Securities Litigation and Government Enforcement Trends

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U.S. Supreme Court's Long-Awaited *Omnicare* Decision

On March 24, 2015, the Supreme Court decided *Omnicare v. Laborers District Council Construction Industry Pension Fund* in a decision written by Justice Kagan, with separate concurrences by Justices Scalia and Thomas.[1] The case deals with registration statements required under the Securities Act of 1933 (the Act) for companies that wish to issue securities.[2] Such statements must include specified information about the company and the security for sale, and may also include other representations of fact or opinion.[3] Section 11 of the Act gives purchasers a right of action against the issuer (or other designated individuals) for omissions or misstatements of material fact.[4] The decision focused on the distinction between statements of fact and statements of opinion.

Various pension funds (Funds) that had purchased Omnicare stocks brought suit against Omnicare for providing "materially false" statements in its registration statement.[5] The Funds alleged that Omnicare made materially false representations regarding its legal compliance and failed to state material facts necessary to make its representations not misleading.[6] The statements in question were as follows:

> We believe our contract arrangements with other healthcare providers, our pharmaceutical suppliers and our pharmacy practices are in compliance with applicable federal and state laws.
>
> We believe that our contracts with pharmaceutical manufacturers are legally and economically valid arrangements that bring value to the healthcare system and the patients that we serve.[7]

Although Omnicare noted after making these statements that the federal government had expressed "significant concerns" about specific Omnicare policies, the Funds alleged that Omnicare did not provide enough information to prevent the above statements from being misleading.[8]

The District Court granted Omnicare's motion to dismiss, finding that statements about a "company's belief as to its legal compliance" are "soft" information.[9] The court held that statements of this nature

[1] 135 S. Ct. 1318 (2015).
[2] *Id*. at 1323.
[3] *Id*.
[4] *Id*.
[5] *Id*.
[6] *Id*.
[7] *Id*. at 1323.
[8] *Id*. at 1324.
[9] *Id*.

are actionable only if the statement maker "knew they were untrue at the time."[10] Since the complaint did not include an accusation that the company's officers knew their policies were violating the law, the allegations did not satisfy the requirements for a cause of action.[11] The Sixth Circuit reversed, holding that even though the statements of opinion were not hard facts, the Funds had to allege only that Omnicare's beliefs were "objectively false," not necessarily that Omnicare disbelieved its own statements.[12]

The Supreme Court vacated the decision of the Court of Appeals and focused its decision on the application of Section 11 to statements of opinion.[13] Using a commonsense rationale, the Court clarified that opinions affirm only the fact that the speaker holds the stated belief.[14] The Court further explained that "the two sentences to which the Funds object are pure statements of opinion and the Funds do not contest that Omnicare's opinion was honestly held."[15] Applying the Section 11 standard of liability, the Court held that "a sincere statement of pure opinion is not an 'untrue statement of material fact,' regardless of whether an investor can ultimately prove the belief wrong."[16]

The Court further addressed whether Omnicare's statements were misleading. The Court determined that "whether a statement is 'misleading' depends on the perspective of a reasonable investor."[17] A reasonable investor would not equate an opinion with a guarantee of fact.[18] However, the Court noted that it would be reasonable for an investor to assume that a statement of opinion is consistent "with the information in the [statement] issuer's possession at the time."[19] Therefore, the Court held that, "if a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, then § 11's omissions clause creates liability."[20] The Court remanded the case for further proceedings to determine whether "the alleged omission rendered Omnicare's legal compliance opinions misleading."[21]

In his concurrence, Justice Scalia disagreed with the objective test the majority proposed for determining reasonableness of opinions.[22]

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10 *Id*.
11 *Id*.
12 *Id*.
13 *Id*. at 1325.
14 *Id*. at 1326.
15 *Id*. at 1327.
16 *Id*.
17 *Id*.
18 *Id*. at 1328.
19 *Id*. at 1329.
20 *Id*. (internal citations omitted).
21 *Id*. at 1333.
22 *Id*. at 1336 (Scalia, J., concurring).

The *Omnicare* decision provides long-awaited resolution to a circuit split on the scope of liability under Section 11 for false statements of opinion.

He expressed concern that this test was "inconsistent with common law and common institutions about statements of opinion"and that it may invite "roundabout attacks upon expressions of opinion."[23] Justice Thomas also concurred in the judgment, but he believed it was improper for the Court to rule on the issue of when omissions may make a statement of opinion misleading.[24]

The *Omnicare* decision provides long-awaited resolution to a circuit split on the scope of liability under Section 11 for false statements of opinion. In establishing that opinions which turn out to be wrong are not necessarily materially false statements, *Omnicare* provides a higher degree of protection to issuers when their statements are framed as opinions. Additionally, because the *Omnicare* test involves examining a reasonable investor's understanding, there may be significant uncertainty going forward with respect to how lower courts will assess whether an opinion is misleading.

SEC Settles Conflict-of-Interest Case Against BlackRock and Former Chief Compliance Officer Concerning Portfolio Manager's Outside Business Activities

On April 20, 2015, the United States Security and Exchange Commission (SEC) announced that it had reached a settlement with BlackRock Advisors LLC and BlackRock's former Chief Compliance Officer, Bartholomew A. Battista, relating to an undisclosed conflict of interest involving a BlackRock portfolio manager.

According to the SEC, in 2007 Daniel J. Rice III, portfolio manager for various energy-focused funds and separate accounts at BlackRock since 2005, formed Rice Energy, L.P., a family-owned and operated oil and gas company of which Mr. Rice was the general partner and in which he personally invested $50 million. The SEC order stated that in 2010, Rice Energy formed a joint venture with Alpha Natural Resources, Inc. (ANR), a publicly traded coal company whose common stock was held in the various funds and accounts Mr. Rice managed for BlackRock. The SEC stated that by

[23] *Id*.
[24] *Id*. at 1337 (Thomas, J., concurring).

midyear 2011, ANR was the largest holding of the BlackRock Energy & Resources Portfolio, a registered fund managed by Mr. Rice. The SEC found that BlackRock knew and approved of Mr. Rice's involvement with Rice Energy and the joint venture with ANR but failed to disclose the conflict of interest to relevant BlackRock funds' boards and advisory clients.

"This is the first SEC case to charge violations of Rule 38a-1 for failing to report a material compliance matter such as violations of the adviser's policies and procedures to a fund board."

The SEC found that BlackRock willfully violated Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in any activity that operates as a fraud or deceit upon an advisory client, and that BlackRock breached its fiduciary duty to the relevant funds and advisory clients by failing to disclose the conflict of interest involving Mr. Rice's outside business activities to the funds' boards and advisory clients. The SEC also found that BlackRock failed to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder, as required by Section 206(4) and Rule 206(4)-7, concerning the monitoring and assessment of employees' outside activities for conflicts of interest and the reporting of such conflicts of interest to fund boards and advisory clients. The SEC further found that Mr. Battista, the former CCO, caused these violations. Finally, the SEC found that BlackRock and Mr. Battista caused the relevant registered BlackRock funds to violate Rule 38a-1 under the 1940 Act as a result of Mr. Battista's failure to disclose the conflict of interest involving Mr. Rice to the funds' boards.

In settlement of these charges, BlackRock consented to the entry of an order finding that it committed the violations described above and agreed to pay a $12 million penalty. Mr. Battista also consented to the entry of an order finding that he caused the violations described above and agreed to pay a $60,000 penalty. Neither BlackRock nor Mr. Battista admitted or denied the charges.

The SEC staff stated, "This is the first SEC case to charge violations of Rule 38a-1 for failing to report a material compliance matter such as violations of the adviser's policies and procedures to a fund board."

SEC Administrative Proceedings Under Constitutional Scrutiny

Since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), the SEC has come under greater scrutiny and criticism regarding its use of administrative proceedings.

Criticism stems mainly from the perceived one-sided nature of administrative proceedings, and the Defense Bar, in particular, views administrative proceedings as “stacking the deck” in favor of the Commission. Specifically, this “home court” alternative to pursuing claims in federal district court creates significant disadvantages for defendants, including accelerated hearing schedules, the inapplicability of the Federal Rules of Civil Procedure and the Federal Rules of Evidence, limited pre-hearing discovery and the elimination of a jury trial.

Many critics have also questioned the constitutionality of the administrative proceedings. These constitutional challenges include due process and equal protection concerns as well as Article II violations. The SEC has had success in fending off these constitutional challenges, mainly by arguing that the district courts lack subject matter jurisdiction to hear the constitutional challenges raised by defendants because Congress granted exclusive authority to review orders entered in administrative proceedings to the U.S. Circuit Courts of Appeal. The Commission has been very successful in asserting this jurisdictional argument, until recently.

On June 8, 2015, a Georgia federal judge issued a preliminary injunction halting an administrative proceeding against a real estate developer accused of insider trading. In *Hill v. SEC*, Case No. 1:15-cv-01801 (N.D. Ga. June 8, 2015) (*Hill* Opinion), Judge Leigh Martin May enjoined the SEC from moving forward with the evidentiary hearing in the administrative proceedings that had been instituted against Charles L. Hill, Jr. on the grounds that his claim over the constitutionality of the administrative proceeding was likely to succeed on the merits.

Hill challenged the constitutionality of the administrative proceeding on three grounds: (i) the proceeding violates Article II of the Constitution because administrative law judges (ALJs) are protected by two layers of tenure; (ii) Congress's delegation of authority to the SEC to pursue cases before ALJs violates the delegation doctrine under Article I of the Constitution; and (iii) the proceeding violated his Seventh Amendment right to a jury trial.[1] He raised these constitutional challenges in the administrative proceeding, moving for summary disposition on all three grounds.[2] The ALJ ruled that he did not have the authority to address the second and third issues raised by Hill and was doubtful that he had authority to address the first issue.[3] Five days after the ALJ issued his decision, Hill filed his complaint, asking the district court to declare the administrative proceedings unconstitutional and to enjoin the administrative proceedings from moving forward.[4]

Hill's initial complaint raised the same three grounds asserted in the administrative proceeding, but he later amended his complaint to add a claim that the SEC's appointment of ALJs violated the Appointments Clause of Article II of the Constitution.[5]

The SEC first challenged the court's subject matter jurisdiction. Specifically, the SEC argued that, under 15 U.S.C. § 78y, judicial review of Hill's constitutional claims could come from the Court of Appeals only *after* the administrative proceeding had concluded and the SEC issued a final order in Hill's case.[6] Judge May initially noted that the SEC's position was in "tension" with 28 U.S.C. § 1331, which provides that federal district courts "have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States,"[7] and 28 U.S.C. § 2201, which authorizes declaratory judgments.[8] After a lengthy discussion, Judge May concluded that the district court did have jurisdiction over Hill's constitutional claims.

The court then went on to analyze each of Hill's constitutional challenges, finding merit to only one—Hill's claim that the SEC's appointment of ALJs violates the Appointments Clause of Article II of the Constitution. Hill specifically claimed that, under the Appointments Clause, "inferior officers" must be appointed by the

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[1] See *Hill* Opinion p. 10.
[2] *Id*.
[3] *Id*.
[4] *Id*.
[5] *Id*. p. 11.
[6] *Id*. p. 12.
[7] 28 U.S.C. § 1331.
[8] *Hill* Opinion p. 12.
[9] *Id*. p. 34.

President, a court of law or a department head.[9] Hill contended that ALJs are inferior officers because they exercise "significant authority pursuant to the laws of the United States," while the SEC contended that ALJs are "mere employees" based upon their treatment by Congress and the fact that ALJs cannot issue final orders and do not have contempt power.[10] Relying on *Freytag v. Commissioner of Internal Revenue*,[11] Judge May held that ALJs are inferior officers.[12] Specifically, Judge May found that ALJs exercise "significant authority," including the ability to take testimony, conduct trial, rule on the admissibility of evidence and issue sanctions.[13] Judge May also dispensed with the SEC's "mere employee" argument, finding that "Congress may not 'decide' an ALJ is an employee, but then give him the powers of an inferior officer; that would defeat the separation-of-powers protections the Clause was enacted to protect."[14] As a result of her conclusion that ALJs are "inferior officers," Judge May found that the ALJ's appointment in Hill's administrative proceeding is "likely unconstitutional in violation of the Appointments Clause."[15] She went on to note, however, that while "this conclusion may seem unduly technical, as the ALJ's appointment could easily be cured by having the SEC Commissioners issue an appointment or preside over the matters themselves, . . . the Appointments Clause guards Congressional encroachment on the Executive and 'preserves the Constitution's structural integrity by preventing the diffusion of appointment power.'"[16]

Notably, Judge May's order preliminarily enjoins the SEC from "conducting the administrative proceeding brought against [Hill] . . . *before an [ALJ] who has not been appointed by the head of the Department.*"[17] This left open the question of whether the *Hill* Opinion has any real teeth to it.

The SEC intends to appeal Judge May's decision and is awaiting the solicitor general's approval to move forward with the appeal to the Eleventh Circuit. In a separate case brought by Lynn Tilton, the owner of the Patriarch Partners investment companies, a New York federal court judge ruled that Tilton cannot challenge the constitutionality of the SEC's administrative proceedings against her in federal court.[18] Tilton has since filed an appeal with the Second Circuit.

[10] *Id*. p. 36.
[11] 501 U.S. 868 (1991).
[12] *Hill* Opinion p. 36.
[13] *Id*. p. 38.
[14] *Id*. p. 41.
[15] *Id*. p. 42.
[16] *Id*. p. 44 (citing *Freytag*, 501 U.S. at 878).
[17] *Id*. p. 44 (emphasis added).
[18] The case is *Tilton v. SEC*, 1:15-cv-02472 (S.D.N.Y.).

Regardless of the outcome of the *Hill* case, one thing is clear—the SEC's use of administrative law proceedings is likely to foster a continued attack by the defense bar.

In May of this year, in response to growing criticism over its use of administrative proceedings, the SEC issued a memorandum entitled "Division of Enforcement Approach to Forum Selection in Contested Actions." The memo first states that the "Division recommends the forum that will best utilize the Commission's limited resources to carry out its mission." Although there is "no rigid formula dictating the choice of forum," the Division of Enforcement then laid out four overarching considerations that factor into its forum selection: (i) the availability of the desired claims, legal theories and forms of relief; (ii) whether the charged party is a registered entity or an individual associated with a registered entity; (iii) the cost-, resource- and time-effectiveness of litigation in each forum; and (iv) the fair, consistent and effective resolution of securities law issues and matters.

Regardless of the outcome of the *Hill* case, one thing is clear—the SEC's use of administrative law proceedings is likely to foster a continued attack by the defense bar.

SEC Enforcement Moves Toward Automatic Detection of Possible Accounting Fraud

Under the leadership of Chairman Mary Jo White, the SEC has continued to increase its focus on identifying and investigating accounting abuses at publicly traded companies. In order to accomplish this initiative, the SEC announced in 2013 that it would be utilizing a proprietary tool known as the Accounting Quality Model (AQM) in an attempt to automatically detect fraudulent or improper financial reporting. The SEC also created a Financial Reporting and Audit Task Force (Task Force) in 2013 to further focus its efforts in this area. The SEC hoped that its use of the AQM would lead to earlier detection of potential accounting issues and more rigorous examinations by SEC staff. Although the AQM has yet to fully revolutionize the SEC's detection of accounting fraud to the extent initially suggested, registered entities should anticipate SEC questions regarding any inconsistencies in their financial reporting, including unusual changes in financial accounting data or accounting treatments and the theoretical economic impact of such issues. The use of the AQM may result in increased self-reporting and disclosure of accounting anomalies to the SEC and to the public by registered entities.

As the SEC's use of the AQM improves, registered entities should be aware of the potential for further SEC review of its filings if they present a potential anomaly.

The AQM is a set of quantitative analytic modeling tools designed to review public filings. The AQM searches publicly filed financial statements for indications of anomalies, which are then automatically flagged and reviewed by an examiner. The model attempts to identify firms with accounting practices that vary from a peer group. Theoretically, the AQM will identify any statistical anomalies, whether or not they represent a potential error, and invite additional scrutiny by the SEC prior to the discovery of more significant evidence of wrongdoing. One reported issue preventing more widespread use of the AQM by the SEC has been its identification of false positives. The Task Force was created in part to address this gap by combining targeted staff analysis with AQM results.

In order to determine which accounting anomalies to focus on for further review, the SEC, through the Task Force, will analyze the likelihood that a particular anomaly is indicative of fraud. The primary factor in this analysis is typically the potential economic impact of the anomaly. In other words, the SEC is motivated by the "materiality" of a potential error, or the substantial likelihood that a reasonable investor would consider it to be important information. The SEC may also scrutinize accounting anomalies that may not be accompanied by an immediate and clear stock price movement. The AQM allows the SEC to investigate potential anomalies prior to a corrective disclosure—for example, those situations in which a stock price remained steady, rather than falling as it might have if a proper disclosure had been made.

The SEC has shown no signs of abandoning its goal to increase the number of accounting cases and investigations. As the SEC's use of the AQM improves, registered entities should be aware of the potential for further SEC review of their filings if they present a potential anomaly. Specifically, if a company's financial reporting is out of line with past reporting or that of its peer group, the AQM may very well flag the filing for further review by the SEC, even if there are legitimate explanations for the manner of reporting. Registered entities should analyze whether their financial reporting may (1) deviate from their own historical method of financial reporting; (2) be internally inconsistent, such that all financial statements are not fully aligned; and/or (3) differ from the typical method of financial reporting in their industry peer group. The SEC may evaluate various financial ratios arising from these factors in order to further refine its investigation efforts. Although a significant portion of the SEC's financial fraud cases are likely to continue to arise from reactive sources such as restatements, tips and self-reporting, proactive tools such as the AQM will likely become more widespread and relied upon more frequently by regulators to detect investment and accounting fraud.

SEC Brings First Whistleblower Enforcement Action Involving Employee Confidentiality Agreements

On April 1, 2015, the SEC instituted a first-of-its-kind enforcement action against KBR, Inc. (KBR), a Houston-based global technology and engineering firm, for violating SEC Rule 21F-17 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), based on language contained in KBR's confidentiality agreements with its employees. KBR had required employees interviewed in connection with internal investigations to sign a form confidentiality statement that prohibited employees from discussing their internal investigation interviews and the subject matter of such interviews without prior authorization from KBR's law department and under penalty of disciplinary action, including termination of employment.

SEC Rule 21F-17, which was enacted under the Dodd-Frank Act and which became effective on August 12, 2011, provides that "[n]o person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications."

The SEC's pursuit of this enforcement action against KBR signals the Commission's broad interpretation of SEC Rule 21F-17, as well as its ongoing commitment to investigating conduct at companies that it views as potentially silencing the reporting of securities violations by whistleblowers.

Notably, in this settled cease-and-desist proceeding, the SEC found that KBR had violated SEC Rule 21F-17 even though the Commission was unaware of any instances in which a KBR employee had in fact been prevented from communicating with the SEC about a potential securities law violation and despite the fact that KBR had not enforced the confidentiality statement at issue. Rather, the SEC found that KBR's violation stemmed only from the language contained in KBR's confidentiality statements, which provided as follows: "I understand that in order to protect the integrity of this review, I am prohibited from discussing any particulars regarding this interview and the subject matter discussed during the interview, without the prior authorization of the Law Department. I understand that the unauthorized disclosure of information may be grounds for disciplinary action up to and including termination of employment."

KBR entered into a settlement agreement with the SEC without admitting or denying the SEC's charges. As part of the settlement, KBR agreed to pay a civil money penalty of $130,000 to the SEC, and it also agreed to amend its confidentiality agreements to expressly state that said agreements do not prohibit KBR employees from reporting possible violations of federal law or regulation to the SEC or other federal agencies. KBR further agreed to amend its confidentiality agreements to further state that KBR employees did not need prior authorization from KBR before making any reports or disclosures to the SEC or other federal agencies.

The SEC's pursuit of this enforcement action against KBR signals the Commission's broad interpretation of SEC Rule 21F-17, as well as its ongoing commitment to investigating conduct at companies that it views as potentially silencing the reporting of securities violations by whistleblowers. Indeed, following the release of the settled cease-and-desist proceeding with KBR, SEC Enforcement Director Andrew Ceresney stated that the SEC has a number of similar ongoing investigations involving whistleblowers and that the Commission "will vigorously enforce" SEC Rule 21F-17.

The SEC's recent investigative activity suggests that certain company practices designed to protect confidentiality during internal investigations may be viewed as violating SEC Rule 21F-17. Accordingly, in light of the KBR proceeding, companies should consider evaluating their employment or confidentiality agreements, as well as their internal investigation interview processes.

With respect to written employment agreements (including confidentiality agreements, nondisclosure agreements, settlement agreements and/or severance agreements), companies may want to consider including express carve-outs for protected whistleblowing conduct. For example, as KBR agreed pursuant to its settlement with the SEC, companies may want to consider including language which expressly states that employees are not prohibited from communicating with government agencies about possible violations of federal law. In connection with instructions given to employees during internal investigations, companies should continue to adhere to the standard *Upjohn* warning, but they should be mindful of the scope of the instructions given to employee interviewees.

Merlin Partners LP v. AutoInfo, Inc.: Merger Price and Process Key in Determining Appraisal Value

On April 30, 2015, the Delaware Court of Chancery issued its post-trial opinion in *Merlin Partners LP v. AutoInfo, Inc.*, setting forth its findings of fact and conclusions of law and rejecting an attempt by dissenting shareholders to obtain additional value for their shares above the merger price through an appraisal demand pursuant to 8 Del. Code § 262.[1] The *AutoInfo* decision reiterates the importance of merger price and the process of arriving at the same in determining fair value in Delaware appraisal proceedings.

Background

AutoInfo, Inc. (AutoInfo or Company) was a small, publicly traded, non-asset-based transportation services company offering nationwide brokerage and contract carrier services through a network of independent sales agents.[2] In the first quarter of 2011, based on growing concern that it was undervalued in the market relative to comparable companies, AutoInfo's board of directors

[1] *Merlin Partners LP v. AutoInfo, Inc.*, No. 8509-VCN (Del. Ch. Apr. 30, 2015).
[2] *Id*. at *1–2.

decided to explore strategic options, including a potential sale.[3] AutoInfo retained Stephens Inc. (Stephens), an investment bank with expertise in the industry, to serve as its advisor through this process.[4] At Stephens's direction, AutoInfo's management prepared a five-year financial forecast (the Management's Projections).[5] Management had never prepared multiyear projections before and internally doubted its ability to do so, leading members of management to characterize the projections as "aggressively optimistic" and "a bit of a chuckle and a joke."[6]

Following a months-long process that involved pitching the Company to 164 potential acquirers and the formation of a special committee to evaluate several formal bids, Comvest emerged as the highest bidder, valuing the Company at $1.26 per share.[7] During due diligence, however, Comvest learned of various issues with AutoInfo's business, including accounting irregularities, poor bookkeeping and weaknesses in the Company's financial reporting practices.[8] As a result, Comvest reduced its offer and, after months of negotiations, the parties agreed on a new price of $1.05 per share (Merger Price).[9] On April 25, 2013, AutoInfo's stockholders approved the deal, and the transaction closed the same day.[10]

Two AutoInfo shareholders petitioned the court for appraisal of their shares pursuant to 8 Del. Code § 262, which allows stockholders who elect against participating in certain merger transactions to petition the court to determine the fair value of their stock.[11] The petitioning shareholders' expert valued the Company at $2.60 per share using both a discounted cash flow (DCF) analysis and two comparable companies' analyses.[12] AutoInfo's expert, on the other hand, valued the Company at $0.967 per share by analyzing the merger price and market evidence regarding the strength of AutoInfo's sales process.[13]

Analysis/Decision

The court rejected the petitioners' valuation for several reasons. First, the court discredited the DCF analysis because it relied exclusively on the Management's Projections, which the court found to be unreliable because: (1) such projections were not prepared in the ordinary course of business, but rather at Stephens's request

[3] *Id*. at *3.
[4] *Id*. at *4.
[5] *Id*. at *6.
[6] *Id*.
[7] *Id*. at *8–10.
[8] *Id*. at *12–13.
[9] *Id*. at *14–16.
[10] *Id*. at *16.
[11] *Id*. at *17; 8 Del. C. § 262.
[12] *Id*. at *16–17.
[13] *Id*. at *17.

and with the guidance that they "needed to be optimistic," and (2) AutoInfo had never before prepared such projections and admitted having serious doubts about their accuracy.[14] Second, the court gave no weight to the petitioners' comparable-companies analyses because the analyses used purportedly "comparable" companies that were significantly larger than AutoInfo and, unlike AutoInfo, were based on the company store business model, generally considered to be more desirable and less risky than the 100% agent-based model used by AutoInfo.[15]

The *AutoInfo* decision reiterates the importance of merger price and the process of arriving at the same in determining fair value in Delaware appraisal proceedings.

In ultimately finding that the $1.05 Merger Price was a far more reliable indicator of fair value, the court focused on the fact that the price was the result of a fair and adequate process.[16] The court noted that it was undisputed that the Company was "shopped quite a bit" and that the merger was the result of a competition among many potential acquirers.[17] Further, there were no allegations of self-interest or disloyalty. Rather, the merger was negotiated with Comvest by a special committee and "at arm's length, without compulsion, and with adequate information."[18] Finally, the "base case" DCF analysis performed by Stephens in evaluating the deal, which was based on its own projections and not those prepared by management, supported the Merger Price.

Takeaways

AutoInfo's reliance on the Merger Price (and, more importantly, the process used to arrive at the same) in determining fair value offers potential lessons for companies, directors, shareholders and their counsel. When considering strategic mergers or other transactions, companies and their directors may be able to insulate themselves to some extent from claims that they agreed to sell the company at an inadequate price by creating and implementing a sales process that is fair, negotiated at arm's length, and free from any self-interest or disloyalty. Conversely, shareholders may need to think twice before challenging the merger price and demanding appraisal where the company and/or its directors can demonstrate that such a proper and fair process has been followed.

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14 *Id*. at *19–20 ("[W]hen reliable inputs are unavailable, 'any values generated by a DCF analysis are meaningless.'")
15 *Id*. at *21–27.
16 *Id*. at *35–36.
17 *Id*. at *35.
18 *Id*. at *29.

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SEC Continues to Pursue Clawbacks Under Sarbanes-Oxley and Issues Proposed Dodd-Frank Clawback Rules

In the recent administrative proceeding *In the Matter of Computer Sciences Corp., et al.* (3-16575), the SEC alleged that Computer Sciences Corp. (CSC) engaged in accounting and disclosure fraud by concealing major problems with the company's multibillion-dollar contract with United Kingdom's National Health Service (NHS). In a settlement announced June 5, 2015, the SEC found that CSC's former CEO, Michael Laphen, approved the use of CSC's improper models for CSC's contract with NHS and made misleading statements to investors regarding the NHS contract and CSC's financial performance. Pursuant to the settlement, Laphen agreed to return more than $3.7 million in incentives and bonus compensation to CSC and to pay a $750,000 penalty.

As cases such as this illustrate, the SEC continues to be interested in pursuing CEOs and CFOs pursuant to Sarbanes-Oxley Section 304 to claw back incentive-based compensation when a company's financial statements are restated. The SEC has pursued a number of well-publicized clawback cases under Section 304 even when the CEO or CFO did not personally commit intentional or reckless misconduct resulting in restated financials. However, under Section 304 only the SEC, and not companies or their shareholders, may pursue recovery of incentive-based compensation.

On July 1, 2015, the SEC issued proposed Rule 10D-1 to implement the Dodd-Frank requirement that listed companies adopt a policy to recover (claw back) erroneously awarded compensation. The required policy would obligate the issuer to "claw back" unearned portions of incentive-based compensation paid to executive officers following a restatement of a company's financial statements. Under the proposed rules, executives would have to pay back incentive-based compensation received in the three fiscal years prior to the restatement that would not have received had the company's financial information been accurately reported in the original financial statement(s). Unlike Sarbanes-Oxley, the Dodd-Frank mandate adopts a "no-fault" standard, in which executive officers must reimburse unearned incentive-based compensation regardless of whether the company or any individual committed misconduct.

Should a company fail to adopt a compliant clawback policy, fail to disclose its policy as required by the proposed rules or fail to comply with its adopted policy, the company would be subject to delisting.

When finalized, new Rule 10D-1 will require national securities exchanges and associations to adopt listing standards that require listed companies to adopt clawback policies that comply with Rule 10D-1. Should a company fail to adopt a compliant clawback policy, fail to disclose its policy as required by the proposed rules or fail to comply with its adopted policy, the company would be subject to delisting. The proposed rules are not likely to go into effect until sometime in 2016 at the earliest. In the interim, issuers will be well-served to review and perhaps modify existing clawback policies so as to put current executive officers on notice of the impending rules.

Some of the key aspects of proposed Rule 10D-1 are:

- The company's executive officers, defined in Rule 10D-1 to be the Section 16 officers (those who file Form 4s), are subject to this clawback policy.
- The mandatory recovery of excess incentive-based compensation is based on a "no-fault" standard, meaning that recovery is required regardless of the executive officer's responsibility for the accounting errors. Further, issuers cannot indemnify executives for any clawback amounts and are prohibited from paying any portion of insurance premiums for policies that cover clawback amounts.
- The proposed rules define incentive-based compensation as compensation that is granted, earned or vested in whole or in part based on (a) any measures that are determined and presented in accordance with the accounting principles used in preparing the company's financial statements, (b) the company's stock price or (c) the company's total shareholder return. While companies may use a reasonable estimate of the amount to be recovered when dealing with clawbacks of incentive-based compensation based on stock price or total shareholder return, estimating such amounts will be difficult and likely be second-guessed. This provision is certain to be subject to significant comment.

The proposed rules also contain two exceptions to mandatory clawback of incentive-based compensation. First, the company's board of directors has the discretion to decline to pursue a clawback against an executive officer if the board determines that the cost of pursuing the clawback will exceed the amount it would likely recover. In addition, the board would not be required to pursue a clawback when the laws of its home country would prohibit it from doing so. Interestingly, the proposal does not reference state wage payment laws as permitted exceptions to recovery. Several commentators have identified state laws as potentially problematic.

Although these new rules are a long way from being finalized, they will heighten the importance of correctly reporting financial information the first time. Moreover new Rule 10D-1 will place greater scrutiny on the internal review issuers follow when an accounting error is discovered, as well as the decision as to whether a restatement is necessary.

Securities Litigation and Government Enforcement Groups

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