Arnold & Porter Kaye Scholer: Financial Services Litigation and Securities Enforcement

Arnold & Porter Kaye Scholer has a strong team of lawyers dedicated to representing financial services clients facing high-stakes litigation and government investigations. Our team includes experienced securities litigators, former Assistant US Attorneys and SEC staff members. Our depth is enhanced by our active collaboration with our transactional attorneys. We offer our clients creative and proactive analysis of complex factual and legal issues, a strategic approach that addresses business, reputational and budget needs and concerns and a commitment to world class representation, whether in taking a case to trial or seeking an efficient and satisfactory resolution outside of the courtroom.

We have represented investment banks, broker dealers, issuers, ratings agencies, investment funds, insurance companies, directors, officers, and special committees in state and federal class action securities and derivative actions throughout the country; SEC, CFTC and FINRA investigations; civil and criminal Department of Justice investigations; and states Attorney General investigations. We also routinely conduct internal investigations on behalf of our clients, often in response to whistleblower or other internal complaints. These representations often involve allegations of accounting improprieties; claims of market manipulation and insider trading; auditor independence issues; alleged violations of SEC, CFTC and FINRA regulations; disputes concerning broken swap and CDO trades; and claims arising out of indentures and servicing agreements for asset-backed securities, as well as defense of consumer and investor class actions.

Our group has extensive experience representing clients in the adjudication of these various complex financial conflicts at both the trial and appellate levels. In the course of these representations, we manage large internal teams and have worked in joint defense with other prominent law firms on complex, multijurisdictional cases. We actively litigate in federal and state courts, as well as before arbitration panels across the country. Our group and several of our individual attorneys have been recognized in many publications and ranking services, including *Chambers USA, Legal 500, Best Lawyers* and *Benchmark Litigation*.

We also have significant experience and expertise in working with a variety of economic, insurance, regulatory, and financial accounting experts on issues raised in these cases, including those relating to class certification, loss causation, materiality, statistical significance, structured financial products, valuation, various damages' models and substantive financial, market and operational issues.

When necessary, we have advised our clients with respect to crisis management and have assisted them in developing, as well as managing, strategy regarding sensitive media and public relations inquiries on high-profile matters.

In sum, Arnold & Porter Kaye Scholer brings to its clients a sophisticated, experienced and diverse team of lawyers who have the knowledge and ability to confront and resolve the complex liability issues arising from today's financial markets and regulatory regimes in a thoughtful and efficient manner. We are proud of our success in representing our financial services clients.

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SUPREME COURT REAFFIRMS BROAD SCOPE OF INSIDER TRADING LIABILITY

By Veronica E. Callahan, John A. Freedman, Daniel M. Hawke, Joshua R. Martin, Whitney A. Moore, Adam J. Reinhart, Michael D. Trager

The Obama Administration made aggressive enforcement of insider trading laws a centerpiece of its securities enforcement agenda, including high-profile prosecutions of prominent hedge funds such as Galleon Group and SAC Capital. This legacy and the future vigor of insider trading enforcement efforts has been in question since December 2014, when the Second Circuit issued its high-profile decision in *United States v. Newman*. In *Newman*, the Second Circuit overturned the convictions of two hedge fund portfolio managers, holding there was a lack of proof that the individuals who provided the material non-public information (the "tippers") received an "objective" and "consequential" personal benefit of a "pecuniary or similarly valuable nature." Other courts, citing long-standing Supreme Court precedent, had rejected the Second Circuit's suggestion that a tipper must receive some tangible benefit.

On December 6, 2016, in *Salman v. United States*, the Supreme Court unanimously reaffirmed long-standing principles of insider trading liability, expressly rejecting the Second Circuit's ruling in *Newman* that someone who provides a tip to a family member or friend must receive something of a "pecuniary or similarly valuable nature." While the *Salman* decision did not expressly address or resolve several important questions, the decision is likely to embolden enforcement efforts.

BACKGROUND ON INSIDER TRADING ENFORCEMENT

The government has long prosecuted insider trading by traditional corporate insiders (e.g., corporate officers) who trade based on material, non-public information, or where an individual "misappropriates" information to trade in breach of a duty owed to the owner of that information. The government has also prosecuted "tippers" and "tippees" where corporate insiders or others who misappropriate information (tippers) do not themselves trade, but instead provide the information to outsiders (tippees) who trade based on that information.

In *Dirks v. SEC*, the Supreme Court established the standard for assessing liability of an insider tipper, noting that "[t]he need for a ban on some tippee trading is clear" and that "[n]ot only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain."

Thus, the Court held that, in order to determine whether a tipper breached his fiduciary duty, the relevant test asks "whether the insider personally will benefit, directly or indirectly, from his disclosure." The Court stated that while a personal benefit could include pecuniary gains or reputational benefits that later result in future earnings, a breach may also occur when the tipper provides information to a trading relative or friend. Furthermore, the Court stated that a tippee is equally liable if he knows or should have known of the tipper's breach.

In *Newman*, the Second Circuit criticized "recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders." This statement was made in the context of the government's prosecution of remote recipients of material non-public information which, in *Newman*, involved material non-public information being disseminated by employees of two technology firms to investment analysts, who in turn provided it to hedge fund analysts, who in turn provided it to the defendants (who then traded on the information). In this context, the Second Circuit held that, to establish liability for a tipper, a "personal benefit" cannot be inferred from a personal relationship absent "proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." The Second Circuit also held that a tippee must know that the tipper disclosed information in exchange for a personal benefit. Although the government sought further review, the Supreme Court denied *certiorari*.

THE *SALMAN* DECISION BELOW

The *Salman* case concerned the appeal of Bassam Salman, who was prosecuted and convicted of insider trading in 2013. The tipping chain proceeded as follows: an investment banker shared material non-public information about pending mergers and acquisitions with his brother, who both traded on the information and passed along the information to others, including Salman (the tipper's brother-in-law). Salman traded on the information and made over US$1.5 million in profits.

Salman appealed his conviction, arguing that there was no evidence that the source of the inside information (the investment banker) had received anything of "a pecuniary or similarly valuable nature" in exchange for the information, and citing the Second Circuit decision in *Newman*. The Ninth Circuit affirmed the conviction, relying on *Dirks'* holding that a tipper benefits personally by making "a gift of confidential information to a trading relative or a friend." The Supreme Court granted *certiorari* to resolve the conflict between the Second and Ninth Circuits.

THE SUPREME COURT'S DECISION

Writing for a unanimous court, Justice Alito held that the Supreme Court would "adhere to *Dirks*, which easily resolves" the case. The Court noted that while *Dirks* held that the mere "disclosure of confidential information without personal benefit is not enough," *Dirks* squarely held that a "personal benefit can often be inferred from objective facts and circumstances . . . such as a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter . . . [or] when an insider makes a gift of confidential information to a trading relative or friend." Without expressly overturning *Newman*, the Court observed that the Second Circuit's holding that a "tipper must also receive something of a pecuniary or similarly valuable nature" was inconsistent with *Dirks*.

As applied to the facts in *Salman*, the Court concluded that the investment banker made a gift of material non-public information to his brother, who both traded on the information and passed it along to Salman, and noted that "when a tipper gives inside information to a trading relative or friend, the jury can infer that the tipper meant to provide the equivalent of a cash gift." The Court concluded that "Salman's conduct is in the heartland of *Dirks's* rule concerning gifts."

SIGNIFICANCE

While the *Salman* decision signals strong support for established principles of insider trading, the Court took a narrow approach to the issue and did not expressly address or otherwise provide meaningful guidance outside the situation where the tipper and tippee are "friends or family." For example, the Court did not address how *Dirks* would apply to situations where:

- a tipper had only a business relationship with a tippee (which was the factual scenario presented in *Newman*);
- a tipper and tippee had only a casual social relationship rather than a close friendship (i.e., what level of friendship is required);
- a tippee who traded was several layers removed from the insider tipper and did not know whether the insider had received a personal benefit (a situation that also was present in *Newman*); or
- a tipper received a non-pecuniary benefit and is neither a friend nor family member of the tippee.

Indeed, the Court acknowledged that determining whether a tipper "personally benefits from a particular disclosure" is a question of fact that will not always be easy for a court to resolve.

What is clear, however, is that the *Salman* decision resolves (at least in part) a high-profile dispute between courts over the extent to which prosecutors and the SEC can enforce insider trading prohibitions, coming down firmly on the side of the government. This is evident from the emboldened reaction of Preet Bharara—the US Attorney for the Southern District of New York and the Obama Administration's leading proponent of vigorous insider trading enforcement—who called the decision "common sense" and a "victory for fair markets and those who believe that the system should not be rigged."

While there is some uncertainty in the approach the next administration will take on securities enforcement generally, it is notable that President-elect Trump reportedly has asked US Attorney Bharara to remain in his current position in the new administration. If this portends that the Trump Administration will continue to pursue insider trading cases aggressively, the *Salman* decision signifies that the government will continue to have ample legal tools and mechanisms available to enforce and prosecute insider trading.

Arnold & Porter represented the prevailing party, Mr. Dirks, in Dirks v. SEC *in the Supreme Court and earlier proceedings.*

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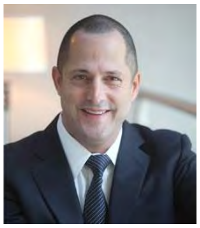

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NEWS & PERSPECTIVES

May 9, 2016

NEW YORK ADOPTS BUSINESS JUDGMENT RULE IN REVIEWING CERTAIN GOING-PRIVATE TRANSACTIONS

By Vincent A. Sama, Catherine B. Schumacher, Daphne Morduchowitz, Joseph F. Clark

The New York Court of Appeals dealt a blow to plaintiffs on May 5, 2016 when it issued its first decision addressing the appropriate standard for analyzing going-private merger transactions. In *In re: Kenneth Cole Productions, Inc., Shareholder Litigation*, the New York Court of Appeals held that New York courts should apply the more deferential business judgment rule, rather than the stricter entire fairness standard, in reviewing going-private mergers, as long as certain "shareholder-protective conditions" are implemented.

Plaintiffs often challenge proposed going-private transactions before the ink is dry in a race to the courthouse to file a merger strike suit, no matter how weak the merits of their case are, in the hopes of surviving a motion to dismiss and forcing a settlement. Recent decisions of the Delaware courts indicate an increasing intolerance of this behavior and the resultant "tax" on merger transactions. The *Kenneth Cole* decision suggests that the New York courts are turning in the same direction.

The case involved a proposed going-private transaction by Kenneth D. Cole of his namesake apparel, footwear, handbag and accessories company, of which he was majority shareholder. The offer was conditioned upon the approval by a special committee of independent directors formed to consider and negotiate the proposal and by a majority of the minority shareholders. After months of negotiations, the special committee approved the proposal and 99.8 percent of the minority shareholders voted in favor of the merger.

As is commonplace in merger transactions, plaintiffs' attorneys filed a merger strike suit as soon as the offer was announced publicly. The case was dismissed on the pleadings and the Appellate Division, First Department, affirmed the dismissal. On appeal, the New York Court of Appeals decided the standard of review for going-private mergers, which had been an open question under New York law. Plaintiffs argued for the "entire fairness" standard to apply, which would have required defendants to demonstrate the merger was the result of a fair process and was at a fair price, thereby making it difficult to obtain a dismissal at the pleadings stage. Defendants advocated for the application of the much more deferential business judgment rule, which warrants dismissal unless a plaintiff pleads specific facts indicating that the special committee did not act in good faith or was otherwise interested.

The court, in recognition of the competing interests of not interfering with the internal management of corporations and "avoiding frivolous litigation" and that of protecting minority shareholders in freeze-out mergers, adopted a middle ground, following the Delaware Supreme court's decision in *Kahn v. M & F Worldwide Corp.* The court held that a going-private merger would be entitled to review under the business judgment rule rather than the entire fairness test if six "shareholder-protective conditions" were met: (1) if the transaction is conditioned on the approval of both a special committee and a majority of the minority shareholders; (2) if the special committee is independent; (3) if the special committee is empowered to select its own advisors and to say no definitively; (4) if the special committee meets it duty of care in negotiating a fair price; (5) if the vote of the minority is informed; and (6) if there is no coercion of the minority.

The court went further and held that a merger strike suit would be subject to dismissal unless it alleges "a reasonably conceivable set of facts" showing that one of the six conditions did not exist, and that conclusory or unsupported legal assertions are not sufficient. In particular, with respect to the special committee's independence and care in negotiating a fair price—two conditions likely to face challenges by plaintiffs—the court set a high bar, requiring a plaintiff to allege the special committee engaged in fraud or unfair conduct, or had a conflict of interest or other incentive to accept an inadequate price without meaningful negotiations. Since the plaintiffs only attempted to meet their burden with conclusory allegations, the court affirmed the dismissal of the complaint.

*   *   *

Parties contemplating a going-private transaction should condition it on the approval of a properly formed special committee and of a majority of minority shareholders in order to satisfy the six conditions laid out in *In re: Kenneth Cole Productions, Inc., Shareholder Litigation*. Merger strike suits are more susceptible to dismissal under the deferential business judgment rule, which may allow for the avoidance of costly discovery and litigation.

Kaye Scholer represented the former CEO of Kenneth Cole Productions, Inc. and Kenneth Cole Productions, Inc. in this action.

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