoenix went public, COVID-19 "was already ravaging China—particularly Wuhan, which was widely regarded as the epicenter of the virus and a significant hub for Phoenix," and that although the company warned that "business could … be adversely affected by the effects of Ebola virus, H1N1 flu, H7N9 flu … or other epidemics," Phoenix did not specifically identify known risks related to COVID-19.

That Phoenix had failed to disclose the risk posed by COVID-19 allegedly began to emerge

> as Phoenix's going-public transaction was publicized, and investors began to understand that the coronavirus was significantly and adversely impacting the Company's business and operations,

and then finally spilled out on March 25, 2020, when Phoenix issued a press release "caution[ing] investors that it expected the coronavirus to adversely affect its financial performance for the first quarter of 2020." Although the plaintiffs do not allege a specific stock drop, Phoenix's stock price fell approximately 48 percent between the date of its initial public offering (IPO) and the date the complaint was filed.

While the following actions do not directly relate to COVID-19, they allege losses that appear to be based on stock drops that occurred during the COVID-19-induced market volatility.

Canaan, Inc. On March 4, 2020, a putative Securities Act class action was filed suit in the District of Oregon against Canaan, Inc., a China-based technology company that went public on November 21, 2019, and its underwriters.[1] The complaint alleges that Canaan's offering documents failed to fully disclose a related-party transaction with a China-based company; that Canaan's "financial health was worse than what was actually reported;" that Canaan had "recently removed numerous distributors from its website just prior to the IPO, many of which were small or suspicious businesses;" and that, contrary to Canaan's disclosures, several of the company's largest clients were not likely to be repeat customers.

The truth about Canaan's alleged misstatements purportedly emerged on February 20, 2020, when a third party published a report "explaining Canaan's numerous false and/or misleading statements" and detailing the supposed inaccuracy of the allegedly false portions of the company's registration statement. That day, the price of Canaan's American depositary shares (ADS) allegedly fell "over 6.8%," from $5.71 to $5.32.

XP, Inc. On March 21, 2020, a putative Securities Act class action was filed in the Eastern District of New York against XP, Inc., a financial services company based in Brazil that went public on December 11, 2019, and its underwriters.[2] The plaintiffs allege that XP failed to fully disclose related-party transactions with a Brazil-based bank, technological issues, and risks related to relying on Independent Financial Agents as part of the company's business strategy, and that XP "had material weaknesses … [and] fired its previous accounting firm due [to] that firm finding and disclosing material weaknesses."

The complaint asserts that on March 6, 2020, a third party published a report allegedly "detailing how XP had misled investors and failed to disclose pertinent information generally and in its Registration Statement." XP's shares allegedly "plummeted … 25.5%" over the next 2 trading days.

SEC Enforcement Actions

By early February, the SEC began warning about COVID-19-related investment scams, and, since then, has continued to issue public warnings to investors about the heightened risk of fraud amidst COVID-19.[3] Throughout the crisis, the SEC has "actively monitor[ed]" "markets for frauds, illicit schemes and other misconduct affecting investors relating to COVID-19" and has noted that "microcap stocks may be particularly vulnerable to

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fraudulent investment schemes, including coronavirus-related scams."

On May 12, 2020, the SEC's Co-Director of Enforcement outlined the Enforcement Division's Coronavirus Steering Committee that was created to respond to COVID-19-related enforcement issues, including microcap fraud, insider trading, market-moving announcements by issuers in industries particularly impacted by COVID-19, and accounting or other disclosure improprieties.[4] Indeed, the Coronavirus Steering Committee has

> developed a systematic process to review public filings from issuers in highly-impacted industries, with a focus on identifying disclosures that appear to be significantly out of step with others in the same industry.[5]

Following this enhanced scrutiny—and after disclosing a "spike" in COVID-19 related tips, including that tips are up 35 percent since mid-March over the same period last year[6]—the SEC recently has joined class action plaintiffs in bringing securities law claims based on allegedly false and misleading statements related to COVID-19. Although the number of investigations launched by the SEC that may result in litigated enforcement actions is unknown, in April and May 2020, the SEC filed at least three complaints in federal court, each against a microcap or penny stock issuer, alleging securities fraud violations related to COVID-19 under Section 10(b) of the Exchange Act.

Applied Biosciences Corp. On May 13, 2020, the SEC filed suit against Applied Biosciences Corp. (APPB), a biotechnology issuer, in the Southern District of New York. The SEC alleges that between late March and late April 2020, APPB made false and misleading statements in a series of press releases touting the company's efforts to manufacture and sell coronavirus-related products. The complaint alleges that on March 25, 2020, APPB issued a press release falsely stating that the company "diverted manufacturing resources" to manufacture products designed to fight COVID-19 and had "formulated its [own hand] sanitizing blends according to CDC guidelines." One week later, on March 31, 2020, the company issued a second allegedly false press release describing its efforts related to coronavirus testing, stating that

> the company had begun shipping a line of "Home Test Kits" to "be used for Homes … or anyone wanting immediate and private results" and touted results in under 15 minutes using only a finger prick.

The complaint alleges that each of these statements was false and misleading, and that APPB "misleadingly failed to disclose that the Food and Drug Administration (FDA) had not approved or authorized the sale of any at-home test kits."

The SEC alleges that following the release of the March 31, 2020 press release, APPB's "stock price increased almost 80 percent from the previous day." Two weeks later, on April 13, 2020, the SEC suspended trading in APPB stock for 10 days.

Praxsyn Corp. On April 28, 2020, the SEC filed suit in the Southern District of Florida against Praxsyn Corporation, a healthcare company, and its CEO. The SEC alleges that on February 27, 2020, Praxsyn issued a press release stating that it was negotiating the sale "of millions of masks meeting the standards for N95 masks," and that the company was vetting suppliers to establish a dependable supply chain of masks. Approximately one week later, on March 4, 2020, Praxsyn issued a second press release "asserting it had a large number of N95 masks on hand and had created a 'direct pipeline from manufacturers and suppliers to buyers' of the masks." Then, on March 31, 2020, Praxsyn issued a third press release "acknowledging it never had masks on hand"—a conclusion that, according to the SEC, was supported by "[d]ozens of emails and other documents from late February through March [that] show that the [CEO] and at least one Praxsyn director knew efforts to obtain and sell N95 or other masks were proving futile."

The SEC alleges that trading volume in Praxsyn stock "increased significantly after both releases" and that Praxsyn's stock price approximately doubled after both releases, "fluctuating between $.0095 and $.0188" on February 27, 2020, on "$.0053 and $.0091" on March 4, 2020. On March 26, 2020, the SEC suspended trading of Praxsyn stock for 10 trading days.

Turbo Global Partners. On May 14, 2020, the SEC filed suit in the Middle District of Florida against Turbo Global Partners, a digital marketing company, and its CEO—a recidivist securities law offender. The complaint alleges that Turbo issued false and misleading press releases on March 30, 2020 and April 3, 2020 that described a purported "strategic alliance" between Turbo and BeMotion, Inc. to sell thermal scanning equipment. Turbo's March 30, 2020 press release represented that Turbo and BeMotion "were actively selling equipment that scans large crowds to detect individuals with elevated fevers," which Turbo claimed could "be instrumental in breaking 'the chain of virus transmission.'" The release further stated that Turbo's partner, BeMotion, was part of a public-private partnership "for this innovation which … is the only scanning technology on the planet with non-contact intelligent human temperature screening and facial recognition," allegedly attributed multiple false statements to BeMotion's CEO, and concluded that the thermal scanning equipment was "available to be deployed immediately" and could be shipped "within five days of receiving an order." On April 3, 2020, Turbo issued another press release stating that the CEO had been in contact with governors and CEOs for major retailers regarding the availability and procurement of the thermal scanning equipment. The SEC alleges that each of these statements was false and misleading.

The complaint concludes that the alleged misstatements "materially affected the trading" for Turbo stock by doubling trading volume and increasing the stock price following their release. On April 9, 2020 the SEC suspended trading of Turbo stock for 11 trading days.

Conclusion

While the number of securities cases involving claims related to COVID-19 remains limited, it is increasingly evident that COVID-19 and the resulting market volatility exposes issuers to private securities litigation and SEC enforcement. While there is no magic bullet to crafting disclosures related to COVID-19, companies should keep in mind the above examples as they prepare future disclosures.

Notes

1. On March 6, 2020, a different set of plaintiffs filed a substantially similar complaint in New York state court. *See* Salmaan et al. v. Canaan et al., Case No. 651515/2020 (N.Y. Sup. Ct. Mar. 6, 2020).
2. On March 19, a different set of plaintiffs filed a similar complaint in New York state court. *See* Kazi et al. v. XP Inc. et al. Case No. 65177/2020 (N.Y. Sup. Ct. Mar. 19, 2020). A third complaint alleging substantially similar claims was filed on April 16 in the Eastern District of New York.
3. "Look Out for Coronavirus-Related Investment Scams—Investor Alert," Securities & Exchange Commission (Feb. 4, 2020), *https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_coronavirus*; "Frauds Targeting Main Street Investors—Investor Alert," Securities & Exchange Commission (Apr. 10, 2020), *https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_frauds*.
4. Steven Peikin, Keynote Address: "Securities Enforcement Forum West 2020," Securities & Exchange Commission (May 12, 2020), *https://www.sec.gov/news/speech/keynote-securities-enforcement-forum-west-2020*.
5. *Id.*
6. Al Barbarino, "SEC Confronts Fraud Amid 'Spike' In COVID-19 Tips," *Law360* (May 27, 2020), *https://www.law360.com/securities/articles/1277290/sec-confronts-fraud-amid-spike-in-covid-19-tips?nl_pk=39e63b94-7013-43d9-94d1-ea9ee06bfcc1&utm_source=newsletter&utm_medium=email&utm_campaign=securities*; Chris Prentice, "Tips to U.S. Securities and Exchange Commission surge in recent weeks—official," *Reuters* (May 12, 2020), *https://www.reuters.com/article/us-usa-sec-enforcement/tips-to-u-s-securities-and-exchange-commission-surge-in-recent-weeks-official-idUSKBN22O329*.

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CORPORATE LAW

2020 Amendments to the General Corporation Law of the State of Delaware

The 2020 amendments to the Delaware General Corporation Law make several important changes, including clarifying the circumstances under which emergency bylaws may be invoked, providing safe harbors for specified corporate actions taken during an emergency condition, reducing the statutory hurdles to become a public benefit corporation, providing further definition around mandatory indemnification for officers and effecting other technical changes.

By John Mark Zeberkiewicz

On June 23, 2020, the Delaware General Assembly passed House Bill 341, an act to amend the General Corporation Law of the State of Delaware (DGCL). The legislation was signed by the Governor on July 16 2020. The amendments make several important changes to the DGCL, including clarifying the circumstances under which emergency bylaws may be invoked, providing safe harbors for specified corporate actions taken during the pendency of an emergency condition, reducing the statutory hurdles for a conventional corporation to become a public benefit corporation (and vice versa), eliminating some of the existing governance restrictions imposed on operating companies resulting from a statutory holding company reorganization, providing further definition around statutory-based mandatory indemnification for officers, clarifying the application of the safe harbor provisions for documents executed by electronic means, and effecting other technical changes. Except as specifically noted below, the 2020 amendments to the DGCL become effective when enacted into law.

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Emergency Bylaws

The COVID-19 pandemic precipitated a renewed focus on Section 110 of the DGCL, which currently authorizes the adoption of bylaws that become operative during any emergency resulting from an attack on the United States or on a locality in which the corporation conducts its business or holds meetings, or during any nuclear or atomic disaster, or during the existence of any catastrophe, or other similar emergency condition, that prevents a quorum of the board from convening, and provides for the exercise of other emergency powers.[1] Section 110 was adopted in 1963, in the wake of the Cuban Missile Crisis, which likely accounts for the specific references to nuclear and atomic disasters.[2] The language of Section 110, however, is not expressly limited to such disasters, and emergency bylaws may become operative while other catastrophic or emergency conditions persist.

The 2020 amendments to the DGCL clarify the application, and expand the scope, of Section 110 in several key respects. First, the amendments clarify that "an epidemic or pandemic, and a declaration of a national emergency by the United States government," are among the catastrophes that may result in emergency bylaws becoming operative and allow for the exercise of emergency powers under Section 110. Second, the amendments dispense with the requirement that the specific catastrophe or emergency be one that prevents a quorum of the board from convening a meeting. Third, the amendments provide that emergency bylaws may be adopted by

the board of directors or, if a quorum cannot be readily convened for a meeting, by a majority of the directors present.

The 2020 amendments make two significant changes to Section 110—one dealing with meetings of stockholders and the other dealing with dividends—that are directly attributable to fallout from the COVID-19 pandemic. As a result of government-ordered lockdowns and in view of public health and safety, many corporations determined it was necessary or advisable to switch from holding an annual meeting of stockholders at a physical location to a virtual meeting format, or to adjourn or postpone a previously called meeting. In many cases, the decision to change the format of the annual meeting, or to adjourn or postpone the meeting, gave rise to questions regarding whether the corporation would be required to mail a new notice of the meeting.

On April 6, 2020, the Governor of the State of Delaware issued the Tenth Modification of the Declaration of a State of Emergency for the State of Delaware Due to a Public Health Threat (Order) that sought to relax some of the notice requirements for public corporations that, before the date of the Order, had called a physical meeting and were seeking to switch to a virtual meeting format. The Order, however, was limited in scope and included a so-called savings clause that called into question its enforceability, and it did not address the multitude of issues that corporations were facing as they navigated calling and convening an annual meeting in the midst of a public health crisis.

Separately, many corporations that had declared dividends in the pre-pandemic era were seeking to conserve cash once it became clear that the pandemic was likely to have a severe economic toll on various industries and sectors. Those corporations, however, were forced to contend with case law indicating that the declaration of a dividend creates a debtor-creditor relationship between the corporation and the stockholders entitled to receive it. New Section 110(i) of the DGCL addresses both of these issues and provides safe harbor protection for specified actions taken under emergency conditions.

Section 110(i) provides that, during any emergency condition, the board may change the record date and payment date of any dividend that has been declared.

First, new Section 110(i) provides that, during any emergency condition, the board (or, if a quorum cannot be readily convened, a majority of the directors present) may take any action that it determines to be practical and necessary to address the circumstances of the emergency as it relates to a meeting of stockholders, regardless of any contrary provisions of the DGCL, the certificate of incorporation or bylaws. This includes postponing any such meeting to a later time or date (with the record date for determining the stockholders entitled to notice of, and to vote at, such meeting applying to the postponed meeting) and, in the case of a public corporation, giving notice to stockholders of any postponement or change of the place of the meeting (or a change to hold the meeting solely by means of remote communication) solely by a document publicly filed by the corporation with the Securities and Exchange Commission (SEC) pursuant to Sections 13, 14 or 15(d) of the Securities Exchange Act of 1934 and the rules and regulations thereunder (Exchange Act). In addition to providing safe harbor protection with respect to notices, adjournments and postponements of stockholders' meetings, new Section 110(i) provides that no person shall be liable for, and no meeting of stockholders shall be postponed or voided due to, the corporation's failure to make a stocklist available pursuant to Section 219 of the DGCL if it was not practicable to allow inspection during any such emergency condition.

Second, Section 110(i) provides that, during any emergency condition, the board (or, if a

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quorum cannot be readily convened, a majority of the directors present) may change the record date and payment date of any dividend that has been declared, but whose record date has not yet occurred, to a later date or dates. In delaying the record date and payment date, the board (or majority of the directors) must ensure, consistent with Section 213(c), that the new payment date is within 60 days of the new record date. In all cases, the corporation must give notice of any change to the record date or payment date of a dividend to stockholders as promptly as practicable thereafter (and in any event before the applicable record date). In the case of a public corporation, the notice may be given solely by a document publicly filed under Sections 13, 14 or 15(d) of the Exchange Act.

It is important to recognize that Section 110(i) operates as a safe harbor provision for purposes of Delaware corporate law. Indeed, the synopsis to House Bill 341 makes clear that the amendments to Section 110 are

> not intended, by implication or otherwise, to limit or eliminate the availability of any powers or emergency actions that are not specifically enumerated with respect to stockholders' meetings, dividends, or other matters that are practical and necessary in connection with the particular emergency, or to affect the validity of any action taken in an emergency situation but not authorized by the amendments or taken in a non-emergency situation.

To this point, it should be noted that Section 110(i) does not address other issues that might arise as a result of a previously declared dividend, including the potential consequences that might arise if a board seeks to delay a record date or payment date after the shares have begun trading "ex-dividend." In addition, Section 110(i) does not alter or change any existing law that would preclude the payment of dividends under specified circumstances, including situations in which the corporation does not have sufficient "surplus" to make the payment.

In recognition of the disruption to ordinary corporate processes wrought by the COVID-19 pandemic, House Bill 341 provides that the amendments to Section 110 shall be effective retroactively as of January 1, 2020 with respect to any emergency condition occurring on or after that date and with respect to any action contemplated by those provisions and taken on or after that date by or on behalf of the corporation with respect to a meeting of stockholders held or a dividend as to which the record date or payment date is anticipated to occur during the pendency of such condition.

Public Benefit Corporations

The 2020 amendments to the DGCL make several significant changes to the statutory regime governing public benefit corporations. A public benefit corporation is a for-profit corporation that is intended to produce a public benefit or public benefits and to operate in a responsible and sustainable manner.[3] In furtherance of that purpose, public benefit corporations are to be managed in a manner that balances the stockholders' pecuniary interests, the best interests of those materially affected by the corporation's conduct, and the public benefit or benefits identified in the corporation's certificate of incorporation.[4]

When the concept of the public benefit corporation was first introduced to the DGCL, significant hurdles, largely in the form of super-majority stockholder votes and appraisal rights, were placed on any conventional corporation seeking to convert to a public benefit corporation, and vice-versa.[5] These statutory hurdles were considered to be important protections to stockholders due in large part to the differences between conventional corporations, the directors of which are charged with a duty to maximize value for the benefit of stockholders, and public benefit corporations, the directors of which are obligated to engage in a balancing of interests.

After a few years of experience with public benefit corporations, and with interest in sustainability and

corporate environmental and social responsibility on the rise, questions arose as to the need for those statutory hurdles, particularly given that the DGCL is a flexible, enabling statute that is designed to allow corporations to implement the governance regime that best suits their particular needs. To that end, the 2015 amendments to the DGCL reduced the vote required to convert a conventional corporation to a public benefit corporation (and vice versa) and limited the circumstances in which appraisal rights would be available upon conversion to or from a public benefit corporation. The 2020 amendments continue this trend, further relaxing some of the barriers to converting to or from a public benefit corporation.

Elimination of Super-Majority Voting Rights

Section 363(a) of the DGCL currently provides that a corporation that is not a public benefit corporation may not, without the approval of two-thirds of the outstanding stock entitled to vote thereon, (1) amend its certificate of incorporation to include provisions resulting in its becoming a public benefit corporation, or (2) merge or consolidate with or into another entity if, as a result of the merger or consolidation, the shares of the corporation would become (or would be converted into or exchanged for the right to receive) shares or equity interests in a domestic or foreign public benefit corporation or similar entity.[6] In addition, Section 363(c) of the DGCL currently provides that a public benefit corporation may not, without the approval of two-thirds of its outstanding stock entitled to vote thereon, amend its certificate of incorporation to delete the provisions relating to its status as a public benefit corporation or merge or consolidate with another entity if, as a result, the shares of the public benefit corporation would become, or be converted into or exchanged for the right to receive, shares or other equity interests in an entity that is not a public benefit entity.[7]

The 2020 amendments to the DGCL eliminate current Sections 363(a) and 363(c). As a result, the vote of stockholders required to amend the certificate of incorporation of a conventional corporation to become a public benefit corporation, as well as the vote required to amend the certificate of incorporation of a public benefit corporation to become a conventional corporation, will be the default vote required under Section 242(b) of the DGCL—that is, a majority of the outstanding stock entitled to vote thereon (along with any greater or additional vote of stockholders required under the certificate of incorporation). Likewise, the vote of stockholders required to approve a merger in which shares of capital stock of a conventional corporation are converted into shares of a public benefit corporation, as well as the vote required to approve a merger in which shares of a public benefit corporation are converted into shares of a conventional corporation, will be the default vote required under Section 251 or other applicable provision governing mergers—that is, a majority of the outstanding stock entitled to vote thereon (along with any greater or additional vote of stockholders required under the certificate of incorporation).

Appraisal Rights

Section 363(b) of the DGCL currently provides that any stockholder of a conventional corporation that holds shares of stock of the corporation immediately prior to the effective time of (1) an amendment to the corporation's certificate of incorporation that causes it to become a public benefit corporation, or (2) a merger or consolidation that would result in the conversion of the corporation's stock into or exchange of the corporation's stock for the right to receive shares in a public benefit corporation and who has not voted for such amendment or merger will be entitled to appraisal rights, subject to the "market out" exception.[8] In the case of private corporations, the existing provisions of Section 363(b) have the practical effect of severely restricting conversions to a public benefit corporation model, as few private corporations are willing to risk being subject to a liquidity event requiring an outlay of cash.

The 2020 amendments to the DGCL eliminate Section 363(b) in its entirety. (The 2020 amendments

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make conforming changes to Section 262, which governs the procedures for demanding and perfecting appraisal rights.) Following the amendment to Section 363(b), appraisal rights will no longer be automatically provided by statute as a result of an amendment of a certificate of incorporation that effectively converts a conventional corporation to a public benefit corporation. Nevertheless, the determination as to whether appraisal rights will be available in connection with a merger in which a public benefit corporation is a constituent corporation will be determined in accordance with Section 262 of the DGCL; in many cases, appraisal rights will be triggered in such mergers.

Director Interest

The 2020 amendments to the DGCL make several changes in respect of the governance of public benefit corporations. To explain these changes, it is important to recite the existing statutory framework. Section 365(a) of the DGCL sets forth the duties of directors of a public benefit corporation, providing that the board shall manage or direct the business and affairs of the public benefit corporation in a manner that balances the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation's conduct, and the specific public benefit or public benefits identified in its certificate of incorporation. Section 365(b) then provides that, for any decision implicating the "balancing requirement," a director will be deemed to have satisfied such director's fiduciary duties if such director's decision is informed and disinterested and not such that no person of ordinary, sound judgment would approve. Section 365(c), in turn, authorizes the certificate of incorporation of a public benefit corporation to include a provision that any disinterested failure to satisfy the provisions of Section 365 shall not, for purposes of Section 102(b)(7) of the DGCL (which generally exculpates directors against liability for monetary damages for breaches of the duty of care) or Section 145 (which governs rights to indemnification, subject, in specified cases, to the indemnitee having met specified standards of conduct), constitute an act or omission not in good faith or a breach of the duty of loyalty.

The 2020 amendments revise Section 365(c) in two key respects. First, the amendment clarifies that a director's ownership of or other interest in the stock of the public benefit corporation will not, of itself, create a conflict of interest on the part of the director with respect to any decision implicating the director's balancing requirements, except to the extent such ownership or other interest would create a conflict of interest if the corporation were a conventional corporation. Put differently, a stockholder generally will not be able to attack a director's balancing decision solely on the basis that the director owned stock in the public benefit corporation (and therefore presumably could be alleged to favor the pecuniary side of the balancing test). Second, the amendment revises Section 365(c) to provide that, absent a conflict of interest, no failure to satisfy the balancing requirement shall, for purposes of Section 102(b)(7) or Section 145 of the DGCL, constitute an act or omission not in good faith, or a breach of the duty of loyalty, *unless* the certificate of incorporation so provides. In other words, this latter revision to Section 365(c) provides, by statutory default, the protection available to directors of public benefit corporations that previously could be obtained only through a provision of the certificate of incorporation. Following the 2020 amendments, public benefit corporations seeking to divest directors of the protection afforded to their satisfaction of the balancing requirement must do so through the certificate of incorporation.

Suits to Enforce the Balancing Requirement

Section 367 currently governs the rights of stockholders to maintain derivative suits to enforce the statutory balancing requirements, setting forth minimum stock ownership thresholds for the plaintiffs, individually or collectively (currently fixed at 2 percent of the outstanding stock or, in the case of certain listed corporations, the lesser of 2 percent of such

shares or shares with a market value of $2,000,000).[9] The 2020 amendments revise Section 367 to clarify that any action to enforce the balancing requirement (including any individual, derivative or other type of action) to which a public benefit corporation is subject must be brought by one or more plaintiffs owning individually or collectively at least 2 percent of the corporation's outstanding shares or, in the case of certain listed corporations, the lesser of 2 percent of the corporation's shares or shares with a value of at least $2,000,000.

Effective Time of Amendments

The amendments effecting the repeal of Section 363(b)(2), and the corresponding amendments to Section 262 described above, are effective only with respect to a merger or consolidation consummated pursuant to an agreement entered into, or, with respect to a merger consummated pursuant to Section 253, resolutions of the board of directors adopted, on or after their enactment. Because Section 262 of the DGCL requires that a current copy of that section be included with a notice of appraisal rights, corporations and practitioners preparing disclosure documents for a merger or consolidation are reminded to confirm the enactment date of House Bill 341 to ensure that they include in such notices the correct version of Section 262.

Holding Company Reorganization Mergers

Section 251(g) of the DGCL allows a corporation to effect a so-called holding company reorganization merger without the need to obtain a vote of its stockholders, subject to compliance with specified conditions and procedures.[10] In general, to effect a holding company reorganization under Section 251(g), an existing operating corporation first establishes a wholly-owned subsidiary corporation, which eventually will become the new holding company. That first subsidiary corporation then establishes a wholly-owned merger subsidiary, which may either be a Delaware corporation or Delaware limited liability company. The merger subsidiary is then merged with or into the original operating corporation. In the merger, all of the shares or equity interests in the merger subsidiary outstanding prior to the merger are converted into all of the shares or equity interests of the surviving entity, and all of the shares of the original operating corporation outstanding prior to the merger are converted into shares of the new holding company. The end result is that the stockholders of the original operating company become stockholders of the new holding company, which owns all of the equity of the operating company.

Section 251(g) currently provides that the provisions of the organizational documents of the surviving entity in a merger under that subsection must be identical to the provisions of the certificate of incorporation of the original operating corporation immediately prior to the merger, subject to limited exceptions. In many cases, the provisions of the certificate of incorporation of the original operating corporation, which is often a public corporation with widely-held stock, make little sense in the context of corporation that will be managed as a wholly-owned subsidiary in a holding company structure. Moreover, in cases where the operating company that emerges from the reorganization is to be a limited liability company, it often is difficult to recreate the provisions of the original operating corporation's certificate of incorporation in the form of a limited liability company agreement.

The 2020 amendments to Section 251(g) eliminate the requirement that the provisions of the organizational documents of the surviving entity in a reorganization merger under that subsection be identical to those of the original operating company as of immediately prior to the merger. The amendments to Section 251(g), however, do not disturb the existing requirement that the organizational documents of the surviving entity contain provisions requiring approval of the holding company's stockholders for any act or transaction by the surviving entity that, if taken by the original operating company immediately prior to the

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merger, would have required stockholder approval. In addition, Section 251(g) will continue to provide, following the 2020 amendments, that the business and affairs of a surviving entity that is not a corporation must be managed by or under the direction of a board of directors, board of managers or other governing body consisting of individuals who are subject to the same fiduciary duties applicable to, and who are liable for breach of such duties to the same extent as, directors of a Delaware corporation.

The 2020 amendments to Section 251(g) are effective with respect to agreements of merger consummated pursuant to an agreement entered into on or after their enactment into law.

Indemnification

The 2020 amendments make certain changes to the provisions of the DGCL governing rights to indemnification.

Mandatory Indemnification by Statute

Section 145(a) of the DGCL generally provides that a corporation may indemnify its directors, officers, employees, agents and other persons against expenses, judgments, fines and amounts paid in settlement arising out of specified actions, suits or proceedings (other than those brought by or in the right of the corporation).[11] Section 145(b) generally permits a corporation to indemnify those parties against expenses they incur in connection with actions brought by or in the right of the corporation.[12] Those permissive rights to indemnification under subsections (a) and (b) of Section 145 may be made mandatory by a provision of the certificate of incorporation, the bylaws, agreement or through other means. In either case, however, a person asserting a claim to indemnification under subsection (a) or (b) of Section 145 generally must establish that such person has met the so-called "standard of conduct"—that he or she acted in good faith and in a manner in or not opposed to the best interests of the corporation and, with respect to any criminal action or proceeding, had no reason to believe that his or her conduct was unlawful.[13] Section 145(d) then specifies the manner in which such standard of conduct determination must be made with respect to persons who are directors or officers of the corporation at the time of the determination.[14]

Section 145(c) of the DGCL, however, currently requires the corporation to indemnify its present and former directors and officers against expenses they incur in connection with any action, suit or proceeding if they are successful (on the merits or otherwise) in defending any action, suit or proceeding for which the corporation may indemnify them under subsections (a) or (b) of Section 145, regardless of whether such rights have been granted under the certificate of incorporation or bylaws, any agreement or through other means and without any need for a determination as to whether the officer or director has met the standard of conduct.[15] Currently, Section 145(c) does not define the "officers" to whom such mandatory rights to indemnification must be provided.

The 2020 amendments revise Section 145(c) to add a new clause (1), which preserves the existing text of Section 145(c) and adds a new sentence providing that, for indemnification with respect to any act or omission occurring after December 31, 2020, references to "officer" for purposes of Section 145(c), shall mean only a person who at the time of such act or omission is deemed to have consented to service by the delivery of process to the registered agent of the corporation pursuant to Section 3114(b) of title 10 of the Delaware Code.[16] Thus, by reference to Section 3114(b), the "officers" entitled by statutory default to mandatory indemnification under Section 145(c) are: (i) the corporation's president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer or chief accounting officer; (ii) an individual identified in public filings as one of the most highly compensated officers of the corporation; or (iii) an individual who, by written agreement with the corporation, has consented to be identified as an officer

for purposes of Section 3114(b) (all such officers, "3114 Officers").[17]

The 2020 amendments then add a new clause (2) to Section 145(c), which provides that the corporation *may* indemnify any other person who is not a present or former director or officer against expenses (including attorney fees) actually and reasonably incurred by such person to the extent he or she has been successful on the merits or otherwise in defense of any action, suit or proceeding identified in subsections (a) or (b) of Section 145. Following the effectiveness of the amendments to Section 145(c), if a corporation has officers that, although appointed pursuant to the bylaws, do not qualify as 3114 Officers (Non-3114 Officers), those Non-3114 Officers will not be entitled, by statutory default, to mandatory indemnification under Section 145(c) with respect to acts or omissions occurring after December 31, 2020. (The Non-3114 Officers should, however, remain entitled to the statutory protection under Section 145(c) with respect to acts or omissions occurring before December 31, 2020.) Although new Section 145(c)(1) narrows the scope of covered persons, new Section 145(c)(2) makes clear that corporations may provide Non-3114 Officers (along with other indemnifiable persons) the same basic protection that is granted to directors and 3114 Officers under new Section 145(c)(1).

In light of these changes, corporations should review the provisions of their certificates of incorporation and bylaws dealing with indemnification and advancement to ensure that they meet the corporation's objectives. In this regard, it is important to consider the amendments to Section 145(c) in light of the opinion of the Court of Chancery in *Zaman v. Amedeo Holdings*.[18] In *Zaman*, the Court was called on to construe a bylaw providing that the corporation

> shall indemnify and hold harmless, to the fullest extent permitted by applicable law . . . any person who was or is made or is threatened to be made a party or is otherwise involved in any threatened, pending, or completed action, suit, or proceeding . . . by reason of the fact that he, or a person for whom he is the legal representative, is or was a director or officer of the corporation or is or was serving at the request of the corporation as a director, officer, employee, or agent of another corporation or of a partnership . . . against all liability and loss suffered and expenses (including attorneys' fees) reasonably incurred by such indemnitee,

to determine whether agents serving at the corporation's request were entitled to mandatory indemnification under Section 145(c) by virtue of that bylaw. The Court stated:

> Under § 145(c), mandatory indemnification for success is not required as to an agent, only as to "a present or former director or officer of a corporation." But, § 6.1 [of the bylaws] contractually obligates the defendants to indemnify an agent serving at their request at another corporation to the full extent permitted by Delaware law. Therefore, as a contractual matter, if the [agent-indemnitees] acted in an indemnifiable capacity, the defendants must indemnify if § 145(c) would authorize them to do so if the [agent-indemnitees] were directors or officers. The reason why is simple: if Delaware law mandates indemnity for success by a director or officer, a corporation is not prohibited by Delaware law from providing indemnity to an agent who was successful. Having promised to indemnify persons they ask to serve as agents of other corporations to the fullest extent permitted by Delaware law, the defendants are bound if a person is sued in an indemnifiable capacity and is successful.[19]

Thus, in cases where the corporation has bound itself, through its certificate of incorporation or bylaws, to provide mandatory indemnification, to the fullest extent permitted by law, to its "officers," without

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further qualification or conditions, the corporation likely would be required to extend such protection to all those persons who serve as officers pursuant to its bylaws, including any Non-3114 Officers. The changes to Section 145(c), however, would be expected to affect the protections of Non-3114 Officers not party to separate indemnification contracts in cases where: (i) the corporation's certificate of incorporation and bylaws contain no provisions extending rights to indemnification (or contain provisions that are entirely permissive); (ii) the corporation's certificate of incorporation or bylaws contain provisions that extend mandatory rights to indemnification to "officers" but clearly subject to the officers' entitlement to indemnification to a standard of conduct determination; or (iii) the corporation's certificate of incorporation or bylaws narrowly define the class of officers entitled to mandatory indemnification such that it includes only 3114 Officers.

Corporations may wish to consider adopting express provisions clarifying which parties constitute officers.

The language in new Section 145(c)(1) does not define who qualifies as an "officer" for purposes of the provisions outside of subsection (c), and new subsection 145(c)(2) allows for the extension of mandatory indemnification of expenses under Section 145(c) to persons other than "officers" (as that term is used and defined in Section 141(c)(1) (*i.e.*, 3114 Officers)). Thus, corporations that want to specify the universe of "officers" to whom they wish to provide mandatory rights to advancement of expenses or to provide mandatory rights to indemnification under subsections (a) or (b) of Section 145 may wish to consider adopting express provisions clarifying which parties constitute officers for those purposes. In considering these matters, corporations also may want to consider whether to make clear that employees bearing officer-like titles (*e.g.*, Vice President) but who are not "officers" appointed pursuant to the bylaws should be excluded expressly from any structural mandatory indemnification and advancement rights provided to "officers."[20]

Continued Application of Indemnification and Advancement Provisions

Section 145(f) prohibits the elimination or impairment of a right to indemnification or to advancement by an *amendment* to the certificate of incorporation or the bylaws after the occurrence of the act or omission that is the subject of the civil, criminal, administrative or investigative action, suit or proceeding for which indemnification is sought, unless the provision in effect at the time of the act or omission expressly authorizes such elimination or impairment after such act or omission has occurred. The 2020 amendments to the DGCL clarify that the prohibition against divesting such rights applies to an amendment to or repeal or elimination of the certificate of incorporation and bylaws.

Exculpatory Clauses

Section 102(b)(7) of the DGCL provides that a corporation may, through the adoption of a provision of its certificate of incorporation, limit or eliminate the liability of a director for monetary damages to the corporation or its stockholders for breach of fiduciary duty, other than liability stemming from any breach of the duty of loyalty, acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, illegal dividends or share repurchases or redemptions, and any transaction from which the director receives an improper personal benefit.[21] In many cases, corporations that adopt so-called "102(b)(7) provisions" expressly state in their certificate of incorporation that, if the provision is later modified or amended to reduce or eliminate the protection afforded to directors, the modification or amendment will not apply to acts or omissions that occurred prior to that modification or amendment.

The 2020 amendments to the DGCL codify this not uncommon practice, unless the corporation elects otherwise in its 102(b)(7) provision. The amendments to Section 102(b)(7) thus clarify that an exculpatory provision has the effect of eliminating or limiting a director's liability for monetary damages with respect to any acts or omissions occurring while the exculpatory provision is in effect. Unless the corporation's 102(b)(7) provision provides otherwise at the time of such act or omission, any future amendment, repeal or elimination of the 102(b)(7) provision will not revoke the elimination or limitation of liability with respect to acts or omissions occurring while it is in effect.

Electronic Transmissions and Notices

Electronic Signatures, etc.

In 2019, Section 116 was added to the DGCL to provide, among other things, a non-exclusive safe harbor for the execution and delivery of documents contemplated by the DGCL.[22] In general, Section 116(a) broadly enabled the use of electronic signatures and electronic transmissions for the execution and delivery of documents, while Section 116(b) carved out various classes and categories of documents and instruments that would not be covered by the safe harbor provisions of Section 116(a).[23] In some cases, specific classes of documents and instruments, such as board and stockholder consents, were carved out of the safe harbor provision of Section 116(a) on the basis that separate statutes (*e.g.*, Section 141(f), in the case of board consents, and Section 228, in the case of stockholder consents) already addressed the manner in which those documents and instruments could be executed and delivered through electronic means. Nevertheless, to provide additional clarity, the 2020 amendments to the DGCL revise Section 116 in a few technical respects to confirm the validity of the use of electronic signatures and transmissions for the execution and delivery of various documents and instruments.

First, the amendments to Section 116(a)(2) clarify that a person may "execute" a document (such as agreements of merger and other documents that require execution under the DGCL) by using any type of signature contemplated by Section 116(a)(2), which includes both "wet ink" signatures and electronic signatures. Second, the amendments to Section 116(b) clarify that the Section 116(a) safe harbor may be relied upon as a basis for using an electronic transmission to document director, stockholder, member and incorporator consents and for signing and delivering those documents by electronic means.

In connection with the amendments to Section 116, conforming changes are being made to several other provisions of the DGCL. Section 108(c) of the DGCL is being revised to permit an incorporator or initial director to rely on Section 116 as a basis to document, sign and deliver a consent by electronic means, unless the use of Section 116 is expressly restricted or prohibited by the certificate of incorporation. Section 141(f) of the DGCL is being amended to reflect that directors may rely on Section 116 as a basis to document, sign and deliver a consent by electronic means, unless expressly restricted or prohibited by the certificate of incorporation or bylaws. The 2020 amendments add a new subsection (c) to Section 212, which deals with proxies, to clarify that a stockholder may rely on Section 116 as a basis to document a proxy and to sign and deliver a document evidencing the proxy, unless restricted or prohibited by the certificate of incorporation or bylaws.

Directors may rely on Section 116 as a basis to document, sign and deliver a consent by electronic means.

Finally, Section 228 of the DGCL, which governs stockholder action by consent in lieu of a meeting, is being revised in several respects to reflect that consents may be executed and delivered in accordance with Section 116, unless the certificate of

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incorporation or bylaws expressly restrict or prohibit consents from being so documented, signed or delivered, and to harmonize the provisions dealing with the execution and delivery of consents in writing or by electronic transmission. Notably, these conforming amendments are designed to confirm the application of the safe harbor provisions of Section 116 to consents and instruments that were previously capable of being executed and delivered through electronic means by reference to other statutory provisions; the amendments should not be used as a basis to call into question the validity of board or stockholder consents otherwise given in conformity with the DGCL prior to the enactment of Section 116(a) or the 2020 amendments.

Notices to Stockholders

When Section 116 was added to the DGCL in 2019, corresponding amendments to Section 232 of the DGCL were made to address the manner in which notices could be given to stockholders.[24] Before the 2019 amendments, Section 232 provided that notices would be deemed given by various means of electronic transmission so long as the stockholder had consented to receive notice through such means. A key objective of the 2019 amendments was to dispense with the need for the corporation to receive consent from stockholders to deliver notice to them by electronic mail. Thus, in 2019, Section 232(a) was amended to specify that the corporation could give notice in writing and that such notices "shall be given" when given by mail, courier service or electronic mail in the manner provided in that subsection. Section 232(b), as amended in 2019, continued to provide that, without limiting the manner in which notice could otherwise be given, notice could be given by "a form of electronic transmission consented to by the stockholder to whom the notice is given."[25] Although the consent requirement for notices by electronic transmission in Section 232(b) was never intended to override the specific authority to give notice by electronic mail pursuant to Section 232(a),[26] the continuing reference to a notice by "electronic transmission"—which includes electronic mail—in Section 232(b) arguably created some ambiguity. To eliminate any doubt as to whether notices to stockholders may be given by electronic mail without the need for their consent, the 2020 amendments revise Section 232(a) so that it states expressly that a corporation may give a notice by electronic mail in accordance with Section 232(a) without obtaining the consent required by Section 232(b).

Other Amendments

Corporate Name

In 2019, the Delaware Limited Liability Company Act was amended to introduce the concept of "registered series" of a limited liability company. Different from a "protected series," a registered series is intended to qualify as a registered organization under the Uniform Commercial Code (UCC) and, accordingly, its formation requires the filing of a certificate of registered series with the Delaware Secretary of State. At that time, Section 102(a) of the DGCL was amended to provide that the name of a corporation must be distinguishable from the name of a registered series of a limited liability company on file with the Delaware Secretary of State. As corresponding amendments to the Delaware Revised Uniform Partnership Act are scheduled to become effective in 2020, Section 102(a) is likewise being amended to provide that the name of a corporation must be sufficiently distinguishable from the name of a registered series of a limited partnership on file with the Delaware Secretary of State.

Provisions Relating to the Delaware Secretary of State

Section 135 of the DGCL, which deals with the resignation of a registered agent and the appointment of a successor registered agent, is being amended to eliminate the requirement that the Secretary of State issue specified certificates upon such an appointment, consistent with its current practices. Section 266 of the DGCL, which deals with a conversion of a corporation to another entity, is also being amended

to reflect the current practice of the Secretary of State relating to the issuance of a certified copy of a certificate of conversion to a non-Delaware entity. Section 377(b) of the DGCL is being amended to conform the process relating to the resignation of a registered agent of a foreign corporation to the process applicable to the resignation of a registered agent of a corporation under Section 136. Finally, Section 391(a)(16) of the DGCL is being amended to include the maximum fee payable to the Secretary of State for a written report of a record search.

Conclusion

The 2020 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. 8 *Del. C.* § 110.
2. *See* 1 David A. Drexler et al., *Delaware Corporate Law and Practice* § 9.07, at 9-21 (2019 Supp.).
3. 8 *Del. C.* § 362(a).
4. *Id.*
5. *See* William J. Haubert, John Mark Zeberkiewcz & Brigitte Fresco, "Significant Proposed Amendments to the General Corporation Law of the State of Delaware," *Insights*, June 2013, at 7.
6. 8 *Del. C.* § 363(a).
7. *Id.* § 363(c).
8. *Id.* § 363(b). The "market out" exception generally provides that appraisal rights are not available for holders of shares listed on a national securities exchange or held of record by more than 2,000 holders, unless, in the case of a merger, the holders are required to accept anything other than shares listed on a national securities exchange or held of record by more than 2,000 holders. *Id.*
9. *Id.* § 367.
10. *Id.* § 251(g).
11. *Id.* § 145(a).
12. *Id.* § 145(b).
13. *Id.* §§ 145(a), 145(b).
14. *Id.* § 145(d).
15. *Id.* § 145(c).
16. 10 *Del. C.* § 3114(b). Although Section 3114(b) does not apply to residents of Delaware, given that they are already subject to personal jurisdiction, new Section 145(c)(1), as amended, treats Delaware residents as if they were non-residents to ensure that persons who hold the officer positions identified in Section 3114(b) are entitled to indemnification, whether or not they are Delaware residents.
17. *Id.*
18. Zaman v. Amedeo Holdings, 2008 WL 2168397 (Del. Ch. May 23, 2008).
19. *Id.* at *16.
20. *See generally* Aleynikov v. The Goldman Sachs Group, Inc., C.A. No. 10636-VCL (Del. Ch. July 13, 2016) (observing, in *dicta*, that the doctrine of *contra proferentem* could be used to construe the provisions of the corporation's bylaws granting mandatory rights of indemnification and advancement to "officers" for purposes of determining whether a non-employee with the title "Vice President" may be entitled to such rights as an officer).
21. 8 *Del. C.* § 102(b)(7).
22. John Mark Zeberkiewicz, Brigitte Fresco, and Robert G. Greco, "2019 Proposed Amendments to the General Corporation Law of the State of Delaware," *Insights*, April 2019, at 2–5.
23. 8 *Del. C.* § 116.
24. *See* Zeberkiewicz, et al. at *supra* n. 22 at 6.
25. *Id.*
26. *Id.* ("As the initial set of amendments allowing for notices by electronic transmission were adopted in 2000, at a time when electronic mail was not nearly as ubiquitous, the consent requirement was intended as a means of protecting stockholders. The requirement to obtain such consent from stockholders has in many cases limited the usefulness of notice by electronic mail, with corporations effectively being forced to give notices by traditional means, even in cases where they have valid electronic mail addresses for their entire stockholder base. As revised, Section 232(a) will reverse the statutory default as it relates to notices to stockholders by electronic mail.").

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IN THE COURTS

Second Circuit Heightens Standard for Establishing Corporate Scienter in Securities Fraud Cases

By Joel Kurtzberg, Adam Mint, and William McCaughey

The lynchpin of many securities fraud cases is whether a plaintiff can establish with particularity that a defendant acted with scienter (*i.e.*, fraudulent intent). When the defendant is an individual person, this question may be relatively straightforward. When the defendant is a corporation, however, it can be more complicated: a plaintiff must demonstrate the misconduct was not the result of mismanagement of lower-level employees but rather the *corporation's* fraudulent conduct.

On May 27, 2020, in *Jackson* v. *Abernathy*,[1] the US Court of Appeals for the Second Circuit, in a *per curiam* decision, clarified the standard for pleading corporate scienter. Specifically, a plaintiff must adequately plead that the individuals who made or disseminated the alleged misstatements were responsible for making or disseminating the corporations' alleged misstatements and either acted with the requisite fraudulent intent or that the statement was so dramatic that fraudulent intent may be inferred.[2] The plaintiff in *Jackson* failed to meet that exacting standard because he relied solely on the testimony of lower-level employees of the defendant corporations in which those employees raised concerns about the accuracy of some of the defendant corporations' alleged misstatements. The Second Circuit held that was insufficient to plead corporate scienter because the plaintiff failed to adequately plead that the corporate officials actually responsible for making or disseminating the corporations' alleged misstatements knew of those employees' alleged concerns.[3] The decision heightens the already heavy burden plaintiffs have in securities fraud cases in pleading that corporations acted with the requisite scienter.

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Background

In many securities fraud actions, such as those brought under Section 10(b) of the Securities and Exchange Act of 1934 (Exchange Act), plaintiffs must adequately plead a strong inference of scienter.[4] Ordinarily, this involves pleading "with particularity facts giving rise to a strong inference that" the maker[5] of an alleged misstatement acted with the intent to deceive, manipulate, or defraud.[6] However, a corporate entity has no state-of-mind and cannot speak for itself, so demonstrating that a corporation acted with the requisite scienter becomes more complicated.

The US Courts of Appeals have taken somewhat varied approaches to the pleading requirements for corporate scienter. The Fifth and Eleventh Circuits follow a *respondeat superior* approach, whereby courts "look to the state of mind of the individual corporate official or officials who make or issue the statement . . . rather than generally to the collective knowledge of all the corporation's officers and employees."[7] In other words, courts in these Circuits may only impute scienter from the individuals who made[8] the misstatement at issue.[9]

In contrast, the Second, Seventh, and Ninth Circuits have adopted a somewhat broader corporate scienter pleading standard. In these Circuits, adequately pleading scienter requires pleading facts that give rise to "a strong inference that someone

whose intent could be imputed to the corporation acted with the requisite scienter."[10] Under this standard, courts examine the roles of the personnel connected to the alleged misrepresentation and whether their knowledge can be imputed to a corporate defendant.[11] Unlike the *respondeat superior* approach, it is possible for a plaintiff in these Circuits to plead a strong inference of corporate scienter "without doing so with regard to a specific individual defendant."[12]

The Second Circuit's Decision in *Jackson* v. *Abernathy*

In *Jackson* v. *Abernathy*, the Second Circuit made clear the heavy burden that plaintiffs face in satisfying the collective corporate scienter standard. The plaintiff, Ronald Jackson, brought a securities fraud action against two corporations and individual executives at those companies for allegedly misleading investors as to the quality and effectiveness of a surgical gown that defendants manufactured and sold.[13] Defendants designed and marketed the surgical gown for use in the treatment of patients with highly infectious diseases, such as HIV and Ebola.[14] The plaintiff alleged that the defendants misled investors by representing the surgical gown as having met certain safety standards, "despite the companies' senior executives knowing that the gown had failed numerous quality-control tests."[15]

On March 30, 2018, the district court dismissed the plaintiff's complaint for failure to allege scienter adequately against the individual and corporate defendants.[16] The plaintiff moved to set aside the judgment and file an amended complaint. The district court denied that motion as futile, and plaintiff appealed. On appeal, plaintiff challenged whether the proposed amended complaint failed to raise a strong inference of scienter against the corporate defendants.[17]

Plaintiff argued that the proposed amended complaint sufficiently alleged scienter because it included new allegations, based on testimony from three low-level employees of the corporate defendants in a related California consumer fraud action.[18] In that action, employees of the corporate defendants testified that the "gown's compliance problems were well known at the companies," and that the chief executive officer (CEO) of one of the corporate defendants received documents "that detailed manufacturing problems and resulting product compliance failures."[19]

The Second Circuit was unpersuaded and affirmed the district court's denial of plaintiff's motion for leave to amend. Building off the Second Circuit's decision in *Dynex* and the Seventh Circuit's decision in *Makor*, the Court explained that in cases of collective corporate scienter, "a plaintiff must show that the misstatement was not a case of mere mismanagement, but rather the product of collective fraudulent conduct."[20] This could be done: (1) by imputing scienter from the maker of the alleged misstatement; (2) by imputing scienter from other officers and directors, who were not makers of the misstatement but were involved in disseminating the alleged misstatements; or (3) where a misstatement is so "dramatic" that a court can infer corporate scienter.[21]

In *Jackson*, the crux of the Court's decision was plaintiff's failure to provide any "connective tissue between those employees [in the California action] and the alleged misstatements."[22] The plaintiff failed to show that the testifying employees in the California action were involved in crafting or reviewing the alleged misstatements at issue.[23] Further, the plaintiff "offer[ed] only general allegations of warnings made to unidentified senior executives."[24] The Court held that these unparticularized allegations failed to raise a strong inference of scienter against the corporate defendants.[25]

Finally, the Second Circuit rejected plaintiff's argument that the surgical gown at issue was so "key" to the corporate defendants' business that senior management must have known the statements at issue were false or misleading.[26] On this, the Court again held that such "naked assertion[s], without more," were insufficient to plead corporate scienter.[27]

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Takeaways

Jackson confirms that, to establish corporate scienter, the state of mind that matters is that of those responsible at the company for making or disseminating the alleged misstatements. In doing so, the Second Circuit heightened the already heavy burden plaintiffs have to establish corporate scienter. A plaintiff can no longer plead securities fraud simply by relying on the concerns of low-level employees. Rather, plaintiffs must tie the concerns of those low-level employees to those at the company who actually made the alleged misstatements.

Notes

1. Jackson v. Abernathy, No. 19-1300-cv, 2020 WL 2755690 (2d Cir. May 27, 2020), available at *https://www.ca2.uscourts.gov/decisions/isysquery/caf59294-7fd7-48eb-a05a-73a6cc84c680/20/doc/19-1300_opn.pdf#xml=https://www.ca2.uscourts.gov/decisions/isysquery/caf59294-7fd7-48eb-a05a-73a6cc84c680/20/hilite/*.
2. *Id.* at *3.
3. *Id.* at *3-4.
4. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 322-323 (2007).
5. The "maker" of a statement is the person or entity "with ultimate authority over the statement, including its content and whether and how to communicate it." Janus Capital Group, Inc. v. First Derivative Traders, 564 U.S. 135, 142 (2011).
6. 15 U.S.C. § 78u-4(b)(2)(A).
7. Southland Securities Corp. v. INSpire Insurance Solutions, Inc., 365 F.3d 353, 366 (5th Cir. 2004); Mizzaro v. Home Depot, Inc., 544 F.3d 1230, 1254 (11th Cir. 2008).
8. Again, it is important to remember that the "maker" of a misstatement is a term of art in securities fraud cases, as defined by *Janus* and its progeny.
9. The Sixth Circuit, in In re Omnicare, Inc. Securities Litigation, 769 F.3d 455 (6th Cir. 2014), proscribed a defined list of persons whose states of mind are probative of corporate scienter. *Id.* at 476 (this list includes: "The individual agent who uttered or issued the misrepresentation . . . . Any individual agent who authorized, requested, commanded, furnished information for, prepared . . . reviewed, or approved the statement . . . . Any high managerial agent or member of the board of directors who ratified, recklessly disregarded, or tolerated the misrepresentation after its utterance or issuance.").
10. Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital Inc., 531 F.3d 190, 195 (2d Cir. 2008).
11. *Jackson*, 2020 WL 2755690, at *3.
12. *Dynex*, 531 F.3d at 195; *see also* Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 710 (7th Cir. 2008) ("[I]t is possible to draw a strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud."); Glazer Capital Management, LP v. Magistri, 549 F.3d 736, 744 (9th Cir. 2008) ("[T]here could be circumstances in which a company's public statements were so important and so dramatically false that they would create a strong inference that at least *some* corporate officials knew of the falsity upon publication.").
13. *Jackson*, 2020 WL 2755690, at *1.
14. *Id.*
15. *Id.*
16. *Id.* at *2.
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.* at *1.
21. *Id.* at *3.
22. *Id.* at *4.
23. *Id.*
24. *Id.* at *3.
25. *Id.* at *4.
26. *Id.*
27. *Id.*

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.

Akin, Gump, Strauss, Hauer & Feld LLP
Washington, DC (202-887-4000)

New ADV Part 3: Form CRS for Registered Investment Advisers and Dual Registrants (June 2020)

A discussion of filing requirements for investment advisers and recent guidance from the Securities and Exchange Commission (SEC). A client relationship summary (CRS) for registered investment advisers, broker-dealers and dual registrants is now Part 3 of Form ADV.

Baker Botts LLP
Houston, TX (713-229-1234)

The Southern District of New York Holds That Syndicated Loan Is Not a Security (June 8, 2020)

A discussion of a Southern District of New York decision, *Kirschner v. JP Morgan Chase Bank, N.A. et al.*, holding that certain syndicated bank loans were not "securities" and therefore dismissed the state law securities fraud claims the plaintiffs had asserted.

M&A in a Post-COVID World (June 9, 2020)

A discussion of ways in which the crisis has changed merger and acquisition (M&A) deals for the longer term and how buyers and sellers can adapt to the changing patterns in M&A to take full advantage of the opportunities that will arise.

Cahill Gordon & Reindel LLP
New York, NY (212-701-3000)

Nasdaq Proposes to Adopt and Amend Rules Applicable to Companies Operating in Restrictive Markets (June 26, 2020)

A discussion of three proposals the Nasdaq Stock Market LLC (Nasdaq) filed with the SEC to adopt new Listing Rules and amend existing Listing Rules that impose more stringent listing standards when a company's business is principally administered in a jurisdiction that Nasdaq determines to have secrecy laws, blocking statutes, national security laws or other laws and regulations restricting access to information by regulators of US-listed companies in such jurisdiction.

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

SDNY Decision Shows the PSLRA's Protections Remain Strong for Chinese Issuers (June 30, 2020)

A discussion of a dismissal by the US District of Court for the Southern District of New York in *Barilli v. Sky Solar Holdings, Ltd.*, highlighting the continued significance of the heightened pleading standards of the Private Securities Litigation Reform Act (PSLRA).

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Covington & Burling LLP
Washington, DC (202-662-6000)

Some Dos and Don'ts for Voluntary ESG Reporting and Disclosures (June 2, 2020)

A discussion of recommendations to assist companies in preparing voluntary environment, social, and governance (ESG) reports.

Davis Polk & Wardwell LLP
New York, NY (212-450-4000)

Inadequate per Disclosure Remains in SEC's Sights (June 8, 2020)

A discussion of a SEC enforcement case that is a reminder for companies to use care in tracking and disclosing all elements of executive compensation.

Ninth Circuit Affirms Dismissal of Securities Class Action against Endologix, Inc. (June 15, 2020)

A discussion of a Ninth Circuit decision, *Nguyen v. Endologix, Inc*., affirming the dismissal of a putative class action securities fraud complaint due to the plaintiff's failure to plead facts establishing a strong inference of scienter.

Debevoise & Plimpton LLP
New York, NY (212-909-6000)

DOJ Updates Guidance on Corporate Compliance Programs (June 8, 2020)

A discussion of the Department of Justice's updated version of its guidance to federal prosecutors on evaluating corporate compliance programs.

Eversheds-Sutherland Ltd.
Atlanta, GA (404-853-8000)

Considerations as Regulation Best Interest and Form CRS Approach June 30th Compliance Date (June 17, 2020)

A discussion of considerations for broker-dealers and investment advisers in view of the June 30 compliance deadline for Regulation Best Interest and the Form CRS Relationship Summary.

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

Structuring Acquisitive Transaction in Difficult Times (June 11, 2020)

A discussion of structuring transactions in a tax efficient manner in the midst of a downturn in the US economy during the COVID-19 pandemic.

Locke Lord LLP
Dallas, TX (214-740-8000)

Buybacks: How Companies Can Benefit from Undervalued Stock (June 2, 2020)

A discussion of considerations when preparing for a stock buyback in a time of COVID-9 and economic uncertainties.

Mayer Brown LLP
Chicago, IL (312-782-0600)

A Primer on Public Benefit-Focused Corporate Models in California and Beyond (June 20, 2020)

A discussion of considerations relating to the benefit corporation structure and third-party certification and third-party certifications such as those offered by the nonprofit organization B Lab.

Mintz, Levin, Cohn, Ferris, Glovsky & Popeo P.C.
Boston, MA (617-542-6000)

How SEC Whistleblower Complaints Swell to a Flood: How to Find the High Ground of Sound Compliance (June 9, 2020)

A discussion of the increased volume of whistleblower complaints received by the SEC and areas for companies to focus on with respect to their compliance and internal control program.

Morgan, Lewis & Bockius LLP
Philadelphia, PA (215-963-5000)

Challenges Facing Public Companies in the Age of COVID-19 (June 12, 2020)

A discussion of the need for public companies to consider guidance from the SEC, increased examination and enforcement activity at the federal and state levels and possible shareholder activism, among other effects of the COVID-19 pandemic.

Pepper Hamilton LLP
Philadelphia, PA (215-981-4000)

Best Practices with Notices for Force Majeure Events (June 11, 2020)

A discussion of considerations in deciding whether and how to invoke force majeure, best practices in drafting force majeure notices and general notices as an alternative to specifically addressing force majeure.

MFW Pitfalls: Bypassing the Special Committee and Retaining Authority to Pursue Detrimental Alternatives (June 12, 2020)

A discussion of a Delaware Court of Chancery decision, *In re Dell Technologies Inc. Class V Stockholders Litig.*, containing guidance to boards of directors and their controlling stockholders seeking to use the dual protections of *MFW*—a special committee and a majority of the minority vote—to insulate themselves from fiduciary liability in connection with various corporate transactions.

Proskauer Rose LLP
New York, NY (212-969-3000)

SEC Releases Risk Alert Identifying Common Private Equity and Hedge Fund Compliance Deficiencies (June 30, 2020)

A discussion of a risk alert issued by the SEC Office of Compliance Inspections and Examinations (OCIE) focusing on deficiencies identified in the course of examinations of registered investment advisers that manage private equity funds and/or hedge funds.

Ropes & Gray LLP
Boston, MA (617-951-7000)

SEC Investor Advisory Committee Recommend Updating Public Company Reporting Requirements to Include ESG Factors (June 1, 2020)

A discussion of the recommendation of the SEC Investor Advisory Committee to update issuer reporting requirements to specifically include ESG factors.

Schulte Roth & Zabel LLP
New York, NY (212-756-2000)

LIBOR Transition: SEC Announces Examination Initiative (June 23, 2020)

A discussion of a Risk Alert issued by the SEC Office of Compliance Inspections and Examinations that provides registered investment advisers with additional information about the scope and content of examinations assessing registrants' preparedness for the transition away from the London Interbank Offered Rate (LIBOR).

Skadden, Arps, Slate, Meagher & Flom LLP
New York, NY (212-735-3000)

An Alternative Paradigm to "On the Purpose of the Corporation" (June 2, 2020)

A discussion of commentary on a memorandum captioned "On the Purpose of the Corporation."

Key Considerations for Non-US Companies Listing in the United States (June 17, 2020)

A discussion of the unique considerations for companies to go public; in particular the legal framework for non-US issuers.

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Venable LLP
Baltimore, MD (410-244-7400)

Complying with Oversight Fiduciary Duty Obligations in Response to COVID-19 (June 4, 2020)

A discussion of the need for companies to have board-level monitoring and compliance systems in place to ensure their directors and managers are able to comply with fiduciary duties regarding oversight of the business in the COVID-19 era.

SEC Division of Investment Management Reverses Its Position on Maryland Control Share Acquisition Act (June 8, 2020)

A discussion of the withdrawal by the Staff of the Division of Investment Management of a no-action letter (Boulder No-Action Letter) issued in 2010 in which the Staff had expressed the view that it would be inconsistent with Section 18(i) of the Investment Company Act of 1940 for a closed-end investment company to be subject to the provisions of the Maryland Control Share Acquisition Act.

SEC Office of Chief Accountant and SEC Division of Corporation Finance Provide Further Guidance with respect to the Impacts of COVID-19 (June 6, 2020)

A discussion of further guidance issued by the SEC Office of Chief Accountant and Division of Corporation Finance to assist companies in addressing their financial statement reporting and disclosure obligations with respect to the impacts of COVID-19.

Vinson & Elkins L.L.P.
Houston, TX (512-542-8400)

Paycheck Protection Program Loan Borrowers Beware: SEC Turns Attention to Public Borrowers (June, 2020)

A discussion of the SEC launching of investigations into public companies that have borrowed Paycheck Protection Program (PPP) funds. They are looking into whether companies were eligible to receive PPP funds and looking into certifications to determine if they contradict public disclosure statements concerning access to capital and liquidity, among other things.

Wilmer Cutler Pickering Hale and Door
Washington, DC (202-663-6000)

Investment Management COVID-19 (June 10, 2020)

A chart summarizing relief issued by the SEC and other regulatory agencies within investment management regarding the COVID-9 pandemic.

Wilson, Sonsini Goodrich & Rosati LLP
Palo Alto, CA (650-493-9300)

10b5-1 Trading Plans (June 2020)

A discussion of practical considerations for company insiders with respect to 10b5- plans, including entering into a 10b5-1 plan and developing trading instructions.

Winston & Strawn LLP
Chicago, IL (312-558-5600)

Delegation of Discretionary Authority to an Investment Advisor Insufficient to Confer "Insider" Status upon Clients (June 2, 2020)

A discussion of a Second Circuit decision, *Rubenstein v. International Value Advisers, LLC*, addressing the scope of "insider" status under Section 13(d) of the Securities Exchange Act of 1934. The Court held that non-insider clients of investment advisors who entered into a discretionary, non-issuer-specific, investment management agreement with their advisor were not liable for disgorgement of short-swing profits solely by virtue of their advisor's insider status.

INSIDE THE SEC

Trends in Early Adoptions of New Rules on Guarantors and Issuers of Guaranteed Securities

By Justin F. Hoffman, Lee Davis and Rachel E. Collier

On March 2, 2020, the Securities and Exchange Commission (SEC) adopted amendments to Rules 3-10 and 3-16 of Regulation S-X, largely contained in new Rules 13-01 and 13-02, respectively.[1] The new rules significantly streamline and simplify the disclosure requirements with respect to subsidiary guarantees and collateral supporting registered debt securities. The new rules are intended to reduce disclosure burdens on reporting companies, as well as make the relevant disclosure more useful and intelligible for investors. Amended Rule 3-10 expands the conditions under which a reporting company may omit separate financial statements for subsidiary guarantors or issuers of registered debt, and new Rule 13-01 specifies the new disclosure requirements for such subsidiaries. Similarly, for any affiliate the securities of which constitute collateral of the reporting company's registered securities, amended Rule 3-16 permits the reporting company to omit separate financial statements for such affiliate in lieu of the new, reduced disclosure requirements of new Rule 13-02.

Justin F. Hoffman, Lee Davis, *and* **Rachel E. Collier** *are attorneys at Baker Botts L.L.P.*

The New Requirements

The new disclosure requirements under Rules 13-01 and 13-02 include, among other things:

- Financial disclosure consisting of the summarized financial information described in Rule 1-02(bb) of Regulation S-X; and
- Material non-financial disclosure about any relevant guarantors, issuers or guarantees, in the case of Rule 13-01, and material non-financial disclosure about the securities pledged as collateral and the associated affiliates, in the case of Rule 13-02.

Reporting companies may even in certain instances omit summarized financial information if the information presented is not materially different from the corresponding amounts reported in the company's consolidated financial statements. Further, these new rules and amendments allow reporting companies the flexibility to present the new disclosure in either a footnote to the consolidated financial statements or in Management Discussion and Analysis (MD&A).

In conjunction with the new non-financial disclosure requirements, the SEC also adopted amendments to Item 601(a) and new Item 601(b)(22) of Regulation S-K. These amendments require a new Exhibit 22 to be filed with a reporting company's annual reports on Form 10-K and quarterly reports on Form 10-Q, among others, that lists each of the subsidiaries or affiliates of the reporting company that are covered by new Rules 13-01 and 13-02. Under new Item 601(b)(22), Exhibit 22 must identify each such subsidiary or affiliate and the associated securities.

These new rules and amendments will not be effective until January 4, 2021, but they allow for voluntary adoption and compliance, and many reporting companies have opted to early adopt these new disclosure rules.

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The Early Disclosures

We surveyed 39 companies that have early adopted the amended Rule 3-10 and new Rule 13-01 through May 19, 2020, we note the following trends:[2]

- **Disclosure—**6 of the 39 surveyed companies determined under the new rules to omit summarized financial information of their subsidiary issuers or guarantors, finding that their combined financial statements were not materially different from the corresponding amounts reported in the company's consolidated financial statements, and that providing summarized financial information for the subsidiaries would be repetitive and not useful to investors. The remaining 33 surveyed companies provided summarized financial information in accordance with Rule 1-02(bb) in the form of line item presentation that tracked the requirements of the rule.
- **Location—**35 of the 39 reporting companies that early adopted the new rules opted to include their non-financial disclosure in MD&A, while only four included it in a footnote to the consolidated financial statements. Most of the discussions were fairly comparable, with brief descriptions of the new rules in addition to discussions of the subsidiary guarantors or issuers and associated securities to which the new rules applied.[3]
- **Sufficiency of the Guarantees—**Most of the reporting companies included some description of the sufficiency of the guarantees at issue in their non-financial disclosure pursuant to Rule 13-01(a)(6) of Regulation S-X.[4] Among other things, such descriptions included: the conditions under which such guarantees might terminate; the circumstances under which the rights of holders against the issuer may become limited due to, for example, the US Bankruptcy Code or state fraudulent transfer or conveyance law; and the possibility that payments to holders may be affected by relationships between a parent and its non-guarantor subsidiaries or affiliates.
- **Exhibit 22—**Of the 39 surveyed reporting companies that early adopted the new rules, 28 included an Exhibit 22. The format of, and information included in, these exhibits varied considerably. Some companies opted to use narrative style disclosure, while others provided tabular disclosure; and some companies included only the name of the subsidiary or affiliate and the associated security, while others provided such subsidiary's or affiliate's jurisdiction of incorporation and the nature of the guarantee (*e.g.*, as joint and several, conditional or unconditional).

Other Amendments

Finally, in addition to the amendments to Rules 3-10 and 3-16 and the additions of Rules 13-01 and 13-02 described above, the SEC has eliminated the portion of Rule 3-10(a) that required parent companies to continue providing modified financial information described by Rule 3-10(b) through (f) relating to subsidiary issuers or guarantors. If the subsidiary issuer's or guarantor's reporting obligation under Section 15(d) is suspended by operation of Section 15(d)(1) or compliance with Rule 12h-3, the SEC's recent amendment of Rule 3-10(a) also permits the parent to cease providing the relevant disclosure. It remains to be seen whether reporting parent companies will take advantage of this change or whether registrants will continue to produce the more streamlined information to preserve the ability to offer guaranteed or collateralized securities on a registered basis.

Notes

1. Release No. 33-10762.
2. We found one example of a company early adopting Amended Rule 3-16 and Rule 13-02, but the company provided no summarized financial information for its affiliates thereunder. Due to the prior version of Rule 3-16's reporting obligations, among other reasons, secured bonds were rarely offered in SEC-registered transactions.

3. Additionally, although not expressly required by the new rules, 6 of the 25 reporting companies which included their non-financial disclosure in MD&A also included a brief discussion of their early adoption of the new rules in a footnote to their financial statements devoted to new accounting policies or recent accounting pronouncements.
4. Rule 13-01(a)(6) requires reporting companies to include in their subsidiary-guarantor disclosure "[a]ny financial and narrative information about each guarantor if the information would be material for investors to evaluate the sufficiency of the guarantee." SEC Release No. 33-10762 provides as an example of such information a scenario in which substantially all of a subsidiary guarantor's non-current assets consisted of goodwill, in which case goodwill would need to be presented separately from other non-current assets in order to allow investors to evaluate the sufficiency of such guarantee.

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