



Securities and Shareholder Litigation
2017 ♦ A LOOK AHEAD

BASS BERRY ♦ SIMS

Contents

1.
INTRODUCTION

2.
SEC ENFORCEMENT HITS ALL-TIME HIGH IN 2016; WHAT'S NEXT?

5.
BUYER AND SELLER BEWARE: THE POTENTIAL PITFALLS OF SHARING PRIVILEGED INFORMATION DURING DUE DILIGENCE

7.
DONE DEAL! NOT SO FAST: STRATEGIES FOR MINIMIZING POST-CLOSING DISPUTES

10.
CAN LIABILITY IN A DATA BREACH EXPAND TO THE BOARDROOM?

13.
SIXTH SENSE: SIGNIFICANT SECURITIES CASES DECIDED BY THE SIXTH CIRCUIT IN 2016

16.
ABOUT THE SECURITIES & SHAREHOLDER LITIGATION PRACTICE GROUP



INTRODUCTION

While not necessarily as eventful as 2015, 2016 saw courts interpret and build upon major decisions from prior years, and have set up at least one important issue for consideration by the U.S. Supreme Court in 2017. As we look in the rearview mirror, we will discuss best practices and offer guidance and direction for the year ahead.

2016 was an active year for securities and shareholder litigation, seeing an overall increase in securities litigation filings, other shareholder-related litigation and SEC enforcement activity. 2016 also featured several important legal developments that should continue to impact both private litigation and public enforcement in the year ahead. This Look Ahead will discuss, among other things:

- ✦ **SEC Whistleblower Program.** By the time the SEC closed its 2016 fiscal year in September, it had filed a record number of enforcement actions. In addition, the SEC's whistleblower program awarded more than \$57 million to 13 whistleblowers during the year, almost as much as in all previous years combined. The big question will be whether the Trump administration will allow this trend to continue.
- ✦ **Mergers and Acquisitions Litigation.** In June, the New York Court of Appeals, in a split decision, ruled that the "common interest doctrine" protected only shared communications relating to a common legal interest in pending or reasonably anticipated litigation. Because parties to a prospective merger often rely on the common interest doctrine to protect certain due diligence discussions from a claim that one or both parties have waived the attorney-client privilege, this decision has significant implications for parties to transactions subject to New York law.
- ✦ **Director and Officer Liability.** Private plaintiffs continue to attempt to hold directors and officers liable for cybersecurity breaches affecting their companies. While in the past such lawsuits have been largely unsuccessful, a recently-filed wave of new lawsuits merits watching.
- ✦ **Sixth Circuit Developments.** Among other things, the U.S. Court of Appeals for the Sixth Circuit contributed to an emerging circuit split on whether a private securities plaintiff can rely on a pending class action to toll a statutory repose period. In a case in which Bass, Berry & Sims served as counsel, the Sixth Circuit ruled that plaintiffs' claims were barred by the respective three- and five-year statutes of repose under the Securities Act of 1933 and the Securities Exchange Act of 1934, and rejected plaintiffs' argument that they were entitled to rely on the pendency of multiple class actions to toll the statutes' application.

These are just a few examples of the topics discussed in the following pages. Throughout this report, we focus on the short- and long-term impact of these and other changes on companies and their officers, directors and shareholders. In addition, we forecast other challenges likely to affect our clients in the year ahead. As a new administration with a different regulatory focus takes office, and private plaintiffs' attorneys continue to seek new opportunities to bring class and derivative actions against companies and their officers and directors, we can expect 2017 to bring even more surprises that may impact our clients.



SEC ENFORCEMENT HITS ALL-TIME HIGH IN 2016; WHAT'S NEXT?

FY 2016 was a record year for SEC enforcement.¹ This marks the third consecutive year the agency has filed a record number of actions in its more than 80 year history. In taking a deeper dive into the numbers, what can we learn? Will this trend continue under the new administration?

The SEC filed a record number of enforcement actions this past fiscal year. Since the implementation of the so-called “broken windows” strategy in 2013, actions have ranged from small violations to high-profile insider trading charges and enforcement actions seeking hundreds of millions of dollars against firms.

ENFORCEMENT ACTIONS

The SEC filed 868 enforcement actions in FY 2016, more than in any other year. The total eclipsed the 807 actions filed in FY 2015 and the 755 actions filed in FY 2014. During FY 2016, the SEC ordered over \$4 billion in disgorgement and penalties, which is consistent with amounts ordered in the prior two years.

**868 ENFORCEMENT
ACTIONS SETS
NEW SINGLE
YEAR HIGH**

Of the 868 actions filed in FY 2016, 548 were substantive enforcement actions, with the remainder being routine administrative actions. Notably, FY 2016 was a record year for cases involving investment advisors and investment companies (160) and the Foreign Corrupt Practices Act (21). As in years past, the SEC filed the vast majority of its actions as administrative proceedings before the Commission or an administrative law judge.

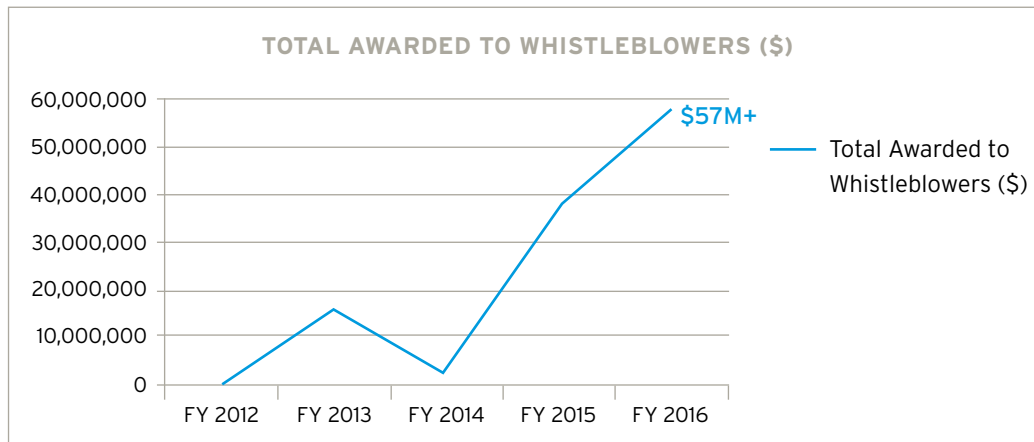
The SEC continued to prioritize reporting and disclosure matters, pursuing actions against both companies and executives relating to these issues. The SEC further touted its recent use of “new data analytics,” which then SEC Chair Mary Jo White credited with helping the SEC detect and crack complex insider trading rings. Overall, the SEC formally charged 78 parties with insider trading in FY 2016, with the SEC’s new analytics and the whistleblower program likely playing a key role.

WHISTLEBLOWER PROGRAM

The SEC’s whistleblower program, which directs the SEC to grant monetary awards of 10–30% to whistleblowers whose original information leads the SEC to collect \$1 million or more in sanctions, continued its steady growth in 2016. In fact, FY 2016 was a record year that saw the SEC award more money to whistleblowers than in all previous years combined.

Record Monetary Awards. The SEC awarded over \$57 million to 13 whistleblowers in FY 2016. This tops the approximately \$37 million the SEC awarded in FY 2015, the previous record. Notably, the SEC issued seven of its 10 highest awards ever between May and November 2016. Including the first month of FY 2017, the SEC has awarded more than \$134 million to 36 whistleblowers since the program’s inception.

¹ The majority of statistics used in this article come from two SEC publications, *SEC Announces Enforcement Results for FY 2016* (Oct. 11, 2016), available at <https://www.sec.gov/news/pressrelease/2016-212.html>, and *2016 Annual Report to Congress on the Dodd-Frank Whistleblower Program* (Nov. 15, 2016), available at <https://www.sec.gov/whistleblower/reportspubs/annual-reports/owb-annual-report-2016.pdf>.



Record Tips Received. The SEC has received more tips in each successive year of the whistleblower program's operation, and received a record-high 4,218 tips in FY 2016. It has averaged 3,600 tips per year since FY 2012. While the number of individuals submitting tips is high, the chances of receiving an award remain low: the SEC issues awards for about one in every 500 tips. According to the SEC, successful whistleblowers typically provide specific information, such as identifying individuals involved in the misconduct or providing documents to substantiate their allegations.

Types of Allegations. In FY 2016, the top three categories of complaints – as self-reported by whistleblowers – were Corporate Disclosures and Financials (22%), Offering Fraud (15%) and Manipulation (11%), with many tips falling in the catchall “Other” category (24%). This matches the top categories from FY 2015.

Whistleblower Profiles. While about 60% of award recipients provided information that opened an investigation, the remaining 40% significantly contributed to existing investigations. Approximately 65% of award recipients are company insiders. Of these, 80% raised their concerns internally before reporting to the SEC.

Increasing Whistleblower Protection. The SEC brought the first stand-alone retaliation case during FY 2016 and settled its first retaliation claim concerning purely internal whistleblowing. The SEC also signaled its commitment to whistleblowers by bringing actions to enforce Rule 21-F, which prohibits companies from using confidentiality and severance agreements to limit or impede an employee's ability to communicate with or receive awards from the SEC.

ISSUES FOR THE YEAR AHEAD

While predicting future trends in SEC enforcement actions in 2017 is difficult, given the new presidential administration and inevitable changes to the commission, here are some issues to consider:

Continued Growth in Enforcement Actions and Whistleblower Program. For several years, the number of enforcement actions filed by the SEC has increased, as has the number of whistleblower awards issued. The SEC's success in bringing enforcement actions, and the increased visibility of the whistleblower program, suggest that both will continue to expand. While the SEC's efforts could be slowed by a shake-up in SEC leadership and potential legal and regulatory changes, both of which are described further below, we would expect any slowdown to occur over time. Even if SEC enforcement slows, state regulators, especially states with active enforcement programs like New York and California, might attempt to fill the void.

Leadership Changes. SEC Chair Mary Jo White left the SEC at the conclusion of President Obama's term in office. White's departure followed that of Director of Enforcement Andrew Ceresney, who stepped down at the end of 2016. White and Ceresney, who both came to the SEC in 2013, oversaw the filing of nearly 3,000 enforcement actions and the imposition of more than \$13.8 billion in sanctions. President Trump has selected Jay Clayton, a mergers and acquisitions partner at Sullivan & Cromwell, to succeed White as SEC chair.² Clayton, if confirmed, will hire a new Director of Enforcement. Although little is known to date about his plans for the SEC, Clayton and his team will set the tone for whether the SEC's enforcement efforts continue to move at a record pace, and whether the SEC continues to pursue similar priorities like targeting

² Information in this article is based on developments at the time of publishing.

individuals and obtaining admissions of wrongdoing. President Trump will also have the opportunity to fill two existing vacancies on the Commission, with a third seat opening later in 2017.

Dodd-Frank Act. President Trump and several of his cabinet nominees have voiced strong opposition to the Dodd-Frank Act. How far the Trump administration will go toward repealing the law and what, if any, impact such changes will have on SEC enforcement, remain to be seen. In a recent statement, House Financial Services Committee Chairman Jeb Hensarling, R-Texas, said he would work with the administration to repeal Dodd-Frank by the end of the year and replace it with a new system. Treasury Secretary nominee Steven Mnuchin said that stripping back Dodd-Frank is his number one regulatory priority; however, he supports the Volcker Rule with some changes including a better definition of “proprietary trading.” The administration has signaled that its chief targets are provisions that inhibit lending. Trimming these provisions likely would not affect enforcement. Dodd-Frank also created the whistleblower program. Given the program’s success, though, it would seem difficult for the administration to scrap it entirely – at least not without enacting a similar program in its place.

Constitutionality of Administrative Proceedings. Several defendants have filed lawsuits in federal court challenging the constitutionality of the SEC’s administrative proceedings. In December 2016, a Tenth Circuit panel set aside an SEC administrative opinion after finding that the SEC’s use of administrative law judges violated the Appointments Clause. This ruling creates a split with a prior D.C. Circuit opinion that found the administrative law judges passed constitutional muster. While the Tenth Circuit’s opinion alone is unlikely to slow the SEC’s use of administrative proceedings, the issue is likely to arise in other circuits and is ripe for Supreme Court review. Importantly, the D.C. and Tenth Circuit cases involved challenges brought after the conclusion of the administrative process. A number of defendants have sought to enjoin ongoing administrative proceedings, but the five federal courts of appeals that have heard these cases have unanimously held that federal courts lack jurisdiction until the administrative process has finished.



BUYER AND SELLER BEWARE: THE POTENTIAL PITFALLS OF SHARING PRIVILEGED INFORMATION DURING DUE DILIGENCE

In June, New York's highest court issued an important decision narrowing the application of the common interest doctrine under New York law, causing New York to diverge from Delaware and numerous other jurisdictions that use the common interest doctrine to extend attorney-client privilege protection to certain communications between parties to an M&A transaction. How will this deepening split of authority impact parties going forward?

During the due diligence process, parties to a prospective merger and their counsel often discuss sensitive legal and/or regulatory matters and exchange what ordinarily might be considered privileged documents and information. Parties believe such exchanges are necessary to ensure that both parties to the transaction are “on the same page” regarding what soon will become the legal obligations of the combined company. Parties typically rely upon the common interest doctrine to shield these exchanges from a later claim that the privilege has been waived – an exception to the traditional rule that attorney-client communications made in the presence of, or otherwise disclosed to, a third-party results in a waiver of the privilege. The common interest doctrine preserves the privilege as long as the parties share a “common legal interest” in the subject matter of the privileged communications.

TWO “COMMON” APPROACHES

Courts have approached the common interest doctrine in two different ways. Traditionally New York and a handful of other states have imposed a “litigation requirement” on the common interest doctrine, requiring not only a shared legal interest between the parties, but that the communications at issue relate to pending or anticipated litigation in order to avoid waiver. Other jurisdictions, notably Delaware, have moved away from a “litigation requirement” and extended the common interest doctrine to any circumstances where two or more entities have shared legal interests, including a shared interest in a signed merger agreement or other pending transaction. This exception has even been codified in Delaware law.

In recent years, the thought was that the courts of most states (and federal jurisdictions) would gravitate toward the Delaware approach as being the more “modern” of the two, and consistent with the most recent Restatement of the Law Governing Lawyers. In 2014, an intermediate New York appellate court attempted to expand the scope of New York's common interest doctrine to parallel Delaware and other jurisdictions, holding that a plaintiff could not take discovery of certain attorney-client communications shared between Countrywide and Bank of America when they were in the process of merging. The intermediate court held that Countrywide and Bank of America had “a common legal interest because they were engaged in merger talks during the relevant period and [had] a completed and signed merger agreement. Indeed, the circumstances presented in this case illustrate precisely the reason that the common interest privilege should apply – namely, that business entities often have important legal interests to protect even without the looming spectre of litigation.” *Ambac Assurance Co. v. Countrywide Home Loans, Inc.*, 2014 N.Y. Slip Op. 08510 (App. Div. 1st Dep't Dec. 4, 2014).

THE NEW YORK RULING

With respect to New York, such hopes for expansion of the doctrine proved short-lived. In *Ambac Assurance Corp. v. Countrywide Home Loans, Inc.*, 27 N.Y.3d 616 (2016), the New York Court of Appeals declined to extend the protection of the common interest doctrine to privileged communications shared between parties to a prospective merger, unless the parties share a common legal interest *and* the

privileged communications at issue relate to pending or reasonably anticipated litigation. The New York Court of Appeals reversed the lower appellate court, refused to “[e]xpand[] the common interest doctrine to protect shared communications in furtherance of any common legal interest,” and adhered to “the litigation requirement that has historically existed in New York.”

Among other things, the court found that Bank of America had not offered any compelling justification for expanding the scope of the common interest doctrine under New York law, and that “[a]ny benefits that may attend such an expansion of the doctrine are outweighed by the substantial loss of relevant evidence, as well as the potential for abuse. The difficulty of defining ‘common legal interest’ outside the context of litigation could result in a loss of evidence of a wide range of communications between parties who assert common legal interests but who really have only non-legal or exclusively business interests to protect.”

Attorneys working on potential transactions governed by New York law should consider this development when conducting due diligence and responding to information requests.

BEST PRACTICES FOR THE YEAR AHEAD

As a general matter, regardless of the jurisdiction in which a transaction may take place, or the governing law that may be deemed operative, parties to a transaction and their counsel should take basic precautions to maximize the probability that a court will find the common interest doctrine applicable and avoid a claim of waiver, including:

Timing. Wait until a merger agreement has been signed, or as late in the process as possible, before exchanging potentially privileged information or discussing sensitive legal or regulatory issues. The closer the transaction is to closing, the stronger the argument will be that a common legal interest exists.

Know What You are Disclosing. It goes without saying that parties should make every effort to familiarize themselves with documents exchanged during due diligence, and to understand the potential privilege implications beforehand.

Documentation. Both parties and their counsel should sign a Confidentiality and Common Interest Agreement documenting in writing that information is being exchanged in confidence and subject to the common interest privilege. If the parties can reasonably tie any disclosures to “pending or reasonably anticipated litigation” (which the court in *Ambac* does not define), they should do so in writing.

Separate Discussion of Common Legal Interests from Business Interests. Don’t mix legal and business communications, and make sure that anyone copied on any written correspondence or information exchange has a valid legal reason for being on a conference call or email chain.

Discuss Instead of Exchange. If you can avoid the actual physical exchange of potentially privileged documents and attorney work product, then by all means do so, especially if a telephone call between the parties and their respective counsel could accomplish the same purpose.

Consider Jointly Retaining Counsel. In jurisdictions where the viability of the common interest doctrine appears particularly uncertain, parties to a prospective merger should consider jointly retaining special counsel to advise them on matters in which they share a legal interest, but which might not be sufficiently litigation-related to avoid the risk of a waiver. The *Ambac* court acknowledged that becoming “co-clients” of the same attorney or law firm might be one means by which parties to a prospective transaction could preserve the attorney-client privilege with respect to sensitive discussions.



DONE DEAL! NOT SO FAST: STRATEGIES FOR MINIMIZING POST-CLOSING DISPUTES

Analysts are optimistic about an M&A boom this year. A boom can easily turn into gloom if a deal results in a post-closing dispute between the parties. What steps can businesses take to reduce their risk in 2017?

The topic of post-closing liability continues to be of interest to businesses active in the ever-changing arena of mergers and acquisitions. Post-closing disputes seem to be increasing and often relate to indemnification for alleged breaches of representations or warranties in a transaction agreement, or for claims or lawsuits brought by third parties after closing and arising out of facts occurring pre-closing. Sometimes these disputes are the result of unforeseeable circumstances that are impossible to avoid. Often, however, these disputes implicate contractual provisions that many businesses and their attorneys regard as “boilerplate,” and, therefore, might get little attention during the negotiation of a transaction. Careful consideration of these provisions on the front-end can facilitate resolution of these disputes down the road.

MERGER & ANTI-RELIANCE PROVISIONS

Most, if not all, merger and acquisition agreements include contractual language similar to the following:

This Agreement constitutes the entire understanding and agreement between the parties, and there are no terms, conditions, restrictions, representations, or understandings between the parties not included herein.

Provisions such as these are intended to prevent parties from later bringing claims based on promises or statements outside the four corners of the agreement. Parties and their counsel should be aware, however, that certain courts have found this language, standing alone, insufficient to preclude one party from later bringing claims for breach of contract or fraud based on extra-contractual promises or representations. Courts in both Delaware and New York now expect parties to go beyond this boilerplate language if they want to fully protect themselves from claims relating to representations outside the agreement.

In early 2016, the Delaware Chancery Court held that despite a merger agreement’s inclusion of a basic merger clause such as the one discussed above, a buyer could bring a fraud claim based on statements made by the seller before the signing of the agreement.³ In so holding, the court noted that the agreement lacked an affirmative expression by the buyer as to the specific information it was relying on when it entered into the agreement or a disclaimer that the buyer was not relying on any representations made outside of the merger agreement. The agreement’s disclaimer *by the seller* about what it was neither representing nor warranting was not enough to preclude *the buyer’s* reliance on extra-contractual statements. New York courts have similarly held that absent specific anti-reliance language, a merger clause alone will not preclude a fraud claim.⁴

Going forward, parties should keep this distinction in mind when drafting merger or purchase agreements. To avoid a later dispute and potential liability over what was or wasn’t said prior to closing a deal, in addition to standard merger clause language, parties – especially sellers – should make every effort to include the following: (1) an affirmative acknowledgment by both parties that no extra-contractual representations were made; and (2) an affirmative disclaimer by both parties – and especially the buyer – of reliance on

³ *FdG Logistics LLC v. A&R Logistics Holdings, Inc.*, 131 A.3d 842 (Del. Ch. 2016).

⁴ See e.g., *Plaza PH2001 LLC v. Plaza Residential Owners LP*, 79 A.D.3d 587 (N.Y. App. Div. 2010); *Danann Realty Corp. v. Harris*, 157 N.E.2d 597 (N.Y. 1959).

extra-contractual statements and omissions. An example of such a clause is:

Buyer agrees and acknowledges that Seller has not made, and Buyer is not relying upon and hereby disclaims, any representations and warranties other than the representations and warranties of Seller that are expressly set forth in this Agreement, and Seller shall not have any liability to Buyer resulting from Buyer's reliance on any such representations or warranties.

While no contractual language can completely foreclose the possibility of a post-closing dispute, these steps should help deter parties from bringing claims for breach of contract or fraudulent inducement based on representations not contained in the parties' written agreement.

SANDBAGGING PROVISIONS

Another potential issue that periodically arises in post-closing disputes is the issue of "sandbagging," which refers to the practice of one party – typically the buyer – entering into a transaction despite knowing of the potential inaccuracy or breach of a representation or warranty by the other side – typically the seller – and later making a claim for breach of contract, or even fraud based on the purported "misrepresentation."

The easiest way to render sandbagging a non-issue is to negotiate an "anti-sandbagging" clause in the agreement, the purpose of which would be to preclude a buyer from bringing an indemnification claim against the seller based on facts or circumstances of which the buyer had knowledge when it entered into the transaction:

Buyer has no knowledge of any facts or circumstances that would serve as the basis for a claim by Buyer against Seller based upon a breach of any of the representations and warranties of Seller contained in this Agreement. Buyer shall be deemed to have waived in full any breach of any of Seller's representations and warranties of which Buyer has knowledge at the Closing.

Anti-sandbagging provisions, however, typically meet heavy resistance from buyers at the negotiation stage. More often, buyers will negotiate to include a "pro-sandbagging" provision to preserve their right to bring an indemnification claim in the contract for defects the buyer knew existed before completion of the transaction. An example of such a clause would be:

The right to indemnification, payment, reimbursement, or other remedy based upon any such representation, warranty, covenant, or obligation will not be affected by any investigation (including any environmental investigation or assessment) conducted or any knowledge acquired at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of, or compliance with, such representation, warranty, covenant, or obligation.

But what happens when an agreement is silent on the issue of sandbagging? Both Delaware and New York courts tend to take a buyer-friendly approach. The Delaware Chancery Court has held that a buyer was entitled to indemnification for breaches of the seller's representations and warranties even if the buyer knew of the seller's breach prior to closing.⁵ In fact, the court held that the buyer could bring an indemnification claim even if the buyer did not rely on the seller's breach of warranty or misrepresentation.

New York similarly allows sandbagging and will also allow an indemnification claim even where the buyer cannot establish reliance on the alleged misrepresentation. Unlike Delaware, however, New York will take into consideration whether the source of the buyer's knowledge was the seller or another party.⁶ If the buyer learned of the breach from the seller (i.e., during discussions leading up to the merger), the buyer will be less likely to be able to sue for indemnification later. However, if the buyer learned about the breach from a third party, its claim for indemnification is more likely to go forward.

We underscore the importance of ensuring that any representations and warranties made in a merger or purchase agreement are accurate to the best of a party's knowledge, regardless of whether or not the other side "is aware" or "should know" of any possible issues. However, because many courts tend to allow sandbagging when the contract is silent about it, sellers in particular should attempt to contractually limit the buyer's right to assert claims in cases where it knew or was on notice of a seller's breach prior to closing. Likewise, if buyers know of a breach prior to signing, they may well be better served by raising the issue and getting a purchase price adjustment versus relying on a cumbersome and often limited recourse indemnification process after closing. Leaving these issues unaddressed or up to the interpretation of a court may not always be in either parties' best interest.

⁵ *Universal Enter. Grp., L.P. v. Duncan Petroleum Corp.*, 2013 WL 3353743 (Del. Ch. July 1, 2013).

⁶ *Galli v. Metz*, 973 F.2d 145 (2d Cir. 1992); *Kriegel v. Donelli*, No. 11 CIV. 9160 ER, 2014 WL 2936000, at *7 (S.D.N.Y. June 30, 2014).

BEST PRACTICES FOR THE YEAR AHEAD

With analysts forecasting a big year for M&A, parties can minimize the possibility for liability in connection with post-closing disputes by following certain best practices:

Be Specific. While conscious ambiguity may have its place on occasion, most often the more specific the terms of an agreement, the less chance of an eventual dispute about what the agreement requires. Sellers should seek to include an appropriate merger clause and anti-reliance language to limit the terms of the agreement to the written contractual language. Buyers may likewise at least try to preserve fraud claims.

Be Transparent and Consistent. Err on the side of full disclosure and if you have disclosed an issue in discussions with the other party, make sure the representations and warranties and disclosure schedules reflect the parties' mutual understanding.

Plan Ahead. Consider whether alternative dispute resolution would be appropriate for any post-closing disputes that do eventually arise, especially if parties do not want sensitive business issues discussed in a public forum.



CAN LIABILITY IN A DATA BREACH EXPAND TO THE BOARDROOM?

Although most lawsuits seeking to hold management liable for cybersecurity breaches have failed out of the gate, persistent plaintiffs are racing to find a case that gains traction. Given the high bar for liability that courts have set, will the most recent high-profile data breach lawsuit fare any differently?

As a rising number of companies experience data breaches, director liability lawsuits have inevitably followed. Thus far, however, these suits have been uniformly unsuccessful, failing to move past the motion to dismiss stage. In 2016, despite a continued reluctance on the part of courts to permit these cases to move forward, plaintiffs persisted in pursuing such claims.

The first significant case claiming that directors and officers breached fiduciary duties by failing to take action to prevent data breaches was filed against Wyndham Worldwide in February 2014. Another derivative data breach suit was brought against Target in February 2014, and then Home Depot in August 2015. The Wyndham case was dismissed in October 2014 for failure to show demand futility. Dismissal of the Target case followed in July 2016, after a special litigation committee completed its investigation and requested dismissal of the claims. The last remaining high profile data breach-related derivative suit against Home Depot was dismissed on November 30, 2016, raising questions about the future of such lawsuits going forward.

DISMISSAL IN HOME DEPOT CASE SETS “INCREDIBLY HIGH” HURDLE FOR PLAINTIFFS

The most recent *Home Depot* decision merits further discussion, because the court’s analysis highlights the high hurdles plaintiffs face in successfully prosecuting these suits and the extent to which courts have refused to second guess directors’ and officers’ business judgment with the benefit of hindsight. The *Home Depot* suit involved a data breach in September 2014 which compromised Home Depot’s retail payment system and allowed hackers to gain access to 56 million customer credit card numbers – one of the largest data breaches in U.S. history. Following Home Depot’s announcement of the breach, as many as 44 consumer protection actions were filed against Home Depot, alleging the company failed to act reasonably to prevent or to mitigate the effects of the breach.

In August 2015, shareholders filed derivative complaints against Home Depot and some of its current and former directors and officers in federal court. The plaintiffs alleged that the defendants breached their duty of loyalty by failing to implement adequate internal controls and by disbanding the board of directors committee that was tasked with overseeing such efforts. The plaintiffs also brought claims for waste of corporate assets and violation of Section 14(a) of the Securities Exchange Act. With respect to the claim of waste, plaintiffs alleged that the board’s insufficient reaction to the threat posed by Home Depot’s inadequate data security caused the company to incur significant losses, which plaintiffs claim constituted a waste of Home Depot’s assets. Plaintiffs also alleged that defendants had violated Section 14(a) of the Securities Exchange Act by failing to disclose in their proxy statements that Home Depot had known of specific threats to its data security. In response to these claims, the defendants filed a motion to dismiss the plaintiffs’ complaint on the grounds that plaintiffs failed to make demand on the board, or plead facts showing that such demand was futile.

Applying Delaware law, Judge Thrash of the Northern District of Texas found that plaintiffs had in fact failed to show that demand was futile, and granted defendants’ motion to dismiss for failure to make a demand. Judge Thrash evaluated demand futility with respect to the three separate substantive claims the plaintiffs asserted – breach of loyalty, corporate waste and violation of Section 14(a) of the Securities Exchange Act. With respect to each of these claims, Judge Thrash found that there was insufficient evidence that demand was excused. For the breach of loyalty claim, Judge Thrash held that in order for plaintiffs to demonstrate demand futility, they must “show with particularity facts beyond a reasonable doubt that a majority of the Board faced substantial liability because it

consciously failed to act in the face of a known duty to act.” Judge Thrash described this as “an incredibly high hurdle.”

Accordingly, Judge Thrash noted that it was “not surprising” that plaintiffs’ allegations that the defendants had failed to implement sufficient controls and had disbanded the board cybersecurity oversight committee were insufficient to satisfy this high standard. He noted that there was “no question that the Board was fulfilling its duty of loyalty to ensure that a reasonable system of reporting existed;” though “with the benefit of hindsight, one can safely say that the implementation of the plan was probably slow.” The business judgment rule, however, requires a decision to be “reasonable, not perfect,” and does not permit second-guessing with the benefit of 20/20 hindsight.

The claims regarding corporate waste were also subject to scrutiny, and Judge Thrash found that the plaintiffs had failed to raise a reasonable doubt that the “challenged transaction was ... the product of a valid exercise of business judgment.” Again noting that the “Board’s decision to upgrade Home Depot’s security at a leisurely pace was an unfortunate one,” Judge Thrash found that this decision still fell “squarely within the discretion of the Board and is under the protection of the business judgment rule.” Finally, for the claim of demand futility with respect to allegations of inadequate proxy disclosures, Judge Thrash found that plaintiffs had failed to allege particularized facts raising a reasonable doubt that the directors were disinterested and independent.

WENDY’S LAWSUIT: A LAST GASP?

As noted above, the dismissal of the *Home Depot* derivative lawsuit put an end to the most recent pending high-profile data breach-related derivative lawsuit, which, together with the suit against Target and Wyndham Worldwide, failed to overcome initial pleading and procedural hurdles. Despite this lack of success, a new plaintiff shareholder filed a derivative lawsuit against The Wendy’s Company and certain current and former directors and officers of the company in the U.S. District Court for the Southern District of Ohio on December 16, 2016, just two weeks after the *Home Depot* decision.

The Wendy’s suit arose out of a data breach that took place at the company between October 2015 and June 2016, affecting more than 1,000 Wendy’s franchise locations. Following a report by an online cybersecurity blogger, the company began investigating a potential data breach in January 2016. The company announced that experts had found malware on some of its systems in February 2016. In its May 11, 2016, 10-Q filing the company disclosed additional details about the data breach including the information that had been compromised and the extent of the breach. This was followed by a press release on June 9, 2016, and another on July 7, 2016, gradually revealing the duration of the breach and the specific locations associated with the breach. Class actions based on claims of consumer protection and negligence were filed by financial institutions and on behalf of Wendy’s customers, respectively, seeking damages resulting from the breach.

The derivative suit filed on December 16, 2016, asserted claims for breach of fiduciary duty, waste of corporate assets, unjust enrichment, and gross mismanagement. The complaint names 19 of Wendy’s current and former directors and officers, and seeks damages, corporate governance reforms, and restitution of benefits and compensation. These substantive allegations are nearly identical to other suits that have been dismissed: i.e., that defendants breached their fiduciary duties by failing to implement effective internal controls and procedures to mitigate losses from a potential data breach, exercise their duty of oversight with respect to cybersecurity risks, etc. In an attempt to avoid the fate of other data breach derivative lawsuits, plaintiffs appear to have provided more detailed allegations to support their claim of demand futility, noting that several of the defendants own a large amount of company stock, thereby giving them a controlling interest in the company. The plaintiffs also claimed that the controlling shareholder defendants have familial or past business ties with other defendants, resulting in these directors being “ beholden to the controlling shareholder defendants.”

It remains to be seen whether these plaintiffs will be able to survive an initial challenge at the pleadings stage, where all other lawsuits have been dismissed. Even though the Wendy’s plaintiffs’ allegations of demand futility are somewhat more detailed, they are still somewhat generic “conflict of interest” allegations that have difficulty prevailing in other contexts. Regardless, however, the mere fact that this lawsuit was filed demonstrates that plaintiffs and their attorneys will continue to pursue similar derivative litigation against company management, at least for the foreseeable future, in the hope that they can land the right legal theory or the right set of facts. Given the prevalence of cybersecurity threats, they likely will have no shortage of opportunities for additional bites at the apple.

BEST PRACTICES FOR THE YEAR AHEAD

MANY PEOPLE SAY DATA BREACHES ARE INEVITABLE IN TODAY'S WORLD

1. **Develop a Crisis Management Plan.** Be thorough; define rapid response protocol, risk management steps, key stakeholders, and a post-mortem review. And test it.
2. **Ensure You Are Insured.** Review your D&O and data breach insurance coverage twice a year to make sure it fully protects the business, as new issues arise.
3. **Educate, Educate, Educate.** From your directors and officers to employees, conduct training and education to minimize risks.
4. **Develop Policies That Protect.** Evaluate technology, off-site data storage, employee mobility and other policies to protect your business and minimize exposure to litigation.



SIXTH SENSE: SIGNIFICANT SECURITIES CASES DECIDED BY THE SIXTH CIRCUIT IN 2016

STEIN V. REGIONS MORGAN KEEGAN SELECT HIGH INCOME FUND, INC., ET AL.

At issue: Whether securities plaintiffs can rely on a pending class action to toll applicable statutes of repose.

Background: The circuit courts are divided on the issue of whether repose periods can be tolled under U.S. Supreme Court precedent. With this decision, the Sixth Circuit now has definitively answered that the *American Pipe* tolling doctrine is incompatible with the concept of a statute of repose, though the U.S. Supreme Court has recently granted certiorari in *CALPERS v. ANZ Securities, Inc.*, Case No. 15-1879 (2d Cir.) to address this issue, and presumably resolve the Circuit split.

In a case of first impression in the Sixth Circuit, the appellate court affirmed the dismissal of two cases brought by investors in certain Morgan Keegan-affiliated investment funds stemming from losses incurred in the wake of the global credit crisis. *Stein v. Regions Morgan Keegan Select High Income Fund, Inc.*, 821 F.3d 780 (6th Cir. 2016).⁷ The court ruled the plaintiffs had waited too long to file suit and their claims were therefore barred by the three-year and five-year statutes of repose under the Securities Act of 1933 and the Securities Exchange Act of 1934, respectively.

Plaintiffs attempted to argue that the class action tolling doctrine, as set forth in the U.S. Supreme Court's decision in *American Pipe & Const. Co. v. Utah*, 414 U.S. 538 (1974), tolled the repose period during the pendency of two class actions involving the same funds. Recognizing a circuit split over the issue of whether a plaintiff can rely on a pending class action to toll a repose period (as opposed to a limitations period), the Sixth Circuit ultimately endorsed the Second Circuit's holding in *Police & Fire Ret. Sys. of City of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95 (2d Cir. 2013), agreeing that tolling was incompatible with the concept of a statute of repose, and that the 1933 Act and 1934 Act "are indeed unequivocal in extinguishing liability" after a specified period of time.

Significance: This decision is significant because it highlights the circuit split on the issue of whether *American Pipe* tolling applies to a statute of repose, and provides a definitive answer for cases pending or filed in the Sixth Circuit.

Britt K. Latham and **Joseph B. Crace, Jr.** of Bass, Berry & Sims served as counsel to certain defendants in both cases and participated in the appeal.

OHIO PUBLIC EMPLOYEES RETIREMENT SYSTEM V. FEDERAL HOME LOAN MORTGAGE CORP., ET AL.

At issue: Whether the "materialization of the risk" standard is a viable means of alleging loss causation in securities fraud cases in the Sixth Circuit.

Background: The majority of other circuit courts have recognized the "materialization of the risk" as an alternative theory to pleading loss causation, seeking to avoid defendants escaping liability by simply not making a corrective disclosure revealing that investors were misled. With this result, the Sixth Circuit allows plaintiffs an alternative way to allege loss causation in securities fraud actions.

⁷ The District Court dismissed both *Stein v. Regions Morgan Keegan Select High Income Fund, Inc., et al.*, Case No. 15-5903, and *Canale Funeral Directors, Inc. v. Regions Morgan Keegan Select High Income Fund, Inc., et al.*, Case No. 15-5905, as barred by the statute of repose. On appeal, the two cases were consolidated for briefing and argument.

This year, the Sixth Circuit joined the majority of circuits and adopted the “materialization of the risk” standard as a viable means of alleging loss causation in securities fraud cases. *Ohio Pub. Employees Ret. Sys. v. Fed. Home Loan Mortg. Corp.*, 830 F.3d 376 (6th Cir. 2016). In reversing the dismissal of this securities fraud class action, the Sixth Circuit explained that while loss causation is required to allege a *prima facie* claim for securities fraud, it is “not meant to impose a great burden upon a plaintiff;” rather, it is meant “to provide a defendant with some indication of the loss and the causal connection” between “the alleged misconduct and the economic harm ultimately suffered by the plaintiff.”

The Sixth Circuit noted that it already had recognized a corrective disclosure theory whereby loss causation can be shown “on the ground that the market reacted negatively to a corrective disclosure.” (citing *In re KBC Asset Mgmt. N.V.*, 572 Fed. Appx. 356 (6th Cir. 2014)). The court then recognized the alternative loss causation theory of “materialization of the risk, whereby a plaintiff may allege proximate cause on the ground that negative investor inferences, drawn from a particular event or disclosure, caused the loss and were a foreseeable materialization of the risk concealed by the fraudulent statement.” The court concluded that Freddie Mac allegedly disclosed the true extent of its involvement in subprime and other nontraditional mortgage markets and reported a loss of more than \$2 billion. The same day it reported its involvement in subprime markets, Freddie Mac’s stock price fell by 29%. Thus, the court held that plaintiffs’ allegations were within the “zone of risk” that Freddie Mac allegedly concealed when the revelation of \$2 billion in losses was made public and Freddie Mac’s stock price fell.

Significance: This decision is significant because it highlights the continued development among the circuit courts of the requirements for pleading loss causation in securities fraud cases, and allows plaintiffs in the Sixth Circuit to allege that the materialization of an undisclosed risk caused the alleged loss.

DOSHI V. GEN. CABLE CORP., ET AL.

At issue: The requirements for adequately pleading scienter (i.e. a knowing or deliberate intent to manipulate, deceive, or defraud, and recklessness) in federal securities fraud cases.

Background: The Sixth Circuit continues to refine what district courts should consider when examining a plaintiff’s allegations “holistically” at the motion to dismiss stage of a securities fraud case.

In *Doshi v. Gen. Cable Corp.*, 823 F.3d 1032 (6th Cir. 2016), the Sixth Circuit revisited the pleading requirements for scienter in federal securities fraud cases. The court affirmed the district court’s dismissal, ruling that the plaintiff’s allegations of defendants’ recklessness in issuing the materially false statements failed to adequately plead scienter.

In conducting a “holistic[]” review of the plaintiff’s allegations, the court found some support for inferring scienter because the head of the company’s Brazilian operations knew of certain theft and accounting errors at issue. However, the court concluded that the employee’s state of mind, even if reckless, was not imputed to the company because he made no public misstatements.

Furthermore, the court determined that the divergence between the company’s internal reports and its external statements were diminished, because the reports on Brazilian operations constituted only a part of the company’s firm-wide data. The court also looked at the lack of suspicious insider trading and lack of impact the statements had on the CEO’s or CFO’s compensation, and, following its internal investigation, the company clawed back the incentive bonus for the head of its Brazilian operations and forced him to resign. The court also held that the plaintiff failed to connect the knowledge of the head of Brazilian operations to the CEO and CFO. Examining the allegations “holistically,” the court concluded the company and its officers were at most negligent in issuing or authorizing the misstated financial statements, which is insufficient to state a federal securities fraud claim.

Significance: The decision specifically provides further precedent for how the Sixth Circuit applies its “holistic” analyses of federal securities fraud claims, and illustrates how courts will weigh facts, including proactive company internal investigations that lead to remedial measures, when deciding if federal securities fraud claims can survive motion to dismiss.

GAYNOR V. MILLER, ET AL.

At issue: Whether state courts lack subject matter jurisdiction over securities class actions that only allege claims brought under the Securities Act of 1933.

Background: Plaintiffs bring claims in state courts in an attempt to avoid federal court jurisdiction with its heightened pleading standards. This case highlights the current controversy among several circuit courts, indicating a need for the U.S. Supreme Court to decide whether plaintiffs can avoid federal court jurisdiction by bringing class actions that only allege Securities

Act of 1933 claims. For now, the Eastern District of Tennessee has made it clear its position on this controversy.

In the Eastern District of Tennessee, Chief Judge Thomas Varlan analyzed a current circuit split on the issue of whether state courts lack subject matter jurisdiction over covered class actions that allege only Securities Act of 1933 claims. *Gaynor v. Miller*, No. 3:15-CV-545-TAV-CCS, 2016 WL 6078340 (E.D. Tenn. Sept. 8, 2016). In this case, the shareholders tried to avoid federal court jurisdiction by filing a putative class action in state court alleging, *inter alia*, that the corporation's registration statement and prospectuses issued in connection with public offerings of certain preferred stock violated the Securities Act of 1933. After the defendants removed the case from state court, the plaintiffs filed a motion to remand, asking the district court to follow circuit courts that allow plaintiffs to avoid federal court jurisdiction by alleging only Securities Act of 1933 claims. In denying the motion to remand, Judge Varlan sided with other circuit courts concluding that "plaintiffs' interpretation of SLUSA [Securities Litigation Uniform Standards Act] would produce 'absurd' results, in that complaints alleging state and federal claims must be removed to federal court, but that those alleging solely federal claims *may not* be removed."

Significance: Notably, two separate cases have recently filed petitions for *writ of certiorari* asking the U.S. Supreme Court to weigh in on this important circuit split. *Cyan, Inc. v. Beaver County Employees Retirement Fund*, No. 15-1439 (U.S. May 24, 2016); and *FireEye, Inc. v. Superior Court of California, County of Santa Clara*, No. 16-744 (U.S. Dec. 5, 2016).

W. Brantley Phillips, Jr., Jeffrey P. Yarbrow and Shayne R. Clinton of Bass, Berry & Sims serve as counsel to certain defendants in this matter.

*As new developments and uncertainties arise, it is important
that you remain informed, prepared and protected.
Bass, Berry & Sims is here to help, and we invite you to
reach out to our team any time you need direction.*



ABOUT THE SECURITIES & SHAREHOLDER LITIGATION PRACTICE GROUP

Bass, Berry & Sims' Securities & Shareholder Litigation team members are recognized by *Chambers USA* for their experience in corporate and securities litigation and shareholder class actions. Our clients include more than 35 publicly traded companies, some of the country's largest privately held companies, as well as their officers, directors, issuers, underwriters, special committees and financial and investment advisors. In recent years, we have represented these clients in litigation matters arising out of corporate transactions valued at more than \$75 billion, as well as litigation matters related to alleged violations of federal and state securities laws and alleged breaches of fiduciary duty by corporate officers and directors. We currently serve as lead counsel in a large MDL involving dozens of matters related to structured investment products. Our team has significant experience resolving insurance coverage disputes, including working with D&O insurance carriers and their counsel on securities litigation matters filed against corporate clients and directors and officers.

Our work on behalf of clients takes us to state and federal trial and appellate courts throughout the United States. We also defend clients nationwide in securities-related arbitrations, as well as other forms of alternative dispute resolution.



Joseph B. Crace, Jr.

Co-Chair of Securities & Shareholder Litigation Practice Group

jcrace@bassberry.com
615.742.7896



Britt K. Latham

Co-Chair of Securities & Shareholder Litigation Practice Group

blatham@bassberry.com
615.742.7762



Shayne R. Clinton

Member

sclinton@bassberry.com
865.521.0372



Wallace W. Dietz

Member

wdietz@bassberry.com
615.742.6276



W. Brantley Phillips, Jr.

Member

bphillips@bassberry.com
615.742.7723



Overton Thompson III

Member

othompson@bassberry.com
615.742.7730



Elaina S. Al-Nimri

Associate

eal-nimri@bassberry.com
615.742.7766



Margaret Dodson

Associate

margaret.dodson@bassberry.com
615.742.7712



Brian Irving

Associate

birving@bassberry.com
615.742.7769



Brittain W. Sexton

Associate

bsexton@bassberry.com
615.742.7962



Virginia Maynard Yetter

Associate

vyetter@bassberry.com
615.742.7858



NASHVILLE KNOXVILLE MEMPHIS WASHINGTON DC bassberry.com